Project Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 30-Jul-2020 | Report No: PIDISDSA30162

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Afghanistan	P171886	Strengthening Afghanistan's Financial Intermediation	
Region	**Estimated Appraisal Date**	**Estimated Board Date**	**Practice Area (Lead)**
SOUTH ASIA	13-Jul-2020	24-Sep-2020	Finance, Competitiveness and Innovation
Financing Instrument	**Borrower(s)**	**Implementing Agency**	
Investment Project Financing	Government of Islamic Republic of Afghanistan	Da Afghanistan Bank, Ministry of Finance	

Proposed Development Objective(s)

The project development objective (PDO) is to strengthen institutional capacity for financial stability and to enhance access to finance for micro, small and medium enterprises.

Components

Component 1: Strengthening Credit Guarantee Fund
Component 2: SME Matching Grants Program
Component 3: Strengthening Deposit Insurance
Component 4: Enhancing DAB's IT Infrastructure
Component 5: Strengthening DAB's Regulatory and Supervisory Capacity
Component 6: Project Management
Component 7: Contingent Emergency Response Component -

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Project Cost	100.00
Total Financing	100.00
of which IBRD/IDA	100.00
Financing Gap	0.00

DETAILS

World Bank Group Financing

International Development Association (IDA)	100.00
IDA Grant	100.00

Environmental and Social Risk Classification

Moderate

Decision

The review did authorize the team to appraise and negotiate

Other Decision (as needed)

B. Introduction and Context

Country Context

1. **The COVID-19 pandemic is already imposing a large social and economic burden on Afghanistan.** As of June 09, 2020, the Ministry of Public Health reported 20,342 confirmed cases in the country, with cases reported in all 34 provinces. While the number of confirmed cases and deaths is relatively low compared to nearby countries, Afghanistan is extremely vulnerable to rapid spread of the virus due to limited access to information, high percentage of poor and vulnerable households who subsist on daily earnings, constrained access to water and sanitation, and weaknesses in basic health systems, and ongoing violent conflict. The recent large influx of hundreds of thousands of people crossing back into Afghanistan from Iran has further exacerbated the situation. Economic impacts are already severe and expected to worsen. The pandemic and related containment measures, including border closures and the recent lockdown of major cities, has led to: i) massive disruptions to productive economic activity and consumption; ii) disruptions to imports, including of vital household items, leading to rapid inflation; iii) reduced exports due to disruptions at border points; iv) negative impacts on remittances; and v) increased fiscal pressures, with government revenues expected to decline by at least 30 percent below budgeted levels. Due to the impacts of COVID-19, GDP is expected to contract by at least 5.5 percent in 2020.

2. **Afghanistan faces several additional challenges and uncertainties in 2020.** Despite the recent signing of a peace agreement between the United States and the Taliban, active conflict between Taliban and government forces continues, and there is no clear path to a sustained and comprehensive peace. Grants equal to around 43 percent of GDP continue to finance more than 75 percent of total public spending and around half of budget expenditures. Current civilian aid pledges expire in December 2020 and future levels of grant support are not known. Grants may decline rapidly over coming years in the context of the global COVID-19 crisis, and with some donors dissatisfied with the pace of anti-corruption and governance reform efforts. A power-sharing agreement has recently been reached between the two major factions contesting the outcomes of the 2019 presidential elections. Additional disputes may arise

through implementation of this agreement, including around control of key ministries, posing risks of further political instability and administrative disruption.

3. **Afghanistan's economy was fragile even before the COVID-19 crisis**. Growth has averaged only around three percent since 2012, due to the combined impacts of declining grants, increasing insecurity, and political instability. The trade deficit remains extremely large, over 30 percent of GDP, financed mostly by grant inflows. While revenues reached a new high of 14.1 percent of GDP in 2019, more than half of budget expenditure is financed by grants. Short-term priorities for sustainable growth include continued implementation of reforms to improve private sector confidence, mobilize investment, and ensure confidence of the international community. Over the medium-term, reforms should focus on attracting additional investment in agriculture and extractives, to deliver increased employment, exports, government revenues, and growth. To ensure that benefits of growth are maximized, and widely shared, continued investment is required in human capital, regional connectivity, expanded infrastructure, and an improved business regulatory environment.

4. **The poverty rate in Afghanistan has increased markedly from 38 percent in 2012 to 55 percent in 2017, when the last household survey was carried out.** The vast majority of the Afghan population was poor and vulnerable before the arrival of the COVID-19 crisis. The official poverty rate at 55 percent understates the extent of poverty and vulnerability as illustrated by the fact that 93 percent of the population lived on less than US$2 a day before the crisis. Economic growth over recent years has barely exceeded the rate of population growth (2.7 percent annually). Per capita incomes will decline substantially over the coming years as the economy contracts in 2020, leading to a likely substantial deterioration in living standards. While new data is not available, poverty is expected to have since increased and deepened.

5. **Poverty co-exists with exposure to a large number of shocks, which disproportionately affect the poor.** Shocks that are inherent in a conflict affected country (e.g. forced displacement, disrupted access to markets and basic services, price volatility of consumption staples) are added to high prevalence of food insecurity due to the unique geography of Afghanistan (e.g. droughts, floods, avalanches and infestation of agricultural production). Three in four poor households are affected by at least one shock and 80 percent of them cannot recover from their shocks within one year; many of them need to turn to harmful coping strategies such as the sale of productive assets and taking children out of school for income generation. While new data is not available, poverty is expected to have since increased and deepened. The widespread poverty also makes the population especially vulnerable to extreme weather events such as droughts and floods. Drought-induced displacement has reached record levels of nearly 300,000 individuals.

6. **Afghanistan has a Human Capital Index of 0.39 and ranks 133 out of 157 countries.** This suggests that children born in Afghanistan today will be on average 61 percent less productive than they would be if there was perfect survival, education and health in the country. About 7 out of 100 children do not survive to age 5; children on average have only about 4.9 learning-adjusted years of school (out of a maximum of 14 years); 41 out of 100 children are stunted; and only 78 percent of the population over 15 years survive to the age of 60. In addition to increasing the intrinsic benefits and values of optimal health and education of its people, Afghanistan could more than double its GDP by improving its health and

education outcomes. In contrast, an income and nutritional shock to the population may significantly worsen human capital prospects for the future.

Sectoral and Institutional Context

1. **The financial sector in Afghanistan is bank-dominated and concentrated in urban areas.** The sector consists of 13 banks: seven private commercial banks, one private Islamic bank, three state-owned banks (SOBs), and two foreign bank branches[1]. All banks in the three categories are regulated and supervised by the central bank, the Da Afghanistan Bank (DAB). There are more than 400 commercial bank branches across the country. Banks are mostly active and concentrated in the three largest urban centers—Kabul, Herat, and Mazar-e-Sharif—which account for two-thirds of their branch network. The SOBs have the widest branch network, but due to legacy issues their lending operations are limited. Private banks dominate the market with around 66 percent of total banking sector assets. Credit to GDP ratio of 3.3 percent remains among the lowest in the world indicating very low level of financial intermediation. The non-bank financial sector is very small in size and has limited outreach. There is a formal microfinance sector, consisting of six microfinance institutions (MFIs) supported by the Microfinance Investment Support Facility (MISFA), the apex organization for microfinance sector. Also, informal financial services providers in Afghanistan continue to flourish and are widely used by Afghans across the country.

2. **Financial system regulation and oversight - including sound bank resolution, crisis management and deposit insurance frameworks - are crucial for financial stability.** After the Kabul Bank crisis in 2010, the stability of the financial system was threatened, and the credibility of banking supervision was questioned. Kabul Bank's assets accounted for one-third of domestic banking assets. During the bank run, half of the assets of Kabul Bank were withdrawn. The government guaranteed the deposits following the run and extended a last-resort-facility of US$825 million. After resolving the Kabul Bank and transferring the good assets to a bridge bank, total loss was estimated at almost one-fifth of the initial loss. DAB had subsequently taken number of steps to strengthen its technical and operational capacity for financial sector regulation and supervision, including the establishment of the Afghan Deposit Insurance Corporation (ADIC).

3. **While the sector has gradually recovered since Kabul Bank crisis, financial stability challenges could be further amplified with COVID-19 crisis and the resulting contraction of economic activity.** While data is not yet available to fully capture the effect of COVID-19 on the banking and microfinance sectors, the sudden stop in economic activity - especially among micro, small and medium enterprises (MSMEs) and the informal sector - is expected to increase the risk of loan defaults and could pose liquidity challenges for the microfinance sector. In this regard, additional capacity building aimed at strengthening financial stability is required.

4. **Due to very low financial intermediation lending to MSMEs remains very limited, comprising only 16 percent of total bank lending as of end December 2019.** Small and medium enterprises (SMEs) are also served by the microfinance institutions; as of end-2019, they represented about a fifth of MFI lending, with an average outstanding loan below US$19,000. According to the 2017 MSME Finance Gap, around 54 percent of Afghan MSMEs are financially constrained; 40 percent

[1] Operating license of one bank was reported as revoked in 2019.

of which are fully constrained.[2] To facilitate access to finance, the Afghan Credit Guarantee Foundation (ACGF) was established to provide partial credit guarantees to eligible financial intermediaries for lending to MSMEs.

5. **Access to finance constraints for SMEs has been further exacerbated with COVID-19 resulting in gaps which cannot be filled with lending alone; thus there is a need to consider temporary provision of matching grants, both as a short term alternative as well as to increase the "bankability" of SMEs.** Matching grants are acknowledged as a viable instrument in fragile contexts to temporarily help overcome immediate access to finance constraints faced by SMEs in the short term, increase the "bankability" of grantees by strengthening their future loan applications (and related capital/collateral contributions), and crowd-in commercial finance in the medium term.

6. **Women-owned MSMEs are particularly underserved and represent barely two percent[3] of the current MSME financing, indicating an immense gender gap.** According to the Enterprise Survey 2014 the ratio of women-owned enterprises with bank account stood at 3.6 percent in 2014, down from 4.8 percent in 2008; moreover, as of 2014 only 11 percent of women-owned entrepreneurs reported that they had a loan or line of credit for their business. The 2018 survey by ACGF found that lack of finance was the top challenge for women entrepreneurs (75 percent) following by lack of equipment and machinery (62 percent), and access to markets (58 percent)[4].

C. Proposed Development Objective(s)

Development Objective(s) (From PAD)

7. **The project development objective (PDO) is to strenghten institutional capacity for financial stability and to enhance access to finance for micro, small and medium enterprises.**

Key Results

8. **The project implementation progress will be monitored with tracking of the following PDO indicators:**

i. Bank resolution and crisis management framework established;
ii. Legal and Regulatory Framework for Deposit Insurance Scheme established;
iii. Volume of MSME loans facilitated by ACGF; and
iv. Private capital mobilized through SME matching grants.

D. Project Description

9. **To achieve the PDO the project will include the following components:**

- **Component 1: Strengthening Credit Guarantee Fund (US$20 million).** The objective of this component is to incentivize greater financial intermediation towards MSMEs in Afghanistan

[2] International Finance Corporation (IFC) Enterprise Finance Gap Database (2017).
[3] MSME Finance Gap, International Finance Corporation, 2017.
[4] Assessment of women-owned SME borrowers, ACGF, 2019.

through risk-sharing and technical assistance. This component includes two sub-components: i) *Supporting Expansion of the Credit Guarantee Fund* to provide partial credit guarantees to financial institutions for lending to MSMEs; and ii) *Technical Assistance to ACGF and participating financial institutions (PFIs)*. In light of the constraints affecting women entrepreneurs this component will include specific interventions to facilitate progress with their access to finance. The capital contribution to ACGF will also facilitate its response to impact of the COVID-19 crisis on its PFIs and MSME borrowers.

- **Component 2: SME Matching Grants Program (US$40 million).** The objective of this component is to support SMEs with capital and non-capital costs (including working capital) for COVID-19 adaptation, including retrofitting and retooling, market re-engagement, recovery, productive capabilities across sectors, and to strengthen the pipeline of bankable firms and demand for banking services. This component includes two sub-components: i) *Matching Grants to SMEs*; and ii) *Grant Administration and Technical Assistance to SMEs*. In light of the constraints affecting women entrepreneurs, women-owned SMEs will be encouraged to apply. The program will provide support to enterprises recover from economic impacts of COVID-19 and capture possible emerging growth opportunities by re-engaging with the market.

- **Component 3: Strengthening Deposit Insurance (US$17 million).** The objective of this component is to support establishment and implementation of a credible and explicit (i.e. established with formal legal act) deposit insurance scheme for deposit taking financial institutions in accordance with international good practices and sufficient level of capital to set, sustain and/or increase the appropriate level of deposit insurance coverage without compromising the sustainability of the fund. To this end the component will comprise two sub-components: i) *Technical Assistance and Capacity Building*; and ii) *Capitalization of Deposit Insurance Fund*. In light of potential financial stability challenges as a result of COVID-19 crisis, strengthening deposit insurance will be critical for mitigating related risks, including payout of insured deposits in the case of challenges affecting the banking system.

- **Component 4: Enhancing DAB's Information Technology (IT) Infrastructure (US$16 million).** The objective of this component is to support investment in IT hardware and software for the central bank to strengthen its operational, regulatory, and supervisory capacity along with investments in upgrade of financial infrastructure aimed at facilitating financial intermediation. These investments will be critical for strengthening DAB's core operational capacity which is also required to mitigate potential impact of COVID-19 on the financial system.

- **Component 5: Strengthening DAB's Regulatory and Supervisory Capacity (US$5 million)**. The objective of this component is to support the DAB with advisory, technical assistance and capacity building aimed at strengthening its core regulatory and supervisory function thus facilitating financial stability. This capacity building support will also be critical for DAB's ability to proactively manage the risks and impacts of the COVID-19 crisis on the financial sector.

- **Component 6: Project Management (US$2 million).** This component will fund relevant project management functions administered by the Financial Sector Strengthening Projects Directorate

(FSSPD) of DAB. FSSPD acts as Project Implementation Unit for all World-Bank funded projects administered by DAB.

- **Component 7: Contingent Emergency Response Component - CERC (US$0 million).** This is a contingency component to be considered in the case of a relevant emergency event. In light of overall security situation in Afghanistan and expected impacts of COVID-19, the project will contribute to providing immediate and effective response in the event of eligible emergency or crisis that affects the financial sector.

Legal Operational Policies

	Triggered?
Projects on International Waterways OP 7.50	No
Projects in Disputed Areas OP 7.60	No

Summary of Assessment of Environmental and Social Risks and Impacts

10. **Environmental and social (E&S) risk and impact under the project are limited to *Component 1: Strengthening Credit Guarantee Fund* and *Component 2: SME Matching Grants Program*.** The implementation of these two components will be governed by the World Bank's Environmental and Social Framework. Component 1 is a financial intermediary financing activity supporting ACGF as an established entity with a strong record of E&S risk management. The participating financial institutions' (i.e. banks, microfinance institutions) lending – guaranteed by ACGF - will exclusively focus on micro, small and medium enterprise borrowers (final beneficiaries) including activities with limited environmental risk based on experience to date. ACGF has also established grievance mechanism allowing the final beneficiaries to lodge complaints. The potential impacts are expected to be low in magnitude, easily mitigated and temporary in nature. The SME matching grants program under Component 2 will provide capital directly to eligible SMEs and will also be administered by ACGF. As a result it will rely on the E&S risk management system as applicable to Component 1 described above and tailored to matching grants program. The key difference is that project will be directly responsible for managing E&S risks under Component 2, as opposed to relying on intermediaries (i.e. financial institutions). For details, refer to appraisal stage Environmental and Social Review Summary (ESRS).

E. Implementation

Institutional and Implementation Arrangements

11. **The Ministry of Finance will be the implementing agency for Components 1 and 2 and ACGF will be the implementing partner for these two components. DAB will be the implementing agency for Components 3, 4, 5 and 6.** The project will be governed with the following agreements: i) Financing Agreement between the World Bank and MOF; ii) Project Agreement between World Bank and DAB; and iii) Subsidiary Agreement between MOF and DAB. Implementation of

Components 1 and 2 will be governed by an Implementing Partner Agreement (IPA) between MOF and ACGF. Implementation of Components 3-6 will be governed with the Project Agreement and Subsidiary Agreement. Responsibility for implementation of Component 7 will be determined in case of a relevant crisis event that affects financial sector.

12. **The FSSPD at DAB will have the operational responsibility for implementation of Components 3, 4, 5 and 6 in lieu of a standalone project implementation unit.** FSSPD acts as Project Implementation Unit for all World-Bank funded projects administered by DAB. The project management functions include ensuring compliance with fiduciary requirements such as procurement, financial management, audits, processing of withdrawal and disbursement requests, and reporting.

13. **ACGF will be the implementing partner under Components 1 and 2 governed by the IPA between MOF and ACGF.** The ACGF's activities will include guarantees to PFIs, technical assistance, and administration of matching grants program.

CONTACT POINT

World Bank

Andrej Popovic
Senior Financial Sector Specialist

Borrower/Client/Recipient

Government of Islamic Republic of Afghanistan

Implementing Agencies

Da Afghanistan Bank
Ajmal Ahmady
Acting Governor
ajmal.ahmady@gmail.com

Ministry of Finance
Abdul Habib Zadran
Deputy Minister
habib.zadran@mof.gov.af

FOR MORE INFORMATION CONTACT

The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 473-1000
Web: http://www.worldbank.org/projects

APPROVAL

Task Team Leader(s):	Andrej Popovic

Approved By

Environmental and Social Standards Advisor:		
Practice Manager/Manager:		
Country Director:	Homa-Zahra Fotouhi	06-Aug-2020