REFORM OF FINANCIAL SYSTEM IN AFGHANISTAN

By

KHELWATI LAILA

THESIS

Submitted to

KDI School of Public Policy and Management

In partial fulfillment of the requirements

For the degree of

MASTER OF PUBLIC POLICY

2008

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ABSTRACT

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The economy of Afghanistan has improved significantly since 2002 due to the infusion of multi-billion US dollars in international assistance and investments, as well as remittances from experts. It is also due to dramatic improvements in agricultural production and the end of a four-year drought in most of the country. However, Afghanistan still remains poor for now and highly dependent on foreign aid.

About half the population suffer from shortages of housing, clean drinking water, electricity and employment. The Afghan government and international donors have remained committed to improving access to these basic necessities by prioritizing infrastructure development, education, housing development, jobs programs, medical care, and economic reform over the recent years. The replacement of the opium trade - which probably makes up about one-third of the country's GDP - is one of several potential spoilers for the economy over the long term.

Reforming of financial sectors in post conflict countries face many challenges, among Damaged physical infrastructures, deskilled staff, and outdated technological capacity. Because properly functioning financial systems enhance economic development, reduce costs in the economy, promote the efficient use of financial resources, and improve financial market liquidity, it is vital that those challenges be met.

The thesis of this study is that financial sector reforms in Afghanistan will take a long time to implement; further, these reforms will continue to face significant challenges. The sector had so deteriorated by the end of 2001—namely, the absence of a legal framework; poor and outdated infrastructure; lack of trained personnel; inappropriate governance and ownership structures in the state banks; inadequate collateral and bad debts; low depositor confidence; absence of clear accounting standards; and an ineffective formal payment system—that only focused and unrelenting reform efforts can help. Afghanistan banking sector is unlike in the past. In the past, we had commercial banks being part of the central bank. Now we have commercial banks that are separate from the central bank, we have private and state own commercial banks and now there is significant progress in that area, our banking system serious problem is human resources. We need qualified people for this.

Commercial banks are supposed to compete with each other, and through competition, we hope they will offer better services, a more consumer friendly environment, and lower prices. This is the benefit you would expect from any privately owned, free market, and competitive economic environment. The second benefit would be that the Government would not be involved in any losses that these banks might incur. We would hope that we will change the banking culture from one of being dominated by bureaucratic procedures to one that is dominated by initiative, competition, and result orientation.

We recognize that financial sectors in post conflict countries have varying levels of development and capacity for reform. Reform efforts must therefore continue to accommodate Afghanistan's unique characteristics and circumstances. Specifically, the government and its development partners must bear in mind.

In spite of its political progress, Afghanistan continues to face huge challenges, including extreme poverty, insecurity, weak human capacity, and gender inequality. While the country has managed to avoid a resurgence of major civil conflict, insecurity continues to hamper its reconstruction and development. Following a lull in incidents involving antigovernment elements during the winter, since May 2005 there has been an upsurge in violence, including attacks directed at foreign forces and international aid personnel. In addition, instability in some of Afghanistan's neighboring countries poses a threat to both national and regional security. Cultivation of opium poppy has increased and now takes place in more provinces, posing a threat to Afghanistan's long-term stability.

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CHAPTER ONE

INTRODUCTION

1. BRIEF OVERVIEW OF AFGHANISTAN ECONOMY:

Afghanistan's economy is in a state of collapse. The three-year drought and resulting famine, the ban on opium production, the choking of trade via Pakistan and the massive displacement of population have exhausted what coping capacity was left among families and civil society. The key economic institutions of State—a central bank, treasury, tax collection and customs, statistics, civil service, law and order, judicial system—are extremely week or simply missing. Basic infrastructure—roads, bridges, irrigation, canals, telecommunications, electricity, markets—have been destroyed.

Afghanistan, which has always been at bottom of the poverty and social indicator rankings of countries, must now be considered the poorest, most miserable state in the world.

2. There is little reliable up to date data on Afghanistan's economy. There has never been an accurate Census or other precise data on Afghanistan's population. In 1979 the total population of Afghanistan was estimated at 14 million, whereas at present the population in-country (not including refugees in Pakistan and Iran) is estimated at 18-20 million. Before the war about 85% of the people lived in rural areas, including 1.5 million nomads. The bulk of the total labor force was engaged in agriculture, livestock, and livestock-based handicrafts. Even before the war Afghanistan was one of the world's least

developed countries. The past 20 years of conflict have exacerbated poverty, deprivation, and suffering.

3. Afghanistan's pre-war economy was mainly based on agriculture and animal husbandry. The country has a low population density due to difficult topographical and climatic conditions (high mountains covering most of the country, extremes of temperatures, and arid to semi-arid climate). In 1978—the last year of peace—Afghanistan was largely self-sufficient in food and was a significant exporter of agricultural products. Agriculture was largely concentrated in narrow river valleys and plains where irrigation water from snowmelt was available. Manufacturing industry was largely undeveloped, with only a few plants established (in textiles, medicines, cement, etc.). Afghanistan's strategic position during the Cold War period made it a large recipient of foreign aid, which funded the running of a centralized but relatively weak state without substantial domestic taxation. Also largely as a result of foreign aid, the country had a relatively good major road network, as well as some other infrastructure including major irrigation and hydroelectric facilities. This modern infrastructure, however, did not extend beyond the main arteries and urban centers. Social and other services (such as education and health) were largely limited to the relatively small urban sector.

4. The long drawn-out war of Soviet occupation and subsequent internecine conflict severely damaged Afghanistan's economy. By the mid-1990s, most of the country's limited modern infrastructure was destroyed, and traditional irrigation systems greatly suffered from destruction and lack of maintenance. Even more important than the physical damage was the increasing breakdown of the state over time and the progressive

erosion of institutions—both modern and traditional—which had governed the pre-war economy and society. Government-provided social services, which had never had a strong outreach into the rural areas, atrophied and to a large extent stopped functioning. Inflation wiped out the value of the Afghan currency in the 1990s. Agricultural output down sharply, livestock herds were depleted, and large-scale industries almost ceased functioning. Millions of Afghans became refugees in neighboring Pakistan and Iran, and to a lesser extent elsewhere. This diasporas played an important role, however, in supporting Afghanistan's economy through remittances. And finally, land and infrastructure were widely and indiscriminately sown with landmines, causing enormous human and economic losses.

5. There was a modest economic recovery in the mid-1990s in areas that became largely free of conflict. Agricultural production increased; livestock herds sharply rose in numbers, taking advantage of widely available unutilized grazing lands; and horticultural production also grew based on restoration and expansion of orchards and vineyards. Substantial numbers of refugees returned to their home with international assistance. The economic recovery was concentrated in areas of the country taken over relatively early by the Taliban (who now control about 90% of the country); they removed barriers to trade and restored a certain degree of order. However, the deterioration in social services (particularly education) was aggravated by the Taliban's social policies, which largely excluded women from work and girls from school.

6. The introduction of a certain degree of stability in large parts of the country also facilitated the growth of various kinds of unofficial economic activities, most notably long-distance trade (particularly re-exports to Pakistan) and opium poppy cultivation.

Although these activities had always been present, they underwent unprecedented expansion in the 1990s. Unofficial exports to Pakistan are roughly estimated to have exceeded $2 billion in 1996, and by the late 1990s Afghanistan had become the largest producer of opium poppy in the world. Also falling in this category of economic activities is uncontrolled exploitation of natural resources—timber, gems, marble and granite, etc.—which have resulted in extensive deforestation and environmental degradation, among other problems.

7. Most recently, Afghanistan has been hit by a severe, protracted drought, which started in 1999 and has lasted until the present. Crop production has been halved and livestock herds heavily depleted, more than erasing the modest gains of the early and mid-1990s. Large and increasing numbers of people have lost their means of livelihood and have become displaced, either internally or to neighboring countries. Malnutrition has significantly worsened, and starvation deaths have been reported. The impact of the drought, which would have been serious under any circumstances, has been aggravated by the continuing conflict in parts of the country (particularly in northeastern and central Afghanistan), and by the run-down condition of irrigation systems and other agricultural Infrastructure.

8. In sum, Afghanistan's economic structure has been gravely weakened, distorted, and made more vulnerable through two decades of conflict. Agriculture (including livestock), the most important licit economic activity, is highly vulnerable to natural conditions as is demonstrated by the current drought. Trade activities are vulnerable to the policies of neighboring countries, most notably Pakistan—in fact, there appears to have been a substantial decline in Afghanistan's unofficial re-exports to Pakistan in the recent past,

probably reflecting changing policies and stronger enforcement behavior in Pakistan. The post September 11 closing of the Afghan transit trade through the Karachi port is a major example of this vulnerability. Remittances, another major source of income, tend to be more stable, but nevertheless they are vulnerable to changes in economic conditions in the source countries. The Taliban's recent complete ban on opium poppy cultivation, which was a positive move and has been largely effective, has sharply reduced the incomes of those small farmers and rural wage laborers who were dependent on poppy cultivation and related work. Foreign aid, another important albeit smaller source of income, has increased sharply in the wake of the drought but also is subject to fluctuations and severe logistical constraints.

9. Afghanistan's economic situation has significant regional spill-over effects through, financial flows, and movement of people. These spill-over effects tend to undermine collection, governance, and the effectiveness of economic policies in neighboring countries, particularly Pakistan. The long drawn-out conflict situation, without an effectively functioning state most of the time, has led to a situation where conflict-related or conflict enabled economic activities and structures have become entrenched, and there are significant groups who are benefiting from the current situation and therefore have a vested interest in its continuation.

2. THE FINANCIAL SECTOR IN AFGHANISTAN

When reforming their financial sectors, postconflict countries face many challenges, among Damaged physical infrastructures, deskilled staff, and outdated technological capacity. Because properly functioning financial systems enhance economic development, reduce costs in the economy, promote the efficient use of financial resources, and improve financial market liquidity, it is vital that those challenges be met. The World Bank's experience in Bosnia -Herzegovina, Kosovo, and East Timor has proven that these challenges are not insurmountable. Buildings can be rebuilt, staff retrained, and technology upgraded. Comprehensive, well-sequenced, and well-coordinated financial sector reforms can restore basic services in the short-term, and the financial sector can return to long-term growth and vitality.

This is the first comprehensive study of the financial sector in Afghanistan. It details the state of the financial sector after the fall of the Taliban regime in 2001; the reforms that have taken place in the period 2002–2003, and outline the medium- to long-term financial sector development strategy for Afghanistan.

Although this study is specific to Afghanistan, it sheds some light on some of the common macroeconomic and financial sector challenges facing governments of countries emerging from conflict, and some of the possible solutions that would allow for successful financial sector reconstruction. This study builds on the Bank's experience with reconstruction efforts in Bosnia -Herzegovina, Congo, Liberia, and East Timor. Although every post-conflict society is unique, some general lessons can nevertheless be drawn from experience. As happened elsewhere, financial sector reforms in Afghanistan continue to produce a dynamic learning experience for the government and its international, multilateral, and bilateral development partners. Already, their experiences, as documented in this study, have reaffirmed lessons learned elsewhere—namely, that legal reforms are critical; reforms should focus on just a few areas; and efforts to rehabilitate state banks will fail without fundamental reforms of the legal and regulatory frameworks or the ownership and governance structures.

This study reaffirms the World Bank's shared commitment, with the government of the Islamic Republic of Afghanistan, in strengthening the capacity of its financial sector and promoting financial sector reforms. Although we still do not have all the information we need for a definite understanding of how the financial sector works in Afghanistan (nor, in fact, do we have answers for the many reform questions that have been raised) we can begin to move ahead with reforms with that we know. The challenge now is to design, develop, and implement reforms, in partnership with the government of Islamic Republic of Afghanistan, with other donors, and with financial institutions in the country, practical, effective programs what will serve Afghanistan's financial sector needs.

Afghanistan financial sector after the fall of the Taliban regime in 2001; it discusses the reforms implemented since 2002–03; and it outlines a medium- to long-term financial sector development strategy. Although specific to Afghanistan, it sheds light on general factors that contribute to successful financial sector reform in postconflict countries. Afghanistan has faced more than 25 years of international and domestic conflict. When the Taliban regime fell in 2001, the country was one of the poorest in the world. Its financial sector, like the rest of the economy had collapsed—infrastructure, human, and technological capacity was weak and in most cases absent.

Afghanistan's recovery has advanced through a variety of opportunities and resources among them its strategic location; its natural resources; a government committed to reform and; full multilateral engagement by the international community; and the determination and entrepreneurial spirit or the Afghan people.

To sustain this progress, concerted efforts are required on all fronts—political, economic, and security. Improvements in security depend on a functioning, representative, and inclusive political system. Economic growth can occur only if security continues to improve and the political situation becomes more stable. Employment, to bring people out of perpetual poverty, is indispensable for long-term political stability and security. At the heart of the current economic recovery, upon which so much depends, is an intense effort to rebuild and reform Afghanistan's banking and finance system. That effort is based on a thorough investigation of the system's problems.

The implementation of financial sector reforms in Afghanistan will take longer than originally anticipated, given the profound and cumulative deterioration of the financial sector, as of the end of 2001. Afghanistan requires a focused and sustained reform effort to fully address a complex and challenging set of problems:

- Absence of an effective legal framework
- Poor and outdated physical infrastructure
- Lack of trained personnel
- Inappropriate governance and ownership structures in the state banks
- Inadequate collateral and bad debts
- Low depositor confidence
- Absence of clear accounting standards
- Lack of an effective formal payments system.

3. HISTORICAL BACKGROUND

Afghanistan has a private sector banking tradition. going back to 1933, when the country's first commercial bank (Bank Millie Afghan [BMA]) was established. A second commercial bank was founded in 1955 (Pashtany Terjaraty). Initially capitalized with Af9.6 million (old Afghanis), BMA was a mixed-ownership financial institution—72 percent of its shares were held by private shareholders and the rest by government. Pashtany Terjaraty Bank (PTB) was established as a joint venture between the government of Afghanistan and private Afghan investors, with initial paid-up capital of Af120 million (old Afghanis). A portion (58.3 percent) of this shareholding was held by the government through various state-owned organizations, namely the central bank (Da Afghanistan Bank–DAB), the Ministry of Finance, and the Ministry of Commerce. Another portion (33.3 percent) of the shareholding was held by more than 1,000 private shareholders with the Agricultural Bank. An employee provident fund under Ministry of Finance administration held the remaining 8.4 percent. Interestingly, even the Industrial Development Bank was initially established as a private institution. Sixty percent (or Af144 million) of the bank's shares were held by 203 domestic shareholders, and 40 percent by six foreign investors.

It is only in the 1970s that the state, under the Dauod government, took an ownership interest in both financial institutions. PTB was nationalized by the Dauod government in 1974. All the shares of the original shareholders were purchased by the Ministry of Finance, at a discount of 30 percent to face value.

Government organizations, mainly the Ministry of Finance and DAB, assumed ownership of PTB's equity. The nationalization of PTB does not, however, appear to have resulted in any major change in its operations. Controls and procedures were not diluted, and normal business activity continued. Before 1974, private individuals and companies owned at least 49 percent of the Mortgage and Construction Bank. Their names and identities are not known as most of the bank's records were destroyed during the civil war between 1992 and 1996. After nationalization in 1974, the shareholding was divided between DAB (40 percent), the Afghan Chamber of Commerce (30 percent), Ministry of Finance (20 percent), and BMA (10 percent) .

During the 1970s the government also established two development banks—Industrial Development Bank (IDBA) (1973) and Export Promotion Bank (1975), in addition to the Agricultural and Development Bank (Ag Bank), which had been established in 1954. The original shareholders of the Export Promotion Bank, which remain unchanged, were the Ministry of Finance on behalf of a "retirement fund" under its administration (80 percent), the Chamber of Commerce (10 percent), and the Association of Carpet and Dry Foods Traders (10 percent). The initial paid-in capital at Ag Bank was supplied by the Ministry of Finance (69.67 percent), Da Afghanistan Bank (30.03 percent) and Bank Millie (0.30 percent), all three of which retain the same ownership shares. Today, the Ministry of Finance and the central bank hold equity stakes in all the financial institutions, with minor public shareholdings by others.

CHAPTER TWO

THE CENTRAL BANK

1. State Of The Central Bank After The Fall Of The Taliban

When the Taliban regime fell in 2001, Da Afghanistan Bank (DAB) was a moribund institution operating in a legal vacuum and unable to offer basic financial services. Staffed with unskilled and often de-skilled employees, it had little in the way of technological resources to undertake conventional central banking functions. Its problems fall into five main categories:

1. **Legal and regulatory framework***:* Afghanistan's 1994 Law on Money and Banking, which provided the country's only legal framework for the financial sector, was fundamentally flawed. Designed on the now outdated socialist principle that the purpose of monetary policy is to direct credit, the legal framework was unsuitable for a market economy. It tolerated significant conflicts of interest between the government, central bank, and commercial banks and lacked important modern prudential standards and enforcement tools.

2. ***Monetary policy framework:*** No functioning monetary policy framework was in place. Confidence in the national currency was low, as the Afghani had lost much of its value during years of high inflation. Moreover, DAB had little or no control over the issuance of currency—at least three versions of the national currency were in circulation.

3. ***Banking supervision structure:*** Banking supervision in a modern sense did not exist. DAB's staff had almost no knowledge of the objectives and techniques of modern banking supervision. Banking data had not been collected in years and no assessment had been made on the health of the banking sector.

DAB means (Da Afghanistan Bank) the central bank of Afghanistan

4. ***Commercial banking activities and the national payments system:*** The central bank had no capacity to play its role in international and domestic payments systems. With a single, unreliable telephone connection, it had no SWIFT or related connections with the rest of the banking world. Domestically, the central bank branch network faced serious structural and operational problems that made it difficult to achieve quick interbranch connectivity.

5. ***Operational capacity:*** DAB's staff did not have the banking and technical skills needed to conduct non-cash-based banking business. Consequently, the central bank had not prepared audited financial statements since 1996. Although accounting data for financial transactions had been, and continued to be, collected, the data was not processed in a manner that enabled the preparation and audit of financial statements in accordance with international accounting and audit standards.

2. CENTRAL BANKING REFORMS IN 2002–2003

With the help of international organizations and bilateral partners, the central bank's restructuring and modernization commenced in mid-2002, albeit with enormous challenges:

- A new central banking law is now in place that guarantees the central bank's autonomy.
- A new commercial banking law is in place that requires of banks prudent entry, conduct of banking operations, and exit from the financial sector.
- A rudimentary monetary policy regime is emerging after the successful issuance of a new currency.

- A new banking supervision department is in place and has commenced on-site inspections of banks.
- The central bank's SWIFT connection is functional—one-third of the central bank branches are now connected electronically for domestic payments.
- The central bank's operational capacity has been substantially improved.

Overall, progress has been modest but the pace of reform has been seriously stalled. There were reports of legal wrangling over the degree of central bank independence; attempts at improving the international and domestic payments systems were at times poorly funded; and steps at building internal human and technological capacity were limited. In a hasty effort to address the problems plaguing the payments system, the reforms of 2002 and 2003 failed to realize the scope of the reforms envisioned at the beginning of the process. In December 2003 DAB remained far behind even basic standards of modern central banking. Central bank reforms urgently require a more comprehensive approach. The modest progress made to date includes:

- ***Legal and regulatory framework:*** After an exhaustive consultation process, numerous revisions, and a presidential decree the government passed a new central bank law in September 2003. The law provides a strong framework for a two-tier banking system in Afghanistan. Significantly, the law also provides for full central bank independence in the design and implementation of monetary and banking supervision policy. Article 4 of the central bank law states that the management of Da Afghanistan Bank shall enjoy *autonomous* regulatory powers, be entirely independent from any other authority in the pursuit of its objectives and the performance of its tasks, and must refrain from political activities.

- ***Monetary policy:*** The government made a crucial step in establishing financial stability with its introduction of the new currency on January 2, 2003. With it, the country will be able to create an environment conducive to restoring sustainable economic growth in Afghanistan. The exchange rate of the Afghani has remained broadly stable since the completion of the conversion process, reflecting both sound financial policies and popular confidence in the new currency. The central bank also has chosen to adopt a floating exchange rate regime because, at least for the near term, the economy is undergoing large structural changes, and the equilibrium exchange rate will change as a result.

- ***Banking supervision:*** The Banking Supervision Department was created in July 2002. By December 2002, the central bank had begun to design and implement specific policies and procedures for licensing, off-site analysis, enforcement of laws and prudential standards, reporting, accounting, and off-site examinations. Training for the department's 38 staff members was done concurrently with the realignment of its activities into three sections:

  - Supervision of banks and non-banks
  - Special supervision of troubled banks
  - Licensing and regulation.

  By June 2003, the bank had a semi-functional supervision department.

- ***Commercial banking activities and national payments system*:** Very early in the reform process, it was clear that DAB should not continue its commercial banking activities and needed an appropriate exit strategy. It was also recognized that, given Afghanistan's circumstances, DAB should make a gradual transition from its direct role in the payment and settlement system to one in which it regulated, supervised, and oversaw other institutions. While the payments system is being developed, confidence in that system needs to be built and maintained, and the exit plan needs to be carefully coordinated and phased. The central bank law of September 2003 recognizes DAB's overall strategy, particularly the need for commercial banking services in areas where there are no banks or services, and pre-establishes an exit strategy for the central bank once those services are established by others.

3. THE STATE COMMERCIAL AND DEVELOPMENT BANKS

The financial condition of the state commercial and development banks and considers the feasibility of restructuring some of them. In the absence of any recent financial statements, annual reports and regulatory information.

At the end of the Taliban regime, in the beginning of 2002, Afghanistan was left with a banking system that was physically destroyed, technologically outdated, and operationally nonfunctional. The six state owned commercial banks remain in frail and dilapidated buildings. They lack the basic infrastructure to sustain business of any sort and are in bad and often insolvent financial condition. Loan portfolios are virtually unrecoverable, and the only source of income for many of the banks is foreign currency accounts held outside of the country. Many of the banks still employ many personnel hired before the hostilities began in the *mujahedin* (anti-Soviet) era. Such employees generally lack the skills and training required to run modern financial institutions. Management relies heavily on the central bank for basic operating instructions and guidance, a reflex that has hindered the banks' ability to evolve into commercially viable financial institutions.

Incidentally, this practice predates the de cades of hostilities and civil collapse and must be changed if the banks are to function properly.

The banks need major assistance with basic accounting, as they all still rely on book ledgers, and audited financial statements have not been prepared for many years. Employees probably do not have the necessary skills to follow internationally recognized accounting standards—standards that would help in accurate assessments of these institutions' financial health. But the existing skill levels at some of the banks provide at least a foundation that, with training, could see a great deal of improvement.

All of these factors have contributed to the public's loss in confidence in the banking system. The public no longer uses the banks to place deposits or for other basic transactions, a development that has severely reduced the resource base banks require for lending. With the exception of a few minor directed lending transactions and a special loan program in one of the provinces, the banks have ceased all lending operations. Their loan portfolios in most cases originated more than 15 years ago. It is unlikely, given the loss of loan documents, the destruction of property, and the deaths of many of the original borrowers, that they will be able to collect on these loans.

Given their intermediary role in the economy, Afghanistan's banks are in critical need of rehabilitation and reconstruction. Some of the banks are beyond recovery, but others have the potential to return to good financial health provided they pursue sound recovery programs. This assessment is based on a review of the state banks by a World Bank team that began in 2002 and ended in July 2003. Team members interviewed bank management and personnel, and conducted basic analysis of fragmented and often incomplete financial information. The following section contains a summary of these reviews and a basic financial analysis of the banks.

The state banking sector after the fall of the Taliban

Afghanistan has a very old banking tradition oriented toward the private sector. Bank Mille, Afghanistan's first private bank, was established in 1933; and the second, Pashtany Terjaraty Bank (PTB), in 1955. It was only in the 1970s that the state, under the president Dauod khan government, took an ownership interest in both financial institutions. PTB was nationalized in 1974, and Bank-e-Mille in 1976. During the 1970s the government also established two development banks—Industrial Development Bank (1973) and Export Promotion Bank (1975), in addition to the Agricultural Development Bank, which had been established in 1954.

By December 2001, however, all these state-owned banks were plagued by the same problems as DAB—weak corporate governance and management structures, unskilled human resources, outdated technological capacity and accounting systems, and grave liquidity and solvency problems:

- ***Corporate governance and management structures:*** Political interference in the banks' operations, management, and control (including lending decisions), lax legal and regulatory oversight, poor incentives for sound banking, the lack of banking experience among the clerics and mullahs appointed to management positions, the transformation of the banking system into mono-banking during the Soviet era, and inappropriate applications of Islamic banking practices during the Taliban period resulted in unclear organizational and policies, procedures, information and data flows, decision-making responsibilities, and accounting systems.

- ***Human resource capacity:*** Unqualified and inexperienced bank personnel staffed all levels of banking operations, including the managing board and department heads in most, if not all, banks.

There was little understanding of the components of profit and loss, cash and funds flows, financial intermediation, branch management and operations, computer and automation technology, accounting, loan administration, and risk assessment and management. The Taliban ordered the termination of all qualified staff and top management, as well as anyone educated in the Soviet Union, any member of pro-Soviet political parties, and all women.

- ***Computing technology:*** In 2001 the few personal computers in use in Afghanistan's banks were old, slow, and had little storage capacity. They were used primarily as word processors in the chief executive's office. Occasionally, a fax machine was found, but they too were of little use, given the unreliability of telecommunications. Until the early 1990s a few banks used NCR machines to record ledger and statement entries, but these machines had fallen into disuse. Universally, transactions were processed and recorded by hand. Customers were given passbooks and ledger cards, which were maintained manually.
- ***Accounting systems:*** Weaknesses in the banks' accounting systems (for financial reporting, Management, budgeting, and decision-making), made it almost impossible for management and staff to perform any meaningful financial analysis and disclosure. Given the ineffective corporate governance structures, the weak financial and management accounting systems in the banks resulted in their failure to:

- ➢ Comply with the existing financial, operational, and management regulatory requirements (poorly designed as they were)
- ➢ Assess credit worthiness and manage risk
- ➢ Observe appropriate loan accounting policies, practices, and reporting consistent with sound credit and risk analysis, and asset and liability management
- ➢ Ensure that minimum capital requirements, capital adequacy, required liquidity, credit concentration, and foreign currency exposure levels are properly accounted for and
- ➢ Provide for the timely recognition of identified losses and credit risks.

- ***Financial condition*****:** The first financial assessment of the banks conducted in January 2003 Concluded that all the banks were in dire financial condition. Using incomplete financial data, the reconstructed the balance sheets and income statements of all the banks first suggested adverse capital, asset quality, earnings, and liquidity positions. A subsequent financial review by the central bank conducted at the end of the year yielded slightly better results—all the banks had positive capital:

Bank Millie $61 million

Bank e Pashtany $18 million

Agricultural Bank $127 million

Export Promotion Bank $4 million

Mortgage and Construction Bank $0.037 million

With the exception of Bank Pashtany and the Mortgage and Construction Bank, the banks had positive net liquid assets:

Bank Millie $42 million

Bank e Pashtany ($11 million)

Agricultural Bank $1 million

Export Promotion Bank $3 million

Mortgage and Construction Bank ($0.016 million)

The State Commercial And Development Banking Reforms Of 2002–03

With the enactment of the new commercial banking law in September 2003, the central bank had to decide which banks would be allowed to apply for relicensing as specified in the act. Banks operating under a license granted by DAB before implementation of the new law were required to apply for a new license by March 15, 2004. Under the related presidential decree, DAB must decide on those applications by June 15, 2004.

Owing to their present impaired condition (see above), all six of the existing commercial banks are required to submit, as part of their license reapplication, a restructuring plan to bring them into line with the prudential and management standards specified in the banking law. Formulation of these restructuring plans should be the task of the banks' management or board of supervisors (from which employees of DAB, the Ministry of Finance, and all other state authorities and municipal bodies are legally excluded).

Shareholders (including the Ministry of Finance, if it is a shareholder) are to have the opportunity to consider and vote on the restructuring plans prior to their submission to DAB for approval. Assent or dissent is to be conveyed by a majority vote of an extraordinary general meeting of shareholders.

DAB has the sole authority to review and pass judgment on the applications for new bank licenses—and thus sole responsibility for evaluating whether the restructuring plans submitted with the applications are adequate. In its evaluation, DAB is bound to ensure that the banks will meet the conditions and standards specified in the banking law, and that each bank will be treated equally in this regard Should DAB reject an individual bank's relicensing application, the bank's operations are to be suspended immediately. The owners of the bank must then dispose of the bank's assets.

DAB is bound by the banking law to ensure that operations of the subject bank are terminated, and its assets liquidated in compliance with legal requirements. Should the bank fail in this task, DAB is to appoint a conservator to carry out or complete the liquidation of the bank under DAB's supervision.

4. LEGAL AND REGULATORY REFORMS NEEDED IN AFGHANISTAN'S FINANCIAL SECTOR:

Area Short term Medium term Long term Central bank

• Introduce prudential regulations for monitoring bank performance—capital, asset quality, and liquidity

• Strengthen the ability of banking supervisors to conduct on- and off-site inspections

• Strengthen prudential regulations, including loan classification standards, capital adequacy; increase minimum bank capital requirements

• Establish competent commercial courts

• Continue progress on financial sector reform including strengthening the regulatory framework and modernizing the central bank ,Banking ,State banks New private banks

• Strengthen corporate governance structures; process of appointing and dismissing board members and management.

• Strengthen criteria and procedures for new banks to clarify capital entry requirements, the scope of individual operations, management and shareholder requirements, impact on banking sector competition, and reporting requirements.

- Sever state ownership of banks
- Introduce anti–money laundering legislation
- Introduce product/service specific regulations to ensure safe banking practices
- Continue progress on financial sector reform including resolution of state-owned commercial banks and entry of private sector banks.
- Strengthen risk-based prudential regulations Microfinance
- Establish a more effective system of NGO and microfinance registration and monitoring
- Facilitate entry and expand outreach
- Adopt new NGO legislation encompassing microfinance activities, cooperatives, and other savings and credit associations
- Continue progress on financial sector reform including entry of nonbank financial institutions Informal financial sector
- Recognize the self-regulatory potential of the Money Dealers Association to introduce prudential regulations required by law
- Work with the association to draft a code of ethics and standards of conduct, and to adopt disciplinary procedures
- Introduce prudential regulations for licensing or registration, suspicious activity reporting, and record keeping
- Continue progress on financial sector reform including entry of nonbank financial institutions

- Given the growing concerns over resurging poppy production and the terrorist threat in some parts of the country, the government will soon be expected to pass legislation to combat money laundering and the financing of terrorism.
- *Microfinance institutions*: The new banking law includes no provisions for regulating and supervising microfinance institutions. Despite the increasing number of NGOs entering this field, microfinance is still at an early stage; it needs to be nurtured within the parameters of an accommodating legislative and regulatory structure. Reforms must focus on establishing a basic but effective system for NGO and microfinance registration and monitoring. A legal framework that is too detailed may stifle rather than develop the sector.
- ***Informal financial institutions*:** Although DAB lacks the capacity to regulate money exchange dealers, it should recognize the potential of the Money Dealers Association to act as a selfregulatory body and work with it to introduce the new prudential regulations called for in recent legislation. The central bank should encourage the association to draft a written code of ethics and standards of conduct, and to develop disciplinary procedures.

Concurrent with these reforms, DAB should continue to strengthen the administrative mechanisms for implementing the law and the regulations provided for under the law. In particular, it should enhance the ability of its banking supervision departments to conduct on- and off-site inspections of key financial institutions under its purview, establish a more effective system of NGO and microfinance registration and monitoring, and work with the money exchange dealers' association to introduce its members to the benefits of external regulation and oversight mechanisms for licensing, identifying customers, reporting suspicious activity, and keeping records.

In the medium term, it will be necessary to reform ancillary legislation for banks, institutions, and informal financial entities to permit a wider range of financial transactions. The reform will have to embrace prudential regulations (including loan classification standards); capital adequacy requirements; establishment of commercial courts; anti–money laundering legislation; NGO legislation encompassing microfinance activities, cooperatives, and other savings and credit associations; and regulations for licensing or registration, suspicious activity reporting, and record keeping. As it increases its supervisory role, the central bank must continue to reduce the government's role in the financial sector by decreasing its equity stake in the banks.

Improving corporate governance and the quality of financial sector infrastructure

In coming years, DAB should strive to improve the corporate governance structures of state banks that are relicensed. Particular attention should be given to the composition and personal qualifications of the board, the directors' remuneration, the board's relationship with the shareholders, and its accountability to shareholders. Every financial institution, including DAB, should be headed by an effective board capable of leading the institution—and every board should have a balance of executive and nonexecutive directors. Every institution should have a formal and transparent procedure for the appointment, remuneration, and removal of new directors to the board; every one should hold an annual general meeting to communicate with private investors and encourage their participation; and every board should have procedures for regularly reviewing all controls—notably financial, operational, and compliance controls and risk-management procedures. In addition to improving corporate governance structures, the reforms need to address the overall quality of the financial sector's infrastructure: human resources policy and processes, accounting and auditing standards that meet international standards, technology-based management information systems, and an effective interbank and national payments system.

- *Human resources*: Significant investment is needed in human resources in the central bank, especially in the areas of monetary policy and banking supervision. Immediate solutions include

(i) identifying a core cadre of young prospective managers for accelerated training in key aspects of central banking activities, and

(ii) establishing a separate bankers' training institute, jointly financed and managed by the central bank and the rest of the financial sector.

- *Accounting and auditing procedures*: Present weaknesses in accounting and auditing practices must be addressed immediately. Information on DAB's financial position and the financial condition of the state banks is unreliable, because internationally accepted accounting standards are not used. The central bank should phase in such standards for banks and nonbanking financial institutions, starting with basic rules for asset and liability recognition, provisioning, writing-off, and depreciation and then moving on to more complex standards such as consolidated accounting. In the medium term, DAB should begin producing externally audited financial statements.

- *Computing technology*: Substantial investment is required in the central bank's technological capacity. DAB should start the computerization process at the points of data entry—in the banking hall, computer departments, research and statistics, and other operational departments. The hardware rollout should be matched with a systems development process that will enable DAB's departments to communicate electronically.

- *Interbank transactions*: DAB must create and strengthen the operational infrastructure for new banks, which will need physical and technological infrastructure for interbank transactions, international payments and settlements, and day-to-day treasury operations. Presently, the necessary infrastructure is significantly lacking, and it is unclear whether the central bank has the resources to provide it.
- *Payments system*: Infrastructure investment must also focus on key branches of the domestic payments system. Developing basic payment mechanisms and savings facilities in postconflict countries is a key step toward enabling the population to participate fully in the formal economy. The absence of effective rural payments systems is particularly acute. Given the absence of private investment in rural financial infrastructure, DAB must improve its rural physical infrastructure and the capacity of some of its key branches to facilitate basic financial transactions between Kabul and the regions. In the medium to long term, there should be a conversion from state central bank branches to privately owned commercial bank branches.

In the medium- to long term, the private sector is best placed to provide effective and efficient infrastructure for the financial sector. For that reason alone, it is imperative that DAB complete the relicensing process in a timely and effective manner. Only banks that meet the minimum legal licensing requirements and have a viable management plan must be allowed to reenter the financial system.

Given the complexities associated with rehabilitating state banks, it is recommended that DAB relicense no more than two of the six existing state commercial and development banks. The rest should be liquidated or quickly sold to private investors. In the medium- to long-term the assets of the state financial sector should be privatized to promote efficiency. Of the available resolution options, DAB should avoid merging the development banks to create another government bank. Merging financial institutions under good financial conditions is complex; in the presence of solvency and liquidity concerns, it is needlessly risky.

Improving Access To Financial Services For Small And Medium Enterprises, And For Rural Communities

The old model of directed lending to small and medium enterprises (SMEs) and to rural communities through publicly owned and managed development-finance institutions or specialized banks has become redundant and outdated. Universal experience shows that a strong, market-based, competitive financial system comprising banks as well as capital markets serves these needs in a much more efficient and cost effective manner.

Provision of funds through directed and subsidized credits by development-finance institutions contributed to the current state of the financial sector in Afghanistan. Their nonperforming assets and those of specialized banks account for a large proportion of their total advances, degrading the overall quality of banking-system assets.

Strengthening the infrastructure of Afghanistan's financial sector

Area Short term Medium term Long term Central bank

- Board and management:

strengthen the central bank's corporate governance structure

- Human resources: Identify a core cadre of prospective managers for accelerated training
- Accounting: Complete the introduction of a new chart of accounts
- Banking and information systems: Install hardware and software

- Human resources: Establish a dedicated international and domestic management training program
- Accounting: Prepare externally audited financial statements in accordance with international accounting standards
- Continue progress on financial-sector reform including strengthening the financial sector infrastructure within the central bank Banking , State banks, Private banks
- Board and management: strengthen the central bank's corporate governance structure
- Complete the relicencing process
- Introduce independent management in banks to be rehabilitated
- Revive safe and sound operations
- Install accounting and financial controls
- Establish a legal framework with appropriate regulations for payments system and domestic interbank market
- Revive retail payments systems including the use of checks
- Complete the resolution of the unlicensed state banks
- Commence the Voluntary Retirement Scheme, taking into account the government's fiscal commitments
- Improve check clearing and settlement systems
- Complete the privatization of the remaining relicensed state banks
- Convert to real-time gross settlement systems Microfinance
- Begin licensing microfinance institutions under the new legislation
- Entrust larger, well managed institutions to expand their

range of products, including deposit taking among members

• Consider the transformation of some of the large microfinance

NGOs into banks or nonblank financial institutions Informal financial institutions

• Accept applications for banking licenses from large money exchange dealers that have a strategic banking partner and meet legal licensing requirements

• Consider licensing compliant money exchange dealers as nonbanking financial institutions, thus permitting them to engage in a wider range of well-regulated financial activities

• Consider the transformation of some of the larger money exchange dealers into banks

At the same time, market failure, particularly in postconflict countries, justifies public policy intervention on behalf of underserved SMEs and rural communities. Currently, the financial system provides little or no access to financial products and services for urban or rural enterprises. Instead, an extensive array of informal money exchange dealers and some NGOs support urban and rural micro enterprises with limited financial services.

As the reconstruction effort progresses, there is a pressing need to address the burgeoning requirements of such enterprises, along with the needs of more formal enterprises and those of international investors. Finance for microenterprise, rural communities, and SMEs are all essential components of a comprehensive and sustainable financial sector reform program based on a diversified and competitive economy.

The development of rural financial markets is currently hindered by several factors:

(i) dispersed populations and poor transport and communications facilities; (ii) high risks associated with rain-fed agriculture; (iii) absence of physical collateral and land-tenure systems that minimize the value and use of land as collateral; and (iv) past history of state involvement and subsidized lending, leading to low recovery rates. These problems, some of which may affect urban microenterprise finance, tend to be more acute in rural areas. The strategy for developing financial services in rural areas will need to take into account the above factors.

Bringing the commercial financial system closer to rural customers will require improving the business environment and regulatory framework to facilitate rural finance operations and increase the perceived creditworthiness of clients; using technology to lower transaction costs and improve transfer mechanisms; introducing new products and risk-reduction techniques; and encouraging the use of agency arrangements to leverage scarce or expensive infrastructure and to create flexibility and mobility in service provision.

Broadening And Deepening The Financial Sector

Achieving the high rates of growth necessary to reduce poverty significantly will require increased mobilization of domestic and foreign savings to support higher rates of private sector investment.

Mobilizing savings implies a broadening and deepening of financial markets, institutions, and products, particularly long-term project finance. It also means supporting the creation of banks and nonblank financial institutions offering a range of products and services that compete with or complement those traditionally provided by banks.

While the banking sector is likely to remain the largest component of the financial system for some time, there is also a need to develop leasing companies, commercial credit companies, credit unions, factoring companies, insurance companies, and pension and provident funds, and, in the longer term, to develop debt and equity markets. The establishment of a broad range of instruments into which savers can deposit their funds and through which companies and consumers can obtain access to capital and credit, will spur the overall development of the economy.

To enhance competition and make the intermediary role of the banks and nonbanks more efficient, DAB should ensure that the banking industry is not dominated by a single bank or group of banks.

Conventional means of enhancing competition within banking systems—such as bank privatization and changes in laws and regulations affecting companies, banks, foreign ownership, and bankruptcy—should constitute the basis of such a policy.

Authorities must create an environment, through regulation, to prevent collusive behavior among banks and conglomerate relationships between banks and nonbank financial institutions. Therefore, the present ownership structure of the two state banks to be relicensed should be gradually changed through their privatization and through the entry of reputable new private banks and financial institutions. To ensure continuing effective competition, DAB should permit new banks to be set up only by qualified, professional, and experienced parties.

In the long run, financial sector reforms should result in the following outcomes:

- Only self-sustaining and commercially viable financial institutions that do not depend on the government's support for resource mobilization or pricing should be allowed to operate in the market. Government should channel resources to priority sectors or subsectors in cases of market failure, for reasons of equity, or to achieve social objectives, but such allocations should be explicit budgetary costs and not subsidized through a tax on financial intermediation.

- The government's role should be confined to creating a regulatory environment and an incentive regime that will draw investors and savers to financial institutions. Where government participation in equity becomes necessary it should be done without involvement in management. In arriving at the conclusions and recommendations made in this chapter, we recognize that financial sectors in postconflict countries vary in their levels of development and capacity for reform. Therefore, reform efforts must continue to accommodate Afghanistan's unique characteristics and circumstances.

Specifically, the government and its development partners must bear in mind:

Sustainable financial reforms have a long maturity period. Enacting legislation, improving governance structures, developing competitive financial practices, building financial infrastructure, and encouraging international and domestic confidence in financial institutions require patience and determination. In postconflict countries, the need for persistence is even greater.

- *Proper sequencing of reforms is essential*5: Financial sector reforms achieve the best results when the macro economy is stable. Price stability depends on low inflation rates; fiscal stability on no more than modest deficits. A conducive environment is needed to promote investment only from "fit and proper" sources, domestic and foreign, into the system. And financial infrastructure—in the form of laws and regulations, institutions that implement policy effectively, skills formation, information systems, and accounting and audit capacity—must be in place. All of these components are essential for effective implementation of financial reforms. In some cases, results can be achieved relatively quickly, whereas in others they will take time. Because a stable and sound environment will make it easier to meet the longer-term challenges of institutional development, reforms should be appropriately sequenced.

- *Financial reforms are incomplete without well-conceived measures for introducing and supporting acompetitive environment*. Reforms should be designed to have long-term effects, always keeping in mind the ultimate objective of establishing a competitive environment based on principles of safe and sound banking under stable financial conditions. Financial sector legislation and regulations (along with appropriate tax policies and open current and capital accounts) constitute the basis for a competitive policy.
- *Efforts to recapitalize previously existing and troubled banks should be pursued only as a last resort (resulting from the absence of new investment and in the interest of broad provision of banking services), and within the context of a time-bound privatization program*. It takes a long time for private banks to tool up in an environment like Afghanistan. But because the costs of recapitalizing troubled state banks are high relative to monetary and fiscal returns, any move to rehabilitate any of the existing troubled banks should be carried out using performance-based contracts.
- *Financial reforms are not sustainable unless they are comprehensive and penetrate institutional structures*. Strengthening financial infrastructure requires several developments. A good starting point is to ensure the central bank's ability to supervise banks. Attention must next be given to infrastructure, including the payment and settlement system, accounting and auditing standards, the framework for secured transactions, and institutional capacity to comply with and enforce prudential norms.

Professionalism in banking, combined with steady development of accounting and audit standards and capacity, should help to implement the reform process.

- *Reforms will not succeed without development of the system for payments and settlements*. The lack of a formally functioning payments system for international and domestic funds transfers has been an important obstacle to the timely and effective delivery of reconstruction assistance in Afghanistan. It has also impeded support of central authority, as the government has had problems paying civil servants. Action to improve the payments system should be accelerated.
- *Security risks hamper implementation and private sector competition.* So far, few private sector bidders have responded to government tenders. Perceived security risks have led firms to withdraw their offers, even after being selected through competitive bidding. Where tenders attract too few bidders, external consultants and contractors should be sought to implement the reform strategy.

Overall, the sustainability of the reform program will depend on continued commitment by political and technical leadership teams, and on the cascading of support to middle management and the entire financial system. In the long term, sustainability will depend on the degree of institutional capacity for professional service delivery, and on energy and support driven by economic growth and opportunity.

5. RETAIL BANKING ACTIVITIES AND A NATIONAL PAYMENT SYSTEM

Establishing an efficient payment and settlement system is critical to the stability of any economy, because it “reduces the cost of exchanging goods and services, and is indispensable to the functioning of the interbank, money and capital markets. A weak payment system is a severe drag on the stability and developmental capacity of an economy; its failures can result in inefficient use of financial resources, inequitable risk-sharing among agents, actual loss for participants and loss of confidence in the financial system and in the very use of money." An efficient and effective payment and settlement system is one of key reform challenges for any developing financial sector. Due to the fragmented nature of the banking system in postconflict economies, the payment system (if one exists) is often in need of significant improvements. Above all, reforms must anticipate that the vast majority of transactions are of comparatively small value. Fortunately, technologies and software packages have been designed to make implementation of effective payment systems attainable around the globe. This is essential not only for broad market confidence and basic transactions but also to contain money laundering and other financial crimes. For these reasons, one of the immediate demands for policymakers in postconflict countries is establishing a strong, efficient, reliable, safe, and stable payment system that facilitates a country's economic development.

As of January 2002 DAB was conducting activities normally reserved for the second, commercial, tier of the banking system. Indeed, DAB's commercial activities accounted for most of the commercial banking activity taking place in Afghanistan at the time.

Under the circumstances, this decision was grudgingly accepted because there were no functioning banks under sound regulation and supervision. Thus, DAB strengthened its commercial payments capacity to ensure that government, NGOs, private businesses, households, and other parties had access to the system to make payments and transfers. Likewise, DAB provided letters of credit and other trade finance facilities to businesses, organizations, and others to handle such needs through its existing network of bank branches. The status quo raised several developmental concerns. First, losses in trade financing might risk undermining DAB's financial position, weakening its role in devising and implementing monetary policy.

Second, it might send an adverse market signal to potential commercial banks: they might be competing with the central bank. For DAB to retain its commercial functions could, in other words, deter investment.

Finally, there were concerns about the inevitable conflict of interest resulting from DAB acting as both a commercial bank and bank supervisor.

DAB consequently agreed it needed to develop an exit strategy from retail banking. Given Afghanistan's circumstances, a gradual exit from its direct role in the payment and settlement system to one in which it regulates and supervises was considered appropriate. The payment system is still being developed, confidence in that system needs to be built and maintained, and an exit strategy needs to be carefully coordinated and phased. Such an approach would accommodate the transition from state to private provision of financial services.

The Central Bank Law passed in September 2003 recognized DAB's overall strategy, particularly the need for commercial banking services in areas where there are no banks or services, and establishes an exit strategy for the central bank once others begin to provide these services.

129(Da Afghanistan Bank's commercial banking services) states that:

"… in any region of Afghanistan where commercial banking services are not provided to the public by at least one bank licensed by Da Afghanistan Bank, Da

Afghanistan Bank shall be authorized to provide such services for commercial holders of account on its books that maintain an active place of business located in that region, notwithstanding any other provision of this Law, for a period not more than two years from the effective date of this Law. Da Afghanistan Bank shall ensure that the agreements governing each such account permit Da Afghanistan Bank by written notice to discontinue providing commercial banking services to the account holder in circumstances including that one or more banks licensed by Da Afghanistan Bank provide such services in the region, and to close such account as soon as shall be practicable thereafter. No failure on the part of Da Afghanistan Bank to provide or not to provide commercial banking services in accordance with this Article shall affect the validity or enforceability of agreements concluded by Da Afghanistan Bank for the provision of such services. For the purposes of this Article, the term "*commercial banking services*" means any of the banking activities defined as such by the Banking Law."

Meanwhile, the installation of SWIFT equipment in 2001 under a USAID grant of US$80,000 led to numerous technical and staffing problems. The initial absence of a dedicated telephone line was an obvious technical constraint. Training was ineffective, at least at first. Two sessions have been held in Dubai. The first, attended by two DAB secretaries, focused on SWIFT configuration. The second, involving more than 10 bank staff members, focused on processing SWIFT transactions. Only one staff member is said to have successfully completed the course. Until the technical and human skills components of the SWIFT connection are addressed, DAB has no reliable means for effecting international payments.

For a while, Crown Agents Financial Services Limited (CAFSL) provided the only formal secure arrangements for effective bank transfers to Afghanistan and for making Afghanis and U.S. dollars (USD) available in-country. The procedure was simple. The remitting client paid the fund to CAFSL and completed a form advising it of the sum to be transferred to Afghanistan and the name and passport number of the individual who will collect the funds in Kabul. On receipt of the fund, CAFSL sent an instruction to the central bank in Afghanistan, to pay a fixed amount of dollars to a named individual on application and identification at the central bank counters in Kabul. Funds were normally available for collection immediately, subject to banking hours in Kabul. The local Kabul office manager accompanied the named individual to Da Afghanistan Bank for first collection and assisted with any queries on subsequent collections. The fee for each transaction was 1 percent of the sum to be transferred with a minimum of USD250 and a maximum of USD500. If, however, the recipient client had an account at the central bank, the transfer charge was only $50. In its first three months of operation, CAFSL remitted over US$4 million on behalf of well over twenty clients. But this service suffered some limitations. First, it is available only to international organizations engaged in development activities in Afghanistan. Second, the funds can be made available only to DAB counters in Kabul. CSFSL could not arrange the transfer of funds to other areas of Afghanistan. Third, the funds had to be withdrawn in full as soon as possible after the client's local representative has been advised that the funds are available. It was not possible to withdraw the funds in installments—unless, of course, the client has an account at the central bank, or requests CSFL to hold the funds in London and make the funds available as required.

Consequently, the central bank continued to strengthen its payment system capability. By September 2003, it had reconnected 35 of its main provincial branches to DAB's head office in Kabul. These branches had been connected by laptops with Immerses connections, and by end-December 2003 they were expected to be able to report to the center their balances and account movements, with the capacity to do so on a daily basis. Bank branches in Kabul were already reporting to the head office on a daily basis under the existing communication system. In the near future they were to be connected by a computer network.

One of the driving forces for the central bank branch reforms was the need to disburse government salaries, the main expenditure item in the provinces, and the provincial donor-funded programs.

But much remains to be done, including: developing a physical distribution system with some regional cash centers from where the distribution of cash could be made; the introduction of a software system for the management of the currency inventory; the purchase of an armored fleet or use of an aircraft suited to the important yet risky task of transporting cash within and outside the city. For the medium term, with the emergence of a commercial banking system, discussions are underway to discuss plans to implement two payment systems that will represent the core of the National Payment System. The payment systems are expected to provide the clearing and settlement of both high- and low-value credit payments, using a Real Time Gross Settlement (RTGS) system and a Direct Giro Credit (GC) system.

6. FinTRACA

Overview

The Financial Transactions and Reports Analysis Center of Afghanistan (FinTRACA) was established as a Financial Intelligence Unit (FIU) under the Anti Money Laundering and Proceeds of Crime Law passed by decree late in 2004. The main purpose of this law is to protect the integrity of the Afghani financial system and to gain compliance with international treaties and conventions. The Financial Intelligence Unit is a semi-independent body that is administratively housed within the Central Bank of Afghanistan (Da Afghanistan Bank).

Objectives

The main objective of FinTRACA is to deny the use of the Afghani financial system to those who obtained funds as the result of illegal activity, and to those who would use it to support terrorist activities. In so doing, FinTRACA will make a significant contribution to the overall integrity of the Afghan financial environment, the ability of the Afghan financial system to integrate with the global financial system, and to future economic growth, investment, and prosperity in Afghanistan.

Functions

In order to meet its objectives, the FinTRACA collects and analyzes information from a variety of sources. These sources include entities with legal obligations to submit reports to the FinTRACA when a suspicious activity is detected, as well as reports of cash transactions above a threshold amount specified by regulation. Also, FinTRACA has access to all related Afghani government information and databases. When the analysis of this information supports the supposition of illegal use of the financial system, the FinTRACA works closely with law enforcement to investigate and prosecute the illegal activity. FinTRACA also cooperates internationally in support of its own analyses and investigations and to support the analyses and investigations of foreign counterparts, to the extent allowed by law. Other functions include training of those entities with legal obligations to report information, development of laws and regulations to support national-level AML objectives, and international and regional cooperation in the development of AML typologies and countermeasures.

Security

The FIU recognizes the important roll it plays as an independent intermediary between reporting entities and law enforcement. It rigorously applies its legal obligations to protect the sources and confidentiality of information received, and to use information received only for the specific purposes allowed under the law.

CHAPTER THREE

AFGHANISTAN BANKS ASSOCIATION

Back ground: Prior to 2003 the banking sector in Afghanistan was merely operational and formal economic activity in the country was minimal. By the end of 2003 the Central Bank (Da Afghanistan Bank) resumed the licensing process for the formation & establishment of new local & foreign commercial bank branches in the country. It became apparent that the enlarging banking sector needed to organize itself and create an apex body representing all banks & to serve as its mouthpiece in the dialogue with DAB & other government & private sector institution. Thus with the advice of DAB, the Afghanistan Banks Association was established in September 2004. ABA initially started with eight member banks and has been playing a constructive role in bringing the Banking community together with a common goal of improving the functioning of the Banking system in Afghanistan. At Present there are 14 licensed banks & all are members of the Association.

1. GOAL OF THE ASSOCIATION:

To promote, advance and protect the rights, privileges and interests of banks and financial institutions functioning in Afghanistan and to take such actions within the Afghanistan legal frame work in order to benefit the member licensed commercial banks in particular and as well as customers of banking communities in general.

Objective of the Association:

The main objectives of the Association shall be:

1. To promote and protect the rights and interests of the member banks.
2. To promote and protect the interests of the clients and customers.
3. To build the capacity of the domestic banking industry, and to contribute to the improvement of the new banking systems by using media resources and launching public awareness campaign trough local media and awareness programs.
4. To improve the awareness, image and salience of banking services amongst the general public and all those engaged in business and financial transaction.
5. To promote sound and easily applicable of procedures and practice among the member banks.
6. To raise the voice of banking community.
7. To collect, classify and circulate statistics and information relating to banks and financial institutions functioning in Afghanistan.
8. To promote and develop common policy amongst members of Association in relation to the staff.
9. To award and grant scholarships, medals and prizes to brilliant students perusing education in the field of banking and finance in particular and other related.

2. ABA STRUCTURE:

The Association comprises of the following bodies:

(a) The General Assembly

(b) The Management Board

(c) The Chairman

(d) The Vice-Chairman

(e) And the General Secretary

Every component of the Association got rights and duties according to the Articles of Association. Fund of ABA:

The Association is an unprofitable organization financed from the membership fees and additional contributions of its members; and it can receive monetary donation and gifts in equipment and other technical items from domestic and foreign legal entities and associations.

3. FOUNDER MEMBERS OF ASSOCIATION:

1. Afghanistan International Bank (AIB)
2. Habib Bank Limited (HB Ltd) – Pakistan
3. National Bank of Pakistan (NBoP)
4. Standard Chartered Bank (SCB)
5. Punjab National Bank India (PNB)
6. The First Micro Finance Bank (FMFB)
7. Kabul Bank (KB)
8. Pashtani Bank (PB)
9. Bank -E- Meilie Afghan (BMA)

Honorary members of the Association:

The General Assembly of ABA granted honorary membership to the followings bodies:

- The Governor of Da Afghanistan Bank
- The two deputy governors of Da Afghanistan Bank (DAB) .
- Mr.Sharifullah Ibrahimee the deputy minister of custom Mof

4. MISSION STATEMENT:

Afghanistan Banks Association (ABA) is a non – political & non-profit association formed by the local & foreign commercial banks branches striving for a strong, healthy and competitive banking industry in Afghanistan, representing the common interests of the banking sector. It is committed to create an environment in which its member can work in coordination with decision makers for promoting the financial services to the wider public and advocating transparency and professionalism.

Banks services

ABA member banks generally provide the following services and products**:**

1. Opening of Current, saving & deposit accounts in Afghanis and other permitted Foreign Currencies.
2. International Funds transfer through – SWIFT.
3. Domestic funds transfer through Afghanistan clearing and settlement system (ACSS- Da Afghanistan Bank).
4. Cheque collection services.

Member Banks:

Da Afghanistan Bank (DAB) has licensed (15) commercial banks who are members of the ABA:

1. Afghanistan International Bank
2. Azizi Bank
3. Arian Bank
4. Bank-E-Mili Afghan

5. Bank Alfalah Ltd
6. BRAC Afghanistan Bank
7. Development Bank of Afghanistan
8. Export Promotion Bank
9. Habib Bank of Pakistan
10. Kabul Bank
11. National Bank of Pakistan
12. Pashtany Bank
13. Punjab National Bank - India
14. Standard Chartered Bank
15. The First Microfinance Bank

Banking Laws

- Da Afghanistan Bank (DAB) Law
- Banking Law
- AF CFT Law
- Anti-Money Laundering Law

Regulations under Banking Law:

- Liquidity
- Corporate governance
- Control regulation
- Classification Provision and Reserve
- Capital Regulation
- DMFI regulation

- Enforcement Regulation
- Large exposures
- Open FX Regulation
- Regulation on Prohibited and Authorized Activities
- Related Persons

Regulations under DAB Law:

- Foreign Exchange Dealers
- Money Service Provider Regulation
- Regulation on Required Reserves
- Protection of the Payment System

Regulations under AML Law:

Responsibilities of financial Institution under AML & CFT

Other relevant Laws of banking / financial sector:

- Income Tax Law
- Investment Law
- Paying tax by Electronic Fund Transfer English
- Insurance Law (coming Soon)

5. CORPORATE GOVERNANCE AND MANAGEMENT STRUCTURES

Over the years, political interference in the banks' operations, management, and control (including lending decisions) has left them with weak corporate governance and flawed organizational structures.

For example, as of the fall of the Taliban regime, the central bank governor was also chairman of the board for all the banks, presenting clear conflict-of-interest concerns. Interference in credit allocation, deposit and lending rate-setting, policy and operations has long tarnished the banks activities . Lax legal and regulatory oversight and, until recently, poor incentives for sound banking, undermined the banks operations as well. These weaknesses combined with the lack of banking experience among the clerics and mullahs appointed to management positions, the transformation of the banking system into monobanking during the Soviet era, and some inappropriately applied versions of Islamic banking during the Taliban period led the banks to almost certain insolvency and liquidity. Overall, in almost all the banks, corporate governance and organizational structure were characterized by the following weaknesses:

- unclear organizational and departmental policies, procedures, data and information flows, decision-making responsibilities and accounting systems;
- vague and imprecise lines of communication for policy dissemination and decision-making
within and between departments;
- ill-defined duties, responsibilities, accountability, and span of staff and supervisory authority in all operating departments;

- weak, if any, management information system for information dissemination, financial analysis, decision-making, and long-range planning due to the banks heavy reliance on DAB for policy, operational guidelines, and planning;
- weak written operating policies and procedures, especially in credit administration, risk assessment and management, and loan servicing and workouts;
- poor branch management control, and ineffective general banking operations oversight procedures;
- ineffective treasury management operations, absent collateral appraisal procedures and techniques, and nonexistent debt recovery operations.
- unreliable broken communication links, and data transmission and delivery that often break down, as telecommunications systems are outmoded and unreliable;
- an entire corporate structure that is void of computerization, automation, and information technology, having only eight computers, which are used primarily for word-processing, and;
- archaic accounting systems that are not IAS-compliant and are incapable of resulting in a "true and fair" value of the bank's financial condition and performance.

In general, the concept of corporate governance is alien to all bank management, which operates under a weak corporate governance structure. In theory, the banks were subject to inspections and audits from DAB, Ministry of Finance, Ministry of Commerce, Ministry of Justice, and the Control and Inspection Department. In reality, however, the poor quality and tardiness of financial information made independent audits difficult. For example, the last DAB audit covering the inspection of Pashtany Terjaraty's financial accounts for the year ended in March 1998. Also, these bodies did not have the expertise and tools required to ensure the adequacy of corporate governance standards. At PTB, the overall division of responsibilities between the commercial vice president and the administrative vice president (who reported to the president) meant that the former handled all external trade-related and lending functions, and the latter managed all operational issues, support functions, and domestic branches. Other than this broad differentiation, reporting lines are unclear and are based neither on functional/product lines nor on customer segments. There are no independent credit, treasury, operational risk, or human resource functions.

CHAPTER FOUR

1. THE RELICENSING OF STATE COMMERCIAL AND DEVELOPMENT BANK

Following the September 2003 enactment of the new commercial banking law, the central bank now has to decide which banks will be allowed to submit applications for relicensing, banks that operated with a license granted by Da Afghanistan Bank prior to implementation of the new banking law are required to apply for a new license no later than six months after implementation of the law (i.e., by March 15, 2004). The Presidential Decree for a Banking Law (Banking Law) requires DAB to render decisions on these applications no later than three months after submission—June 15, 2004.

All six of the existing commercial banks are required to submit, as part of their license reapplication, a restructuring plan that brings them into line with required prudential and management standards specified under the banking law.

Formulation of these restructuring plans should be the task of the management or board of supervisors of these banks (from which employees of DAB, Ministry of Finance [MOF], or of any other state authority or municipal body are legally excluded). Shareholders (including MOF, if a shareholder) should have the opportunity to consider and vote on these restructuring plans prior to their submission for DAB approval. Shareholder assent or dissent could be conveyed by a majority vote at an extraordinary general meeting of shareholders.

DAB has the sole authority to review and pass judgment on the applications for new bank licenses, and consequently has sole responsibility for evaluating whether the restructuring plans submitted as part of these applications are sufficient. In this evaluation, the DAB is bound to ensure that these banks meet the conditions and standards specified in the new law, and that each of the six banks will be treated equally in this regard.

Should DAB's decision on an individual bank's relicensing application be negative, the bank's operations should be suspended immediately, and a decision by the owners of the bank would then have to be taken with regard to the disposition of the bank's assets. DAB has the sole licensing authority and would be bound by the new law to ensure that operations of the subject bank had been terminated and that the bank's assets be liquidated in an orderly fashion and in compliance with the requirements set out in the law. Should any bank fail to comply, DAB shall appoint a conservator who shall carry out or complete the liquidation of the bank under its supervision.

2. LEGAL AND REGULATORY REFORMS FOR AFGHANISTAN'S FINANCIAL SECTOR

Area Short term Medium term Long term Central bank

• Introduce prudential regulations for monitoring bank

performance—capital, asset quality, and liquidity

• Strengthen the ability of banking supervisors to conduct on- and off-site inspections

• Strengthen prudential regulations, including loan classification standards, capital adequacy; increase minimum bank capital requirements

• Establish competent commercial courts

• Continue progress on financial sector reform including strengthening the regulatory framework and modernizing the central bank Banking State banks New private banks

- Strengthen corporate governance structures; process of appointing and dismissing board members and management
- Strengthen criteria and procedures for new banks to clarify capital entry requirements, the scope of individual operations, management and shareholder requirements, impact on banking sector competition, and reporting requirements
- Sever state ownership of banks
- Introduce anti–money laundering legislation
- Introduce product/service specific regulations to ensure safe banking practices
- Continue progress on financial sector reform including resolution of state-owned commercial banks and entry of private sector banks.
- strengthen risk based prudential regulations Microfinance
- Establish a more effective system of NGO and microfinance registration and monitoring
- Facilitate entry and expand outreach
- Adopt new NGO legislation encompassing microfinance activities, cooperatives, and other savings and credit associations
- Continue progress on financial sector reform including entry of non bank financial institutions Informal financial sector
- Recognize the self-regulatory potential of the Money Dealers Association to introduce prudential regulations required by law
- Work with the association to draft a code of ethics and standards of conduct, and to adopt disciplinary procedures

- Introduce prudential regulations for licensing or registration, suspicious activity reporting, and record keeping
- Continue progress on financial sector reform including entry of non bank financial institutions
- Given the growing concerns over resurging poppy production and terrorism in some parts of the country, the government will soon be expected to pass legislation to combat money laundering and the financing of terrorism.
- *Microfinance institutions*: The new banking law includes no provisions for regulating and supervising microfinance institutions. Despite the increasing number of NGOs entering this field, microfinance is still at an early stage; it needs to be nurtured within the parameters of an accommodating legislative and regulatory structure. Reforms must focus on establishing a basic but effective system for NGO and microfinance registration and monitoring. A legal framework that is too detailed may stifle rather than develop the sector.
- *Informal financial institutions*: Although DAB lacks the capacity to regulate money exchange dealers, it should recognize the potential of the Money Dealers Association to act as a self-regulatory body and work with it to introduce the new prudential regulations called for in recent legislation. The central bank should encourage the association to draft a written code of ethics and standards of conduct, and to develop disciplinary procedures.

Concurrent with these reforms, DAB should continue to strengthen the administrative mechanisms for implementing the law and the regulations provided for under the law. In particular, it should enhance the ability of its banking supervision departments to conduct on- and off-site inspections of key financial institutions under its purview, establish a more effective system of NGO and microfinance registration and monitoring, and work with the money exchange dealers' association to introduce its members to the benefits of external regulation and oversight mechanisms for licensing, identifying customers, reporting suspicious activity, and keeping records.

In the medium term, it will be necessary to reform ancillary legislation for banks, microfinance institutions, and informal financial entities to permit a wider range of financial transactions. The reform will have to embrace prudential regulations (including loan classification standards); capital adequacy requirements; establishment of commercial courts; anti–money laundering legislation; NGO legislation encompassing microfinance activities, cooperatives, and other savings and credit associations; and regulations for licensing or registration, suspicious activity reporting, and record keeping. As it increases its supervisory role, the central bank must continue to reduce the government's role in the financial sector by decreasing its equity stake in the banks.

Improving Corporate Governance And The Financial Sector Infrastructure

In coming years, DAB should strive to improve the corporate governance structures of the relicensed state banks. Particular attention should be given to the composition and personal qualifications of the board, the directors' remuneration, the board's relationship with the shareholders, and its accountability to shareholders. Every financial institution, including DAB, should be headed by an effective board capable of leading the institution—and every board should have a balance of executive and non executive directors. Every institution should have a formal and transparent procedure for the appointment, remuneration, and removal of new directors to the board; every one should hold an annual general meeting to communicate with private investors and encourage their participation; and every board should have procedures for regularly reviewing all controls—notably financial, operational, and compliance controls and risk-management procedures. In addition to improving corporate governance structures, the reforms need to address the overall quality of the financial sector's infrastructure: human resources policy and processes, accounting and auditing standards that meet international standards, technology-based management information systems, and an effective interbank and national payments system

- *Human resources*: Significant investment is needed in human resources in the central bank, especially in the areas of monetary policy and banking supervision. Immediate solutions include, first, identifying a cadre of young prospective managers for accelerated training in key aspects of central banking activities, and, second, establishing a separate bankers' training institute, jointly financed and managed by the central bank and the rest of the financial sector.
- *Accounting and auditing procedures*: Present weaknesses in accounting and auditing practices must be addressed immediately. Information on DAB's financial position and the financial condition of the state banks is unreliable, because internationally accepted accounting standards are not used. The central bank should phase in such standards for banks and nonbanking financial institutions, starting with basic rules for asset and liability recognition, provisioning, writing-off, and depreciation and then moving on to more complex standards such as consolidated accounting. In the medium term, DAB should begin producing externally audited financial statements.

• *Computing technology*: Substantial investment is required in the central bank's technological capacity. DAB should start the computerization process at the points of data entry—in the banking hall, computer departments, research and statistics, and other operational departments. The hardware rollout should be matched with a systems development process that will enable DAB's departments to communicate electronically.

• *Inter bank transactions*: DAB must create and strengthen the operational infrastructure for new banks, which will need physical and technological infrastructure for interbank transactions, international payments and settlements, and day-to-day treasury operations. Presently, the necessary infrastructure is significantly lacking, and it is unclear whether the central bank has the resources to provide it.

• *Payments system*: Infrastructure investment must also focus on key branches of the domestic payments system. Developing basic payment mechanisms and savings facilities in post conflict countries is a key step toward enabling the population to participate fully in the formal economy. The absence of effective rural payments systems is particularly acute. Given the absence of private investment in rural financial infrastructure, DAB must improve its rural physical infrastructure and the capacity of some of its key branches to facilitate basic financial transactions between Kabul and the regions. In the medium to long term, there should be a conversion from state central bank branches to privately owned commercial bank branches.

In the medium- to long term, the private sector is best placed to provide effective and efficient infrastructure for the financial sector. For that reason alone, it is imperative that DAB complete the re licensing process in a timely and effective manner. Only banks that meet the minimum legal licensing requirements and have a viable management plan must be allowed to reenter the financial system.

Given the complexities associated with rehabilitating state banks, it is recommended that DAB re license no more than two of the six existing state commercial and development banks. The rest should be liquidated or quickly sold to private investors. In the medium- to long-term the assets of the state financial sector should be privatized to promote efficiency. Of the available resolution options, DAB should avoid merging the development banks to create another government bank. Merging financial institutions under good financial conditions is complex; in the presence of solvency and liquidity concerns, it is needlessly risky.

Strengthening the infrastructure of Afghanistan's financial sector

Area Short term Medium term Long term Central bank

• Board and management: strengthen the central bank's corporate governance structure

• Human resources: Identify a core cadre of prospective managers for accelerated training

• Accounting: Complete the introduction of a new chart of accounts

• Banking and information systems: Install hardware and software

• Human resources: Establish a dedicated international and domestic management training program

• Accounting: Prepare externally audited financial statements in accordance with international accounting standards

• Continue progress on financial-sector reform including strengthening the financial sector infrastructure within the central bank Banking State banks Private banks

- Board and management: strengthen the central bank's corporate governance structure
- Complete the re licensing process
- Introduce independent management in banks to be rehabilitated
- Revive safe and sound operations
- Install accounting and financial controls
- Establish a legal framework with appropriate regulations for payments system and domestic inter bank market
- Revive retail payments systems including the use of checks
- Complete the resolution of the unlicensed state banks
- Commence the Voluntary Retirement Scheme, taking into account the government's fiscal commitments
- Improve check-clearing and settlement systems
- Complete the privatization of the remaining re licensed state banks
- Convert to real-time gross settlement systems Microfinance
- Begin licensing microfinance institutions under the new legislation
- Entrust larger, well managed institutions to expand their range of products, including deposit taking among members
- Consider the transformation of some of the large microfinance NGOs into banks or non bank financial institutions Informal financial institutions
- Accept applications for banking licenses from large money exchange dealers that have a strategic banking partner and meet legal licensing requirements.

- Consider licensing compliant money exchange dealers as non banking financial institutions, thus permitting them to engage in a wider range of well-regulated financial activities
- Consider the transformation of some of the larger money exchange dealers into banks

Improving Access To Financial Services For Sme's, And For Rural Communities

The old model of directed lending to small and medium enterprises (SMEs) and to rural communities through publicly owned and managed development-finance institutions or specialized banks has become redundant and outdated. Universal experience shows that a strong, market-based, competitive financial system comprising banks as well as capital markets serves these needs in a much more efficient and cost effective manner. Provision of funds through directed and subsidized credits by development-finance institutions contributed to the current state of the financial sector in Afghanistan. Their nonperforming assets and those of specialized banks account for a large proportion of their total advances, degrading the overall quality of banking-system assets.

At the same time, market failure, particularly in postconflict countries, justifies public policy intervention on behalf of underserved SMEs and rural communities. Currently, the financial system provides little or no access to financial products and services for urban or rural enterprises. Instead, an extensive array of informal money exchange dealers and some NGOs support urban and rural micro enterprises with limited financial services. As the reconstruction effort progresses, there is a pressing need to address the burgeoning requirements of such enterprises, along with the needs of more formal enterprises and those of international investors. Finance for microenterprise, rural communities, and

SMEs are all essential components of a comprehensive and sustainable financial sector reform program based on a diversified and competitive economy.

The development of rural financial markets is currently hindered by several factors: (i) dispersed populations and poor transport and communications facilities; (ii) high risks associated with rain-fed agriculture; (iii) absence of physical collateral and land-tenure systems that minimize the value and use of land as collateral; and (iv) past history of state involvement and subsidized lending, leading to low recovery rates. These problems, some of which may affect urban microenterprise finance, tend to be more acute in rural areas. The strategy for developing financial services in rural areas will need to take into account the above factors.

Bringing the commercial financial system closer to rural customers will require improving the business environment and regulatory framework to facilitate rural finance operations and increase the perceived creditworthiness of clients; using technology to lower transaction costs and improve transfer mechanisms; introducing new products and risk-reduction techniques; and encouraging the use of agency arrangements to leverage scarce or expensive infrastructure and to create flexibility and mobility in service provision.

3. BROADENING AND DEEPENING THE FINANCIAL SECTOR

Achieving the high rates of growth necessary to reduce poverty significantly will require increased mobilization of domestic and foreign savings to support higher rates of private sector investment. Mobilizing savings implies a broadening and deepening of financial markets, institutions, and products, particularly long-term project finance. It also means supporting the creation of banks and nonblank financial institutions offering a range of products and services that compete with or complement those traditionally provided by banks.

While the banking sector is likely to remain the largest component of the financial system for some time, there is also a need to develop leasing companies, commercial credit companies, credit unions, factoring companies, insurance companies, and pension and provident funds, and, in the longer term, to develop debt and equity markets. The establishment of a broad range of instruments into which savers can deposit their funds and through which companies and consumers can obtain access to capital and credit, will spur the overall development of the economy.

To enhance competition and make the intermediary role of the banks and nonbanks more efficient, DAB should ensure that the banking industry is not dominated by a single bank or group of banks.

Conventional means of enhancing competition within banking systems—such as bank privatization and changes in laws and regulations affecting companies, banks, foreign ownership, and bankruptcy—should constitute the basis of such a policy.

Authorities must create an environment, through regulation, to prevent collusive behavior among banks and conglomerate relationships between banks and nonbank financial institutions. Therefore, the present ownership structure of the two state banks to be relicensed should be gradually changed through their privatization and through the entry of reputable new private banks and financial institutions. To ensure continuing effective competition, DAB should permit new banks to be set up only by qualified, professional, and experienced parties.

In the long run, financial sector reforms should produce the following outcomes:

- Only self-sustaining and commercially viable financial institutions that do not depend on the government's support for resource mobilization or pricing should be allowed to operate in the market. Government should channel resources to priority sectors or subsectors in cases of market failure, for reasons of equity, or to achieve social objectives, but such allocations should be explicit budgetary costs and not subsidized through a tax on financial intermediation.
- The government's role should be confined to creating a regulatory environment and an incentive regime that will draw investors and savers to financial institutions. Where government participation in equity becomes necessary it should be done without involvement in management.

THE LAW ON MONEY AND BANKING

1. The 1994 Law on Money and Banking was a compound of a central bank law and banking law; it was poorly written and at times contradictory. Part I defines the legal tender, the afghani, and its value, ambiguously both in terms of gold and SDRs. It also defines the minimum reserves DAB has to hold against issued banknotes at 25 percent. It further reserves the right of printing and issuing money to DAB.

2. Part II of the 1994 law relates to the DAB, its objectives, responsibilities, and powers, and its organs.

It states that DAB is responsible for the implementation of the government's monetary and credit policy and that it shall maintain the value of the Afghani in order to facilitate banking and commercial transactions. It also empowers DAB to supervise operations of banks and credit institutions and to regulate and carry out foreign exchange operations. It mandates DAB to determine the commercial banks' interest rates for deposits and loans and to set minima and maxima on their commissions. DAB is also mandated to define liquidity and capital requirements and limits on large loan exposure. These provisions are mostly ill-defined, however, and do not comply with international best practice. There are no loan classification or provisioning requirements. Furthermore, the law only empowers DAB to define ratios and to collect information, but no provisions exist on the enforcement of the regulations.

Part II further requires DAB to manage government accounts and, if necessary, to finance the government budget deficit, as well as to grant loans to government institutions, agencies, and municipalities. With respect to loans for government projects, DAB is required to check on the projects' economic and financial efficiency.

3. The final section of Part II defines the composition and the role of DAB's organs, namely the Supreme Council, the Monetary and Credit Committee, the Executive Board, the Board of Supervisors, and the Banknote Reserves Supervision Board. The highest organ is the Supreme Council composed of nine members: the prime minister, the ministers of finance, commerce, planning, mines and industries, agriculture and light industries and food products, the minister without portfolio (advising the Prime Minister on economic affairs), and the governor of DAB. The Supreme Council is supposed to meet at least four times a year and decides on all important matters of DAB or on recommendations made by the other supervisory organs. It notably approves all regulations.

4. According to the law, the Monetary and Credit Committee is charged with drafting regulations and recommending the level of interest rates to the Supreme Council. This

committee is also charged with determining the accounting principles to be used and advising the Supreme Council on monetary, banking, and credit matters. The Monetary and Credit Committee is composed of the following: the governor and the first deputy governor of the DAB, the treasury director of the Ministry of Finance (MOF), the financial and commercial director of the Ministry of Planning, the foreign trade director of the Ministry of Trade, the president of the Chamber of Commerce and Industry, two presidents of state commercial banks, one of a private bank, and one of a specialized state bank (all four selected by the president of DAB), and a professor of economics (specialized in banking) from Kabul University. The composition of the Supreme Council and of the Monetary and Credit Committee is highly problematic as it politicizes decisions that should be made on purely technical grounds. DAB thus lacks the necessary independence that a modern central bank should have.

5. The Executive Board consists of the governor and his two deputies. Upon of the Supreme Council, the governor is to be appointed by the president for three years. The law stipulates that the members of the Executive Board are not allowed, during their tenure of office, to accept any position in any other government or private institution. Finally, a Board of Supervisors with a chairman and two members would supervise DAB's banking operations and accounting practices and submit monthly reports to the MOF and quarterly reports to the Supreme Council. This control function has not been fulfilled for years.

6. Part III of the law relates to banking. A bank is defined as an establishment that accepts deposits for the purpose of granting loans or making investments. Private banks receive a special definition as institutions whose operations are limited in scope and

whose activities consist of "monetary and credit transactions" and the purchase and sale of movable and immovable assets. It defines the conditions for establishing a bank, including its minimum capital requirement and its by-laws. The law further requires banks to use a double entry accounting method and to submit to DAB its annual balance sheet and profit and loss statement within four months following the end of each year, together with an audit report. The law empowers the Supreme Council, upon recommendations of the governor and the Money and Credit Committee, to transfer the management of a bank to DAB, or to take measures for the management of the bank or to close the bank (if, for example, the bank acts against the law or its by-laws). The law allows that liquidation of an insolvent bank would be carried out by a team that could include officials of the failed bank. The involvement of the management of the closed bank is particularly problematic if the bank failed for fraudulent reasons. If a government bank is closed, all outstanding deposits, salaries, and claims of other creditors would be paid by the government. In the case of the closure of a private bank or semipublic bank, the law states that outstanding claims would be paid with the 15 percent of capital the bank deposited with DAB at the time the bank was constituted, without indicating the order of priority.

1/ The text above is based an unofficial Dari-to-English translation of the Law on Money and Banking of the Islamic State of Afghanistan. Legal weaknesses noted here may stem

from an incorrect translation of the Dari.

Source: **"Islamic State of Afghanistan: Rebuilding a Macroeconomic Framework for Reconstruction and Growth," IMF Country Report No. 03/299, 2003.**

4. FUNCTIONS AND POWERS OF THE SUPREME COUNCIL

Functions of the Supreme Council

1. The Supreme Council shall be charged with the adoption of the principal policies of Da Afghanistan Bank and the supervision of the administration and operations of Da Afghanistan Bank.

2. In carrying out its functions, the Supreme Council must periodically assess the monetary and economic situation. To that end, the Executive Board shall report, not less than once every calendar quarter, to the Supreme Council on the administration and operations of Da Afghanistan Bank, on the conduct of its monetary and regulatory policies (including domestic price stability), on the soundness of the financial system including in particular the banking and payment systems of Afghanistan, and on the state of the money, capital and foreign exchange markets, including the events and conditions that have or must be expected to have a significant effect on the administration or operations of Da Afghanistan Bank, the conduct of its policies, the financial system or the before mentioned markets.

3. The Comptroller General shall present to the Supreme Council such reports and studies as the Supreme Council shall request for the supervision of the administration or operations of Da Afghanistan Bank.

4. The Governor shall ensure that each member of the Supreme Council shall promptly upon his request receive all such information as he or the Supreme Council shall require for the supervision of the administration or operations of Da Afghanistan Bank.

Powers of the Supreme Council

The Supreme Council shall have the following powers:

a) to formulate and adopt the monetary policy of Afghanistan, including the limits of open market operations by Da Afghanistan Bank, the interest rates for discounts and loans by Da Afghanistan Bank, and the types and levels of reserves that banks are required to maintain with Da Afghanistan Bank;

b) to formulate and adopt the foreign exchange policy and the exchange arrangements of Afghanistan;

c) to adopt all regulations, guidelines and instructions of general application that are to be issued by Da Afghanistan Bank pursuant to this Law or other legislation in force;

d) to approve all reports and recommendations that Da Afghanistan Bank is to make to the government or the parliament of Afghanistan;

e) to decide on the participation by Da Afghanistan Bank in international organizations;

f) to determine the face value and design of banknotes and coins, and the conditions of any currency recall;

g) to decide on the issue of debt securities by Da Afghanistan Bank and the terms and conditions of such securities;

h) to determine the categories of assets that shall be suitable for investment of the foreign exchange reserves and other financial resources of Da Afghanistan Bank;

i) to approve the discounting by Da Afghanistan Bank of instruments having a maturity of more than three months from the date of their acquisition by Da Afghanistan Bank;

j) to approve, with the consent of at least three-fifths of the members of the Supreme Council present, each loan and each guarantee or other contingent commitment of Da Afghanistan Bank to or for the benefit of a bank pursuant to Article 88;

k) to adopt the by-laws of Da Afghanistan Bank and the regulations applicable to the administration and operations of Da Afghanistan Bank;

l) to determine the organization of Da Afghanistan Bank;

m) to approve the appointment of the deputy governors (other than the first deputy governor) and the comptroller general of Da Afghanistan Bank, and to approve subsequent service at another financial institution by the governor and the first deputy governor;

n) to establish and close subsidiaries, branch offices and agencies of Da Afghanistan Bank;

o) to decide on the purchase, construction, utilization and sale of buildings and other real estate by Da Afghanistan Bank;

p) to determine the budget of Da Afghanistan Bank and in general the terms and conditions of employment, including pensions, of the employees, agents and correspondents of Da Afghanistan Bank other than the members of the Supreme Council;

q) to propose increases in the authorized capital of Da Afghanistan Bank set forth in article 27;

r) to determine the accounting policies and the financial risk management policies of Da Afghanistan Bank;

s) to adopt the annual reports and financial statements of Da Afghanistan Bank;

t) to decide on the depreciation of assets and the rate of depreciation of assets of Da Afghanistan Bank, to establish special reserves on the books of Da Afghanistan Bank, to determine the net income of Da Afghanistan Bank, and to decide what amount of such net income shall be transferred to any reserve; and

u) such other powers as shall be granted to the Supreme Council by law.

Introducing the new currency

The introduction of the new currency was a difficult task. Ravaged by more than 20 years of armed conflict, Afghanistan is a rugged country slightly larger than France and has a population of about 22 million. Roads are in very poor condition and there is little or no secure ground transportation between major cities; the lack of communication facilities present enormous difficulties. To reach all holders of the old currency within a limited period of time posed enormous logistical challenges. To address these vast challenges, a steering committee was formed of senior officials from the central bank and the Ministry of Finance (MOF), assisted by international experts from the IMF, USAID, the Bundes bank, and the U.N. Planning for the exchange started in earnest in the early summer of 2002 with the formation of a task force, composed mainly of senior officials from the central bank and several international advisors.

2. The first stages included the ordering, printing, and delivering the new bank notes. DAB contracted the printing of the new currency in denominations of Af 1, 2, 5, 10, 20, 50, 100, 500, and 1,000 to two reputable banknote printers, building upon the work that had already been done for the Taliban regime.

The new notes included several advanced security features to deter future counterfeiting. It was difficult to determine how many new banknotes would be needed. The authorities only had a crude estimate of the existing amount of old notes in circulation. Including the various counterfeits, the face value of the old Afghanis in circulation was initially estimated at about Af 16 trillion. For political reasons, it was decided that two types of unofficial notes would be eligible for conversion, but at a 50 percent discount (close to the actual discount at which these counterfeits traded in the Kabul money market). Taking this discount into account, the total value of old Afghanis to be exchanged was estimated at about Af 13 trillion. The authorities realized, however, that running out of new bank notes before all old ones would be converted would fatally undermine the public's confidence in the new currency. Because of this, and to be able to accommodate an increase in money demand at least in the first year following the new currency's introduction, the authorities ordered a total value of the new notes of Af 27.9 billion (with 1 new Afghani replacing 1,000 old ones), equivalent to almost 800 million notes or about 500 tons. The first deliveries were received in August 2002 and the last shipments arrived in January 2003. The five smallest denominations make up almost 90 percent of the total volume of notes ordered, but only 15 percent of the total value.

3. A first problem to overcome was the extremely poor condition of DAB's regional facilities. DAB had 89 branches, but most of them did not meet even the most basic requirements in terms of secure vaults and office space. With the assistance from international donors, DAB urgently set out to refurbish or

construct a minimum of one currency distribution facility in each province. The country was divided into seven regions, each the responsibility of an area manager. In addition to

Kabul, the regions were Kunduz, Mazar-i-Sharif, Herat, Kandahar, Jalalabad, and Gardez. Each region had a number of exchange points, depending on estimates of population size and levels of economic activity. All in all, 47 exchange points were established where the public could exchange their old notes for new ones. An exchange point consisted of one to five units, with each unit having seven windows: five windows to take in the old currency and two to give out the new. With communication still difficult, the success of the whole program depended significantly on the work of the area and the exchange point managers, who often had to act on their own to deal with problems in their regions. Some 2,500 local staff were selected to carry out the operation. They were selected from the most experienced and skilled personnel in the banking sector. In order to motivate staff and to establish reliable operations, staff were paid considerably more than the $30 to $40 a month normally earned by a bank employee. In addition, the U.N. and USAID provided international observers to oversee the process, notably the destruction of old notes.

4. Transportation was another obstacle. The 500 tons of new currency had to be delivered to exchange points throughout the country, with almost half of this to be transported to the provinces. Ground transport for the more distant locations was ruled out for security reasons. Air transport was seen as the best approach, but the facilities available were very limited. USAID met most of the need by providing two helicopters and one airplane, an Antonov 32; it also set up an air operations unit that handled the scheduling and coordination of flights (all flights required clearance from the regional military air command and a two-day advance notification). The Afghan Air Force also provided some assistance, particularly in the early stages of the conversion period, when

difficulties in obtaining aircraft and crews that were willing to operate in Afghanistan led to delays in the arrival of the helicopters and the airplane.

5. Adequate security was yet another requirement, with security needed at all stages, from the delivery of the new currency to the destruction of the old currency. The government, together with DAB, provided all the security during the currency conversion process. The governor and deputy governors of DAB visited the governors and local commanders in the provinces to ensure their cooperation. It is notable that there were no major security problems or serious violations of procedures during the entire three-month exchange period.

6. President Karzai publicly announced the introduction of the new currency on September 4, 2002. This was followed by a broad public information campaign to ensure that most if not all Afghans would be aware of the conversion. With a largely illiterate population and few households with a television, the campaign relied mainly on radio broadcasts and dissemination by word of mouth, through speeches, village meetings, etc. Also, many posters were distributed, and these depicted the new notes and specified their main security features. The conversion process began on October 7, 2002, and was initially set to last two months, ending December 4, 2002. The authorities opted for a relatively short changeover period to limit the risk of new counterfeit printing. A currency decree was issued to enable and to regulate the implementation of the currency conversion.

7. During the first two weeks of the exchange period, only the money changers would be allowed to exchange their old notes. This way DAB aimed to collect large volumes of old notes early on. In order to be able to handle the large volumes that were expected to be

exchanged this way, a sampling procedure was agreed with the money changers, whereby only 10 percent of the total amount presented was verified to make sure that the count was correct, the denominations were correct, and the notes were indeed eligible for exchange. If the sample count found, for example, 2 percent to be incorrect, this proportion would be discounted from the entire amount that a money changer was presenting.

8. Demand from the general public to exchange their old bank notes was such, however, that the exchange was opened to the general public before the first two weeks were over. Thus, almost all of the exchange points in the major cities opened in the first two weeks. Many exchange points in the provinces had delays in opening, due in large part to delays in the arrival of air transport, but also because many were simply not yet operational until two to three weeks after their planned opening at October 21. In November, uncertainty grew among the general public whether everyone would be able to convert their old notes for new ones on time. As result, the exchange rate started to depreciate sharply. To ease these pressures, DAB announced in mid-November that the conversion period would be extended by one month to January 2, 2003. Following this announcement, the exchange rate quickly returned to levels close to those at the start of the exchange.

9. In the initial period, large denomination bank notes, 1,000, 500, 100, and 50 afghanis, dominated the exchange, reflecting the early and active role of money changers. This also meant that the weight of bank notes, relative to their value, was much less than in the last month of the exchange, when primarily low denomination bank notes (1, 2, 5, and 10 afghanis) were exchanged. Af3.9 trillion worth of old official notes were exchanged during the conversion process for new notes, plus Af3.3 trillion in unofficial notes at a 50

percent discount. Thus, Af 15.6 billion of new notes were issued in exchange. An additional Af2 trillion in old official notes were absorbed through the foreign exchange auctions during the conversion period. All in all, some Af19 trillion in old notes were collected, equivalent to some 5 billion banknotes, or more than 2,000 tons, almost 20 percent more than the estimated face value of banknotes based on the information received from the printing companies. This difference may reflect inaccurate or incomplete information received from the printers, “last minute” printing of counterfeits, or round-tripping of old notes during the currency conversion process. To address the problem of round-tripping, initially old bank notes were to be invalidated, using punchers and drills, and to be subsequently destroyed, using shredders.

But this approach quickly proved to be ineffective, as the arrival of equipment was delayed and, once it arrived, had a tendency to break down. The solution to the destruction problem was to use incineration as the principal method. Difficulties in transportation and security meant that the best approach was to incinerate the notes locally. The construction of ovens was relatively simple and inexpensive. Also, ovens did not require electricity, which was lacking in many exchange points. A schedule was established for the weekly or biweekly destruction of the old bank notes, with the requirement that there be both international and national observers present to assure the integrity of the process. The exchange ended quietly on January 2, 2003.

State Bank Restructuring Options

Background

In February 2003, the Interim Islamic Government of Afghanistan agreed to a World Bank Financial Sector Support Project aimed at restructuring the state banking system in favor of one or more banks that have reasonable prospects for commercial and financial viability.

Current Status of the Project

The World Bank has completed its initial analysis of the central bank and the commercial banking sector, and drafted detailed proposals on the strategy for achieving the objectives outlined above. Two key policy issues remain, however, on which the project preparation team requires guidance from the minister of finance and the central bank governor. One of these issues relates to the proposed number of state banks to be rehabilitated and the type of management contracts to be employed. Once decisions are reached, the project team will be ready to finalize the administrative arrangements for implementation.

Policy Decision Required

In its initial proposal the World Bank recommended the issuance of a single management contract to rehabilitate one state commercial bank, and encouraged the liquidation of all insolvent state development banks. Since that initial proposal, the World Bank has been asked to consider the rehabilitation of two banks for reasons ranging from geographic distribution of branches, to the need for competition, and possible political considerations. The Bank is willing to proceed with the rehabilitation of either one or two banks and has advised of the cost and management considerations of each approach. Based on discussions with various parties concerned, there appear to be five options for commercial restructuring and privatization.

The assumption in designing the following options is that the restructuring exercise involves two phases or components that may be simultaneous or sequential. One involves an evaluation of “good” and “bad” assets, and the consequent impact on the banks in determining their fate under revised licensing conditions based on new legislation and prudential norms. The second is the actual rehabilitation of the one or more banks that will continue to operate as going concerns, with privatization as the desired and planned outcome.

Options For Management Of The Bank Restructuring Process

OPTION 1:

Unified management contract for one existing bank

This option assumes that there will be one contract for one pre selected bank, and that the "good" assets of the other five banks will be merged with the selected banks, while the "bad" assets will be sent to some

resolution unit for final liquidation/closure. Under such circumstances, other bank(s) could continue to operate, assuming they applied for a license from DAB and are able to meet requirements for relicensing.

Technical assistance under the project would apply, however, only to the one pre-selected bank.

OPTION 2:

Unified management contract for one bank synthesized from salvageable parts of other banks

A variant on the "one bank" approach in Option 1 is that the bank would not necessarily be pre-selected. Rather, the single bank would represent the organizational outcome of the resolution process by which all salvageable assets from all six banks would be merged into one bank, which would then be the recipient of technical assistance under the project. This would include a blending of liquid assets in correspondent accounts abroad along with real estate (i.e., branches) and other usable assets in Afghanistan.

OPTION 3:

Unified management for two banks: This option would seek out a single management team for two banks along with the aforementioned resolution activity. In this case, one chief of party would oversee three teams: one for each bank, and a third team involved in resolution work for the other four banks, or potentially for all six banks.

Option 4:

Three Separate Management Contracts , for Two Banks plus a Third for Resolution Activity

This option would seek out separate management teams for two banks along with a third management team for the aforementioned resolution activity. In this case, the third team involved in resolution work could be involved in the four banks that will not benefit from direct technical assistance (although the resolution work will be financed and would thus constitute technical assistance), or potentially in all six banks as a separate function detached from the reha

bilitation and restructuring efforts of the management teams in the two chosen banks.

Option 5:

Management Contract(s) plus Establishment of Asset Management Company

This option would have one or two management team(s) for the one or two banks, along with a contract to establish an independent Asset Management Corporation (AMC). The AMC would carry out the resolution work noted above, yet also be conceived as more of a formal institutional structure to help build up the legal and institutional infrastructure needed for problem banks, as well as to establish principles, policies, processes and procedures for future asset and bank resolution.

One -bank rehabilitation/creation approach

Option 1 A single management contract for the resolution of all insolvent state development banks and the rehabilitation of one existing commercial bank;

Option 2 A single management contract for the resolution of all insolvent state commercial and development banks and the creation of a new bank;

Two-bank rehabilitation approach

Option 3 A single management contract for the resolution of all insolvent state development banks and the rehabilitation of two existing commercial banks;

Option 4 A single management contract for the resolution of all insolvent state development banks, and two additional contracts for the rehabilitation of each of the two existing commercial banks.

Option 5 The creation of an Asset Management Company for the resolution of all insolvent development banks, and two additional contracts for the rehabilitation of each of the two existing commercial banks.

Voluntary staff rationalization scheme (vsrp)

Key issues

Major issues regarding the labor redeployment and voluntary retirement schemes of the project include the following:

- *Identifying the number of employees targeted for lateral transfer and/or voluntary retirement.* To get a true sense of the costs/benefits associated with the VSRP, extensive analysis must be performed to identify the extent of overstaffing. The total number of staff employed by both the central bank and the commercial banks must be clear, and the percentage of excessive staff targeted for the VSRP must be calculated. Alternatively, if severance is not considered a viable option due to fiscal risks, planners must develop a comprehensive and systematic set of priorities and guidelines for the lateral transfer of surplus personnel to other parts of the civil service, with their ultimate severance or redeployment packages determined within a broader settlement of civil service personnel and compensation issues.

- *Measures to mitigate the risks of insufficient compensation on the one hand, or excessive compensation and the revolving door syndrome on the other, have to be clearly developed.* First, any severance package might be insufficient owing to the larger cost issues involved not only in the banking sector but also in potential fiscal liability. This would result from government pressure to keep severance compensation low to ensure a low cost civil service severance package, introduced more universally. On the one hand, too few bank and DAB employees might voluntarily accept the option, keeping head count too high. On the other, the financial package might exceed a reasonable compensation level, not in line with the rest of the civil service. This latter development would add to the potential fiscal liability, and could lead to excessive exit of bank and DAB personnel. Finally, there is the risk of retired employees being rehired by the same organization or within the same sector, particularly if the severance package is viewed as very attractive and if too many critically needed staff depart. This risk could be managed by requiring that any voluntary severance package be administered on a lump-sum basis; participants would be required to sign contracts attesting to the voluntary nature of the scheme, and contractually requiring that full compensation be remitted should the individual be rehired. More generally, measures such as using a consultative process, having clear eligibility criteria, offering the correct compensation package, and considering political/legal/social issues will have to be considered.

More important, in light of the limited data and potential implications for the budget and civil service at large, a lateral transfer option from the DAB and banks to other parts of the civil service will need to be considered.

- *The absence of employment opportunities in the private sector will complicate the task.*

While some will seek retirement provided sufficient compensation is made available, and others will accept severance to start a business, many will hesitate to take a package of any sort because of the uncertainty of the marketplace right now. There are also nonfinancial issues to consider, including “status.” In some cases, people who are not suited for modern central or commercial banking will still choose to stay, even when compensation is higher elsewhere, because of the status associated with employment in the financial sector.

- *Management autonomy in the restructuring of banking institutions is essential if project objectives are to be achieved*. Management autonomy across the board is vitally important given that the AFSSP is focused on making the banking system more professional, competitive, and efficient so that domestic banks have a foundation that allows them to compete. On this basis, commercial banks will need to be reorganized as commercial institutions. Social considerations with regard to personnel management will need to be subordinated to these priorities and concerns. Thus, arriving at an acceptable solution that provides fair compensation for redeployed individuals, while also safeguarding management autonomy is essential.

• *Dealing with the issue of redundant employees is essential not only for the bank(s) to be restructured but also for the banks to be liquidated.* At a minimum, employees of banks whose licenses will be revoked will need to be reclassified. Under such circumstances, the procedures that apply to these employees should apply to employees of banks that will retain their licenses,

but who are subsequently declared redundant. In neither case should employment issues hold up restructuring or liquidation. At the same time, a transparent system needs to be in place to ensure these civil service employees have the possibility of finding an alternative assignment should they not choose a voluntary retirement option.

• *Delays in civil service reform make it more difficult to provide a precise package for voluntary labor redeployment in this project that is consistent with overall measures that will be taken in the public sector*. Efforts are under way to develop an overall program and plan, but these will take time. Meanwhile, the task is complicated by a number of other sensitive fiscal issues, such as weak revenue flows at the central government level and the consequent absent of a clear human resource plan that can deploy people according to the vast range of public sector needs. A database is still being assembled and verified, and longstanding problems persist with documentation efforts to verify skills, qualifications, years of service, etc.

• Elections scheduled for next year raise the risk that making bold decisions will be nearly impossible, particularly as private investment remains low and private sector employment capacity is essentially informal. Given the private market's current lack of absorptive capacity, the government is in the difficult position of trying to reduce its labor costs, assign responsibilities to individuals and ministries based on key needs, and simultaneously deliver services in an effort to restore the country's confidence in civil authority. Redeployment schemes at this juncture are politically risky and provide little or no benefit to the public. Even if such programs are essential for building a viable banking system and private sector economy, this is a time-consuming process that will not be significantly visible to the public at large by the time of next year's elections. Thus, the political risk associated with any VSRP that does not at least provide some financial resource cover is untenable.

- Among the most likely candidates for redeployment are those most victimized in recent years. The task is made even more because some of those who are least able to fulfill professional functions in banks or the DAB are those who have been deprived of education and other opportunities. This includes women whose access to public education was banned by the Taliban, as well as individuals who have been imprisoned over the years for political and other reasons. In many cases, these people will not be able to assume professional responsibilities in the financial sector.

General Range of Options

At the moment, there appear to be four broad options that could be pursued in seeking to deal with the issues noted above. These are described in the table and then discussed based on considerations of affordability, political acceptability, management autonomy, and impact on project implementation and effectiveness in achieving project objectives.

Option 1: **Attrition**: Proceed by freezing new recruitment and waiting for people to retire. This is certainly the least painful approach. But in a bank restructuring scenario, it has the potential of restricting management capacity to acquire the requisite skills for a more efficient banking services. It will also impede prospects for privatization.

Option 2: **Direct Layoffs with Minor or No Compensation**: This would clearly be affordable from a project and fiscal standpoint, and would enhance and reflect management autonomy. But given the limitations of formal private sector employment and the fragility of whatever safety net exists, this approach is the least socially and politically acceptable.

Option 3: **Full implementation of a market-based compensation scheme** predicated on the employee's age, years to retirement, experience, and needs for the bank. This approach would have major implications for future civil service packages the government budget may have to absorb. It would raise the risk of a significant contingent liability for the government should the package be used as a precedent for future severance payments to civil servants declared to be excess staff.

Option 4: **Interim transfer of staff to a government department or ministry**, until such a time that the Civil Service Commission has completed its work. Existing civil service rules require that staff being considered for redundancy join a surplus list maintained by the Ministry of Labor and Social Affairs for six months, while attempts are made to find them employment in other ministries. This amounts to moving employees, in some virtual sense, to the Ministry of Labor and Social Affairs (MOLSA), which then tries to place them in a government ministry. In all probability, MOLSA will not find another willing ministry or department— and so they will sit there.

sample selection criteria for *hawala* dealers

In selecting financially sound *hawala* dealers to work with, users apply a variety of selection criteria, some of which include the following:

Be registered with the central bank, Da Afghanistan: The registration process includes making a deposit with the central bank and paying an annual license fee. There are no further legal and institutional requirements with which money exchange dealers must comply. Although the central bank currently does not conduct fitness and probity tests of applicants nor determine the reasonableness of the applicants' business plan or assess the adequacy of the capital proposed for the business, this is an important first step at ensuring the operators' legitimacy.

Recognized by the Money Exchange Dealers Association: The market has an informal eight-member Executive Committee that meets regularly to discuss its members' affairs. The committee's executive director and his three assistants direct the activities of the Money Exchange Dealers Association and ensure that each member adheres to the association's unwritten rules of conduct and practices.

Membership to the association is voluntary and there are no subscription fees. Membership is also an additional indicator the operator legitimacy.

Maintain a physical presence at the Sari Shahzada in Kabul: The physical money exchange market, where most of Kabul's money exchange dealers are currently located, has an eighty-year-old history.

Established along side the Kabul River, it is situated close to the gold and silver bazaars and financial service to the meta l traders. Kabul's other specialized markets are all within walking distance of the market, where traders conduct and conclude their financial transactions. Operators with a physical presence at the market are likely to have a longer operational history than those who do not.

Authorized to deal in foreign currencies: New central bank and banking laws have been drafted and are expected to be passed soon. It is important that all transactions conducted through informal financial institutions are in compliance with these laws.

Be able to execute promptly a large number and volume of transactions : There is no limit on the volume of funds transfers the money exchange dealers of Kabul can transfer; individually or severally.

The NGOs alone are estimated to have channeled at least US$200 million in emergency, relief, and development funding through the *hawala* system. Single transactions in excess of US$500,000, especially between Peshawar in Pakistan and Kabul, are not uncommon. The larger international organizations and NGOs have made individual transactions of US$1,000,000. A basic assessment of the operator's operational capacity needs to be done before being contracted.

Agree to issue promptly a detailed monthly statement of funds transfer transactions: Contrary to common belief, money exchange dealers maintain comprehensive records for each *hawala* transaction.

The financial records the money exchange dealers maintain are detailed, and the entire process of remittance and settlement is very well documented. There are records of everything. Dealers know exactly how much cash they have, how much has been transferred, and how much is owed to them. It is important that the accessibility of these documents for users is improved through an agreed financial statement review process.

Have established a satisfactory domestic and international correspondent funds transfer network:

Regional money exchange dealers are generally situated located in a regional rather than village or provincial town or city and service more than one province. For example, Kandahar-based dealers may concentrate on the southern Afghan regions of Helmand, Oruzgan, and Zabol; the international dealers are mainly based in Kabul. They connect the domestic financial system to the rest of the world. Their counterparts are found in traditional trading cities on the Asian subcontinent: Tehran (Iran), Islamabad (Pakistan), and New Delhi (India); and in the Gulf cities and states of Riyadh (Saudi Arabia), Doha, (Qatar) Abu Dhabi, and Dubai (United Arab Emirates), and Muscat (Oman). The government needs to determine which operators are able to serve its interests.

Must have maintained an account in a formal commercial bank for at least five years: A relationship with a formal financial institution provides some measure of comfort about the probity of the money exchange dealer. Also, because banks are mandated to report any suspicious transactions involving client accounts, this measure provides additional oversight criteria. The money exchange dealer must provide the bank the authority to communicate with the central bank directly when providing the reference letter.

Charge reasonable fees for its services: The cost of making funds transfers into and around Afghanistan average 0 to 2 percent. As with every bazaar in South Asia, however, the final quotation depends on the negotiating skills of the parties and their understanding of how the market operates. Some money exchange dealers quote a flat fee of 2 percent on both international and domestic transactions. Yet this is usually only a starting point for discussion. Discounts and premiums are offered and charged depending on the volume of the transaction, the financial relationship with the relationship, currency of exchange, security environment in Kabul, and the destination of funds. The larger international organizations transferring US$200,000 or more per month pay less in fees than the local NGOs transferring US$7000 or less per month for their administrative expenses.

Sample operational procedures for *hawala* transactions

Nongovernmental organizations and international agencies that use the *hawala* system are keen to ensure that all *hawala* transactions include sufficient information to ensure an effective ex-post field review of documentation. Adequate documentation is often required to permit verification and comparison of the financial services provided and payments made by the operator. To that effect, users apply a variety of operational procedures, some of which include the following:

Obtain a written document stating the following:

(1) amount to be transferred;

(2) funds transfer destination;

(3) currency or currencies used for the transaction;

(4) expected date of payment; and

(5) fee chargeable for the transaction: Each *hawala* dealer designs, develops, and maintains his own documentary policies and procedures. Some of the procedures have been in use for many years and adapted to the changing business environment. Each business develops adequate systems that are sufficient for keeping track of transactions and balancing their accounts with international and domestic correspondent partners.

Establish monetary limits for individual transactions which reflect:

(1) capacity of the money exchange dealer;

(2) security situation at the origin and the intended destination of the funds, and;

(3) capacity of the recipient to maintain cash holdings on their premises: Because there are limited storage facilities in Kabul for large sums of money, most organizations remit funds through the hawala system in smaller amounts of US$100,000–US$200,000. The smaller organizations regularly remit US$20,000–US$30,000 to meet operational expenses.

Agree that the remitter will only pay the *hawala* service provider after

(1) the correspondent *hawala* service provider has made payment of the agreed amount to the intended recipient, and;

(2) The recipient has acknowledged receipt of the funds. The confirmation of receipt must be both verbal *and* in writing (fax or e-mail): The *hawala* system is extremely reliable. Seldom do dealers fail to effect payment. Besides the expected high standard of adherence to codes, default risk has been eliminated through the "confirmation-before-payment" process. In all cases reviewed during the study, the remitter paid the *hawala* dealer the value of the funds remitted only after the recipient had confirmed receipt of the money. There was 100 percent satisfaction rate with the delivery of funds. The isolated incidents of client dissatisfaction were limited to occasions when the customer paid a slightly higher fee than competitors were offering.

Agree that, with the exception of small transactions, all financial transactions must be conducted in a secure location, preferably on the premises of the remitting and recipient organization.

Carrying large amounts of cash around Kabul is not advisable, especially in a busy open market. *Hawala* dealers are often willing to come to the premises to collect/pay funds from/to the user/recipient.

Alternative remittance

Each country should take measures to ensure that persons or legal entities, including agents, that provide a service for the transmission of money or value, including transmission through an informal money or value transfer system or network, should be licensed or registered and subject to all the FATF Recommendations that apply to banks and nonbank financial institutions. Each country should ensure that persons or legal entities that carry out this service illegally are subject to administrative, civil or criminal sanctions.

Wire transfers

Countries should take measures to require financial institutions, including money remitters, to include accurate and meaningful originator information (name, address and account number) on funds transfers and related messages that are sent, and the information should remain with the transfer or related message through the payment chain.

Countries should take measures to ensure that financial institutions, including money remitters, conduct enhanced scrutiny of and monitor for suspicious activity funds transfers, which do not contain complete originator information (name, address, and account number).

Nonprofit organizations

Countries should review the adequacy of laws and regulations that relate to entities that can be abused for the financing of terrorism. Nonprofit organizations are particularly vulnerable, and countries should ensure that they cannot be misused:

a. by terrorist organizations posing as legitimate entities;

b. to exploit legitimate entities as conduits for terrorist financing, including for the purpose of escaping asset-freezing measures; and

c. to conceal or obscure the clandestine diversion of funds intended for legitimate purposes to terrorist organizations.

Abu Dhabi declaration on *hawala* (may 2002)

At a conference on *hawala* in the UAE in May 2002, a number of governments agreed to adopt the FATF recommendation and shortly thereafter, the UAE government announced it would soon impose a licensing requirement on *hawalas*. Participants at the UAE meeting drafted and agreed upon the Abu Dhabi Declaration on *Hawala,* which set forth the following principles:

Countries should adopt the 40 Recommendations of the Financial Action Task Force (FATF) on Money Laundering and the 8 Special Recommendations on Terrorist Financing in relation to remitters, including *hawalas* and other alternative remittance providers.

Countries should designate competent supervisory authorities to monitor and enforce the application of these recommendations to *hawalas* and other alternative remittance providers.

Regulations should be effective but not overly restrictive.

The continued success in strengthening the international financial system and combating money laundering and terrorist financing requires the close support and unwavering commitment of the international community.

The international community should work individually and collectively to regulate the *hawala* system for legitimate commerce and to prevent its exploitation or misuse by criminals and others.

World Bank–IMF Conclusions On *Hawala* Systems

Historically, Informal Funds Transfer (IFT) systems are relatively commonplace . Despite the

different terminology ascribed to IFT systems—*fei-ch'ien* (China), *hui kuan* (Hong Kong), *hundi* (India), *hawala* (Middle East), *pedal* (Philippines), and *phi khan* (Thailand)—their growth is primarily found in the monetary facilitation of trade between distant regions at a time when conventional banking instruments were either absent or weak. Over time, the operational features of speed, low cost, and cultural convenience, versatility, and potential anonymity led to their use for various legal and illegitimate remittance purposes.

***Hawala* typically thrives in jurisdictions where the formal banking sector is either absent or weak, or where significant distortions exist in payment systems as well as foreign exchange and other financial markets**. Generally, except for cases where use of the informal sector is for illegal or criminal purposes, the growth of informal funds transfer systems seems to be negatively correlated to the level of development and liberalization of the formal financial sector. The study found that these systems are more likely to be prevalent in jurisdictions where the formal banking sector is either virtually absent or not functioning, as is sometimes the case in postconflict countries, or does not provide a reliable, cost effective, and convenient mechanism for the transfer of funds. Where these conditions exist in recipient countries, the system can be particularly used for migrant labor remittances, humanitarian, emergency, and relief aid in countries experiencing conflict. The attraction of informal operators is also likely to be heightened in countries where inefficient banking institutions operate in an environment of financial policies that include foreign exchange controls.

Illegitimate use of *hawala* could occur regardless of the level of development of the financial sector.

In cases where the user's intent is illegal or criminal, resort to informal financial systems will occur irrespective of a country's level of financial sector development. Although both the formal and informal financial sectors are vulnerable to abuse, the potential anonymity that *hawala* offers its users renders it susceptible to smuggling activities, capital control circumvention, customs, excise and income tax evasion, money laundering, and the financing of terrorist operations. These crimes are not new, and as a consequence law enforcement agencies have long been concerned about IFT and *hawala*. For financial sector regulators, however, legislation against financial crimes is a relatively recent phenomenon. In drafting new international standards against financial crimes—registration, licensing, reporting and record-keeping requirements—financial authorities also need to consider the settlement process between *hawala* operators and the economic and regulatory implications of *hawala*-type systems.

The nature of the *hawala* settlement process has implications for economic and regulatory policies.

Developing appropriate responses to IFT systems requires a clear understanding of both the remittance and settlement analytics of *hawala*. Essentially, the accounting details of these transactions are similar to other kinds of international payments, including those that go through the banking system. Like *hawala*, when effecting transfers, banks do not necessarily move physical cash between branches or correspondent banks. The main difference between *hawala* and formal institutions is that the subsequent settlement of *hawala* accounts usually remains outside formal operating channels that are regulated by national authorities.

Because *hawala* transactions are unrecorded in national accounts and other statistics, the data available to policymakers would not offer an accurate description of the economic and monetary situation of a country and would tend to limit the effectiveness of their policies. A *hawala* transaction is a balance-of-payment transaction, not because "money is sent" across borders or there is any recorded purchase or sale of foreign exchange, but because the transaction is intrinsically linked to changes in international assets and liabilities. Although *hawala* and other IFT transactions are conceptually part of national BOP accounts, accurate compilation is almost impossible. Nevertheless, even though national authorities are unable to directly maintain records of informal financial transfers, the indirect effects of these transactions on monetary aggregates and operations, as well as on the balance of payments, should be taken into consideration. The system reduces the amount of statistical information available to policymakers on the level of economic activity in the country.

IFT systems have fiscal implications for both remitting and recipient countries. First, *hawala* operators are typically not taxed. The revenue collection structures required for informal financial business do not exist. Second, the business activities of IFT users are also likely to evade direct and indirect taxation. Third, since the settlement of accounts between *hawala* operators may include under invoicing and smuggling of goods and services, the government may also incur losses in its customs and excise duty income.

IFT transactions cannot be reliably quantified since accessible records are scarcely available for statistical or BOP purposes. Despite this limitation, certain considerations can be made of the dimensions of IFT transactions, and there are some approaches to quantification that can give indicative results. Although these results are rough simulations, they indicate the significant monetary and fiscal implications of IFT systems.

Current regulatory and supervisory practices vary between *hawala*-recipient and *hawala*-remitting countries. Overall, the study found distinct differences in the regulatory and supervisory responses toward *hawala* in recipient and remitting countries. In recipient countries, concerns over foreign exchange management, capital movements, the quality of the formal financial sector, and the level of political stability have been important influences on the regulatory attitude toward the system. *Hawala*-remitting countries, however, tend to have fairly liberal foreign exchange policies and developed financial sectors.

In these countries, the regulatory and supervisory interest primarily stems from concerns about their potential criminal abuse and terrorist financing.

Emerging approaches to international standards need to sufficiently take into account specific domestic circumstances. In the wake of the recently heightened concerns that money launderers and terrorist groups use IFT systems, the number of national and international regulatory initiatives to license or regulate their activities has increased. A number of countries have decided that the potential anonymity of these systems presents risks of money laundering, terrorist financing, and other law enforcement concerns, which preclude a policy of benign neglect. This said, the study cautions against the application of emerging international standards without due regard to specific domestic circumstances. Developing international regulatory and supervisory standards for informal funds transfer systems is a complex process. Differences in the stages of economic development in general, and the financial sector in particular, imply that national regulators need to give careful consideration to country-specific circumstances and national legal systems.

Regulators must bear in mind that prescribing regulations alone will not ensure compliance .

Regulations are not a panacea for possible abuse of the IFT systems. Specifically, regulators need to possess the appropriate supervisory capacity to enforce the regulations. Also, they must bear in mind that experience shows that restrictive methods will not drive out all businesses involved in unlicensed financial transfer activity from the market. The informal banking system can not be completely eliminated by means of criminal proceedings and prohibition orders. Policymakers should acknowledge the existence of practical reasons, from the customer's point of view, to resort to informal methods for international payment purposes. As long as such practical reasons exist, *hawala* and other IFT systems will persist.

For purposes of long -term financial sector development, addressing the potential risks of financial abuse and criminal activity requires a two-pronged approach. In the majority of countries, where IFT systems exist alongside a functioning conventional banking sector, it is recommended that *hawala* dealers be registered. In these systems, additional efforts should be made to improve the level of transparency by bringing them closer to the formal financial sector without altering their specific nature. Simultaneously, the regulatory response must address the weaknesses that may exist in the formal sector. The formal and informal financial systems benefit from their mutual deficiencies and each tends to expand when the condition of the other is impaired. High transaction costs, long delays in effecting money remittances, exchange controls and overly bureaucratic policies and procedures for simple money transfers in the formal system are major incentives for the existence of the informal financial system. To face the challenge, the formal sector should tackle its deficiencies and enhance its competitiveness. In conflict afflicted countries with no functioning banking system, imposing requirements beyond basic registration may not be feasible because of the lack of supervisory capacity.

Clearly, the development of various informal funds transfer systems over many years and across many countries points to the important role these systems can play in the absence of a robust and efficient formal financial sector. Considering the informality inherent in these systems, particularly the anonymity and the lack of records, it is clear that risks of misuse exist. The development of the ability of the formal financial sector to respond to the legitimate market demand for *hawala*-type transactions, coupled with prudent regulatory policies for *hawala* operators, requires sound and sustainable macroeconomic policies, a well-developed payments system, and a healthy financial sector.

Notwithstanding the progress apparently made by the formal sector in expanding its activity at the expense of informal activity, these gains are not definitive and can easily be reversed. Poorly functioning financial systems, or simply the deterioration in financial or macroeconomic conditions, could produce greater recourse to informal payment systems. A setback in financial and exchange liberalization or the rise in the exchange spread between official and parallel market exchanges can always induce more IFT activity.

Formal banking-style regulation and supervision

Given the country's socioeconomic and political conditions, a comprehensive extension of existing banking regulations and supervision practices to the money exchange dealers was not a realistic option. Such practices affect four key areas: licensing requirements,38 customer identification,39 suspicious activity reporting,40 and record keeping. 41 In the first instance, regulatory requirements beyond basic registration are not feasible in countries that have inadequate or nonexistent supervisory capacity. As noted earlier, Afghanistan's central bank faced several basic but fundamental challenges when the Taliban regime fell—all of which made regulating the *hawaladars* less urgent by comparison—loss of key personnel, weak reporting framework, both in the central bank itself and between the bank and other institutions, lack of office automation, and the seriously damaged physical infrastructure weakened the supervisory capacity of the bank. Even when compared with other conflict-afflicted countries, Afghanistan's authorities face great challenges.

38 Bank licensing requirements are designed to prevent the control or significant ownership of financial institutions by criminals or their associates. In determining the

suitability of applicants, regulators need to consider, first, the skills and experience commensurate with the intended activities, and, second, records of criminal activities and adverse regulatory judgments.

39 Effective customer identification and due diligence enforcement require two complementary activities. First, in cases where money remitters are registered or licensed, the authorities must regularly communicate new legislation, regulations, and other guidance on customer identification, and provide appropriate training. Second, the regulators need to ensure that money remitters accurately record the transaction details of their clients, namely, the name and address of remitter and recipient, type of remittance, amount and currency involved, and other relevant details. The records must be properly maintained and made available for inspection by regulators.

40 Requirements for reporting suspicious activity compel banks to have procedures in place to recognize, record, and report potentially suspicious transactions. The procedures ensure that staff members pay special attention to all complex, unusually large transactions, and all unusual patterns of transactions that have no apparent economic or lawful purpose, especially where funds are suspected to proceed from criminal activity or to be intended for the financing of terrorism. Often the law requires banks not to inform clients of their actions, but instead to cooperate with the regulators or law enforcement agencies, who may be required to further investigate the transactions' background and purpose.

41 Record-keeping requirements make it mandatory for banks to maintain records regarding customer identification and individual transactions for a reasonable period, typically not less than five years. For this requirement to be enforceable, the legislation,

regulations or guidance notes should define which identifying documents are to be maintained and the minimum period the records are to be maintained. At a minimum, the records should be such that regulators and law enforcement agencies will be able to reconstruct individual transactions. **Self-regulation and supervision**

A World Bank study conducted in 2002 suggested that at the time it might be most feasible for Afghanistan to implement a self-regulatory and supervisory framework, instead of pursuing a banking style model for the sector. Self-regulation and supervision at least offer an interim solution. The suggestion was made of the premise that the *hawala* dealers' association had an executive committee responsible for enforcing the tacit rules and business codes of the market. The executive committee was also responsible for the amicable settlement of disputes. The police and the committee rarely intervened in the day-to-day affairs of *hawaladars*. The committee charged no fees for its services, and its appointed members were not salaried or otherwise compensated.

The report also encouraged, however, a move toward formal, written rules and, which offered four advantages. First, if money exchange dealers perceived a tangible value from registering with the association, more might volunteer to register and be identified. Second, dealers operating under formal rules might be better equipped (than external authorities) to identify the *hawala* practices in particular need of regulation and supervision. Third, under formal rules, regional or local association committees might be in a better position to share the administrative and financial burdens of checking compliance.

Finally, regulations and standards designed and administered by the *hawala* dealers themselves might work to bring them closer to the formal financial system (whereas rules imposed by external authorities might push the system further underground). As with all self-regulating bodies, however, there is a high risk of self-serving regulations, perverse incentive structures, and regulatory forbearance.

Special regulations and supervision techniques

A fourth option was to create special regulations and supervision practices that render business practices more transparent without sacrificing *hawala* 's most valuable attributes: cost-effectiveness, convenience, and regional reach. Such regulations might have some or all of the following characteristics:

Hawala dealers would be registered, but not licensed. The central bank could continue its current policy of registering dealers in Kabul. Beside normal business registration procedures, money exchange dealers would not have to comply with further legal and institutional requirements. Registration could be extended to the provinces, and the central bank could refuse registration only if an applicant provided false information, failed to produce the documentation required by law, or did not pay the registration fee.

The bank would not conduct fitness and probity tests of applicants. Nor would it seek to determine the reasonableness of the applicant's business plan or the adequacy of the capital proposed for the business.

Dealers would be required to identify customers and record or copy evidence of identity and address. In particular, the central bank would ask that dealers bear the responsibility for determining suspicious activity regardless of the funds involved, and for keeping sufficient documentation to ensure customer identification. However, the DAB would not prescribe the type and form of documents that dealers must maintain, or the minimum amount above which a suspicious-activity report must be prepared.

Dealers would adhere to a mechanism to facilitate investigations when the need arose. The regulations should not require ongoing regulatory and supervisory oversight from the central bank. Instead, authorities would retain the right to obtain access to records whenever reasonable grounds existed for believing that an offense had been, was being, or was about to be committed.

Overall, regulatory and supervisory requirements for *hawaladars* would be introduced gradually, in coordinated steps, and in close collaboration with the Money Exchange Dealers Association.

Strengthening The Legal And Regulatory Framework And Regulatory Capacity

In the short to medium term, a strong legal framework is a priority for Afghanistan. Sustainable financial sector growth and stability require a framework based on strong creditor rights. Weaknesses in the legal and judicial framework governing commercial contracts and their enforcement, and the slow and biased court system, are common problems in developing countries, particularly postconflict ones. Developing an appropriate legal environment for financial sector development will require attention to the following actions in the short term.

- *Central bank* : The recently passed central bank and commercial banking laws need to be augmented with specific prudential regulations for monitoring bank performance with respect to capital adequacy, asset quality, liquidity, and loan classification. Simultaneously, the ability of bank supervisors to conduct on- and off-site inspections should be strengthened.
- *State commercial and development banks*: Until the state banks are privatized, the central bank should focus its reform efforts on strengthening corporate governance

structures through a variety of options including: guidelines for the appointment and dismissal of managers and board members, new organizational structures, revised credit policy and controls, new procedures for credit-risk evaluation, improved internal documentation and monitoring systems, enhanced asset/liability and treasury-management techniques, and automation.

- *New commercial banks*: Afghanistan needs stronger criteria and procedures for bank licensing; these would provide for more detailed assessment of new banks' ownership and management structures, their operating plan and internal controls, and their projected financial condition, including their capita l base. If the new bank is foreign, it is good practice to obtain prior consent from the home country regulator.

CHAPTER FIVE

ISLAMIC BANKING

There are now (2005) some 250-300 Islamic banks active in the various countries of the world. These countries, mostly Islamic ones, also include non-Islamic countries. The exact number of Islamic banks engaged in interest-free banking throughout the world is quite difficult to ascertain, as some institutions that practice Islamic financial modes and procedures can not strictly be labeled as "banks", according to the current accepted definitions, though they can be classified as financial "institutions". Furthermore, some reputable international conventional (interest-based) banks, like Citibank Group or the HSBC, offer their customers interest-free financial products and services, while many Islamic "Funds", that owing to legal inhibitions can not be classified as banks, perform interest-free financial operations that are similar to Islamic banking practices. Unofficial estimates put the number of Islamic banks that offer a full range of banking services at around 250, growing by 10-15 percent annually. Their assets are estimated at about $200 billion, rising by some 10 percent each year.

1. A GLOBAL DEFINITION

A global definition of what constitutes Islamic banking practices is not a universally-held or widely-agreed proposition: some experts regard an Islamic bank as a financial institution that directly employs investors' funds in the various investment channels that exit, either in the real product markets or in the capital markets. Within this framework, the bank, in its own right, utilizes investors' funds, under one or more of the Islamic modes of contract. Thus the said bank can enter into joint partnership agreements with the client to finance joint ventures and to establish factories or workshops (direct investment), or alternatively, it may act as a mutual fund or unit trust, to buy shares and securities in on-going or newly-established companies. In either case, the Islamic bank becomes an investment company par excellence, not acting as a liaison between depositors and potential seekers of investment funds, but directly investing the surplus capital of holders of such funds. In the opinion of these scholars, potential investors with surplus funds fully realize the risks involved in any business venture, and in search of a higher rate of return on their funds, they are prepared to venture into any risky business proposition. Thus there is no need for them to have an intermediary, with the consequent rise in risk and expenses. They can deal directly with the investment company (bank) and avoid the problems and expenses that such unnecessary intermediation inevitably entails.

Other Islamic thinkers regard the Islamic bank as a financial intermediary, or a monetary institution, acting solely as an attorney to the depositors, placing depositors' funds at the disposal of potential investors. Within this definition, the bank should act solely as an intermediary, relying on its network of information-gathering branches, to select reliable investment partners, and subsequently channeling depositors' funds towards profitable ventures by making them available to potential investors, who conclude interest-free contracts with the bank. The bank thus employs the various Islamic modes of finance in such contracts and ends its intermediation as soon as possible, after expiration of the contract.

Still, some other scholars consider both functions as legitimate areas of operation for Islamic banks. Many Islamic banks now gravitate towards this third category of comprehensive operations. Islamic banks from this perspective are thus multi-functional banks, offering all the services rendered by commercial, merchant, investment and development banks, but on an interest-free basis, and within the constraints laid down by the Islamic law (Shariah). Within this definition, Islamic banking covers a full range of financial activities, both short-term and long-term, that the concept of "universal" banking entails.

It may be noted that while the first category of operations more resembles that of investment or merchant banking, the second set of activities is more akin to the traditional commercial banking operations, with the Islamic and the traditional commercial banks both acting as financial intermediaries, but with the crucial difference that while the former, in fulfilling its intermediary role, employs the rate of profit under the accepted Islamic modes of finance, the latter utilizes the rate of interest in performing financial intermediation. It may further be added that the training requirements and the expertise needed for each of the two categories of operations entail different ingredients: The Islamic bank, under the first category, becomes a direct, or a portfolio-investment company, requiring an intimate knowledge about the running of a company or a factory, the entrepreneurship, technical knowledge of the operations, close involvement with shares and securities, etc. Under the second category, the Islamic bank is only a financial intermediary.

In performing financial intermediation, however, the Islamic bank, after selecting a credit-worthy client-partner and securing an appropriate collateral, relies mainly on its partner's skills and business know-how. Thus the kind of expertise and know-how needed here is different: not so much a close familiarity with inside business operations, but an ability to search for and select, first a potentially lucrative business area and second, a reliable, creditworthy partner-client with considerable business acumen. Another important point is that while the former category gravitates towards longer-term operations, the latter will mostly aim at short-term ventures. A further point to note is that while the traditional (Western-style) commercial bank grants a secured, interest-based loan to the borrower, mostly irrespective of the channel of utilization in which such funds will be put later on by the borrower, the Islamic commercial bank is expected to ascertain the exact end-use of such funds, to make sure that it conforms to the requirements of the Shariah (Islamic laws).

PROBLEMS OF INTERPRETATION

It may be said that as currently practiced all over the world, Islamic banking is not a monolithic system of universally-applied precepts. Problems relating to the interpretation of the Islamic law and snags created by taxation and banking regulations designed to safeguard depositors' funds (principals) and ensure liquidity, have yet to be ironed out. Major subjects of debate, in addition to those referred to above, are the legality within the framework of Islamic law, of various dealings and transactions, such as currency speculation (eg. gold and silver being commodities or currency), commodity dealings and inventory finance. Furthermore, partly because of such definitional interpretations and differences, some of which are still unresolved, a major part of the operation of many Islamic banks has tended toward short-term trade and real-estate financing. Despite such differences in interpretation, however, most Islamic scholars agree that Islamic banking operations possess at least three features:

(a) Avoidance of charging or receiving usury or interest, i.e. any pre-determined addition over the principal amount of the debt. Some controversy has arisen among the Islamic scholars as to whether interest refers to any addition over the nominal or real value of debt, with the majority accepting the nominal amount as the basic norm, over which any addition would constitute usury.

(b) Carrying an element of business or transaction risk, to justify profit-sharing (in addition to the usual credit risk)

(c) Operating in lines of activity that strictly conform to the Shariah (i.e. activities that enhance the moral and material well-being of the society).

2. TECHNIQUES

The various techniques used conducting Islamic banking operations can be summarized under at least four major headings.

- First, short-term financing instruments (Murabaha, and in the Islamic Republic of Iran, Installment Sale and similar modes) are cost-plus (margin-of-profit) arrangements, whereby a bank purchases goods at a client's request and resells them to the client at a higher price, on a deferred payment basis. Murabaha (installment sale contract) has hitherto been the leading source of profit among Islamic banks. While functioning on a rather similar basis as short-term loans advanced by traditional banks on the basis of interest, it contrasts with conventional banking practices in that the bank temporarily holds title to the goods, thereby adding an element of commercial (business) risk to the operation. In some countries where Islamic banks operate side-by-side with conventional Western-style banks, because of value-added and transfer taxes that are twice imposed due to the nature of such contracts, the cost of goods acquired under such arrangements have soared.

- A second category of techniques is based on partnership, or Musharakah. These are joint venture investment contracts in which banks and clients jointly provide equity, with the client being responsible for management services, and with the losses (and not necessarily profits) divided on a pro-rata basis. This mode of Islamic financing which, from the vantage point of the bank, is more risk-prone, is more favored by Islamic thinkers in obvious preference to the first category, on which doubts have been expressed by some Ulema (Islamic jurists), as to its similarity, if not in form but at least in substance, with the loan operations of a traditional commercial bank. However, in practice, Musharakah contracts have not yet been widely utilized by Islamic banks, for three major reasons: First, they involve a basic, unfamiliar venture by the Islamic bank into as yet an unknown territory, about which the normally trade-oriented bank has little grasp and even less experience and expertise; meaning therefore a near-total reliance by the bank on its clients' business acumen and managerial skills. Second, the longer-term nature of such operations affects the Islamic banks' liquidity profile, carrying them away from the realm of traditional commercial operations which are mostly short-term and more liquid, towards development banking which has a longer time frame and is inherently less liquid in nature.

- Third the joint-venture's profit (or loss) is not known in advance, adding to the banks' uncertainty.

A similar investment instrument is Mudharabah (trusteeship), and other aligned modes of financing. Under the terms of Mudharabah, the bank provides the capital and bears the full risk of loss, while the client acts as trustee, availing his expertise and managerial skills in the operations. Profits are divided on a pre-determined basis as defined in the contract. Losses are borne exclusively by the provider of capital. In Iran, Mudharabah contracts are solely used in trade and commercial operations. According to the 1983 Usury-Free Banking Law, Iranian banks may not enter into Mudharabhah contracts with private-sector importers. Under this category, final profits are not known in advance. An "interim" profit rate is stipulated in the contract pending the outcome of the joint venture.

The third category of operations is Ijara, or leasing (hire-purchase) contracts, under which the user may ultimately purchase the rental item. The bank will purchase a building or a machinery for the client and leases the item to him. The client has the option to buy that item at the end of the lease contract, or the contract may make such a purchase mandatory. In Iran, where such a repurchase by the client used to be mandatory, pure leasing (without an obligation to buy) has only recently been introduced to finance the growing consumer goods market.

Finally, there is the usual interest-free lending operations, under the name: Qardhal-hassanah, or beneficent loans, which are advanced mainly on humanitarian grounds. With the present-day complexities of the modern financial markets, other modes of Islamic financing are keenly needed to take care of such essential banking operations as overdraft facilities, inter-bank loans, over-night markets, etc.

An Islamic bank's balance sheet should not normally record deposits as a liability (except for Qardhal-hassanah deposits that are extended on the basis of lender-borrower relationship, are guaranteed and receive no profit), whereas the basic tenet of the international banking system is the immunity of depositors' principal to risk. The consequence of the inherent difference in the interpretation and execution of the banking formula (security, liquidity and profitability) is that in some Western countries such as Great Britain and the U.S., Islamic financial institutions are not permitted to call themselves banks (financial intermediaries) whereas they are free to operate as investment companies, if they abide by the relevant rules and regulations.

In the Islamic Republic of Iran and Sudan, where Islamic banking is the sole mode d'emploi, practiced nationwide and within a regulatory framework, temporary exceptions have been made to the prohibition of guaranteed minimum yields and redemption of the principal amount of deposits, so as to give depositors a measure of security, thus smoothing the way of the Islamization process during the period of its introduction.

Interest-free banks in some other countries operate outside the regulatory framework of host and home countries and are exempt from the rules applied to conventional banks. In Turkey and Malaysia, a dual banking system is in place, with a few Islamic banks co-existing with a predominant conventional system, with the former operating under a separate regulatory and legal framework.

3. APPRAISAL OF THEORY AND PERFORMANCE

Islamic banking is a relatively recent phenomenon and any objective appraisal of its performance must necessarily be based on tentative considerations. From a theoretical angle, the picture is more clear: Studies so far undertaken by international organizations, and specially by the scholars of the International Monetary Fund, demonstrate that the system has considerable merit from an economic standpoint (5) and may well turn out to be better suited to adjusting to shocks that prompt banking crises (6). Further theoretical studies have shown that there is no fundamental change in the way monetary policy affects economic variables in an Islamic economy, and the monetary authorities can change the stance of monetary policy, using the available monetary instruments, in the same way the conventional central banks may affect monetary policy, employing the discount rate and the open-market operations (7). Some scholars have advanced the idea that exchange-rate stability, non-inflationary and full-employment growth are indispensable ingredients of any macro-economic policy in an Islamic state, though there is not a consensus on this issue. International studies have also demonstrated that an Islamic banking system can be more stable (8) than a banking system based on the rate of interest. The non-availability of some of the traditional instruments of monetary policy should not pose any serious problem in conducting an effective monetary policy provided that the generation of high-powered money is appropriately regulated at source.

With regard to the performance of Islamic banks operating in interest-based environments, the records have so far proved satisfactory. Although up-to-date information is not readily available, the existing data suggest a positive overall performance. A comparison of general profitability and rates of return on depositors' funds shows that Islamic banks have fared well, despite competition from interest-free and interest-based banks. International Islamic investment banks such as the Kuwait Finance House (founded 1977), Dar Al-Maal al-Islami (1980) and Al-Baraka Group (1983) have been successful in attracting investment funds and maintaining overall profitability, despite the presence of competition. Actually, the presence of competition has strengthened their efficiency. Individual banks, however, have faced problems in the past. For example, in 1983-4, the Kuwait Finance House which had concentrated most of its assets on real estate and trade finance, had a relatively poor result, owing to the collapse of the unofficial stock market in Kuwait and the war in the Persian Gulf. As a result, it could pay neither dividends to share-holders, nor a share of profits to depositors. The Dar al-Maal al-Islami has also faced problems in the past owing to its unsuccessful dealings in bullion and precious metals, whose prices have fluctuated widely in international markets. These problems, however, have been sporadic and have actively helped Islamic banks to gain effective experience. As a result of the experience gained, the trend in Islamic banking is now toward diversification of short-term investments toward medium and long-term ventures, which generate little income at the outset, but pay off substantially in the long run.

4. RISK-AVERSE CLIENTS

Islamic banking is a risk-based industry which, if implemented correctly, should greatly appeal to risk-prone individuals and institutions. There are, however, millions of risk-averse clients all over the world who shun taking risks and are only looking for risk-free, low-return investment instruments to protect their purchasing power against the inroad of inflation. Such instruments are scanty in the Islamic banking industry. Therefore there is a great need for Shariah-compatible new investment products and processes to be designed and offered to the markets. These financial-engineering products are lacking in Islamic banking and this has adversely affected their effective competition with conventional banks.

Other areas where progress should accelerate is establishment of money and inter-bank markets compatible with Shariah requirements. Lines of credit granted to checking-account depositors, the over-night markets, credit card business and other modern day banking instruments are not fully developed in the Islamic banking industry, with the effect of preventing Islamic banks from competing on an equal footing with conventional banks. However, some progress has been made in recent years, but much remains to be done.

In the Islamic Republic of Iran, where a complete switch-over to interest-free banking was undertaken in 1983, the experience of the last few years suggests that while there has been a general acceptance of the new modes of financing by the public, as measured by the continuous rise in private-sector non-interest-bearing deposits, the transition to the new system has been relatively smooth[(9)(10)] , with non-interest-based modes of financial resource allocation replacing the interest rate mechanism, with no disruption to the stability of the system or the effectiveness of monetary policy. Nevertheless, problems exist that need to be tackled: re-training of bank personnel has proved a major problem. The acceptance of new Islamic financing instruments by the public, in lieu of the rate of interest, has also proved slow and time-consuming, owing mainly to the complexity and multiplicity of such instruments and the related regulations and procedures. A discernible trend in banking operations has been a preference toward short-term asset concentration, rather than longer-term ventures and toward large-scale business ventures, at the expense of small business. In the area of macro-economic policy, problems emerged in devising appropriate non-interest-based instruments for financing development projects and the government budget deficits. In Iran, this problem has partly been resolved by the introduction of Musharakah (participation) papers to fund long-term state and private-sector infrastructure and development projects, and also to finance budget deficits. Also in Iran, a separate interest-free banking law has helped to institutionalize the banking operations. In the other Islamic countries (except in Sudan, Malaysia and Turkey) Islamic banks have to conform to the conventional banking norms and rules. This has sometimes proved difficult to follow.

5. CHALLENGES AHEAD

One problem is for the Islamic banks to find suitable investment outlets for their large volume of deposits, suitable in the sense of being profitable while conforming to the requirements of the Shariah. Currency fluctuations have also proved burdensome, underscoring the banks' need for qualified personnel who can utilize standard foreign exchange techniques. Standardization of procedures, to avoid different interpretations of investment vehicles, is also needed.

The state ownership and management of the banking system, wherever it is practiced, has overshadowed interest-free banking operations, which is fundamentally a market-oriented, private sector practice. In Iran, until 2001, the entire banking system was fully state-owned. The inevitable red-tape and bureaucratic entanglements put their negative mark on the interest-free aspect of the system. With the establishment of private-sector banks in Iran in 2001, six such banks have so far opened offices for business, or are currently awaiting licenses. Their presence in the banking system of Iran is still modest compared with the dominant role of the state banks, which still account for some 93 percent of all deposits. But despite their nascent presence, private-sector banks have injected a modicum of competition into the banking system, which will hopefully accelerate competition with the passage of time.

Taking a global perspective, there is no doubt that, notwithstanding the problems and shortcomings, Islamic banking and finance has an established and promising future, given that there are some 55 Islamic nations in the world, with millions of Muslims living in non-Islamic countries. A good question to ask, however, is: to what degree will Islamic banking penetrate non-Muslim markets, and how will the differences between non-interest banks and conventional banking systems be reconciled? International bankers agree that so far Islamic banks that operate in a conventional setting have tended to compete more against one another, rather than against conventional banks, because they are not appealing to, or catering for, the same markets [(11)]. In the long run, therefore, ways and means have to be found so that Islamic banks can develop Islamic-based techniques to fund the overnight market, the inter-bank operations and the consumer credit needs, as well as other conventional banking practices.

The problems of the savings and loan institutions in the U.S. (early 1990's) once again underscored the applicability and advantages of the principle of profit-and-loss sharing, in avoiding banking crises [(12)]. In an international setting, the debt problem of the developing countries is sometimes being tackled partly by making use of the debt-for-equity swap, a mechanism which is based on a debtor-creditor sharing arrangement, with creditors swapping their interest-based claims for debtor-country equities, thus sharing in the profits and loses accruing to the joint venture. In short, there are many features of Islamic banking that appeal to a conventional non-Islamic financial system.

A second issue to consider is whether in the short run, steps should be taken to circumscribe the activities of Islamic finance institutions in accordance with national regulations, or for the international banking community to adopt a set of regulations applicable to non-interest banks. In some countries, like Turkey and Malaysia, special legislation has been enacted to provide a legal framework for Islamic finance institutions. In some other countries, non-interest banks operate outside the regulatory frameworks of host and home countries and are exempt form the rules applied to conventional banks. In Denmark, however, an exception has been the establishment of the Islamic Bank International, which adheres to the national banking laws. In Great Britain a fully-fledged Islamic bank was established last year (2004) under the existing conventional-banking rules and regulations.

Some international bankers have advanced proposals in order to accommodate non-interest banks in the conventional financial setting of the world. These proposals include higher minimum capital requirements, stricter limits on capital-to-deposit ratios and greater liquidity. There are other attempts to incorporate Islamic banking in the international financial network. Indeed some conventional Western mega-banks have opened Islamic banking "windows" in their branches to accommodate the wishes of their Muslim clients for interest-free banking.

The next few years may prove to be further periods of transition and evolution, as the recently-institutionalized Islamic banking copes with the new innovations and advances in international banking. As more experience is gained and greater know-how is acquired, more sophisticated Shariah-based instruments will have to be devised to consolidate the Islamic banks' already prominent place in international finance.

CHAPTER SIX

THE MICROFINANCE INDUSTRY

Traces the growing importance of microfinance institutions (MFIs) in providing capital to small and medium-scale enterprises (SME) to strengthen their businesses, and small loans to families to improve their livelihoods. This chapter details the state of the microfinance sector at the end of the Taliban regime, discusses the reforms of 2002–03, and concludes with recommendations on how to strengthen the sector and increase its contribution to private sector development. Providing innovative financial services to the poor can be effective in countries like Afghanistan, where most families consider themselves too poor to use conventional financial services from formal banks.

The microfinance sector after the fall of the Taliban regime

The demand for microfinance services in Afghanistan is huge, because few entrepreneurs generate sufficient income internally to reinvest in their business. And where there is a paucity of formal banking services the informal sector fills the vacuum, providing the main source of financial services for the majority of people. The overall lack of capital is a key constraint to micro- and small-business growth, while rural indebtedness is a serious problem in poppy growing areas.

The principal sources of credit in urban and rural areas are shopkeepers, traders, landlords, moneylenders, family, and friends. With the collapse of the formal financial sector, people lost access to finance from commercial banks.

As of May 2002 the supply of microfinance services was extremely limited. A World Bank assessment of some 20 local and foreign nongovernmental organizations (NGOs) that offered, or planned to offer, microfinance activities found that, together, the NGOs had a total outstanding loan portfolio of US$1 million and served just 12,000 clients—a tiny percentage of potential demand.

Overall, the microfinance sector provided financial services where the formal banking sector was clearly failing. Because of the scale of the humanitarian disaster in Afghanistan, none of the NGOs specialized in the provision of microfinance services exclusively. Many were in providing other social services and business support services. Unfortunately, the microfinance experience in Afghanistan has not been well informed by lessons learned from experience elsewhere in the world.

Most NGOs active in Afghanistan have treated microfinance as a charitable undertaking, appearing less concerned about the sustainability of financial services for the poor. The focus on end-clients, instead of the institutional-level clients, led to low repayment rates and very limited outreach. A number of microfinance service providers, recognizing the need for sustainable service delivery, started to be more aware of cost-effectiveness, efficiency, and the possibilities of lending on a cost-recovery basis while not violating Islamic principles. Few microfinance programs, however, incorporated what are considered good practices in microfinance.

Microfinance reforms in 2002–2003

In 2002, the microfinance sector attracted widespread interest among Afghanistan's international and bilateral partners keen to support SMEs. All highlighted the importance of micro-enterprise in helping to revitalize the economy. The lack of information about such enterprises, however, and about how best to support them, led to cautious investment. In mid-2002 no donor was financing microfinance-specific activities, and few had developed concrete plans to support microfinance. Most donors focused on conducting assessments to get a better handle on the state of the industry, notably:

- *International Finance Corporation (IFC):* The feasibility of a business plan to establish the First Microfinance Bank of Afghanistan in partnership with the Agha Khan Fund for Economic Development (AKFED)
- *U.S. Bureau of Population, Refugees, and Migration (PRM) and USAID:* Received proposals from some of the leading U.S. NGOs planning to start microfinance programs.
- *Asian Development Bank:* Assessment of the state of the old Agricultural Development Bank for purposes of revitalizing SME loans for the agricultural sector.

In May 2002 the World Bank and the 28-member Consultative Group to Assist the Poor (CGAP) joined the list with a study on the feasibility of establishing a national microfinance institution to provide financing and technical support for microfinance development. Their efforts resulted in the creation of the Microfinance Support Facility for Afghanistan (MISFA), which is :

- Coordinating investment for microfinance by establishing a mechanism to channel donor funds to microfinance providers within a sector wide development framework.
- Establishing well-structured financing for the start-up and development of sustainable microfinance providers, including financing for institution building and loan-fund capital
- Providing or fund training and advisory services to microfinance providers to build their institutional capacity to deliver high-quality services.
- Promoting good microfinance provider performance and transparent operations by working with practitioners, donors, and government to establish sector wide performance standards, as well as reporting and monitoring criteria.

- Acting as an interim monitor of the non-deposit-taking microfinance sector, and promote the development of a supportive environment for non-deposit-taking microfinance providers (encompassing relevant legal areas such as taxation and NGO registration).

In the months leading to December 2003, real progress was made on microfinance initiatives. MISFA has $25.2 million in committed funding from CGAP, the World Bank, the United States, Canada, Great Britain, and Sweden. Of the total, $15.7 million has been disbursed to finance small loans for more than 17,000 Afghans, with thousands more to follow in the coming months. MISFA has signed funding agreements with three microfinance institutions (BRAC, FINCA, and Mercy Corps) and is close to finalizing two more. Due to higher-than-expected demand, the facility is seeking additional funds.

Meanwhile, local and international organizations showed continued interest in developing larger-scale, sustainable microfinance programs.

- First Microfinance Bank of Afghanistan (FMBA), with AKFED and IFC as its initial shareholders, was licensed by DAB in September 2003 under the new banking law. Donor pledges for the initial technical assistance support were received from Japan, Norway, USAID, the Netherlands, and IFC in the total amount of US$1.95 million. By February 2004, initial capital of US$5 had been paid in by the Agha Khan Fund for Economic Development and the IFC.

The pilot microfinance program started earlier by the Agha Khan Foundation with 2,000 clients, will be transferred to FMBA starting in the first half of 2004. In five years, FMBA intends to reach approximately 23,000 clients.

- The International Labor Organization has formulated a $6 million vocational training and $2.5 million microfinance program to be implemented through two local NGOs. Funding is being sought.
- The United Nations Drug Control Program has drafted a $10 million social compact program, for which it is seeking funds, in poppy-growing districts of Kandahar and Badakhshan provinces.
- USAID is planning a program to rehabilitate agricultural input markets with multiple components. The finance component will focus on agricultural input traders and dealers, of which there are an estimated 1,500 to 3,000, 75 of whom are large wholesalers and importers.
- Several large international NGOs with specialized microfinance capacity have submitted proposals to donors for microfinance programs in Afghanistan and have recruited or are planning to recruit microfinance specialists.

Although microfinance is challenging in the Afghanistan context, the sector could take off rapidly if several challenges can be met. Chief among those challenges are operating efficiently in scarcely populated areas, stabilizing the currency, recruiting appropriate human resources from among a workforce that has not been working for many years, and promoting female home-based businesses.

While the institutional capacity is being strengthened, it is also important that the legal and regulatory frameworks for NGOs and savings and credit associations be addressed. NGOs continue to be regulated under a 1998 law adopted by the Taliban that is very unclear on micro credit activities. The timeframe for drafting new legislation had not been set at the time of our visit. Afghanistan reportedly does not have a strong tradition of informal savings and credit associations, and no legal framework currently exists for membership-based savings and credit institutions.

The study participants make the following recommendations:

- Credit-only NGO MFIs should not be subject to prudential regulation and supervision. That is, the central bank should not have a statutory role in licensing or supervising NGOs doing microfinance, because they do not deal in public money and create no risk to the safety and soundness of the financial system.
- The central bank should consider developing specialized legislation for membership-based savings and credit institutions over the next one or two years.

1. MICROFINANCE INSTITUTIONS

INTRODUCTION

The demand for microfinance services in Afghanistan is huge—and most Afghanis still look to the informal sector to secure their livelihoods. Lack of capital, and until recently the lack of formal banking services, is a key constraint on the growth of small and micro businesses. Rural indebtedness remains a serious problem in poppy-growing regions. Yet despite the devastation wrought by two decades of war, Afghanis and their communities have shown remarkable resilience and entrepreneurial initiative. In fact, with a total population of more than 20 million, Afghanistan has the potential market demand of at least 1 million households for microfinance services. Demand for credit by is even greater in the urban Micro and Small Enterprise (MSE) sector. The deterioration of employment opportunities in war-ravaged rural regions and the disappearance of public sector jobs combined to spur the growth of privately owned and urban MSEs. Rural-urban migration has contributed to the growth of this sector.

A recent study conducted by International Project Consult (IPC) provides a good overview of the MSE sector and its demand for credit. Of the 204 businesses interviewed, nearly 75 percent of the respondents cited lack of funds as a major obstacle to business development and growth. Few entrepreneurs generated sufficient income to reinvest in their business. Almost half of the respondents reported that they regularly reinvested less than 10 percent of their profits. Family and friends were the main source of credit for the majority of urban enterprises. The IPC survey found that 43 percent had received loans from family members or friends, and moneylenders were the second most important source of credit: 25 percent of the respondents reported securing loans from a moneylender. With the collapse of Afghanistan's formal financial sector, commercial banks have played no role at all. NGOs' microcredit schemes have made a tiny dent in the MSE sector: 3 percent of those interviewed in Kabul reported receiving a loan from an NGO.

In the countryside, shopkeepers, traders, landlords, family, and friends are said to be the principal sources of credit; in comparison with the cities, family and friends seem to play a less important role in rural credit provision. This disparity is likely traceable to rural household incomes, which are much lower than urban incomes. A survey conducted by the U.N. Drug Control Program (UNDCP) found that shopkeepers and traders provided three-quarters of all loans. Shopkeepers regularly provide goods and agricultural inputs on credit to trusted customers, with the credit often repaid at harvest time. Known as *salaam,* such advances are common throughout Afghanistan. The below part detail the state of the microfinance sector at the end of the Taliban regime , discuss the reforms implemented in 2002–03, and conclude with recommendations on MSE sector development in Afghanistan ,

The Microfinance Sector After The Fall Of The Taliban Regime, 2001

As of December 2001, the supply of microfinance services in Afghanistan was quite limited. May 2002 World Bank assessment of some 20 local and foreign NGOs that had offered, or planned to offer, microfinance, found that they had a total outstanding loan portfolio of US$1 million and served only 12,000 clients—a tiny percentage of potential demand. More than half the microfinance outreach was rural. Most NGOs had little knowledge of global best practice; only a few programs were judged to be of reasonable quality. BRAC (formerly known as the Bangladesh Rural Advancement Committee) had already demonstrated the demand and potential to develop large-scale microfinance in Afghanistan—they acquired more than 2,000 clients after only three months of operations.

Nongovernmental Organizations

In 2002 about 25 NGOs and U.N. agencies had developed small-scale microfinance (mostly microcredit) schemes in Afghanistan over the previous five to seven years, under very challenging circumstances and with limited funding , Given the anti-usury laws imposed by the Taliban, NGOs developed financing approaches modeled after Islamic finance practices, which are founded on the core belief that money is not an earning asset in and of itself. Islamic law emphasizes ethical, moral, social, and religious factors to promote equality and fairness for the good of society as a whole. Islamic finance models encourage risk sharing and wealth distribution. The principles of Islamic finance and microfinance have much in common. Both systems advocate entrepreneurship and risk sharing and believe that the poor should take part in such activities. Afghanistan has in many ways provided a testing ground to develop Islamic microfinance enterprises.

A brief summary of the main features of NGO programs at the time is provided below for key facts of selected schemes.

• *Goals*. All existing NGO microcredit programs were managed as part of more integrated programs typically focused on community development or income generation, with development goals including poverty reduction, livelihood promotion, employment creation, building self-reliance, micro enterprise development and agricultural development. Most NGOs had linked credit to productive uses, and tended not to provide household, consumption, and emergency credit needs.

• *Target populations* were often specific vulnerable groups, such as:

—women, with some programs having a focus on war widows

—refugees, returnees, and internally displaced persons

—the disabled, primarily victims of armed conflict

—small farmers

—landless labor, unemployed, and local poor

• *Products*. Most NGOs focused exclusively on the provision of microcredit to support income generation activities and micro enterprises. A few schemes, however (e.g., Habitat, UNDP/UNOPS

Bait-ul-Mal scheme), also integrated savings.

• *Nature of Loans/Islamic Financing*. As mentioned, many NGOs in Afghanistan experimented in Islamic finance practices driven both by the Taliban's usury laws but also by local tradition and norms. Others, such as Save the Children (SCF), which had the largest existing program, adapted forms of mainstream microfinance. SCF charged clients for the loan application form or passbook, but did not charge interest in a conventional form.

- *Delivery Methodology*. NGOs experimented with a number of methodologies, including individual lending, group lending and community-based savings and credit approaches. In the first two methodologies, the NGO typically owned or managed the loan capital, making the lending decisions and taking the credit risk. In the community-based approach, the NGO typically helped communities to organize savings and credit associations, with capital ownership, lending decisions, and loan fund management in the control of the community.
- *Business Support Services*. Several programs were also linked to vocational or business training—e.g., UNOPS's Comprehensive Disabled Afghans Program (CDAP)—which provided micro credit for self-employment as well as vocational training/apprenticeships for disabled Afghans. Others provided assistance with product development and marketing, particularly those NGOs that linked microcredit to carpet weaving and handicrafts production.
- *Geographic Reach*. Existing microfinance programs provided limited coverage—programs reached about 10,000 clients in 2002. The largest NGO microfinance program, run by Save the Children, had 1,800 clients. The geographic reach of the programs was largely rural, operating in selected villages in 10 to 15 provinces out of a total of 29.
- *Depth of Outreach*. Most NGOs focused on improving the livelihoods of impoverished and vulnerable groups, with loans ranging from US$20 up to around US$300.

- *Impact*. Anecdotal evidence pointed to the impact of microfinance programs on self-employment, business productivity/profitability, self-reliance and self-esteem, household incomes, and rural indebtedness.
- *Sustainability*. The NGO programs achieved low levels of sustainability, which is to say, income earned from interest and other fees did not cover the costs of operating the program. These low sustainability levels are in large part due to three facts. First, the implementing NGOs had a humanitarian mandate and little experience in microfinance, which meant none of them, except perhaps for Save the Children, had clear objectives or a well-founded strategy to develop institutionally and financially sustainable microfinance services. Most of the NGOs, in fact, took a charitable approach to loan provision and did not consider how to earn revenue to cover costs.

Second, hyperinflation led to the regular decapitalization of loan funds as NGOs did not charge interest rates that would cover inflation. The long-term downward trend in the value of the Afghan currency also led to devalued loan portfolios in dollar terms, as NGOs have not been able to protect or hedge against this. Finally, Islamic usury laws restricted the charging of interest.

Microfinance institutions

Save the Children: Save the Children (U.S.) is probably the only NGO to date to have pursued a strategy of developing financially sustainable microfinance services in Afghanistan. Though the portfolio quality is not great, and operational self-sufficiency not even close, the program in remote Northern Faryab province has roughly 1,700 active clients and has survived five wars. Save the Children intends to spin the program off into a local institution and expand its clientele to 6,000 in five years time. In addition, it is seeking $300,000 in grant funding for one year to reach 400 women clients in Kabul and to lay the foundation for a larger program in the future. It will begin to pilot solidarity-group lending for women in selected districts of Kabul. After receiving training on the policies and operations of the loan program, the clients will receive small working capital loans. The program will target women with pre -existing income earning activities or pre-existing skills to enable them to return to their work with the assistance of a loan. After successful use and repayment of the first loan, borrowers will be eligible to access larger, repeat loans. Save the Children will build its program on lessons learned from six years of experience in providing microcredit to women in Faryab province and to Afghan refugee women in Quetta, Pakistan. It has proven institutional capacity to backstop microfinance programmes and to build sustainable institutions in a wide variety of settings.

BRAC: BRAC, a national private development organization, set up in 1972 was initially established as a relief organization, to afford relief and assistance to resettle refugees returning to Bangladesh from India after Bangladesh's Liberation War. The immediate task of relief and rehabilitation over, BRAC turned its focus to the long-term issue of poverty alleviation and empowerment of the poor, especially women, in the rural Bangladesh. BRAC is one of the largest MFIs in the world. It promotes income generation for the poor—mostly landless rural people of Bangladesh—through microcredit, health, education and training programs . The multifaceted development interventions are particularly relevant to the Afghanistan context where poverty is extensive. BRAC began operations in Afghanistan in June 2002, in Parvan, Balkh and Kabul provinces. It already has more than 2,000 members and intends to reach 300,000 clients in five years time. In addition, BRAC was asked by the Afghan government to prepare a five-year plan on how the government can roll out microfinance in Afghanistan on a massive scale.

CARE: CARE just recently started a savings program in Kabul for a target group it has been assisting for many years—widows. The program promotes a ROSCA-type mechanism and has some similarities with CARE's successful savings and credit program in Niger. Saving is done weekly and monthly, allowing one group member to receive a loan from the funds collected. CARE is expecting to finalize its expansion plans in December, but what is certain is that microfinance will be a major pillar in its next five year programming cycle. CARE also has proven institutional capacity to backstop microfinance programs in Afghanistan and to build sustainable institutions in a wide variety of settings.

- *Performance Data/Reporting*. Until 2002, the NGO community had only limited of microfinance good practice; focus on record collection and performance monitoring was minimal.

Few NGOs kept operational or financial reports that would allow any in-depth performance analysis of their microfinance programs.

- *Coordination*. In 1999–2000 the Agency Coordinating Body for Afghan Relief (ACBAR) launched a task force to assist with the various NGO microcredit schemes. It disbanded in 2001, however, and several NGOs have expressed an interest in reviving the group in an effort to help develop microfinance programs.

Vocational Training + Programs

IRC: The IRC's Small Business Assistance Project arranges apprenticeships to promising workers from Nangarhar and Kabul provinces. After completing a nine-month apprenticeship, the trainee qualifies for a loan to start her/his businesses. IRC pays both the trainee and sponsor, and ensures that the former is not only used as labor but really acquires a skill. IRC also offers training and small loans to both men and women to begin small businesses in such fields as weaving, tailoring, shop keeping, auto-repair and carpentry. With approximately 500 loans outstanding, the repayment rate is about 80 percent. IRC started its Small Business Assistance Project program in 1997 with 75 percent grants and 25 percent loans. It then changed to a 100 percent loan program with no service charge. A three percent up-front management fee is now charged. The loan range is US$50–$250 and the loan term is one year. IRC is primarily active in Paktia, Loghar, and Nangarhar provinces. IRC intends to maintain its current program, with expansion being dependent on access to more funds.

CHA: Coordination of Humanitarian Assistance (CHA) is a local NGO, founded in 1988 with programs in agriculture, education, health, and infrastructure. It is a well-developed organization with an interesting vocational training program, among other activities. Its lending activities, though playing an important role in adding value to the vocational training and rural development, are negligible from a microfinance sustainable institution building perspective. This year it provided 137 loans amounting to $37,800. Loans are for vocational training graduates or to communities for the purchase of a hand pump. CHA has a good repayment (above 95 percent) but does not charge a service fee.

IAM: The International Assistance Mission (IAM) is an international NGO established in Afghanistan in 1966 with programs in eye care, physiotherapy, mother and child care, primary mental health training, English-language instruction, skills development, renewable energy, community development, agriculture, and recreational equipment. The skills -development program provides graduates of the eight- month vocational training program with a loan. Over a five-year period IAM disbursed approximately 400 interest-free loans amounting to $12,000. Loan size ranged from $50–$500. Its current loan program has ended; last repayments were due in June 2003. It intends to separate its microfinance activities from other program activities and to establish a sustainable microfinance institution. IAM operates in Kabul, Logar, Paktia, and Nangarhar (with emergency programs in Mazar); the loan program was implemented in Farah and Herat. The economic development coordinator has been in Afghanistan for eight years and will be staying for another five years. IAM is planning to recruit expatriates with microfinance skills. The envisaged lending methodology and growth plan are in line with best practices and could be slightly more aggressive. It will start in Kabul and does not exclude expansion to other provinces. At the end of the five-year period IAM intends to have serviced 1,500 clients. It plans to grow slowly because of the uncertain context. Once the situation in Afghanistan is fully stabilized, the program will be scaled up.

CDAP: The Comprehensive Disabled Afghans' Program (CDAP) was established in 1995 as a UNDP/UNOPS interagency initiative. Participants include primarily disabled persons, but also vulnerable women and children. The program has three components: microcredit, training, and job placement. The microlending component is a complementary activity to the vocational training program. The CDAP program cannot really be considered microfinance, however, given its heavily subsidized lending. It is also a clear case of the negative effect of subsidized lending and mixing microfinance with other activities without clear demarcations. As a result, the initial loan fund is, to a large extent, depleted. The new program manager has halted lending activities and would like to see the microfinance component outsourced. Statistics are to be delivered.

Agriculture + Programs

AREA: The Agency for Rehabilitation and Energy Conservation (AREA) is one of the largest NGOs in Afghanistan. It was formed out of an environmental project involving Afghan refugees in the Northwest Frontier Province (NWFP) in Pakistan and began operations in Afghanistan in 1993. It has taken on many other activities—one of which is microfinance—as part of its integrated community development program. AREA is a well-established organization, with formalized procedures. It pays attention to organizational development and building its middle managers. Though it has a reporting system, microfinance reporting is done on a project base. As such, basic microfinance indicators are either not readily available, or not available at all. AREA has disbursed 2,500 loans since it started lending in 1999. It lends in-kind and employs a group-lending methodology. It prices its loans according to the *murabaha* cost mark-up principle. Loans tend to be related to animal husbandry, agriculture, a socalled general loan, and a micro-enterprise loan. The maximum loan amount is US$800 for the micro-enterprise loan with relatively long terms. AREA's area of operation is primarily in the middle band of Afghanistan, both East and West. The portfolio at risk is considerable.

ADA: The Afghan Development Association (ADA) is a multisectoral NGO, which is currently still lending interest free, but it is in the process of starting to charge a service fee and establishing a credit department. One staff member has a background in banking. ADA began operations in 1990 in Afghanistan and started the credit program in 1999. It provides loans to cooperatives which on-lend to their members, mainly for horticulture (apricots, apples, pomegranate, grapes, almonds and raisins). It has formed 7 such cooperatives averaging 30 members and provides credit, training, and assistance with packaging and selling products. In addition, ADA provides loans to women who have received vocational training. ADA has an estimated 400 active clients. The loan size ranges from $20–$200 and the maximum loan term is one year. Repayment to cooperatives is 100 percent and to individuals about 75 percent. Its area of operation is primarily southeastern Afghanistan and the Herat and Farah provinces.

Madera: Madera is a French NGO that began operations in Afghanistan in 1989 and runs a rural development program in three western provinces (Lagman, Wardak, Nangarhar). Madera is primarily active in agriculture, arboriculture, sylviculture, animal husbandry, handicrafts, and civil and hydraulic engineering. The credit operations are located within the agricultural department. Loans range from between US$45 and $600. A US$3.5 service fee is charged for loans for seeds and fertilizers; no service fee is charged for loans for oxen. Though the exact number of outstanding loans is not available it is over 1000.

Dacaar: The Danish Committee for Aid to Afghan Refugees (Dacaar) is a multipurpose NGO concerned primarily with water programs. The organization has three main departments: water, integrated agriculture development, and construction and has operations in Lagman, Jaji, and Ghazni. It began operations in Afghanistan in 1990 and started its microfinance program in 2000. The lending falls under the agricultural activities and is intended to break the seasonal cycle of indebtedness by encouraging farmers to diversify. Loan sizes range from US$25 to $1000. The *shura* selects clients. The funds from Dacaar to the shura's are grants which are subsequently used as a revolving fund. At the end of 200 it had granted funds to 81 villages.

Overall, the microfinance sector provided financial services where the formal banking sector was clearly failing. Yet because of the scale of the humanitarian disaster in Afghanistan, none of the NGOs specialized exclusively in the provision of microfinance services. Many provided a number of other social services and business support services. Unfortunately, the microfinance experience in Afghanistan has not been well informed by microfinance lessons learned elsewhere in the world. Most NGOs active in Afghanistan treated microfinance as a charitable undertaking and were less concerned about sustainable financial service delivery to the poor. The focus on end-clients, instead of on institutional clients, has led to low repayment rates and very limited outreach. A number of microfinance service providers have

recognized the need for sustainable service delivery and are starting to be more aware of cost effectiveness, efficiency, and the possibilities to lend on a cost-recovery basis while not contradicting Islamic principles. Few microfinance programs, however, incorporated what are considered good-practice principles in microfinance (CGAP, May 2002).

Microfinance Reforms, 2002–2003

In 2002 microfinance received widespread interest among international and bilateral partners supporting the reforms in Afghanistan. All highlighted the importance of microenterprise activity in helping revitalize the economy. Investment in the area, however, was undertaken with caution mostly because of organizations lacked information. In mid-2002, no donor was financing microfinance specific activities, and few had developed concrete plans for microfinance support. Most focused on conducting assessments to get a better handle on the state of the industry, notably:

- *International Finance Corporation:* the feasibility of a business plan to establish the first Microfinance Bank of Afghanistan in partnership with the Aga Khan Fund for Economic Development (AKFED);
- *The U.S. Bureau of Population, Refugees, and Migration (PRM) and USAID:* received proposals from some of the leading U.S. NGOs planning to start microfinance programs (CHF, Foundation for International Community Assistance [FINCA], ICMC, Save the Children, and Mercy Corps).
- *Asian Development Bank:* assessment of the state of the old AgBank for purposes of revitalizing SME loans for the agricultural sector.

In May 2002 the World Bank and the Consultative Group to Assist the Poor (CGAP) joined this list with a study on the feasibility of establishing some form of national microfinance apex institution to provide financing and technical support for microfinance development.

2. THE MICROFINANCE SUPPORT FACILITY FOR AFGHANISTAN (MISFA)

Having accepted the broad rationale for additional investment in the microfinance sector, donor organizations and the government of Afghanistan must address how best to proceed. How should they invest external funding to support the development of sustainable microfinance and quality financial services so that they are accessible on a large scale?

Four main donor-supported approaches to microfinance development have emerged elsewhere in the world: microfinance NGOs; microfinance banks created *from* NGOs; start-up microfinance banks; and downscaled commercial banks (or developing microfinance delivery through an existing infrastructure).

A fifth approach—credit unions and community-based credit and savings associations—has also played an important role in microfinance provision throughout the world.

All five approaches have succeeded in achieving both scale and sustainability. BRAC is a prominent example of a microfinance NGO; as of the end of 2001, it had an outstanding loan portfolio of over $145 million and 3.5 million active clients. BancoSol, a bank created from an NGO (PRODEM), had a loan portfolio of almost $80 million at the end of 2000, with 61,000 active clients. As of end 2001, a Greenfield microfinance bank created in 1996, the Microenterprise Bank in Bosnia, had an outstanding loan portfolio of $17 million, and 4,300 active clients. Perhaps the best known example of a down-scaling bank is BRI of Indonesia, with a loan portfolio of almost $1 billion and 2.8 million active clients, as of end 2001.

Credit unions are the primary provider of microfinance in some regions, including parts of eastern Europe and Latin America. In Ecuador, for example, 23 of the largest credit unions have a combined outstanding loan portfolio of $66 million, and more than 450,000 active borrowers, whereas NGO and bank MFIs have in the region of $24 million in outstanding loans, with 80,000 active clients.

It is generally accepted that clients are probably best served by access to a range of financially self sufficient microfinance institutions, well-placed to meet local needs. In Afghanistan, it was expected that banks, NGOs, and credit unions could all play a role in microfinance development, in addition to informal community savings and loan funds, and rotating savings and credit associations (ROSCAs). Several NGOs (including AREA, CARE, CHF, Mercy Corps, SCF) and U.N. agencies (UNDP/UNOPS) were already developing plans to further develop or establish microfinance programs. Such programs would focus on particular regions and target groups, and use a range of methodologies, including group lending and community-based savings and credit associations. The Aga Khan Development Network (AKDN), through its Fund for Economic Development (AKFED), started developing a business plan to establish the First Microfinance Bank of Afghanistan. IFC took a keen interest in the banks and received a proposal for review by June 2002.

Against this background, it was felt that given the plethora of NGOs there was room for a national apex institution or microfinance support facility. In an environment with many existing or planned microfinance programs, and a range of approaches, donors, and priorities, a Microfinance Support Facility—a wholesale mechanism that provided financing and technical support to retail MFIs—can help coordinate and rationalize donor support for microfinance within a sector development framework, provided a mechanism for introducing good microfinance practices and standards, and support the development of institutional microfinance provider capacity. It could also provide donors with an efficient funding mechanism that met national market needs. It was with these goals in mind that CGAP—the

Consultative Group to Assist the Poor—initially suggested the model of a national-level microfinance support facility for Afghanistan. The World Bank expressed interest in supporting such a facility and conducted a project identification mission in May 2002, which led to the creation of the Microfinance Support Facility for Afghanistan (MISFA).

In designing MISFA, the Bank and CGAP heeded lessons learned from apex institutions elsewhere. There are few examples of such institutions established to support the start-up and development of MFIs, and the experience has been mixed. 30 PKSF in Bangladesh is sometimes cited as a regional model, but this apex was established in an environment with a critical mass of microfinance institutions. The challenge in Afghanistan is quite different: to develop the microfinance sector practically from scratch. This required a long-term investment approach and a strong focus on building the capacity of microfinance institutions.

In Bosnia and Herzegovina the apex was successfully managed to support the development and start-up of a viable microfinance sector. The apex, which was a World Bank–funded Local Initiatives Project, provided financing and technical support to NGO MFIs in Bosnia for their start-up, growth, and development. The Bank project combined performance-based financing with intensive, well-tailored capacity-building support.

Based on experience, the facility was designed as a transitional intermediary from the outset. Its role was to help jumpstart and develop the microfinance sector, but with the clear aim and a strategy to support microfinance institutions transition to more sustainable sources of finance,31 and foster organizational autonomy and independence from donors. It was also decided to call MISFA a facility rather than an apex to avoid the resource transfer connotations generally associated with the latter organizations.

The overall objective of a Microfinance Support Facility was to actively support the development of a strong, sustainable microfinance sector in Afghanistan that provided widespread access to high-quality financial services to economically active low-income people. In summary, the Microfinance Support Facility for Afghanistan was to undertake the following roles:

- coordinate investment for microfinance by establishing a mechanism to channel donor funds to microfinance providers within a sector-wide development framework;
- provide well-structured financing for the start-up and development of sustainable microfinance providers, including financing for institution-building and loan fund capital;
- provide or fund training and advisory services to microfinance providers to build their institutional capacity to deliver high-quality services;
- promote good microfinance provider performance and transparent operations, by working with practitioners, donors and government to establish sector-wide performance standards, reporting and monitoring criteria; and
- provide an interim umbrella monitoring role for the non-deposit-taking microfinance sector, and promote the development of a supportive environment for non-deposit-taking microfinance providers (encompassing any relevant legal areas such as taxation and NGO registration).

To ensure that MISFA achieved these goals, the following principles were taken into account in its design and operations:

- Buy-in from other donors was to be sought from the concept stage, and the Facility was to be designed in a participatory manner with the full involvement of government, interested donors, and potential client microfinance providers.

- The Facility was to be established as fully independent from government. Government could be represented on the governance structure, but should forswear any control of the Facility's operations beforehand. Contributing donors were also to be represented.
- It was to have the capacity to blend and use grant funding, essential loans, and, over time, fully commercial loans from a range of sources to structure appropriate financing for microfinance providers.
- Grant funding for technical assistance to microfinance providers was to be prominent in the structure of the Facility, in order to build a microfinance sector, with capacity-building preceding and accompanying transfer of funds for on-lending.
- It was to have the capability and flexibility to support innovation and experimentation, so as to encourage the development of microfinance methodologies and institutional forms that are effective and appropriate to market niches and local contexts within Afghanistan.
- It would be committed to financing microfinance providers in a performance-based manner, based on rigorous but realistic performance standards, working in close partnership with practitioners on the development and monitoring of those standards.
- It was to have the capability of supporting microfinance delivery throughout Afghanistan from the beginning of its operations.
- It was to be designed as a transitional intermediary from the outset, with the clear aim and a strategy to build MFI capacity and promote a transition from the Facility's funding to more sustainable sources of commercial or semi-commercial finance for MFIs.

In the months leading up to December 2003, real progress has been made in the microfinance sector.

MISFA has $25.2 million in committed funding: $1 million from CGAP, $5 million from the World Bank, $5 million from the U.S. Agency for International Development, $7 million from Canada, $5.2 million from GreatBritain, and $2 million from Sweden. The $15.7 million from this total sum that has been disbursed to date has already financed small loans for more than 17,000 Afghans, with thousands more to follow in the coming months. MISFA has signed funding agreements with three microfinance institutions (BRAC, FINCA, and Mercy Corps) and is close to finalizing two more. Because of higher than-expected demand, the facility is actively seeking for additional funds.

New microfinance programs

During the period 2002–2003 there was continuing interest in developing larger-scale, sustainable microfinance programs among local as well as international organizations. The Aga Khan Foundation, for example, decided to set up a microfinance bank. The First Microfinance Bank of Afghanistan (FMBA) is sponsored by the Aga Khan Fund for Economic Development, AKFED, with additional sponsorship taken by other bilateral shareholders and institutional microfinance investors. The bank will cater initially to urban micro and small businesses in the Northeastern Province and, if security improves, develop a nationwide branch network in the main economic centers with extension into semi-urban and rural areas.

FMBA aims to be incorporated as a full-service financial institution, providing both credit and savings products. The bank will be capitalized by US$3 million; one of the investors will be the IFC. In five years time, FMBA intends to reach out to approximately 23,000 thousand clients.

The ILO has formulated a \$6 million vocational training and \$2.5 million microfinance program to be implemented through two local NGOs. Funding is currently being sought. The ILO has shown active interest in the development of the microfinance sector and has expressed interest in coordination with the World Bank.

The UNDCP has drafted a \$10 million social compact program, for which it is seeking funds, in poppy growing districts of Kandahar and Badakhshan provinces. Although the first eradication measures were undertaken by the Afghan government in 2002, suitable interventions to inhibit the cultivation of the opium poppy have yet to be developed. At this crucial juncture—where farmers decide whether or not to plant opium poppy in the forthcoming season—the UNDCP finds it essential to start short-term, quick impact activities in the poppy-growing areas, to be continued and expanded by appropriate agencies in due course. Fifty percent of the project budget (i.e., US\$5,000,000) will be used for revolving loans, through a subcontract with an NGO with experience in microfinance (as the implementing agency for the project).

USAID is planning a program to rehabilitate six market areas: agricultural input markets, agricultural market information systems, technology, policy and regulation, finance, and infrastructure. The finance component will focus on agricultural-input traders and dealers, of which there are an estimated 1,500 to 3,000, 75 of which are large wholesalers and importers. Foreseen credit products will be directed to importers (up to \$150K); provincial and district dealers (up to \$50K); and village level dealers (up to about \$10K). The institutional vehicle for credit delivery has not been decided. It could be a short-term structure somewhere between a project and a finance company that concentrates on credit activities.

USAID may also consider a longer-term approach of buying a bank, reforming it, and using it as a shell through which to provide credit and, subsequently, other financial services.

Several large international NGOs with specialist microfinance capacity have submitted proposals to donors for programming in Afghanistan and have recruited or are planning to recruit microfinance specialists: Mercy Corps, CARE, Save the Children, CHF, WfW, and so forth. In addition, Aschiana, ACTED, PHO, Ockenden International, and others have also expressed interest.

New NGO microfinance operations

Mercy Corps : Mercy Corps is requesting US$400,916 to implement a pilot business training and group-lending program in Kabul. It hopes to support sustainable microfinance institutions capable of reaching between 500 and 700 poor Afghan women in its first year of operation; by year five, the institution hopes to have some 5,000 active clients. Services will be provided through traditional group loans, where women use solidarity and community in place of collateral. First loans will average $100, with subsequent loans expanding in tandem with clients' needs and capacity. Mercy Corps has a country director with significant Afghan experience, as well as a microfinance specialist on the ground.

CHF: CHF International is a relative newcomer to Afghanistan (with one year of operation, mostly construction projects). It conducted a market study in Bamian and Kabul provinces, interviewing 580 households and businesses.

Major findings included indebtedness (often only to buy food or clothing). CHF intends to start a microfinance program and is interested in combining microfinance with gender and IT for marketing. The country director intends to stay four to five years.

WfW: Women for Women International is a U.S.-based organization that provides women survivors of war, civil strife, and other conflicts with tools and resources to move from crisis and poverty into a civil society in a way that promotes and protects peace, stability, and self-sufficiency. It has just opened an office in Afghanistan. Its program includes human-rights awareness raising, training, and microfinance. The microfinance program will probably begin after the other training programs are underway.

FINCA: In November 2002, the Foundation for International Community Assistance (FINCA) will receive a $100,000 grant from a private donor to establish FINCA/Afghanistan and start-up a few pilot village banks in rural areas and a few urban community banks in either Herat or Kabul. FINCA intends to begin operations in areas that are not covered by other microfinance service providers. FINCA usually establishes a branch office in an urban area from which it develops satellite offices in rural areas. This pattern of growth will likely be followed in Afghanistan. FINCA conducted a mission to Afghanistan in January of 2002 and surveyed the demand for microfinance services among women in Kabul and the environs. It seeks to mobilize $4 million to reach over 20,000 families. FINCA's end goal is to establish a sustainable microfinance deposit-taking institution that will be part of the community of regulated financial institutions in Afghanistan. In the startup of FINCA Afghanistan, the group will draw on its personnel from FINCA/Kyrgyzstan, a model microfinance institution in the region that reaches over 20,000 clients and is converting into a specialized micro bank.

ICMC: ICMC initially included a microcredit program in their proposed intervention in Herat and Kandahar. It has since decided to wait until the villages are stabilized and the residents are not contemplating migration owing to stresses on their basic livelihood. ICMC loans will be based on a type of in-kind repayment system and will not attempt to be sustainable.

The World Council of Credit Unions, Inc. (WOCCU),32 which is the world's leading advocate, innovator, and development agency for credit unions, has also expressed an interest in the provision of microfinance services by credit unions in Afghanistan. After a recent assessment (and inquiries from Afghans living in the United States), WOCCU believes it can play an important role in Afghanistan: that of establishing and strengthening credit unions in communities. The social values behind the common Afghan *Shura* group identity, self-help, shared responsibility, and collective action—are the very ones that permeate the credit union philosophy. Knowing that these founding values are highly regarded among Afghans, WOCCU expects that people may quickly grasp the community aspects of credit unions.

32 Members of the WOCCU include regional and national credit union associations, cooperative associations, and business service organizations from 91 countries.

WOCCU is therefore expected to: (i) advise on legislation regarding the registration, operation, supervision, and regulation of credit unions in Afghanistan; (ii) assist in the formation and composition of regulatory bodies to oversee credit unions (which may be a functional unit shared with the banking sector); and (iii) organization, operationalization, and development of credit unions in rural areas and urban communities of Afghanistan. WOCCU has already begun to translate key credit union documents into Dari and to recruit Afghan-Americans from the ranks of U.S. credit union professionals and volunteers.

3. LEGAL AND REGULATORY REFORMS

While the institutional capacity is being strengthened, the legal and regulatory frameworks must also be addressed. Microfinance providers, including the multilateral and bilateral partners, were concerned that the existing laws might inhibit growth. Of particular concern were the following:

- *NGOs:* NGOs are currently regulated under a 1998 law adopted by the Taliban. According to NGO representatives, this law is unclear on the matter of microcredit, providing no mention of what activities are permissible, and therefore not prohibiting NGO microcredit in any way. NGOs are required to register with the Ministry of Planning; foreign NGOs register with the Ministry of Foreign Affairs. The existing procedures seem fairly straightforward, with little if any ongoing monitoring by the Ministry of Planning owing to lack of government institutional capacity. The interim authority has proposed drafting new NGO legislation and establishing a more effective registration system, which would provide the government with information on what NGOs are doing where. The timeframe for drafting of the new legislation was not clear.
- *Savings and Credit Associations:* Afghanistan reportedly does not have a strong tradition of informal savings and credit associations, and no legal framework currently exists for membership-based savings and credit institutions. Some donor or NGO-supported savings and credit associations and (farmer) cooperatives do exist, however, and are expected to increase with the further development of microfinance.

It is therefore recommended:

- *NGOs:* Credit-only NGO microfinance institutions (MFIs) should not be subject to prudential regulation and supervision; i.e., the central bank would not have a statutory role in licensing or supervising NGOs undertaking microfinance, given they do not mobilize the public's money and create no risk to the safety and soundness of the financial system (the main concern of bank regulators). Microfinance specialists should be involved in the drafting of the new NGO law to ensure that micro credit is a permissible NGO activity. The tax status of NGO MFIs will need to be clarified (including sales tax and profit tax). Very often there is confusion in countries over the tax status of NGO MFIs, which have a social purpose but earn income (through fees or interest) off their activities.

Such issues will likely need discussion and clarification in Afghanistan over the medium term.

- *Savings and Credit Associations:* In the immediate term, the central bank does not seek to regulate such nonbank financial institutions.33 The central bank will need to focus on establishing a new legal framework and developing the capacity to supervise the commercial banking system. This in itself will be a challenging task. The central bank should, however, consider developing specialized legislation for membership-based savings and credit institutions over the next one to two years. This is currently envisaged under Article 2 of the draft Banking Law. Given the likely large number of informal community-based savings and credit associations, it is suggested that only organizations above a certain size would be required to get a license and be supervised by the central bank. This could be based on asset or equity size of the organization, and/or number of members. Technical assistance could be provided to the government to help develop such

legislation and the capacity of the central bank to supervise such institutions. In the short term, if an apex/microfinance support
facility were to be formed (see Section IX), this could play a role in keeping track of all forms of nonbank microfinance institutions (NGOs, savings and credit associations, etc.) and their basic performance.

Once the legal and regulatory frameworks are in place for microfinance, the sector will undoubtedly ramp up its operations rather dramatically. Microfinance—the provision of financial services to the poor—fits with a vision of self-reliance; it provides a hand up, not a hand out. In other countries, including post conflict countries, microfinance has proved an important tool to support job creation and income generation, and to assist the poor reduce their economic vulnerability. The challenge in Afghanistan is to develop viable systems and institutions that can deliver high-quality, client-responsive services on a large scale and in a sustainable manner.

The Informal Financial Sector

On the current practice of the *hawala* system in Afghanistan. An informal mechanism for transferring money, *hawala* operates in parallel to the conventional banking system and offers many similar services. Its advantages over formal financial institutions include convenience, cost-effectiveness, speed, and access to regions not served by formal financial institutions. The chapter describes the operational characteristics that make the *hawala* system vulnerable to financial abuse and presents regulatory and supervisory options for informal funds transfer systems in Afghanistan.

The state of the informal financial sector after the fall of the Taliban

In 2001 the *Hawala* system was the only reliable, efficient, safe, and inexpensive, means of transferring funds into Afghanistan and among its provinces. The country's formal banking system was not operational. The six licensed banks provided no commercial banking services, nor did they have the capacity to offer international or domestic remittance services. Unless they physically moved money around the country, organizations operating in Afghanistan used the informal financial sector to conduct banking business.

The informal money exchange dealers offer a diverse range of financial and nonfinancial businesses opportunities stratified in to local, regional, and international markets. Presently, more than 300 registered money exchange dealers in the market have organized themselves into an impressive open market offering foreign-currency exchange, funds transfers, microfinance, trade finance, and deposit taking.

Nonfinancial activities may include telephone and fax services, regional and international trade, and, more recently, Internet services.

The term *hawala* simply means "transfer" in Arabic. For purposes of this paper, "*hawala* system" refers to the mechanisms for transferring Funds from one location to another that exists in parallel to the money-transfer mechanisms of the conventional banking system. A *hawala* Transaction, as defined here, encompasses transfers that are made through *hawala* system service providers (money exchange dealers) regardless of the use or purpose of the transaction and the country of remittance or destination. It is an operation that consists of making a financial transfer .

Between principals located in countries A and B, using intermediaries, *hawaladars* HA and HB, who operate in the informal sector. HA receives funds in one currency from a principal (nongovernmental organization) and asks HB to advance the equivalent of the paid amount to a designated beneficiary in the local currency. Since HA instructs HB by phone or fax, funds are delivered in a matter of hours. HA is remunerated through a fee or the spread on the exchange rate, but normally a *hawala* transaction remains less expensive than payments made through the formal banking sector.

The efficiency, speed, and cost-effectiveness of the informal financial sector

The *Hawala* System has become highly efficient. Transferring funds to Kabul from Peshawar, Dubai, and London takes an average of 6 to 12 hours. Most transfers between Kabul and any of the regional centers are completed within 24 hours. Slightly more time is required for payments to more remote regions or villages where the money exchange dealer does not have a local office or representative. As communication facilities improve in Afghanistan, the transaction time will continue to decline.

The cost of making funds transfers into and around Afghanistan averages 1 to 2 percent. The final quotation depends on the volume of the transaction, the relationship between the client and the *hawala* dealer, the currency of exchange, the security environment in Kabul and at the destination for the funds, and the negotiating skills of both parties.

The *hawala* system is also reliable. The international agencies and NGOs contacted during the course of the study expressed general satisfaction with the delivery of funds. Seldom do dealers fail to make payments. In addition to the expected high standard of adherence to codes, default risk has been eliminated through the "confirmation-before-payment" process. In all cases reviewed during the study, the remitter pays the *hawala* dealer for the funds remitted only after the recipient confirms receipt of the money.

The developmental role of money-exchange dealers

International and domestic NGOs, donors, and development agencies use the *hawala* system to deliver humanitarian relief and developmental aid to Afghanistan and to move funds into and around the country.

There is no limit to the volume of funds the money exchange dealers of Kabul can process, either individually or severally. Single transactions in excess of US$500,000, especially between Peshawar and Kabul, are not uncommon. Smaller organizations regularly remit US$20,000–US$30,000 through the *hawala* system to meet operational expenses.

Vulnerabilities to financial abuse

The general inaccessibility of the customer records of money exchange dealers and ambiguities in the settlement process make the *hawala* system vulnerable to abuse. There are no standard documentary requirements for conducting business in the market. Neither the central bank nor the *hawala* dealers' association requires dealers to open their books for external inspection, nor do they require periodic financial reports. (Standardized documentation and reporting are considered unnecessary because of the high level of trust upon which the informal system is founded.) There are no standard requirements for keeping records of completed transactions and no regulatory requirement for customer identification.

Consequently, *hawala* transactions may leave no audit trail for law enforcement agencies investigating predicate offenses of money laundering, tax evasion, corruption, or other related activity. It is difficult to quantify and document the degree to which *hawala* is used to launder money in Afghanistan. It is equally difficult to trace illegal money flows, to separate legal from illicit flows, and to establish the financial links to criminal activities. Law enforcement agencies are often unable to penetrate informal financial systems because of cultural and linguistic barriers or the close business or kinship ties of the participants. Additional constraints in Afghanistan include:

- Poor monitoring of cross-border currency movements
- No reporting requirements for large cash transactions
- Lack of uniform guidelines for identifying suspicious transactions
- Large parallel black market economies
- Few opportunities to share financial information with foreign law enforcement authorities.

Regulatory and supervisory options

Selecting the appropriate regulatory and supervisory scheme for the informal financial system requires a realistic assessment of the environment in which the money exchange dealers operate. At the outset of 2002 the fundamental question facing DAB was whether money exchange dealers required regulation and supervision. Did they pose such systemic risks as to require formal regulatory and supervisory regimes similar to those being developed for the banking sector? Or could they be left alone without endangering the long-term stability of the financial sector and monetary policy?

Afghanistan had four options. It could have prescribed no regulatory or supervisory standard. It could have extended formal banking sector regulations to the money exchange market and establish formal on and off-site supervisory mechanisms. It could have allowed self-regulation and supervision among dealers. Or it could have established special regulatory and supervisory standards for the informal sector.

Each policy approach presented specific administrative and institutional challenges. In light of intense international efforts to combat money laundering and the financing of terrorism, the first option was not feasible. Regulatory authorities immediately begun considering, instead, how current *hawala* practices will be brought into closer compliance with international regulatory and supervisory standards. Could the registration process be strengthened? Could client information the *hawaladars* already collect be standardized? Could *hawaladars* begin to report suspicious activity to their own association or directly to the central bank? What about the records *hawaladars* keep? Could agreement be reached about external oversight and access to these records?

Article 77 of the central bank law (Da Afghanistan Bank Law) states that foreign-exchange dealers, which includes hawaladars dealing in foreign exchange must be licensed by, or registered with, DAB under regulations that have yet to be drafted. Once licensed, they will be expected to:

- Report transactions over a minimum amount to a government department or agency designated by the regulation
- Collect and maintain information about their customers as specified in the regulation
- Periodically provide DAB with information about their customers, management, administration, business, and financial condition.

The success of DAB's attempts at regulating the money exchange dealers will be determined by the dealers' appreciation of the need for external supervision. Because both DAB and the dealers have little experience with regulation and supervision of the informal money transfer business, the regulation to be developed should not impose excessive rules and regulations. Still in its infancy, the theory behind regulating informal transfers does not provide sufficient guidance for policymakers faced with a highly innovative and growing money transfer industry. If too detailed in its prudential requirements, the regulatory structure may stifle rather than promote the growth of an innovative yet accountable and transparent sector. Given the current level of knowledge of the informal transfer market, the regulatory models adopted by the central bank should be based on incentives rather than on direct external regulatory interventions. Broader financial sector policies that improve the quality of money transfer services in the formal sector will, in the long run, be more effective.

LEGAL TRANSACTION

A. Drug dealers approach a *hawala* dealer in Dubai with US$ for the purchase of opium from Kabul-based opium dealers/growers

B. *Hawala* dealer in Dubai communicates payment instructions to a Kabul-based *hawala* dealer.

C. Kabul-based *hawala* dealer gives the opium dealers/growers afghani equivalent as requested by the opium smugglers in Dubai.

Settlement of Accounts between *Hawala* Dealers

The *hawala* dealers use the cash they receive from domestic clients to execute payment instructions on behalf of their foreign counterparts.

When differences arise that can not be matched by reciprocal transactions, *hawala* dealers may use formal transfers between their bank accounts.

International And Domestic Use Of The *Hawala* System

International aid institutions

Most international aid institutions operating in Afghanistan use *hawala* to move funds into and around the country. Only the largest organizations can manage the costs and logistics involved in physically transferring cash around the country.

International Aid Agencies and the *Hawala* System

Agency A: Agency A's policy is to make payments only through official banking channels. Where these do not exist, it physically transfers cash to places where payment is required. To pay salaries and expenses for staff based in Afghanistan, the staff physically transfers cash from Pakistan to Kabul. The monthly transfers from Pakistan now average US$23 million. Within the country, cash transfers are made, especially for large sums of money. In one instance, as much as US$7 million was transferred from Kabul to Kandahar for project financing. However, Agency A does not monitor the remittance methods used by the Kabul-based recipients of its funds.

Agency B: Agency B would prefer to operate through normal banking channels for its international and domestic funds transfers. However, given the current situation, it is compelled to use the *hawala* operators based in Islamabad and Peshawar. When Agency B needs money for salaries, it instructs the *hawaladar* to make a payment to one of its offices in Kabul. The *hawaladar* in Islamabad instructs his counterpart in Kabul to make payment in afghanis. The Islamabad office credits the account of the *hawala* operator in Islamabad only when the Kabul office confirms by fax that it has received the money. Because of growing concerns about counterfeit currency in the market, Agency B's *hawala* operators now stamp the notes with special seals. If the note is later determined to be counterfeit, the organization can return it to the dealer for full compensation. The monthly transfers from Pakistan are significant, but the money exchange dealers have not had any difficulty in sourcing the required amount of afghanis, dollars, or Pakistani rupees. Recently, the organization remitted US$900,000 to pay rent for office and living space, as well as other overhead expenses. The cost of doing business through the *hawala* dealers has come down significantly in recent times.

Agency C: When Agency C requires US$1 million for use in Kabul, the *hawala* remittances are divided into trenches of US$200,000 to $300,000. Occasionally, remittances of US$500,000 are made. Agency C asks its local suppliers and contractors to collect their money as soon as the Kabul-based *hawaladar* is ready to make payment.

Internally, funds transfers average US$20,000 to US$30,000. For security reasons, all transactions take place on Agency C premises. The entire process is well documented. The recipient sends e-mail confirmation to the sender before the money is given to the money exchange dealer. No payment is made until the e-mail or fax is received, even where oral communication has taken place and confirmation has been given. Receipts are issued to money exchange dealers when they deliver cash. The receipts act as settlement documents for the dealer. Each receipt states clearly that the transfer has been made through the informal market because of security concerns and the absence of a functioning banking system in the country.

Agency D: Agency D uses the *hawala* system for all its international and domestic transactions. International transactions between Pakistan and Kabul average US$20,000 to US$30,000 weekly. The *hawala* dealer delivers the monies directly to Agency D's office. He is given a receipt, which he faxes to his counterpart in Islamabad for settlement with Agency D's office there. The mechanism used to deal with counterfeit notes is the same as that used at Agency B. The fee for transactions is 1.5 percent if the settlement is made after confirmation that the transfer has been made, and 1 percent if Agency D pays in advance. Within Afghanistan, the *hawala* system is used to make payments to staff operating in the provinces. Physical transfers of cash are considered too dangerous for staff members. Airlifting cash or arranging armored vehicles to escort cash deliveries is costly and attracts too much attention. The agency is considering using the *hawala* system to make local payments to suppliers. Presently, suppliers collect cash from the Agency D office, or cash is delivered to the supplier. Cash deliveries within Kabul of US$10,000 have taken place. Documentation has not been a problem. The money exchange dealers are willing to provide the documents the organization requires. However, as a security measure, cash balances at the head office are minimized.

Source: Research interviews.

Occasionally, some agencies bring cash when staff members fly into the country, but the amounts involved are usually small and are meant to cover overhead expenses, not program needs. For larger sums of money, *hawala* is often the only option.

International aid institutions now work with several dealers. Under the Taliban regime, agencies worked with perhaps one or two *hawaladars*, with whom they established long-term relationships for some selection criteria. But the competition is now such that the *hawaladars* regularly send agencies dealing in large volumes of cash periodic bids for their services. With each round of bids, rates and services become more competitive. Responding to these inducements, agencies are working with a number of different dealers on different routes. In some cases, the dealer may provide the service at no charge on one route on the understanding that he will receive the contract for another route. The cases below illustrate a few aspects of the *hawala* system that institutions and NGOs must address, including the volume of cash, the confirmation process, concerns about counterfeit cash, and the security of the cash when the local *hawala* operator gives the transferee cash in response to instructions from his counterpart in Pakistan or Dubai. The transfer arrangements of the four agencies reflect their size and area of operation. Generally, funds are remitted from Pakistan (Peshawar or Islamabad) in tranches that meet the organizations' periodic program requirements. Smaller amounts are then remitted to the provinces using the same or a different dealer. In each case, the agency pays the dealer only upon confirmation that the transfer has been made.

Hawala System

Nearly 700 NGOs are now operating in Afghanistan—about 127 international groups and 467 local ones.

Government officials estimate that these NGOs have channeled more than US$200 million into the country in the form of humanitarian relief, emergency aid, and development financing in the year following the fall of the Taliban regime. *Hawala* was used to channel much of this aid, as the system is particularly well suited for NGOs operating in rural Afghanistan, where the formal banking system is absent. Some of the less well funded NGOs are especially grateful for the low costs associated with the system. Although they lack the resources of international aid institutions, these NGOs are still able to implement life-saving relief and emergency assistance programs. The two cases below show the similarities and differences in NGO use of *hawala*.

NGOs and the *Hawala* system

NGO A: NGO A uses the local money exchange market to conduct banking business with its regionally based groups. Most of its community development programs involve regional representatives purchasing equipment from local markets and handing them over to the community. No cash is given to the community directly. The NGO's regional representatives collect cash from local money exchange dealers who may be shopkeepers or traders, depending on the community in which the NGO is working. The commissions are minimal, and the organization has never had a problem with money exchange dealers. The volume of funds remitted through the system depends on the number and type of programs the NGO is implementing in a given region. For example, the eight agricultural cooperatives NGO A works with have approximately 800 members who borrow an average of US$100 per person.

In 115 communities, individual loans average between US$250 and US$450.

NGO B: Every month NGO B receives competitive bids from three or four large money exchange dealers. It accepts the best offers that come in each month. The fees range from 2 to 4 percent for rural areas and 0.7 to 1.5 percent for urban areas. In all cases, NGO B pays the *hawala* dealer only upon receipt of confirmation that the transfer has been made.

Source: research interviews.

A foreign bank in Peshawar is the bank of choice for many NGOs. A second foreign bank plans to open a branch there soon. The volume of transactions ranges from US$100,000 to US$300,000 for international transactions and US$20,000 to US$30,000 for domestic transactions. Transfers are completed quickly and efficiently. Most problems have to do with delays by the Peshawar bank in making the transfer to the *hawala* dealer's account.

Hawaladars are frustrated by such delays, but they understand that conventional banking systems are laboriously slow.

Money exchange dealers provide NGOs with liquidity they otherwise might not have. NGOs are able to cash checks with *hawala* dealers and are discussing with a few dealers ways to make the check system more widespread. Should the discussions succeed, NGOs will be able to issue checks to local suppliers, who will present them to money exchange dealers for cash.

Regulatory And Supervisory Options

Since the terrorist attacks of September 11, 2001, on the United States, there has been renewed public interest in the regulation of *hawala* systems. Media coverage, which often focused on the putative connection between the *hawala* systems and the financing of terror, increased the level of official concern about its potential susceptibility to financial abuse. Some national financial regulators began the process of examining existing regulations, and in some cases, designing, developing, and implementing new financial sector policies, including those that address *hawala* systems.

In October 2001, the Financial Action Task Force (FATF) agreed to Special Recommendations on Terrorist Financing, which included extending anti–money laundering requirements to alternative remittance systems. At a conference on *hawala* in the UAE in May 2002, a number of governments agreed to adopt the FATF recommendation. Shortly thereafter, the UAE government announced it would soon impose a licensing requirement on *hawalas*. Participants at the UAE meeting drafted and agreed upon the Abu Dhabi Declaration on *Hawala,* which set forth five complementary principles The fundamental questions for the Afghan central bank at the beginning of 2002 were whether money exchange dealers required regulation and supervision. Did they pose such systemic risks as to require formal regulatory and supervisory regimes similar to those being developed for the banking sector? Could they be left alone without endangering the long-term stability of the financial sector and monetary policy?

Afghanistan could choose one of four options. It could prescribe no regulatory or supervisory standard. It could extend formal banking sector regulations to the money exchange market and establish formal on and off-site supervisory mechanisms. It could allow self-regulation and supervision among dealers. Or it could establish special regulatory and supervisory standards for the informal sector. Each policy approach presented specific administrative and institutional challenges.

Option #1: No Regulation or Supervision

Various parties, particularly the *hawala* dealers, have argued against regulation or supervision. First, they note that except for dealers with shops at the market, *hawaladars* are difficult to identify or locate for regulatory and enforcement purposes. Grocers, merchants, individuals, and a host of other individuals conduct *hawala* transactions. Second, the dealers have no incentives to declare their activities for external monitoring and supervision. Third, even if it were possible to identify, register, or license *hawaladars,* their transactions are so varied and multifarious it would be impossible to develop a consistent set of regulations for the sector. Fourth, even if it were possible to develop regulations, guidelines, and standards for the sector, the central bank simply does not have the resources to implement them. Finally, attempts to regulate an informal financial system will alter the system's original characteristics and push it farther away from the formal sector, especially as long as the primary reasons for its existence—foreign exchange arbitrage opportunities and poor banking services—have not been addressed.

Yet, in the wake the events of September 11, 2001, and subsequent international efforts to combat money laundering and the financing of terrorism, it is no longer feasible to abstain from regulation or supervision of the informal financial system is no longer a feasible option. Instead, the regulatory authorities have began considering how the current practices of the *hawala* dealers can be brought into closer compliance with international regulatory and supervisory standards. Could the current registration process be strengthened? Could the client information the *hawaladars* already collect be standardized? Could *hawaladars* begin to report suspicious activity to their own association or directly to the central bank?

What about the records *hawaladars* keep? Could agreement be reached about external oversight and access to these records?

In addressing these questions and others, the central bank had the options of introducing notions about formal banking- style regulations and supervision practices, pursuing a self-regulatory model, or developing specially-tailored regulations. Selecting the appropriate regulatory and supervisory responses required a realistic and practical assessment and understanding of Afghanistan's circumstances, and of the environment in which the money exchange dealers operate.

CHAPTER SEVEN

BUSINESS IN AFGHANISTAN:

1. MARKET OVERVIEW

- Afghanistan is rebuilding after over 20 years of conflict and is currently transitioning from a state-based model to a free market economy.
- Afghanistan

  government is working to improve the country’s physical infrastructure, which was largely destroyed, while at the same time struggling to provide basic services and humanitarian assistance to a growing population with some of the most challenging social indicators in the world.
- A multi-billion dollar international effort to help reconstruct Afghanistan is underway, led by the United States and other international donors. Many current business opportunities are linked to these reconstruction efforts.
- In April 2004, President Hamid Karzai declared Afghanistan "open for business." While the Government has taken numerous steps to create attractive conditions for foreign investment, there is much more to be done, particularly in completing the process of reforming the legal and regulatory framework.
- Economic growth has been dramatic over the past three years. The IMF estimates that official GDP growth averaged 22.5 percent between 2002 and 2004; estimates annual growth in Afghanistan’s 2004/2005 fiscal year (the fiscal year ending March 21, 2005) at 7.5 percent; and projects14 percent growth in FY 2005/2006.
- Currency reform was completed in early 2003. Since then, inflation has been relatively low and the nominal exchange rate stable. The tax code was restructured

and clarified in 2005. Trade has increased dramatically with both imports and exports growing at double-digit levels. Customs tariffs have been rationalized, existing trade agreements have been renewed and new agreements entered into force.

- The economy is dominated by small-farm agriculture and 80-90 percent of all economic activity remains informal. Illicit opium production remains a major activity and accounts for nearly a third of total licit and illicit GDP. The IMF estimates licit GDP at $5.9 billion in FY2004/2005.
- Investment is estimated to represent 22 percent of GDP. Over $1.5 billion in new investment has been registered since 2003. The bulk of this figure represents 2/6/2006 public investment financed through donor aid. One-third of this is foreign direct investment (FDI.) More than half has been in construction and construction material; the remainder split equally among industry and services.
- Turkey is the largest single investor and accounts for over a fifth of all registered FDI. The United States is second with 17 percent of investment, followed by China and the UAE at less than ten percent and Pakistan and Iran at five percent.
- The IMF estimates Afghanistan exported $457 million and imported $3.86 billion in FY2005.
- Afghanistan's top export markets are Pakistan, India and the European Union. Imports primarily come from China, Japan, Pakistan, the Central Asian Republics and the European Union.
- The U.S. Department of Commerce estimates U.S. exports to Afghanistan were approximately $257 million and non-assistance related imports were approximately $69 million in 2005.

- Afghanistan’s history and location give it the potential to develop into a vital trade and transit hub for the region.

Market Challenges

- Poor infrastructure, including power, transport and telecommunications.
- A weak legal framework and judicial and regulatory enforcement.
- High levels of corruption.
- Inadequate access to land and to secure land title.
- A nascent commercial banking system, which provides limited commercial financing.
- Customs regulations and procedures that are neither transparent nor uniform.
- A shortage of skilled labor and trained personnel both in the government and among the workforce.
- A critical threat security situation.

Market Opportunities

- Market opportunities are largely driven by Afghanistan's need to completely renovate its infrastructure. Substantial opportunities for U.S. firms are linked to donor and international finance institution (IFIs, including the World Bank, Asian Development Bank) funded reconstruction efforts. Companies are advised to monitor donor and IFI programs for potential opportunities.

Short-Term Opportunities

- Architectural, construction, and engineering services
- Building materials for both residential and commercial properties
- Computer hardware, software and peripherals (to include Dari language capability)
- Telecommunications services and equipment 2/6/2006

- Diesel generators for independent power supply
- Education/training services

All consumer products

- Heavy equipment, including trucks, trailers and buses; motor graders, concrete mixers, heavy-duty dumpers, pavers finishers, and bulldozers
- Security and safety equipment
- Automobiles/light trucks/vans and development of dealerships for 4x4 vehicles (sales, parts, and service)
- Translation services, including simultaneous, conference-style translation products
- Office furniture
- Printing and publishing

Medium-Term Opportunities

- Aircraft and aircraft parts
- Airport/ground support equipment
- Electrical power systems
- Oil and gas field machinery; oil, gas and mineral exploration and production services
- Agricultural chemicals, machinery, equipment and services
- Agro-processing
- Irrigation planning and technologies
- Road upgrades, lighting and signage
- Transportation services
- Carpets and textiles
- Leather and leather processing

- Precious and semi-precious stones
- Marble and natural stone

Establishing an Office/Licensing

Afghanistan ranks an impressive 16 out of 155 countries in ease of registering a business, according to the World Bank's 2005 "Doing Business Report." The Afghan Investment Support Agency (AISA) is every foreign and domestic investor's one-stop shop for registering and establishing a business in Afghanistan.

AISA's Investment Managers will assist the investor with the following procedures, which are necessary to obtain a business license:

1. Completion of the Investment Application Form and Application Form for Tax ID Number

2. Registration of the Investment Application Form

3. Provision of guidance on the requirements for submission of a business plan and review of the project documents to ensure it is within the country's legal framework 2/6/2006

4. Registration of investment documents in commercial court and announcement of investors' business/investment details in a reputable Afghan newspaper

5. Payment of License Fee and Issuance of Investment License

The Ministry of Foreign Affairs also asks that each company provide an introduction letter from its embassy. The U.S. Embassy can provide this letter upon provision of the company's State Articles of Incorporation and evidence of an IRS Tax ID number.

The entire process takes about seven days. Licensing fees range from $100 to $1,000, depending on the size of initial investment.

If the business intends to engage in import/export, additional steps are required. In addition to the Investment License, the Ministry of Commerce will also issue an export license. To obtain an export license, the Ministry requests businesses to provide the following information:

1. Company Profile
2. Bank statement or Certified Public Accountant's (CPA's) statement
3. A copy of the company representative's passport
4. Company Article of Association or Charter
5. Police Certificate (Clean Records Certificate)
6. A letter of introduction from the embassy of the applicant
7. Notarization of all the documents by the applicant's embassy in Kabul or the Afghan embassy in the applicant country of citizenship. There are no separate licensing procedures for joint ventures.

In addition to providing investors with licensing services, AISA also hosts business, trade and investment events and conferences. Investment managers can also refer companies to potential partners, sources of finance, and opportunities in industrial parks.

Establishing a physical office remains more of an art than a procedure. Potential investors face an overheated real estate market, with rents comparable to cities such as New York and Tokyo. Renters are also required to pay a 20% renters tax, which they must personally withhold from their monthly rent payment and remit to the Government of Afghanistan. Foreign investors are not permitted to purchase real estate in Afghanistan Basic infrastructure, such as electricity, heating, and telecommunications, remains a constant challenge.

Potential investors should be aware that the Government of Afghanistan launched an Industrial Park Program in 2004 and is working with donors, including USAID and the World Bank, to develop these parks. The industrial parks offer clear land title, reliable power and water supply, and security. The industrial park in Bagrami (near Kabul) is currently operational and is under consideration for expansion. Parks in Mazar-e-Sharif and Kandahar are currently under construction and several more are planned for the future. The Industrial Park Program is administered by AISA.

Selling to the Government

The Government of Afghanistan has established a procurement agency to facilitate the purchase of goods and services for the Government. This agency, the Afghanistan Reconstruction and Development Service (ARDS), uses internationally recognized procurement procedures. Companies that wish to receive procurement notices can do so by registering through email. Notices on new procurements are sent electronically to all companies registered with ARDS. ARDS also maintains a list of suppliers.

Distribution and Sales Channels

Formal distribution and sales channels are not well developed in Afghanistan. Most commerce is confined to small store fronts, markets and informal roadside trading.

Major distribution centers are Kabul, Herat, Mazar-e-Sharif and Kandahar. Most commercial goods destined for Afghanistan are shipped through ports in Karachi or Port Qasim, Pakistan, moved overland by rail or truck and enter the country via the Torkhum (Nangarhar province) or Chaman (Kandahar province) border crossings. Goods are then distributed throughout Afghanistan by truck. Another major overland route is through Iran via Bandar-i-Abbas, entering Afghanistan at the border with Herat province

However, U.S. law prohibits transshipment through Iran by American companies or individuals without written approval by the U.S. Department of Treasury's Office of Foreign Assets Control. There is no internal rail network in Afghanistan. Though a growing number of air cargo companies are offering their services, this sector is still undeveloped and comparably expensive.

Selling Factors/Techniques

Due to a low level of English among the local population, sales materials should be in Dari and/or Pashto if your market is primarily in the south of the country. Direct marketing is a relatively unused sales technique due to the fact that the postal system is largely defunct and land-line telephone connections are limited. However, with a growing population of cellular users, currently reaching over one million, direct marketing via cellular phone will likely become more widespread in the near future. Electronic commerce is not widespread in Afghanistan due to still developing telecommunications infrastructure. Surveys show that fifteen percent of businesses use email to communicate with their clients and nine percent have websites.

The United Nations Development Program has conducted a Market Sector Assessment of small and medium size enterprises in Afghanistan that includes information on existing marketing practices in some sectors.

Trade Promotion and Advertising

The major trade fair promotion agency is Brightway Exhibitions and Conference Organizing Company , which organizes trade exhibitions several times a year both in Kabul and abroad. The Afghan Investment Support Agency at the quasi-government agency responsible for investment promotion, organizes trade promotion events. The

Afghan International Chamber of Commerce also has a Trade and Investment Promotion Office Businesses in Afghanistan spend limited resources on advertising. Only a handful of Western-style advertising agencies are present, such as Altai Consulting whose marketing and communication branch is an affiliate of John Walter Thompson. Commercial advertising is available through major television and radio outlets such as

Tolo TV http://www.tolo.tv,

Ayna TV http://www.aynatvnet.com,

Ariana TV and Radio http://www.e-ariana.com,

Afghanistan http://rtakabul.tripod.com

and Radio Arman, http://www.arman.fm.

Radio Khillid, Radio Salam Watandar, and Afghan TV also offer such services. Newspaper readership in Afghanistan is negligible and as such, there is no market for commercial advertising in newsprint.

Pricing

Factors to consider in pricing are as follows:

- Corporate and personal income tax of 20%, low by regional standards.
- Business Receipts Tax of 2 percent based on all revenue and billing.
- Import tariffs in the range of 2.5-16 percent.
- High transport costs.
- Competition from cheap, low-quality goods and services from Pakistan and Iran.

Sales Service/Customer Support

Customers in Afghanistan are not accustomed to a high degree of sales service and customer support, with the possible exception of those who use mobile and internet service providers. However, appreciation for higher levels of service is increasing as the general population becomes more market savvy.

Protecting Your Intellectual Property

Afghanistan currently has no legislation that addresses intellectual property rights and as such, investors should have no expectation of protection.

Due Diligence

It is essential to conduct adequate due diligence on potential local partners before entering into business in Afghanistan. As the country currently has no contracts law in place and the commercial court system is inadequate, businesses should tread carefully when entering into commercial agreements or partnerships. thoroughly familiarize oneself with both the business environment and the potential partner is highly recommended. The Afghan International Chamber of Commerce (AICC) and the Afghanistan Investment Support Agency (AISA) can be helpful in providing background on a potential partner. In addition, there are a few local attorneys who specialize in business and commerce that can be contacted for assistance.

Construction Materials

Demand for all types of materials is booming and will remain strong over the next several years given the magnitude of the reconstruction process, a growing population and rising income. Projects range from large scale reconstruction of roads, power and water infrastructure to small scale retail and residential construction. International donor demands for high quality and quantity represent opportunities for both the export market and local investment. This sector offers perhaps the highest potential for both U.S investment and exports.

Most available construction materials are currently imported and are of poor quality. Cement, for example, is primarily imported from Pakistan and Iran and is of such poor quality that is considered not saleable in those countries.

High transportation costs, an abundance of raw materials, and a supply of local workers with adequate skills in this sector combine to offer promising opportunities for investment in local production that could under-price foreign rivals. The national market for materials is well-integrated, with competitive wholesaling and retailing and established distribution channels. There is medium-term potential for local production for export as well, particularly in the marble and marble cutting industry, as Afghanistan's wealth of natural resources offers it a comparative advantage over neighboring countries. Profitable investment opportunities also exist in the manufacturing of final construction inputs, such as doors or windows. Often these activities are carried out on a small scale basis, but many opportunities exist to expand to mass production.

Opportunities in Construction

Cement and Cement Block

Afghanistan is in an earthquake prone region. Demand for quality cement is high and is forecasted to remain strong, both in Afghanistan and in regional countries where industries are operating at capacity levels. Local conditions for the production of cement (i.e., adequate limestone) exist. Given the high transportation costs for this product, investment in locally produced cement has great potential. The Government of Afghanistan has placed a high priority on attracting international investment in this industry.

Cement blocks are a popular local construction material. Upgrading and expanding existing production facilities or establishing new facilities offers good investment potential.

Bricks

Both baked and unbaked bricks are used for construction in Afghanistan. Both are produced locally on a small scale. However, most baked bricks are imported from Pakistan. Given high transportation costs, there are good business opportunities in the expansion and upgrading of local production facilities.

Doors and Windows

Current local production of doors and windows uses low technology and does not meet local demand. Investment opportunities exist in the industrialization and expansion of this process.

Marble and Natural Stone

There are substantial marble deposits within Afghanistan. Only a small fraction of what is mined is processed locally for construction or handicrafts. Most is exported to Pakistan, where it is cut into blocks and slabs. Investment in the local cutting process has high profit potential. The abundance of natural stone also offers potential in mining and processing.

Tiles

The raw materials for the production of ceramic tiles and other ceramic products can be found in Afghanistan. High demand and prohibitive transportation costs represent great potential for investment in local production facilities.

Sand, Gravel and Aggregate

Many production sites for sand, gravel and aggregate are present. However, quality is mixed due to inadequate equipment. Investment and U.S. export opportunities exist in upgrading the quality of production as well as in the exploitation of new mining sites.

Asphalt

Local asphalt production capacity does not meet the booming demand brought on by large scale road construction and reconstruction activities. High profit potential exists in expansion of local production.

Agro Processing

Afghanistan is predominantly an agricultural country; agriculture represents nearly 40% of licit GDP. At one time, high quality Afghan agricultural product exports such as dried fruits, nuts, almonds and pistachios occupied a prominent share of the world market. Following almost three decades of conflict, farmers in Afghanistan have made great strides in reviving agro business in the country. Production has substantially increased; cereal production alone increased by 82% in 2002 and 50% in 2003. Development of the agricultural sector is a high priority of the Government of Afghanistan and is the focus of international donor efforts to revive rural economic activity. Improvements in irrigation systems, fertilizer use and extension services, and a land titling reform program have resulted in increased and more stable production and reduced input prices.

The domestic market potential for agricultural products is huge and demand is increasing with a rise in income across the country. Currently, most processed food is being imported. With rapidly improving supply conditions for agricultural products, there is a large potential for import substitution and early entrants stand to benefit as the first domestic suppliers of their products. In addition, Afghan agricultural products represent a potentially valuable export product for potential investors, particularly in regional markets such as India and Pakistan. There is also great potential in processing, particularly cleaning and packaging, or in other elements of the logistics chain such as testing and certification, for both export and domestic consumption. Agricultural sector investment so far as been limited, representing only 1% of new investment since 2002.

2. OPPORTUNITIES IN AGRO PROCESSING

Dried Fruits and Nuts

The world market for raisins, pistachios, dried apricots, almonds and walnuts is $2.2 billion, of which Afghanistan currently claims only 2%. The potential for dramatically expanded local capacity is high as many of these products were formerly produced on a large scale and continue to enjoy international recognition for quality. Neighboring markets such as Pakistan, India and Russia offer vast export potential. Raisins, for example, are Afghanistan's primary agricultural export commodity and once accounted for 60% of the world's market. Existing raisin plants are ripe for new investment to increase and improve production. Ideal growing conditions exist for almonds, pistachios apricots. The world's largest importers of these products - India for almonds and Russia for dried apricots – are natural regional markets. Low productivity of existing orchards and production facilities, as well as a lack of machinery for sorting, drying and packaging, offers potential for investment and a market for U.S. technology.

Juices, Pastes, Jam

Local demand for fruit juice, jams and tomato paste is high. Industrially processed products available on the local market are almost entirely imported, primarily from Iran and Pakistan. Markets in Afghanistan are estimated at approximately $20 million for fruit juice and $15 million for tomato paste. The abundance of local fruits and tomatoes offer substantial business opportunities in import substitution.

Dairy Products

Most industrially processed and packaged dairy products are imported. Many regions in Afghanistan have a well-established dairy production tradition, particularly in yoghurt, but lack the infrastructure to expand beyond local consumption. U.S. exports, local production for import substitution, as well as investment in collection, processing, packaging, and a cold storage/transportation chain offer great potential.

Karakul Skins and Leather

Karakul skins were formerly one of Afghanistan's major exports. With the number of livestock dramatically increasing, this industry has rebounded. Investment opportunities and potential for U.S. exports of machinery exist in skin processing and leather manufacturing.

Meat Processing

Existing meat processing facilities do not meet international standards. Given the increase in livestock, good opportunities exist for U.S. exports and investment in the upgrading of these facilities and equipment.

Cotton and Sugar

Afghanistan formerly produced substantial quantities of cotton and sugar (beet and cane), been involved in the rehabilitation of former state-owned enterprises in these areas as well as in green field operations. The Spinzar plant in Kunduz and the Balkh Gin and Press in Mazar-e-Sharif were recently privatized under a long term leasing agreement with cotton specialist Digress of France, and KWS of Germany has successfully invested in a joint venture sugar factory in Baghlan. Similar opportunities exist for interested investors.

Mills and Baking

Most baking and wheat processing activities currently are carried out on a very small scale. Substantial opportunities for expansion of the industry exist.

Non-traditional Products

Afghanistan has a number of native plants with unrealized commercial potential. Ideal climatic and ground conditions for many natural ingredients for the flavor and fragrance industry exist. For example, conditions are ideal for the cultivation of roses and the production of rose oil. A number of spices, rare herbs and medicinal plants can also be found. Various market studies have demonstrated substantial possibilities in these areas.

Processing and Packaging

Most processing and packaging facilities currently in use for agricultural goods are technologically outdated. This sector represents attractive opportunities for investment and U.S. export of technology and equipment to crush, press, pasteurize, filtrate, dry, sort/grade, fill, and package a variety of agricultural products.

Cold Storage and Transportation

There are few cold storage facilities in Afghanistan. As the agro business sector strengthens and power and fuel supplies become more reliable, cold storage represents immense potential for U.S. investment and exports.

Carpets and Textiles

Carpets are Afghanistan's most important export, estimated at $40 million. The industry has a centuries-old tradition that enjoys world renown. Afghan carpets are internationally competitive, even with the challenges of a post-war economy; a reflection of the capabilities of generations of skilled Afghan weavers.

The Government of Afghanistan places a high priority on the development of the carpet sector, particularly because of its importance as a source of income for the rural population, including women and refugees. Government policy is directed to the benefit of the industry.

Production is concentrated in several regions of the country. While some carpet factories have been established in urban centers over the last two years, production remains primarily home based and fragmented. A lack of available and appropriate land has inhibited the development of consolidated production sites; however, the initiation of an industrial parks program, administered by the Afghan Investment Support Agency, now provides new opportunities for appropriate locations.

As few local post-weaving facilities exist, most Afghan carpets destined for overseas markets are exported to Pakistan to undergo the washing, trimming, and finishing process, and re-exported from there to overseas markets. These production stages, as well as the commission earned by intermediary traders, represent revenue lost to Afghanistan.

Carpets are transported to foreign markets via land and sea or air, primarily through Pakistan. A growing number of air freight companies serve Kabul and while rates are expensive, this method is increasingly in use. To support the industry, President Hamid Karzai has decreed that Ariana Afghan Airlines transport Afghan carpets at cost.

Hand-knotted Afghan carpets enjoy preferential access to important overseas markets. No customs duty is levied on their import into the United States, Canada or the European Union.

The Afghan carpet industry offers great potential and investment opportunities, particularly in re-establishing those elements of the production chain which now take place outside the country, allowing for direct trade with overseas markets. It is estimated that the value of sector imports could increase two to five times if goods were sold directly to foreign markets rather than through intermediaries. Investment in information technology offers the potential to develop niche markets for customized, made-to-order carpets for foreign buyers. Improvements to wool and yarn inputs and consolidation of production facilities promise increased efficiency, quality and profitability.

3. OPPORTUNITIES IN THE CARPET INDUSTRY

Post Weaving Facilities: Washing, Trimming, Finishing

Facilities for washing, trimming, and finishing carpets are scarce in Afghanistan. The absence of such facilities has created a major bottleneck in the development of direct access to overseas markets. As a result, the carpet industry is dominated by Pakistan based middlemen. The establishment of such facilities in Afghanistan represents the largest investment potential in this sector.

Carpet Factories

While a limited number of carpet factories exist, the industry in still largely based on home production. The establishment of additional factories represents profit potential by allowing for shorter completion time through longer working hours and increased quality via permanent monitoring and skills exchange among workers. While in the past the availability of land represented an impediment to the establishment of such factories, the introduction of an industrial parks program, administered by the Afghan Investment Support Agency, has improved opportunities for investors in this area.

Wool Scouring and Spinning

Quality carpets require quality wool and yarn. While most producers of high quality carpets strive to exclusively use local, handspun wool, supply is insufficient to meet demand. Growing numbers of livestock in Afghanistan have created the potential for investment in additional wool scouring facilities. Spinning of high quality yarn, either from local or imported wool, also represents substantial opportunities.

Design Technology

Most carpet designs are currently sketched and plotted by hand. Investment in Computer Aided Design (CAD) technology and associated training that would improve the efficiency of production and facilitate the niche market for custom ordered carpets has reasonable profit potential.

Logistics and Transportation

Afghanistan has long been a trade hub connecting Asia, Europe and the Middle East. A landlocked country bordering Iran, Turkmenistan, Uzbekistan, Tajikistan, China and Pakistan, it is considered a “land bridge” connecting trading partners and offering a point of access to an expanded regional market of more than 2 billion people.

Inadequate transportation infrastructure represents a major obstacle to increased commerce and thus is a focus of the reconstruction effort. Major highway construction is underway, including the construction of a 2,400 km ring road circling the country and 700 km of links with neighboring countries. The reopening of the Salang Tunnel in 2002 was a major step forward in opening road links with northern Afghanistan. The reopening of the Termez-Hazarey bridge in 2002 opened links to Uzbekistan. A bridge linking Afghanistan to Tajikistan is currently being built in Kunduz province. The Amu Darya (Oxus) River, which forms part of Afghanistan's border with Turkmenistan, Uzbekistan, and Tajikistan, has increasing barge traffic.

With improving infrastructure, transport is a high-growth sector and the demand for transport services is expected to remain strong in the medium to long term. Transport of commercial goods is expected to rise as the commercial infrastructure improves and domestic production of products with strong export potential, such as carpets and dried fruits and nuts, increases. Improving security has also resulted in increased transshipment of goods through Afghanistan.

The market for logistics and transportation services offers first mover advantage to prospective investors with little competition and steady demand. Early investors have reported modest start-up costs, low overhead and high profit margins.

Opportunities exist in areas such as:

- Cold cargo and perishables storage
- Overland transportation
- Truck maintenance
- Customs facilitation
- Air freight and cargo services
- Package and document delivery
- Procurement and supply
- Warehousing

Mining

The mining industry offers considerable growth potential for U.S. investment and export of technology. Afghanistan has a large quantity of known mineral resources as well as vast areas where the potential is unknown. These resources include beryllium, chrome, coal, copper, gold, iron, lead, manganese, nickel, salt rock, silver, uranium and zinc.

The country's known precious and semi-previous minerals include alabaster, amethyst, beryl, emerald, jade, lapis lazuli, quartz, ruby, sapphire and tourmaline. While some of these materials are used in the handicrafts market, few of the reserves are being commercially exploited and there is room for expansion of this industry. A reconstruction boom is generating significant local demand for mineral-based construction materials ,including marble, paving stones, cement and cement blocks, bricks, gravel, wood, steel, sand, glass and tile. High transport costs provide an advantage to locally produced products. Domestic energy needs remain unmet, despite significant deposits of coal. This sector represents medium to long term, rather than short term, potential.

Privatization of Afghanistan's State-Owned Enterprises, which control many of the country's mining resources, such as coal, is not complete. A Minerals Law was passed in July 2004, however, accompanying regulations are incomplete. The World Bank has estimated that the value of solid minerals produced in the country could reach $253 million by 2008, up from $60 million in 2004, if the necessary reforms are implemented. The market for U.S. technology, equipment and expertise in this sector will be substantial. Foreign firms will also be accorded equal opportunity under the privatization program and opportunities for investment will be significant. Investments in this area are required to undergo screening by a sub-cabinet of Ministers and may approved under terms that differ from 2005 Private Investment Law.

Import Tariffs

Afghanistan maintains the lowest import tariffs in the region. A new tariff regime has significantly reduced and simplified the customs duty rates to six major categories: essential food and non-food products – 2.5%; raw materials and capital goods – 5%; petroleum products – 8%; semi-manufactured goods – 10%, and; luxury and non-priority products at 15% and 16% respectively. Further, planned customs rationalization will decrease the number of rates from six to four, increase the tariff rates charges on the bulk of imported products, and increase the weighted average tax rate from 3.9% to 6.9%. Even at these revised tariff rates, Afghan tariffs will remain the lowest in the region.

Trade Barriers

Afghanistan has few trade barriers for imported products. However, deficient infrastructure, a still evolving legal and commercial regime, high levels of corruption and a volatile security situation act as de facto trade barriers.

Import Requirements and Documentation

All imported goods and products must have an original bill of lading and inventory documents. Transit permission is required for shipments transiting through Pakistan, which can be obtained from the Central Board of Revenue's Customs Division in Islamabad, Pakistan.

U.S. Export Controls

In June 2002, the U.S. lifted most restrictions on exports and re-exports to Afghanistan. Such transactions are now subject to export control policies applicable to most countries who are not members of multilateral export control regimes. The majority of everyday commercial goods do not require specific U.S. government authorization for export or re-export to Afghanistan. However, certain items on the Commerce Control List do require a license from the Department of Commerce's Bureau of Industry and Security (BIS).

These include items controlled for chemical and biological weapons, nuclear nonproliferation, national security, and missile technology reasons. There are also foreign policy controls in place for regional stability and crime control reasons. These requirements can be found in Part 742 of the Export Administration Regulations (EAR) The U.S. government generally reviews license applications to export controlled goods to Afghanistan on a case-by-case basis. Note that a license is required to export an item subject to the Export Administration Regulations even when one would not otherwise be necessary, if you know, have reason to know, or are otherwise individually informed by the Department of Commerce's Bureau of Industry and Security (BIS) with respect to a specific transaction that the item will be used in activities related to nuclear, chemical, or biological weapons or missile deliver systems as defined in part 744 of the Export

Administration Regulations. In addition, certain restrictions administered by the U.S. Department of the Treasury's Office of Foreign Assets Control continue in effect with respect to transactions involving members of the Taliban. Detailed information on U.S. export policies can be found at the BIS website .

Temporary Entry

Afghanistan currently has no laws or regulations governing products entering the country temporarily.

Labeling and Marking Requirements

Afghanistan currently has no laws or regulations governing labeling and marketing requirements for products.

Prohibited and Restricted Imports

The following items are prohibited from entry in Afghanistan:

- firearms, explosives, daggers
- obscene and subversive literature
- alcohol (2 liter exception for personal use for commercial air passengers)
- recorded VCR tapes and other movies
- parlor video games or parts thereof
- goods in commercial quantities

Although not prohibited from entry into Afghanistan, Pakistan currently maintains three items on its Negative List (cigarettes, cooking oil and auto parts) that are barred from transiting its territory for import into Afghanistan.

Customs Regulations and Contact Information

Customs regulations and procedures in Afghanistan are neither transparent nor uniform. Coordination between customs and other government authorities is minimal; customs staff are untrained and infrastructure is degraded. Traders face unclear procedures at the borders, as well as extra-legal duties and bureaucratic obstructions.

Customs reform is a priority of the Government of Afghanistan. Large-scale reform efforts are underway to establish standardized fees and procedures for incoming goods and a trained cadre of professional staff. In December 2003 the Customs Department introduced a Single Administrative Document system pilot program, based on the European Union customs regime, for five key provinces. In March 2005, implementation of the Automated System for Customs Data (ASYCUDA) system began on a limited scale. Simplified exemptions processing documentation is being introduced and a new Customs Code is under consideration. A system of Licensed Customs Brokers is also being designed.

Standards

Afghanistan is currently in the process of developing a national standards regime. The Afghan National Standards Authority (ANSA) is an independent agency under the Ministry of Commerce and was established in 2005. ANSA is responsible for the establishment, maintenance, dissemination and enforcement of national standards and technical regulations. ANSA plans to have standards regulations in place for select goods and products in 2006.

Trade Agreements

Afghanistan is a member of the Economic Cooperation Organization (ECO) and the Central Asia Regional Economic Cooperation (CAREC.) It become a full member of the South Asian Association for Regional Cooperation (SAARC) in 2006.

Afghanistan has signed bilateral Trade and Economic Cooperation Agreements with Russia and Turkey, a bilateral Reciprocal Promotion and Protection of Investments Agreement with Turkey, a bilateral Preferential Trade Agreement with India and a bilateral Investment Treaty with Germany.

Afghan products enjoy duty free and quota free access under an LDC Market Access Initiative with Canada and a Generalized Preferences Treatment agreement with Japan. Afghan products also enjoy an “Everything But Arms” (EBA) agreement with the European Union, which allows duty free treatment for all other items manufactured in Afghanistan.

As a least-developed country, Afghanistan is eligible for duty-free access to the U.S. market for approximately 5,700 products under the Generalized System of Preferences (GSP) program. Afghanistan has signed a bilateral Investment Incentive Agreement with the United States to encourage and protect investment activities in Afghanistan through the provision of insurance and investment guarantees under the OPIC program.

In 2004, a Trade and Investment Framework Agreement (TIFA) was also signed with the United States.

Afghanistan became an observer to the World Trade Organization in December 2004 and has announced its intention to complete the WTO accession process within the next five years.

Openness to Foreign Investment

The Government of Afghanistan recognizes that the development of a vibrant private sector is crucial to the reconstruction of an economy ravaged by decades of conflict. As such, it has taken significant steps towards fostering a business-friendly environment for both foreign and domestic investment.

The 2005 Private Investment Law specifically prohibits discrimination against foreign investors. However, it notes that investment in the certain sectors, such as infrastructure (defined to include power, water, sewage, waste-treatment, airports, telecommunications and health and education facilities) or natural resources, are subject to limitation and/or special terms. Foreign investment in these sectors, while not prohibited, is subject to special consideration by the High Commission on Investment, in consultation with relevant government Ministries. Investments can be 100% foreign owned; foreign investors are not required to secure an Afghan partner. Private investors have the right to transfer their capital and profits out of Afghanistan. Foreign and domestic investors enjoy equal treatment, including under ongoing privatization programs, except as noted in the sectors above. Foreigners may not own real estate; but they may lease it for periods up to fifty years.

The Government has adopted progressive policies to foster trade and investment, including currency reform, rationalized customs tariffs and a simplified tax code. It has also set up structures to help promote investment and investment-friendly policies. The High Commission on Investment, comprised of the Ministers of Commerce, Agriculture, Mines and Industries, Foreign Affairs, Finance, and Economy, and Da Afghanistan (Central) Bank, coordinates policymaking. The Afghan Investment Support Agency, a quasi government agency under the Ministry of Commerce, operates a streamlined business registration process and conducts a host of business and investment promotion and facilitation activities.

While private sector development and attracting foreign investment is an official priority, the government remains significantly involved in commercial activities. There are more than 75 state-owned enterprises (SOE) and state-run corporations under 16 different ministries. Although most are moribund or performing at minimal levels, only two have been privatized. SOEs own vast amounts of land and property around the country, and delays in the rationalization and liquidation of some SOE holdings further stalls development and investment. The Government has in some instances exhibited anticompetitive and protectionist bias in areas dominated by State Owned Enterprises. For example, the Ministry of Transport has favored national flag carrier Ariana Airlines by denying some new air service routes to competing commercial carriers.

The Ministry of Commerce continues to support Soviet-style Chambers of Commerce and Industry, which have yet to be dissolved or consolidated with the independent Afghan International Chamber of Commerce, established in 2003.

Although top officials embrace foreign investment, many businesses maintain that this attitude has not trickled down to many of the Soviet era-trained officials who continue to staff Government ministries and regulatory agencies. These individuals, who reportedly demand bribes, levy unofficial taxes and incur bureaucratic delays, are not in step with official government policy.

Conversion and Transfer Policies

There are no restrictions on converting or transferring funds associated with investment into a freely usable currency and at a legal market clearing rate. The Private Investment Law states that an investor may freely transfer investment dividends or proceeds from a sale of an approved enterprise abroad. Furthermore, Afghanistan does not maintain a dual exchange rate regime, currency controls, capital controls, or any other restrictions on the free flow of funds abroad.

Access to foreign exchange for investment remittances is not restricted by any law or regulation. There are large, informal foreign exchange markets in major cities and provinces such as Kabul, Mazar-e-Sharif, Jalalabad, Kandahar and Herat where U.S. Dollars, Sterling Pounds, and Euros are readily available. Under provisions of Afghanistan's Anti-Money Laundering Law, both foreign and state banks are required to accept all foreign currencies. However, in practice, particularly in the provinces, many banks may not have the capacity to deal with foreign exchange.

There is no legally mandated delay period for remitting investment returns such as dividends, return of capital, interest and principal on private foreign debt, lease payments, royalties and management fees through normal, legal channels, as there are no restrictions on such remittances.

There is no limitation on the inflow and outflow of funds for remittances of profits, debt service, capital, capital gains, returns on intellectual property or imported inputs, provided that applicable taxes have been paid. Accordingly, there is no need for a legal parallel market such as convertible negotiable instruments. The only requirements placed on the outflow of funds are procedural, for the purposes of anti-money laundering. For example, any transfer abroad that equals or exceeds AFN 1 million or equivalent must be carried out through a duly authorized or permitted banking organization or licensed money service provider. The transport of more than AFN 1 million or equivalent in cash across the border of Afghanistan into another country must be reported in advance to the Financial Intelligence Unit of the Da Afghanistan (Central) Bank.

Expropriation and Compensation

The Private Investment Law states, "The State can expropriate an investment or assets…only for the purposes of public interest and on a non-discriminatory basis." It further states that the "State shall provide prompt, adequate and effective compensation in conformity with the principles of international law, equivalent to the fair market value." The State may also confiscate private property in order to settle bad commercial debts.

Both the Afghan Constitution and the Private Investment Law prohibit foreigners from owning real estate. There have been no reports of State expropriation of foreign assets, "creeping," or otherwise.

Dispute Settlement

Afghanistan's legal system is only just beginning to rebuild. Much of the framework necessary for encouraging and protecting private investment is not yet in place and the existence of three overlapping systems (the Sharia, the Shura and the formal legal system instituted under the 2004 Constitution) can be confusing to both investors and legal professionals. While a commercial court system exists, the lack of contracts law and a commercial code, drafts of which are still under consideration, is a significant impediment to the arbitration of commercial matters. In addition, there is a shortage of qualified legal practitioners and corruption in the judicial system is endemic.

There is no formal alternative dispute resolution mechanism such as arbitration or mediation. Afghanistan is a party to the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States and the New York Convention of 1958 on the Recognition and Enforcement of Foreign Arbitral Awards. The Private Investment Law provides for dispute resolution under these mechanisms, under United Nations Commission on International Trade Law (UNCITRAL) rules, or under any mechanism that the investor has specified in a contract with another investor. These provisions, however, are untested.

Under these conditions, the legal system plays a limited role in adjudicating commercial disputes and most businesses use informal mechanisms to resolve disputes and enforce property rights. The Afghan Investment Support Agency, for example, has a limited capability to assist investors in the mediation of some disputes.

Investment disputes are common in the areas of land titling and contracts. The lack of a comprehensive titling database means that several individuals may hold deeds to the same property. Real estate agents are not reliable. Those investors seeking to purchase property are advised to conduct painstaking due diligence. The absence of a contract law has resulted in the near unenforceability of commercial agreements.

Performance Requirements and Incentives

Afghanistan has no formal regulations or laws governing performance requirements. The Private Investment Law prohibits discrimination against foreign investors, except in certain sectors, as noted above. It also restricts foreigners from owning real estate.

There are no separate investment incentives or special treatment accorded to foreign investors.

The government does not impose offset requirements on its procurements and foreign firms are accorded equal treatment with national firms.

There are no discriminatory or excessively onerous visa, residence or work permit requirements for foreigners. There are no discriminatory or preferential export and import policies affecting foreign investors.

Right to Private Ownership and Establishment

Under the Private Investment Law, foreign and domestic private entities have equal standing and may establish and own business enterprises, engage in all forms of remunerative activity and freely acquire and dispose of interests in business enterprises. The only exception is in real estate; foreigners may not own land but they may lease it for periods of up to fifty years.

In principal, government policies and regulations apply the standard of competitive equality to private enterprises in competition with public enterprises with respect to access to markets, credit and other business operations. However, the Government has in some instances exhibited anti-competitive and protectionist bias in areas dominated by State Owned Enterprises. For example, the Ministry of Transport has favored national flag carrier Ariana Airlines by denying some new air service routes to competing commercial carriers.

While not sanctioned by law or official policy, small groups of businessmen, many of whom are alleged to have connections with former warlords and militias, dominate the trading market in many areas. These individuals, because of their wealth and insider access to land, credit and contacts and ability to manipulate prices, wield an excessive advantage that results in a non-competitive environment in some fields, notably fuel and construction. In addition, some industries, including money changing and carpet production, have well-organized guilds which protect existing firms and act to prevent newcomers from establishing themselves.

Protection of Property Rights

Property right protection is weak due to a lack of property registries or a land titling database, disputed titles, incapacity of commercial courts, and widespread corruption.

The acquisition of a clear land title to purchase real estate or a registered leasehold interest is complicated and cumbersome. It takes an average of 252 days and costs 9.5 percent of the value to register property. Many businesses cite access to land as one of the biggest impediments to investment in Afghanistan. The concept of a mortgage does not exist yet in Afghan law.

The country's bankruptcy law dates to the 1960s and is not effective. A new bankruptcy law is currently in draft form and under consideration.

Afghanistan currently has no legislation that addresses intellectual property rights. It is not a member of the WTO Trade Related Intellectual Property Rights Agreement or the World Intellectual Property Organization Internet Treaties. Pirated DVDs and software are sold throughout the country. Counterfeit pharmaceuticals and building materials are common.

Transparency of Regulatory System

In general, the Government of Afghanistan promotes transparent policies and effective laws to foster competition, establish "clear rules of the game" and promote, rather than hinder, foreign investment. The inadequacy of the regulatory system, and corruption among those who administer it, is more of an obstacle to investors than the transparency of the regulations.

Procedures for obtaining a business license were streamlined in 2003 with the establishment of the Afghanistan Investment Support Agency (AISA,) which serves as a one-stop shop for investors, and which has greatly facilitated the process of establishing a business in country (see Chapter 3 for further details.) Afghanistan now ranks an impressive 16 out of 155 countries in ease of registering a business, according to the World Bank's 2005" Doing Business Report."

There are no informal regulatory processes managed by nongovernmental organizations or private sector associations.

Prior to December 2005, proposed laws and regulations were passed by Presidential Decree. Drafts were not published for public comment; however, relevant ministries occasionally forwarded draft legislation to interested bodies for informal comment. This process was criticized by the private sector as insufficient. A new Parliament, which convened on December 19, 2005, now must approve all legislation. Parliamentary rules and procedures are still being debated and the mechanism for public comment on proposed legislation is yet to be determined.

Legal, regulatory and accounting systems are inconsistent with international norms. The legal framework for investment is inadequate, accounting and standards regimes have yet to be set up, and regulatory bodies are often understaffed, weak and corrupt.

Reform programs, however, are in progress and rely heavily on foreign experts who base their initiatives on international best practices.

The predictability of the Government with respect to the regulatory system is cause for some concern. In 2003, the transitional government granted tax holidays of four to seven years for new investors, but since then, many of these provisions have been scaled back, in some cases retroactively. This has created insecurity among investors who fear unanticipated reversals in policies on which they have based business decisions.

Efficient Capital Markets and Portfolio Investment

Credit markets are fragmented and under-developed in Afghanistan. Bank credit is available, on limited "market" terms, to domestic and foreign investors in major urban centers. The variety of credit facilities and instruments is limited. Most bank credit is short-term (i.e., less than one year) and unsecured. Lending is underdeveloped because of a lack of adequate legislation and regulatory infrastructure to allow lending institutions to perfect security interests in pledged collateral. Public debt (and equity) markets are not available in Afghanistan. Most local firms rely on family and friends and the informal *hawala* system to obtain necessary funds.

Access to credit has been identified as one of the largest obstacles to investment in Afghanistan. In the World Bank's 2005 "Doing Business Report," Afghanistan ranks 153 out of 155 countries for getting credit, a measure of credit information sharing and legal rights of borrowers and lenders.

As of September 30, 2005, the total assets of the banking system of Afghanistan (12 duly-licensed and permitted banking organizations) were AFN 24.6 billion, or about USD 500 million.

The banking system can be described as sound, with no bank exhibiting deficiencies in either capital or liquidity. Deposits and loans are growing rapidly, and the Central Bank is exercising close supervision of all 12 organizations from both an on-site and off-site perspective. Non-performing loans are about 2.5 percent of the total loan portfolio of AFN 5.4 billion, which is considered healthy.

Political Violence

Afghanistan is making strides towards political stability. Peaceful, transparent presidential elections in October 2004 and parliamentary elections in 2005 were notable achievements. The Government is taking steps to extend its reach into the provinces and to date more than 30,000 members of the Afghan National Army and nearly 54,000 Afghan National Police officers have been trained and equipped. However, risk of violence is high, and security remains a primary concern and an obstacle to foreign investment. Foreign firms operating in country report spending a significant percentage of their revenues on security infrastructure and operating expenses.

The U.S. State Department continues to warn Americans against travel to Afghanistan U.S. citizens should review the Consular Information Sheet and Travel Warning for Afghanistan for the most up-to-date information on the security situation and possible threats. These documents can be found at:

Corruption

Corruption is rife at all levels of the system in Afghanistan. The country ranks 117 out of 159 in Transparency International's Corruption Perception Index, among the highest in the world. While anti-corruption laws exist, and the practice of giving or taking a bribe is illegal, there is limited enforcement. President Hamid Karzai has created an Anti-Corruption Commission to investigate corruption cases and refer suspects to the appropriate authorities; however, the Commission has not forwarded any significant cases against public officials or private individuals. Afghanistan is not a party to the OECD Convention on Combating Bribery of Foreign Public Officials. It has signed, but has not ratified, the United Nations Convention Against Corruption.

U.S. firms identify corruption as one of the biggest obstacles to foreign direct investment and routinely report being asked for a bribe, called *sherini* or *bakshesh*. With government salaries ranging from $60-$100 per month, many officials see small bribes for government services as a necessary means of survival. U.S. companies are expected to comply with the Foreign Corrupt Practices Act, which prohibits the bribery of foreign officials.

Bilateral Investment Agreements

Afghanistan has Bilateral Investment Treaties (BITs) with Turkey and Germany and currently is negotiating such an agreement with Pakistan. It has no Free Trade Agreements with any country.

Afghanistan signed a Trade and Investment Framework Agreement with the United States in 2004, but a BIT has not been negotiated. There is no Bilateral Taxation Treaty with the United States.

OPIC and Other Investment Insurance Programs

OPIC has an active and expanding portfolio of political risk insurance, loans and equity investment in country. For the purposes of inconvertibility claims, the estimated U.S dollar value of the local currency likely to be used by the U.S. Embassy in the host country economy is AFN 50 to USD 1, the rate at which it purchases local currency. Nominal currency values are anticipated to remain stable in this range for the near future.

Afghanistan is a member of the Multilateral Investment Guarantee Agency.

Labor

There is a critical shortage of skilled labor in Afghanistan. Decades of war, a low level of education and lack of training facilities has resulted in a scarcity of skilled technicians, qualified managers and educated professionals.

U.S. companies who establish training programs for their employees should expect significant returns in enhanced productivity.

Labor management relations are undeveloped. While there are eight major trade union organizations in the country, there is no knowledge or practice of collective bargaining. Existing employee's associations function as commercial and trading organizations. The current Labor Code dates to 1987. A draft of a new code, which purports to be in accordance with ILO standards, is currently under consideration. This law should incorporate all ILO Conventions which Afghanistan has signed to date.

A recently passed Law on Foreign Workers prohibits employers from hiring foreign workers for a job for which an equivalently qualified Afghan is available.

At present, the Government has little to no capacity to enforce labor requirements.

Foreign-Trade Zones/Free Ports

Afghanistan has no duty-free import zones or ports. Under Afghan law, foreign-owned firms have the same investment opportunities as host country entities.

Foreign Direct Investment Statistics

Comprehensive Foreign Direct Investment Statistics for Afghanistan are unavailable.

Available figures are somewhat unreliable due to inconsistencies in data collection. The Afghan Investment Support Agency estimates new FDI in Afghanistan for 2005 at USD $415 million, as compared to $310 million in 2004. Of that figure, $172 million was in the construction sector, $167 million in services and $71 million in industry. The largest investor in 2005 was Turkey, followed by the United States (with $85 million), China, the UAE, Iran and Pakistan. It is important to note that AISA's data tracks approved, rather than actual, investment.

The IMF estimates that FDI in Afghanistan represents 22 percent of GDP.

How Do I Get Paid (Methods of Payment)

Most local businesses operate on a cash basis. Import and export letters of credit are available at several banks, as well as electronic funds transfer. Due to wide mistrust and general underdevelopment of the banking system, many local businesses depend on the informal *hawala* system to make payments and transfer funds. The *hawala* system is an informal value transfer system, whereby money is transferred through a network of brokers, or *hawaladars*. Promissory instruments are not exchanged; the transaction is based on the honor system.

How Does the Banking System Operate

The Da Afghanistan (Central) Bank has licensed 15 commercial banks. Out of twelve, seven banks are full-fledged commercial banks:

1. *Bank-e-Milli Afghan* or National Bank (state bank)
2. *Pashtany Tejarati* Bank or Pashtany Commercial Bank (state bank)
3. Export Promotion Bank (stata bank)
4. First Microfinance Bank (an Aga Khan/IFC joint venture)
5. Kabul Bank (a solely Afghan-owned bank)
6. Afghanistan International Bank (AIB)(an ING-affiliated enterprise with American equity)

7. Arian Bank (joint venture of *Bank-e-Mille* “National Bank” of Iran and *Bank-e-Saderat* “Export Bank” of Iran)

8. Brac Afghanistan Bank(Afghan-Bangladesh joint Bank)

9. Development Bank of Afghanistan (Afghan-Russian joint Bank)

10. Azizi Bank (Afghan-owned bank)

11. Afghan United Bank (Afghan-owned bank)

Five Branches of Foreign Banks:

1. Standard Chartered Bank (UK)

2. National Bank of Pakistan (Pakistan)

3. Habib Bank Limited (Pakistan)

4. Punjab National Bank of India (India)

5. Bank Alfalah Limited (Pakistan)

Two represented offices

1. Zerat Turkish Bank represented office

2. Orian Tajekistan bank

Most of the twelve commercial banks licensed to operate in Afghanistan are concentrated in Kabul and provide services primarily to international donors and businesses, foreign NGOs and foreign government agencies. As of January 31, 2005, 2/6/2006 the Da Afghanistan (Central) Bank’s main office in Kabul is no longer involved in commercial activities. However, in provinces with limited or no commercial banking services, the Central Bank continues to offer some commercial services.

The banking system has limited capacity to provide credit and/or non-credit services. There is no long term financing available from commercial banks in Afghanistan; most offer terms of a year or less, with a maximum tenure of three years. There is a small number of non-bank financial institutions (11 micro-finance institutions, one credit union and one leasing company), but these institutions meet only a small fraction of credit needs. There are no credit bureaus or credit rating agencies.

Because of widespread distrust of the banking system, many local businesses use the hawala system for short-term loans to finance working capital needs, or rely on family and friends. The legal and regulatory framework of the financial sector is still under development.

Foreign-Exchange Controls

Exchange rate policy is determined by the Central Bank, and is implemented through a weekly foreign exchange (USD) auction. No foreign exchange restrictions or multiple currency practices are currently in place.

U.S. Banks and Local Correspondent Banks

There are currently no U.S. banks operating in Afghanistan. However, Afghanistan International Bank is an ING-affiliated enterprise with American equity.

Project Financing

Project financing is available from the following organizations:

The Overseas Private Investment Corporation (OPIC) is an independent agency of the U.S. government that offers specialty insurance (stand alone terror/sabotage and political risk coverage,) loans and guarantees to help U.S. businesses of all sizes invest and compete in more than 140 emerging markets and developing nations worldwide. A $100 million line of credit is available to projects that demonstrate substantial U.S. participation, promise significant benefits to the economic and social development of

Afghanistan, and foster private sector competition in Afghanistan. OPIC gives preferential consideration to projects that significantly involve U.S. small businesses.

OPIC is active in Afghanistan. Some examples include up to $35 million in financing and political risk insurance to support construction of a five-star international hotel in Kabul, managed by Hyatt International, and a direct loan of approximately $3 million to support construction of 1,200 homes near Kandahar by a small American company.

The International Finance Corporation (IFC) promotes sustainable private sector investment in developing countries and is the largest multilateral source of loan and equity financing for private sector projects in the developing world. IFC provides loans, equity finance and quasi-equity. It also offers financial risk management products and intermediary finance.

The U.S. Trade and Development Agency (USTDA) advances economic development and U.S. commercial interests in developing and middle-income countries. The agency funds various forms of technical assistance, feasibility studies, training, orientation visits and business workshops that support the development of a modern infrastructure and a fair and open trading environment. USTDA moved quickly to establish its program in Afghanistan and already has approved funding of about $5 million. USTDA has financed projects in telecommunications, civil aviation, oil and gas, higher education, private sector development, and power.

The Export-Import Bank of the United States provides financing for the sale of U.S. products overseas. Although Ex-Im is currently not open for business in Afghanistan, it will continue to survey future opportunities.

Many business opportunities are connected to the reconstruction effort. The following agencies have large programs through which opportunities for interested businesses are available.

4. U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT (USAID)

USAID has taken a leading role in Afghanistan's reconstruction effort, focusing on health clinics and basic health services, school construction and education programs, revitalizing agriculture through irrigation systems, farm-to-market roads, market centers, and infrastructure, including the Kabul-Kandahar-Herat highway. USAID is also funding programs that enhance the central government's capacity and provide it with the tools and technical assistance to govern effectively. Funding in 2005 exceed $1 billion. The USAID Web site, has a business and procurement link that lists upcoming procurements including solicitation documents, announcements, and other resources. This site is updated daily and offers e-mail notification when a new solicitation has been uploaded to the site. U.S. firms interested in bidding on USAID projects in Afghanistan can review requests for applications, proposals, quotations and invitation for bids on this web site. U.S. firms should also review the main portal for U.S. government procurements .

World Bank

Since resumption of operations in April 2002, the World Bank has financed 19 projects in Afghanistan, committing around US $893.2 million in grants and interest free loans.

World Bank projects primarily focus on improving rural livelihoods by rebuilding infrastructure and providing employment opportunities, education and basic health services. They are the largest international donor to the Government’s National Solidarity and National Emergency Employment Programs, which offer cash-for-work on infrastructure projects. In addition, the World Bank administers the multi-donor Afghanistan Reconstruction Trust Fund, which provides coordinated financing of unfunded priority expenditures in Afghanistan's reconstruction program. The World Bank's website includes an information portal for the business community seeking to participate in opportunities that are generated from World Bank-financed projects.

Asian Development Bank (ADB)

ADB's latest Country Strategy and Program for Afghanistan was released in August 2005, covering the period 2006-2008. Since resuming operations in Afghanistan in 2002, ADB has approved seven public sector loans totaling $513.7 million (to the end of July 2005), $78.5 million in ADF grants (to two projects), and 25 technical assistance projects (both project preparatory and advisory or capacity development) totaling some $40.9 million (including $5.3 million in donor co-financing). In addition, ADB has approved $53.1 million in private sector loans, equity investments, and political risk guarantees. Contract awards in 2004 totaled $99.2 million, bringing the cumulative figure for 2002–2004 to $258.3 million. Public sector disbursements in 2004 totaled $43.2 million, with cumulative public sector disbursements totaling $199.8 million.

ADB projects focus in the areas of agriculture and natural resources, energy, gender, governance, financial and private sector development, transport and communications. A detailed description of their program can be found at. The ADB website, offers detailed information for companies interested in participating in upcoming procurements. Projects can be also be tracked at In addition, there are also opportunities to bid on donor-funded projects administered by the Government of Afghanistan.

The Afghanistan Reconstruction and Development Service (ARDS) manages the purchase of goods and services on behalf of the Afghan Government. Companies that wish to receive procurement notices can do so by registering through email. ARDS can be contacted at Political risk insurance is available both through OPIC and the Afghanistan Investment Guarantee Facility, a program of the World Bank's Multilateral Investment Guarantee Agency.

Business Customs

Business meetings are usually conducted in Dari, Pashto or English in the principal's office. Green or black tea, nuts and raisins are served to greet guests. The form of greeting is "Asalam Aleikum" (Peace be with you), followed by a firm handshake and then, for courtesy and to pay homage to the host (you don't necessarily have to), briefly place your right hand over your heart. It is best to take a few minutes initially to engage in pleasantries about each other's country, rather than going straight to business.

Afghan interlocutors may appear vague and non-committal during meetings. In order to build trust and "get to yes," be patient, share meals and other social events and discuss matters other than business. Capture the essence of your business meetings and agreements in a follow up letter to your Afghan interlocutor. Be clear about what you have committed yourself or your U.S. firm to do, or in many cases, have not committed to do. A promise to "look into" or "research" an issue, quote, or pricing policy may be interpreted as a firm commitment.

5. DO'S AND DON'TS IN AFGHAN CULTURE

Don't show impatience if your interlocutor isn't giving you direct answers. Afghans like to elaborate and want to be clear in communicating.

Don't panic. Afghanistan's government can be bureaucratic. It may take you several days to get a simple authorization signed. Keep in mind that Afghanistan's government is undergoing a reform process.

Don't call an Afghan "Afghani." Afghani is the currency, Afghans are the people of Afghanistan.

Don't drink alcohol in front of an Afghan.

Do greet everyone when entering a room. Shake hands with the men, but not with a woman unless she extends her hand first.

Do eat with your right hand as much as possible.

Do dress modestly.

Do accept a chair if someone brings you one to sit on, even if you would rather stand. This is a sign of respect.

Do read about the country's history, culture, and people before you come, as this will be treated as a sign of respect for Afghanistan.

Travel Advisory

While the U.S. Embassy in Kabul encourages U.S. companies to review business opportunities in Afghanistan, it is important to keep in mind the volatile security situation in the country. Travelers should consult the State Department Travel web site prior to any travel and review both the Consular Information Sheet and Travel Warning for Afghanistan. These documents can be found at:

Visa Requirements

A passport and valid visa are required to enter and exit Afghanistan. Afghan entry visas are not available at Kabul International Airport. American citizens who arrive without a visa are subject to confiscation of their passport and face heavy fines and difficulties in retrieving their passport and obtaining a visa, as well as possible deportation from the country. Americans arriving in the country via military air usually have considerable difficulties if they choose to depart Afghanistan on commercial air because their passports do not receive stamps showing they entered the country legally. Those coming on military air should move quickly after arrival to legalize their status if there is any chance they will end up departing on anything other than military air.

U.S. companies that require travel of foreign businesspersons to the United States should know that it could take weeks or months for an Afghan citizen to receive a visa to visit the United States. The U.S. Embassy in Afghanistan currently does not process visas for Afghan citizens. Please see the U.S. Embassy website for information on how Afghan citizens may apply in Islamabad, Pakistan.

Telecommunications

Local telephone networks do not operate reliably. Most people rely on satellite or cellular telephone communications even to make local calls. Cellular phone service is available in Kabul with coverage extending to 23 provinces. Teledensity is 3.5 percent of the population. There are currently four wireless service providers: (i) Afghan Wireless Communications Company (AWCC) (44% market share), a joint venture between U.S.-based Telephone Systems International and the Afghan Ministry of Communications and

(ii) Telephone Development Company Afghanistan (TDCA) (56% market share), operating under the brand name Roshan. TDCA is an international consortium led by the Aga Khan Fund for Economic Development. A third provider is Ariba and the forth one is Etisalat and this company start the operations in 2007. The country has multiple internet service providers.

Transportation

Several commercial airlines serve Afghanistan at Kabul International Airport. Pakistan International Airlines has three weekly flights to and from Islamabad. Azerbaijan Airways has twice weekly flights to and from Baku. Indian Airlines flights three times a week to and from Delhi. Kam Air has flights daily to Dubai**.** The U.S. Embassy does not recommend use of Ariana Afghan Airlines to any destination or Kam Air flights to and from destinations other than Dubai because existing civil aviation regulations in Afghanistan do not meet international aviation standards.

Taxis around Kabul should range between Afs 50 to 100 ($1 or $2 depending on where you are going) per trip, but a dedicated car and driver is recommended. For travel within Kabul, a car and driver (no English) will run up to US$30 to $100 per day. Public buses are not recommended.

Language

Dari and Pashto are the official languages of the country. Few native Afghans speak English, but many returning expatriate Afghans speak English or German. Rates vary widely; a reliable interpreter fluent in English, Dari and Pashto may earn anything between $150 - $3,000 per month.

Health : The weather in Afghanistan is very dry, with summer highs into the 100s F and winter lows into the 20s F with snow. Kabul is very dusty, and shoes and clothes are difficult to maintain.

Well-equipped medical facilities are few and far between throughout Afghanistan. European and American medicines are available in limited quantities and may be expensive or difficult to locate. There is a shortage of standard medical supplies. Basic medicines manufactured in Iran, Pakistan, and India are available, but their reliability can be questionable. Travelers should bring all necessary medications, both prescription and over-the-counter. A couple of western-style private clinics have opened in Kabul in recent months: the DK-German Medical Diagnostic Center and CURE International Hospital (ph. 0799-883-830) offer a variety of basic and routine-type care; Americans seeking treatment should request American or Western health practitioners. American travelers may seek emergency medical services at the International Security Assistance Forces (ISAF) medical facilities in the Kabul area, but routine care is not available. The ISAF German Hospital, located about 10 kilometers from Kabul on Jalalabad Road (a road often off-limits to official Americans because of security concerns), and the combined forces ISAF clinic, adjacent to Kabul International Airport, may provide medical care to American citizens who can show a passport and request emergency care. Shino Zada Private Hospital located in Microrayon 4, opposite the central heating center, provides general surgery, maternity care, ambulance and pharmacy facilities 24 hours a day. Imran Clinic, across from the Ministry of Interior, has limited laboratory and x-ray facilities.

Afghan public hospitals should be avoided. Individuals without government licenses or even medical degrees often operate private clinics; there is no public agency that monitors their operations. Travelers will not be able to find Western-trained medical personnel in most parts of the country outside of Kabul, although there are some international aid groups temporarily providing basic medical assistance in various cities and villages. For any medical treatment, payment is required in advance. Commercial medical evacuation capability from Afghanistan is limited.

Local Time, Business Hours, and Holidays

Local time is GMT +4.5.

Afghanistan observes a five and a half day workweek, with Thursday afternoon and Friday as the days off. Business hours are typically 8 AM to 4 PM. Commercial shops keep longer but varying hours, usually from 7am to 11pm.

Holidays vary year to year and are determined by the Islamic Calendar and the visibility of the lunar crescent. Holidays include three days for Eid-ul-Qurban in January, three days for Eid-Al-Fitr in December, one day for the Prophet's Birthday in May, February 9 (10th of Maharam), March 21 (Nawrooz) and August 18 (Independence Day.)

CONCLUSION AND RECOMMENDATION:

The thesis of this study is that financial sector reforms in Afghanistan will take a long time to implement; further, these reforms will continue to face significant challenges. The sector had so deteriorated by the end of 2001—namely, the absence of a legal framework; poor and outdated infrastructure; lack of trained personnel; inappropriate governance and ownership structures in the state banks; inadequate collateral and bad debts; low depositor confidence; absence of clear accounting standards; and an ineffective formal payment system—that only focused and unrelenting reform efforts can help.

Although progress has been made in since 2002, this study argues that much remains to be done. The central bank now has some equipment, but it needs more. The government has issued two presidential decrees. These provide at least the basis for a modern legal framework for a two-tier banking system.

Although three new banks have been licensed on standards consistent with the new legal framework, the financial sector remains severely undeveloped. Substantial reforms must be implemented if the financial system can play a meaningful role in the country's economic development. This study documents efforts toward this goal and lays out a strategy for enhancing the effectiveness of the reform process.

Outdated legislation, a nonexistent monetary framework, inactive banking supervision, moribund international and domestic payment systems, and inadequate operational capacity, taken together, presented Da Afghanistan Bank with daunting reform decisions in 2002–03. Yet, in a post-conflict environment, countries and organizations must muster the political will to address complex issues.

With the help of international organizations and bilateral partners, the central bank's restructuring and modernization commenced in mid-2002. A new central banking law is now in place that guarantees the central bank's autonomy; a rudimentary monetary policy regime is emerging after the successful issuance of a new currency; a new banking supervision department, which has commenced on-site inspections of banks, is in place; the central bank's SWIFT connection is functional, one-third of the central bank branches are now connected electronically for domestic payments; and the central bank's operational capacity has improved.

The central bank still faces ill-funded attempts at improving the international and domestic payment system; and less than adequate steps at building internal human and technological capacity, all of which have significantly stalled the pace of reforms. In a hasty effort to address the immediate payment system related problems in the financial system, the reforms of 2002 and 2003 failed to realize the full reform aspirations envisioned at the beginning of the process. By December 2003 DAB still lagged behind even basic standards of modern central banking. A more comprehensive approach to the central bank reforms is urgently required. Much remains to be done before DAB develops into a truly competent, efficient, and effective conventional central bank that seeks to reduce urban and rural poverty and to improve economic development through the use of market-oriented financial operations within a well-regulated and stable financial environment throughout the country. More aggressive reforms are required to strengthen the institutional and operational capacity of the Afghanistan Central Bank, and in turn, the banking sector's efficiency and effectiveness in financial intermediation activities, including resource mobilization, resource allocation, and international and domestic payments. To attain these goals, the government of Islamic Republic of Afghanistan needs to strengthen both (1) the legal and regulatory environment in which financial institutions are operating in by building on the recently passed financial sector legislation, with specific prudential regulations, and (2) the operational capacity of the central bank to carry out its central banking functions relating to macroeconomic and monetary policy, banking supervision, national payment systems.

The objective of the reforms must be to implement a structure and culture appropriate for the central bank for the country so that DAB can carry out its duties both in Kabul and outlying cities and towns. These duties include the full creation and implementation of a national payment system, introduction of management information systems, implementation of accounting and auditing standards in accordance with international standards, implementation of a reorganization and operational restructuring program (which includes substantial changes to human resources, personnel management processes, and management information systems). Building a modern information and communication technology infrastructure is a fundamental requirement as it facilitates all activities taking place within DAB.

Critically important is the development of a formal payments system. Such a system will ensure the rational distribution of government salaries through the DAB branch network, allow for fund transfers and disbursements for public and private users, and help to channel foreign aid flows throughout the country in support of the objectives of national development. Establishing an efficient and reliable national payments system directly impacts Afghan citizens, for it provides the means by which funds—for all purposes—reach them in a timely and transparent manner. Beyond the activities listed above, a national payments system will also increase several-fold the speed at which remittances from members of the Afghan Diaspora reach their intended beneficiary at much less cost to the sender.

Intricately linked to development of a national payment system is the reestablishment of a functioning branch network. Interconnectivity between and among DAB branches and headquarters in Kabul is critical. Communication systems, appropriate software (e.g., a General Ledger package), information technology hardware, basic office equipment, and facilities upgrades are required to ensure a properly functioning system. Training in financial reporting, accounting, transaction management, and technology use also fits prominently into the plan.

Monetary Policy

Recognizing the difficulties of developing an effective monetary policy regime, this chapter concludes with recommendations on the implementation of legislation over time.

The sole near-term objective of monetary policy should be stability; the ultimate objective should be a form of price stability. The use of the term *monetary stability* is consistent with legislation found in many developing nations and need not prevent the achievement of an acceptable record on inflation. Given the apparent shortage of competent staff at many levels, the uncertainty of the relationship between the regions and the center (i.e., Kabul), and the need to compile a record of reasonably accurate price level statistics, price stability (i.e., inflation of around 3 percent) may easily take a decade or longer.

1. The central bank should have instrument independence. International organizations ought to assist the country in forming a viable and liquid market for bonds and in producing a

commercial-type study so that an interest rate becomes a useful signal, when combined with inflation, for monetary policy purposes. The use of an interest rate instrument need not be inconsistent with Islamic practices since a discount rate of some form is used, for example, in Kuwait, Qatar, and Saudi Arabia. In the current environment, borrowing tends to occur on an informal scale at times between the central government and the regions in view of the current political situation. In the short-term—lasting, say, 10 years—consideration should be given to permitting the central bank to discount private sector study. If the experience of the transition economies in central and eastern Europe is taken as a guide, one would anticipate loans to be short term. If the state of Afghanistan returns to complete stability it will take at least a decade, likely longer, to establish markets for longer term instruments (i.e., five years or more) which could provide an indication of market expectations for future short-term inflation. Considering the existence of a well functioning internal market for credit in Afghanistan but an essentially nonfunctioning banking system and, again following the example of the transition countries.

2. The central bank should be encouraged to create quasi-banking institutions to permit the intermediation of savings and borrowing with a view to facilitating the growth of a private sector for debt (see also items below). One bank might focus its activities on the export sector, another on the domestic retail deposit market (e.g., through a post office bank), still another on domestic industrial activities.

Serious thought should be given to preparing for the eventual weaning of such specialist banks from the central bank. Several models for this transition exist; the Hungarian model is one of the most successful recent example.

When appropriate, monetary policy guidelines should be outlined on an annual basis. Initially, any inflation objective contained in these guidelines should be flexible and used only to proper policy implementation. With experience and better data, an inflation objective can be quantified and justified and even combined with other objectives (e.g., an exchange rate or money growth) as transitional measures. Since the specification of an inflation objective can begin only after the collection of reasonably useful price statistics, as noted earlier, the central bank may find it more desirable to monitor money supply and deposits in order to assess the spread of the national currency in relation to alternative forms of script that may continue to circulate for a decade or more.

3. The central bank should intervene in foreign exchange markets only to maintain orderly markets. Any intervention should be publicly announced and explained. An important question in the design of central banking legislation is the exchange rate system and the authority of the central bank in this sphere. Some flexibility is necessary at first; determinations about whether to operate under a crawling peg or an adjustable peg can be made at a later date. The crawling peg, followed by countries such as Hungary, may be a useful model because exchange rate movements signaled the implicit inflation objectives of the central bank and the government. Such measures would provide some externally imposed credibility on domestic monetary policy while retaining some domestic control. Ideally, an exchange rate system will be chosen jointly by the central bank and the executive and openly reviewed on a periodic basis thereafter. If there are persistent failures in achieving a stable inflation rate because of exchange rate policies, then a more rigorous fixed exchange rate (or narrower crawl) might be necessary.

Policymakers should know, though, that such regimes tend to fail more often than they succeed and are rarely a permanent means to achieve a stable inflation rate.

4. The central bank's mandate should include maintaining financial market stability in cooperation with an independent supervisory authority as well as via public announcements of any actions the monetary authority deems necessary to advance that objective. Given the shortage of competent personnel, it may be useful, again for at least a decade, to combine the monetary policy and supervisory functions. This is a common approach in most developing and Islamic countries.

Eventually, however, experience has shown that financial stability is more likely to be guaranteed if the central banking and supervisory functions are separated.

5. The central bank will be entirely responsible and accountable for the day-to-day implementation of monetary policy free from any government direction unless the government states publicly why it wishes to direct the central bank to alter its existing policies. From time to time, the government may, via periodic reviews of the conduct of monetary policy, wish to set a new course for the central bank. This may require amending the central bank law. Experience offers many examples of crises facing the central bank ending with poor policy choices made largely because actual or potential interference by the political authorities undermined the capacity of the central bank to make the correct choices consistent with monetary policy stability. This aspect of central bank–executive links transcends other differences among central banks in the developing versus those in the developed world.

In the long term, the central bank's objective should be monetary policy. As stated in the new law, DAB's primary responsibility is to "achieve and to maintain domestic price stability." The other objectives of DAB—to foster liquidity, solvency, and proper functioning of a stable, market-based financial system, and to promote a safe, sound, and efficient national payment system—are subordinated to the overall goal of price stability.

We recognize that financial sectors in post conflict countries have varying levels of development and capacity for reform. Reform efforts must therefore continue to accommodate Afghanistan's unique characteristics and circumstances. Specifically, the government and its development partners must bear in mind:

• *Sustainable financial reforms have a long maturity period*. Enacting legislation, improving governance structures, developing competitive financial practices, building financial infrastructure, and encouraging international and domestic confidence in financial institutions require patience and determination. In post conflict countries, the need for persistence is even greater.

• *Proper sequencing of reforms is essential.*46 financial sector reforms achieve the best results in a stable macro economy. Price stability depends on low inflation rates; similarly, fiscal stability depends on no more than modest deficits. A conducive environment is needed to encourage investment from "fit and proper" sources, domestic and foreign. And the right financial infrastructure must be in place—namely, laws and regulations, of institutions that can effectively implement policy, human resources and skills formation, information systems, and accounting and audit capacity. All these components are essential for the effective implementation of financial reforms.

some cases, results can be achieved relatively quickly, whereas in others they will take time. Because a stable and sound environment will make it easier to meet the longer-term challenges of institutional development, reforms should be appropriately sequenced.

- *Financial reforms are incomplete without well-conceived measures for introducing and supporting a competitive environment.* Reforms should be designed to have long-term effects, always keeping in mind the ultimate objective of establishing a competitive environment based on principles of safe and sound banking under stable financial conditions. Financial sector legislation and regulations (along with appropriate tax policies and open current and capital accounts) constitute the basis for a competitive policy.
- *Efforts to recapitalize previously existing and troubled banks should be pursued only as a last resort (resulting from the absence of new investment and in the interest of broad provision of banking services), and within the context of a time-bound privatization program.* It takes a long time for private banks to tool up in an environment like Afghanistan. But because the costs of recapitalizing troubled state banks are high relative to monetary and fiscal returns, any move to rehabilitate troubled banks should be carried out with performance-based contracts.
- *Financial reforms are not sustainable unless they are comprehensive and penetrate institutional structures.* Strengthening financial infrastructure requires several developments. A good starting point is to ensure the central bank's ability to supervise banks. Attention must next be given to infrastructure, including the payment and settlement system, accounting and auditing standards, the framework for secured transactions, and institutional capacity to comply with and enforce prudential norms. Professionalism in banking, combined with steady development of accounting and audit Standards and capacity should help to implement the reform process.

- *Reforms will not succeed without a payments and settlements system.* The lack of a formally functioning payments system for international and domestic funds transfers has been a major obstacle to the timely and effective delivery of reconstruction assistance in Afghanistan. It has also impeded support for central authority, as the government has had problems paying civil servants.

Action to improve the payments system should be accelerated.

- *Security risks hamper implementation and private sector competition.* So far, few private sector bidders have responded to government tenders. Perceived security risks have led firms to withdraw their offers, even after being selected through competitive bidding. Where tenders attract too few bidders, external consultants and contractors should be sought to implement the reform strategy.

Overall, the sustainability of the reform program will depend on continued commitment by political and technical leadership teams, and on the support cascading down to middle management and the entire financial system. In the long term, sustainability will depend on the degree of institutional capacity for professional service delivery, and on energy and support driven by economic growth and opportunity.

Recommendation

Each option above had implications for the project's pace of implementation, cost, and effectiveness.

Based on detailed analysis of the above option, and the central bank desire to proceed with two banks rather than one bank, the Ministry of Finance may wish to consider the fourth option—namely, two management contracts for each bank to be restructured and privatized, and one bank resolution management contract to lead the liquidation of the remaining state banks.

Although the Bank team technically counsels against a two-bank approach, owing to the significant increase in the costs of TA, potential delays in project commencement, and potential additions to the complexity to the implementation process, it understands the central bank's reasons for preferring two banks, and the Bank is prepared to work with the authorities should this remain the preferred approach.

Under these conditions, the Bank believes it will be imperative that three separate contracts be issued. Although there is a risk of delay, this is not a certainty. All three RFPs can be issued simultaneously, received simultaneously, and awarded simultaneously. Although being more costly, there is also the possible added benefit of competition among the various contractors to achieve the best possible reputation for performance. As for Option 1, the main problem is the selection process. As no single bank appears to represent a clear choice, the risk then becomes excessively political and thus potentially divisive. Options 2, 3, and 5 are not recommended owing to complexity and cost and the potential conflicts of interest for the management teams. Detailed analysis of each of the above options is available in a separate Policy Note.

Based on each option's affordability, political acceptability, scale of management autonomy, and imp act on project implementation and effectiveness in achieving project objectives, Option 4, the interim transfer of staff to a government department or ministry, appears to provide the banking sector with needed flexibility for effective staff rationalization with the least government fiscal costs. There is sufficient flexibility within this option for people to take early/voluntary separation from government and to enter the private sector, effectively reducing civil service head count. There is also interim budgetary support for transferred civil servants to mitigate any financial costs of such an approach. Although it adds to the operational burden of the government, it does support the bank-oriented focus of the AFSSP project, which is to restructure and privatize one or two selected state banks.

The state commercial and development banking sector was practically nonoperational at the end of 2001.

Political interference in the banks' operations had left them with weak governance and organizational structures. Most of the banks were highly overstaffed, while technological capacity was abysmal. Perhaps most desperate of all, their financial systems and accounting records were in dismal shape.

Initial commitment to reform in 2002 wavered in the face of difficult decisions regarding which, and how many, banks to rehabilitate, and which staff members could be redeployed—decisions that were unavoidable if the financial institutions were to have any meaningful chance at rehabilitation. Instead of outsourcing a single comprehensive reform strategy for all the banks, the central bank decided to experiment with a phased reform strategy implemented by its own advisors and staff. With the support of one of its bilateral partners, progress has been made in reexamining the financial condition of five of the six banks. As of December 2003, however, Afghanistan has undertaken no actual reorganization of its banks.

Following the September 2003 enactment of the new commercial banking law, the central bank now has to decide which banks will be allowed to submit applications for relicensing by March 2004; and make a decision on which banks to relicense by

September 2004. Though the central bank has committed itself to meeting these targets, much remains to be done. Further, more aggressive reforms are required to strengthen the institutional and operational capacity of the selected banks. They need to become more efficient and effective in their financial intermediation activities, including resource mobilization and allocation, and international and domestic payments. To attain this goal, the central bank needs to implement a more comprehensive and better-funded reform strategy that includes: (1) the introduction of independent management teams in the banks to be rehabilitated; (2) the commencement of Voluntary Retirement Scheme that takes into account the government's fiscal commitments, and the liquidation of the remaining banks.

When implementing the reforms, the government's focus must be on restructuring commercial and development banking *functions*—agricultural finance, mortgage finance, trade finance, export promotion, and so forth—rather than institutions. These functions are desperately needed for Afghanistan's reconstruction effort. The institutions responsible for providing them, however, are no longer financially or operationally viable. The reforms must ensure that the financial services, and not necessarily the institutions, survive. Ultimately, the reform objectives must be to develop a competitive, market-oriented, and privately owned banking sector that contributes to urban and rural poverty reduction and economic development through the use of efficient and innovative financial products and services, and increased levels of financial intermediation within a well regulated and stable financial environment. Given their intermediary role in the economy, Afghanistan's banks are in critical need of rehabilitation and reconstruction.

Although some of the banks are beyond recovery, others have the potential to return to good financial health provided they pursue sound recovery programs.

Financial sector reforms, particularly of state-owned banks, require strong political commitment. The liquidation of banks and the likely staff reductions and resulting loss of national pride are difficult undertakings for governments. Even where state banks are restructured for subsequent privatization (not infrequently to foreign financial interests), the same concerns are likely to arise. Three factors, however, stand the reform of the Afghan financial sector in good stead:

- First, the banking system in Afghanistan has a history of private-sector ownership. It was not until the mid-1970s, under the Daoud regime, that the banks (and other economic activities) were nationalized. Prior to that, the vast majority of the banking sector had a long, proud history of private ownership and operation. Although the sector's current state is dismal, Afghanistan's memory of efficient private banking is sufficiently recent, and these memories will help both the Afghan authorities and the general public. Moreover, for the many Afghanis with experience in neighboring countries, they have witnessed the buoyant commercial banking systems there.
- Second, the government's commitment to reforms, to date, has been impressive. Considerable progress has been achieved. Most notably, a major currency conversion was completed within a three-month time frame. Although implementation difficulties inevitably emerged, contributing to exchange rate pressures, these were quickly resolved. Today, there is a regular weekly auction system whereby DAB sells dollars for afghanis, regular trading continues unabated in the private money market, and the afghani has stabilized for nearly half a year at roughly NAf50 to US$1.

These activities gave Da Afghanistan Bank the opportunity to assess the condition of the financial system and to identify areas urgently in need of reform.

- Third, while the commercial banks have excess staff and a shortage of skilled employees, the total numbers of people who will be encouraged to find other jobs (in the private sector, or elsewhere in the government) are not overwhelming. Total state bank employment levels (including DAB and the commercial banks) are estimated at around 5,000 to 6,000. Meanwhile, with average pay of around US$50 per month, and very little differentiation in pay between top and bottom grades, voluntary separation packages will not be overly expensive. This minimizes the potential costs of a comprehensive restructuring program for the sector as a whole.

In **Article 77** of the central bank law, every foreign exchange dealer must be licensed by, or registered with, Da Afghanistan Bank, as specified by central bank regulation. Once licensed, foreign exchange dealers will be expected to:

- report transactions in value exceeding a minimum amount set by the regulation to a department or agency of the state designated by the regulation for that purpose;
- collect and maintain on record information about their customers in such format and detail as shall be specified in the regulation; and
- provide Da Afghanistan Bank periodically with information concerning their customers, management, administration, business and financial condition in such detail and format as shall be specified in the regulation.

The success of the central bank's attempts at regulating the money exchange dealers will be determined by the dealers' appreciation of the need for external supervision. Because there is insufficient theoretical and practical experience with informal money transfer business regulation and supervision, the regulation should not impose overly complex rules and regulations. The development of informal transfer regulatory theory is still in its infancy and does not provide sufficient guidelines for policy makers faced with a highly innovative and growing money transfer industry. A regulatory structure that is too detailed in its prescription of prudential requirements, at this stage, may stifle, rather than promote the growth of an innovative yet accountable and transparent sector. Given the emerging level of knowledge about the informal transfer market it is important for the central bank to adopt regulatory models that promote an incentive-based system rather than one based solely on regulatory interventions.

Experience suggests that regulation is most effective when those who are regulated also participate in the formulation of those rules; such participation makes such regulation seem more appropriate and legitimate. Efforts should also, then, be made to consult informal remittance operators and their clients on what measures and steps they see to be desirable, necessary, and realistic. If Afghanistan chooses to adopt the FATF special recommendation on informal remittance systems, the target institutions must be involved in a dialogue that accommodates their interests, concerns, and specific institutional characteristics, and most importantly, are appropriate for the cultural and socio-economic circumstances prevailing in that jurisdiction. For example, in countries where informal remittance systems exists alongside a well-functioning conventional banking sector, it is may be possible to require operators to register and keep adequate records in line with the Financial Action Task Force (FATF) recommendations. In a conflict-afflicted country like Afghanistan with only a basic functioning banking system, requirements beyond basic registration may not be feasible because of inadequate supervisory capacity. To be effective, authorities seeking to strengthen the legal and regulatory framework for informal remittance systems through licensing or registration, suspicious transaction reporting requirements or other regulatory instruments, need to recognize the following:42

- When engaging the informal remittance community, regulators should *focus* on the broader benefits of a regulatory framework, rather than narrowly on the risk of terrorism. Although concerns about the financing of terrorism are of utmost importance given the obvious consequences, focusing exclusively on terrorism creates unease or discomfort among operators, who should be encouraged to work with regulators.

42 See Passas, NIJ report, 2003, for further details.

- Regulators should *seek* out informal remittance associations or recognized leadership as potential partners in improving transparency and accountability in the industry. Generally, members of such associations are those who have been in the business, in the area, fir the longest time or provide wholesale settlement services.43 Although operators are dispersed throughout the country and are engaged in a variety of businesses, they tend to know who their competitors are. Licensing and registration awareness campaigns are best advised to seek out such informal bodies and to work with them in each community or area.
- Regulators should *identify*, and if necessary *create* , incentives for the informal remittance operators to participate in the implementation of a regulatory and supervisory framework. Informal remittance operators, in some cases, are highly trained and well educated individuals. Some are former bankers well aware of the concerns that are shared by regulatory and law enforcement agencies.

Consensus-building consultations, and the subsequent design, development, and implementation of regulatory standards and supervisory arrangements should pay particular attention to wider public and other policy implications of external interventions, emphasizing that, because the informal remittance serve millions of legitimate and mostly poor recipients of remittances in developing countries. For many African households, and African nations for that matter, remittances are a tremendously important source of finance and foreign exchange, helping to stabilize irregular incomes and to build human and social capital. 44 It is on this premise that the recent World Bank–IMF study45 rightly concluded that "policymakers should acknowledge the existence of practical reasons, from the customer's point of view, to resort to these methods rather than formal banks for international payment purposes. As long as such drivers exist, the *hawala* and other [informal remittance] systems will continue to exist, and thus addressing [informal remittance systems] will require a broader response, including well-conceived economic policies and financial reforms, a well-developed and efficient payment system, and effective regulatory and supervisory frameworks."

In the long term, successful regulatory policies will recognize the operators' interests and create more transparent systems—bringing them closer to the formal financial sector without altering their nature.

Meanwhile, national authorities must address weaknesses that may exist in the formal sector. The formal and informal financial systems tend to benefit from each other's deficiencies. As long as the cost, speed, and convenience of remitting funds through the formal sector are incompatible with the needs of migrant workers, the informal remittance industry will continue to prevail.

Over the past two years, Afghanistan has made progress in reforming its financial system. Compared with conditions in December 2001—an outdated legal framework, no functioning commercial banks, a handful of NGOs competing with a vibrant informal financial sector—a basic formal financial system appears to be emerging.

- A new central banking law now guarantees the central bank's autonomy; after the successful issuance of a new currency, a rudimentary monetary policy regime is emerging; a new banking supervision department, which has commenced on-site inspections of banks, is in place; the central banks SWIFT connection is functional, and one-third of the central bank branches are now connected electronically for domestic payments; and the central bank's operational capacity has improved dramatically.
- Although decision makers initially wavered in the face of difficult reform questions (how many state and commercial banks to rehabilitate, for example, and the number of staff members to be redeployed), the bank relicensing process has resumed in earnest. Following the September 2003 enactment of the new commercial banking law, the central bank has committed to deciding which banks will be allowed to submit applications for relicensing by March 2004; and which banks will be re-licensed by September 2004.
- In the months leading to December 2003, real progress has been made on microfinance. MISFA has $25.2 million in committed funding: $1 million from CGAP, $5 million from the World Bank, $5 million from the U.S. Agency for International Development, $7 million from Canada, $5.2 million from Great Britain, and $2 million from Sweden. MISFA has signed funding agreements with three microfinance institutions (BRAC, FINCA, and Mercy Corps) and is close to finalizing two more.

Due to higher-than-expected demand, the facility is actively seeking for additional funds. Much remains to be done, however, before Afghanistan realizes the shared vision of a market-oriented, private-sector-owned financial system in which:

- The autonomous central bank is fully equipped to carry out its regulatory and supervisory responsibilities;
- Financial infrastructure provides full access to modern information technology and telecommunications;
- Financial institutions, instruments, and services meet the needs of the government, NGOs, businesses, and households in both rural and urban communities;
- The country's financial institutions are sound, efficient, and competitive.

But these goals are hindered by the lack of prudential regulations. In addition, DAB has not instituted modern central banking standards and the publicly owned commercial banks—lacking basic management systems, procedures, controls, and skilled personnel—urgently require rehabilitation or liquidation. The central bank and the supporting international development agencies acknowledge that Afghanistan's financial sector requires a multidimensional approach. While ensuring the implementation of medium and long-term goals, reforms must address urgent short-term needs, particularly the restoration of a formal international and domestic payments system and the provision of basic retail financial services in secondary cities and outlying areas. The central bank's reform efforts must now focus specifically on:

- strengthening the legal and regulatory framework of the entire financial system and building regulatory capacity to enforce that framework;

- improving corporate governance in the banking system and the financial sector infrastructure as a whole;
- Improving access to financial services for small and medium enterprises and rural communities, and;
- Broadening and deepening the financial sector.

The first modern attempt to put Islamic banking theory into practice probably took place in 1962 (Nasser Social Bank of Cairo). Many centuries before, however, the economies of Muslim countries were run on roughly Islamic economic principles. A major difference between the old days and the modern times is the appearance of the phenomenon of inflation, non-existent during the earlier periods. The experience of inflation and the subsequent loss in the purchasing power of money prompted nearly all Muslim states to accept the interest rate as a necessary evil, to compensate money holders for the loss in the value of money. Later on, however, and especially in the Twentieth Century, inflation became a fact of life in many Muslim countries, so that attempts were made to transform banking operations into a system based on interest-free principles, notwithstanding the presence of inflation. Inflation is thus the enemy of Islamic banking, depriving risk-averse depositors of a compensation commensurate with the loss in their purchasing power brought about as a result of inflation. So far in the first few years of the Twenty-First Century, many countries have succeeded to fully control their inflation and have reduced their interest rates, as a result. In Japan, both inflation and interest rates are very close to zero making Japan an ideal country to introduce interest-free banking operations.

The first Islamic banks, probably had long existed in many Islamic countries, in the form of Qardhal-hassanah funds, little noticed and even less publicized, to render services to those religious-minded depositors who refused to deal with interest-based banks on moral grounds. These funds, however, were too scattered, informal and unorganized to make a substantial impact on the financial community. The 1973 OPEC oil embargo and the increased oil revenue of many Islamic countries, and the global resurgence of Islam as a political and cultural force, initiated and accelerated developments in the realm of Islamic banking and finance.

Pioneers

The Nasser Social Bank of Cairo and the Dubai Islamic Bank and the Islamic Development Bank of Jeddah were the first formal institutions established in early 1960's and mid 1970's pioneering Islamic banking principles and promoting development and trade among Islamic states. Other Islamic banks soon emerged, appearing in various forms in both Islamic and non-Islamic countries. Today there are close to two hundred and fifty Islamic banks operating in many parts of the world, including Malaysia, Thailand, Turkey, Denmark, Switzerland and Great Britain. Apart from the Islamic Development Bank, which is a development finance institution aiming at economic development of its member states, other Islamic banks work in the financial environment dominated and regulated by interest-based financial institutions. In some of these countries special legislation had to be enacted to enable the functioning of Islamic-based operations. The standard banking regulations, and the central bank supervision had to be modified to conform to the special requirements of these institutions. Apart from central bank supervision, a distinguishing feature of Islamic banks that operate in interest-based environments, vis-à-vis the banks operating in Iran and Sudan where the entire system has been transformed into interest-free banking, is the competition that the former banks face. These banks have to compete with conventional banks to attract deposits and meet their financing requirements. This competition has so far had beneficial impacts on raising the overall efficiency of banking services rendered by Islamic banks.

In the Islamic Republic of Iran and Sudan, the entire banking operations shifted to interest-free basis, in mid-1980's. With the discount rate and the open-market operations remaining outside the scope of their functions, monetary-policy instruments had to be modified. Bank supervision has been exercised through a series of measures including determination of legal reserve requirements for various types of bank deposits; credit ceilings imposed on aggregate and sectoral credits; stipulation of the minimum and maximum expected rates of return from various credit facilities extended by the banks; determination of minimum and maximum profit shares for banks in their Mudharabah and Musharakah operations; stipulation of the minimum ratio of liquid assets to short-term liabilities; fixing of the maximum volume of credit facility granted by banks to each applicant; fixing the ratio of credit facilities granted by each bank, to that bank's capital, fixing a minimum expected rate of profit, which is a cut-off rate for project selection and other measures aimed at strengthening the central bank's supervisory role. Monetary policy in these countries is thus based on direct and selective control of the growth and distribution of domestic credit with certain sectors of the economy enjoying credit priority, in accordance with the economic objectives of the country.

Although microfinance sector development is highly challenging in the Afghanistan context, the sector could take off quite rapidly. If the country's unique challenges are

addressed—operating efficiently in scarcely populated areas, currency instability, human resource recruitment among a workforce that has not been working for many years, female home-based businesses—outreach can increase significantly. To facilitate this growth, two key ingredients are necessary: funds to fuel the loan portfolio growth and capacity building. Chapter 5 elaborates on capacity-building needs; see Table 5.2 for outreach (current
and potential) based on growth rates and for capacity of existing organizations and growth plans of new entrants.

Two scenarios were run, a conservative scenario and one showing more aggressive sector growth. shows—even with conservative figures—sector growth is expected to be rapid. The presence of BRAC is a major factor in this regard, with its proven ability to reach hundreds of thousands clients quickly.

Afghans have shown remarkable entrepreneurship. It is expected that loan volumes can be scaled up quite quickly, and with MISFA in place to facilitate loan funds and adequate investments in capacity building of the microfinance institutions, a critical mass of institutions can reach sustainability within four to five years. MISFA is well placed to channel funds like the above-mentioned UNDCP and possibly ILO mobilized program funds in an effective, coordinated and durable manner.

Over the last two years, progress has been made in reforming the financial system in Afghanistan Compared to December 2001, when the legal framework was outdated, no commercial banks were operating, and a handful of NGOs competed with the informal financial sector, the outlines of a formal financial system are emerging. Much remains to be done, however, before Afghanistan realizes the shared vision of a market-oriented, private-sector-owned financial system in which:

- The autonomous central bank is fully equipped to carry out its regulatory and supervisory responsibilities;
- Financial infrastructure provides full access to modern information technology and telecommunications;
- Financial institutions, instruments, and services meet the needs of the government, NGOs,

Businesses, and households in both rural and urban communities.

- The country's financial institutions are sound, efficient, and competitive.

Achieving those goals is hindered because Afghanistan still lacks prudential regulations, because DAB remains far behind the standards of modern central banking, and because the publicly owned commercial banks—lacking basic management systems, procedures, controls, and skilled personnel—remain in critical need of rehabilitation or liquidation.

To address the key issues constraining the financial sector and achieve the long-term vision outlined above, the central bank's reform efforts must now focus on:

- Strengthening the legal and regulatory framework of the entire financial system and enhancing regulatory capacity to enforce that framework.
- Enhancing the quality of corporate governance in the banking system and of financial sector infrastructure.
- Improving access to financial services for small and medium enterprises and rural communities, and diversifying financial services and products.
- Broadening and deepening the financial sector.

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