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Report No: PAD2481

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED GRANT

IN THE AMOUNT OF SDR 27.5 MILLION  
(US\$40 MILLION EQUIVALENT)

TO THE

ISLAMIC REPUBLIC OF AFGHANISTAN

FOR A

MODERNIZING AFGHAN STATE OWNED BANKS PROJECT  
March 6, 2018

Finance & Markets Global Practice  
South Asia Region

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## CURRENCY EQUIVALENTS

(Exchange Rate Effective January 31, 2018)

Currency Unit = Afghanistan Afghani (AFN)

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AFN69.36001 = US\$1

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US\$1.4545 = SDR1

## FISCAL YEAR

January 1 - December 31

## ABBREVIATIONS AND ACRONYMS

AFD	Administration and Finance Directorate
AFMIS	Afghanistan Financial Management Information System
ANPDF	Afghanistan National Peace and Development Framework
APS	Afghanistan Payment System
ARTF	Afghanistan Reconstruction Trust Fund
ATM	Automated Teller Machine
BMA	Bank-e-Millie Afghan
CAR	Capital Adequacy Ratio
CBS	Core Banking System
CBR	Capacity Building for Results
C-Level	Senior Executive Management Level
CPF	Country Partnership Framework
DAB	Da Afghanistan Bank
DG	Directorate General
DLI	Disbursement Linked Indicator
DR	Disaster Recovery
ECF	Extended Credit Facility
FM	Financial Management
FSRRP	Financial Sector Rapid Response
FX	Foreign Exchange
GA	General Assembly
GDP	Gross Domestic Product
GoIRA	Government of Islamic Republic of Afghanistan

HR	Human Resources
IMF	International Monetary Fund
IRR	Internal Rate of Return
IT	Information Technology
MoF	Ministry of Finance
NKB	New Kabul Bank
NPA	National Procurement Authority
NPL	Non-Performing Loans
PB	Pashtany Bank
PDO	Project Development Objective
PIU	Project Implementation Unit
PPA	Project Preparation Advance
PPSD	Project Preparation Strategy Document
PSC	Project Steering Committee
QCBS	Quality and Cost-based Selection.
RFB	Request for Bids
RFP	Request for Proposals
RFQ	Request for Quotations
SBs	State Owned Banks
SMEs	Small and Medium Enterprises
STEP	Systematic Tracking of Exchanges in Procurement

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**BASIC INFORMATION**

Is this a regionally tagged project? No	Country(ies)	Financing Instrument Investment Project Financing
<input checked="" type="checkbox"/> Situations of Urgent Need of Assistance or Capacity Constraints <input type="checkbox"/> Financial Intermediaries <input type="checkbox"/> Series of Projects		
Approval Date 28-Mar-2018	Closing Date 28-Mar-2023	Environmental Assessment Category C - Not Required
Bank/IFC Collaboration No		

**Proposed Development Objective(s)**

The proposed project development objective is to enhance the corporate governance and operational efficiency of the supported Afghan state-owned banks, thereby contributing to their improved financial soundness and outreach.

**Components**

Component Name	Cost (US\$, millions)
Component 1: Improving MOF's Ownership Role and the Corporate Governance of SBs	7.00
Component 2: Institutional Development, Business Strategy, and Information Technology of SBs	30.00
Component 3: Project Implementation and Monitoring	3.00

**Organizations**

Borrower : ISLAMIC REPUBLIC OF AFGHANISTAN  
Implementing Agency : Ministry of Finance



**PROJECT FINANCING DATA (US\$, Millions)**

<input type="checkbox"/> Counterpart Funding	<input type="checkbox"/> IBRD	<input type="checkbox"/> IDA Credit	<input checked="" type="checkbox"/> IDA Grant	<input type="checkbox"/> Trust Funds	<input type="checkbox"/> Parallel Financing
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Total Project Cost:  
40.00

Total Financing:  
40.00

Of Which Bank Financing (IBRD/IDA):  
40.00

Financing Gap:  
0.00

**Financing (in US\$, millions)**

Financing Source	Amount
IDA-D2830	40.00
<b>Total</b>	<b>40.00</b>

**Expected Disbursements (in US\$, millions)**

Fiscal Year	2018	2019	2020	2021	2022	2023
Annual	0.78	3.41	6.23	11.83	16.65	1.10
Cumulative	0.78	4.19	10.42	22.25	38.90	40.00

**INSTITUTIONAL DATA**

**Practice Area (Lead)**

Finance, Competitiveness and Innovation

**Contributing Practice Areas**



**Climate Change and Disaster Screening**

This operation has been screened for short and long-term climate change and disaster risks

**Gender Tag**

Does the project plan to undertake any of the following?

a. Analysis to identify Project-relevant gaps between males and females, especially in light of country gaps identified through SCD and CPF

Yes

b. Specific action(s) to address the gender gaps identified in (a) and/or to improve women or men's empowerment

Yes

c. Include Indicators in results framework to monitor outcomes from actions identified in (b)

Yes

**SYSTEMATIC OPERATIONS RISK-RATING TOOL (SORT)**

Risk Category	Rating
1. Political and Governance	● High
2. Macroeconomic	● High
3. Sector Strategies and Policies	● Substantial
4. Technical Design of Project or Program	● Substantial
5. Institutional Capacity for Implementation and Sustainability	● Substantial
6. Fiduciary	● Substantial
7. Environment and Social	● Low
8. Stakeholders	● Substantial
9. Other	
10. Overall	● Substantial



**COMPLIANCE**

**Policy**

Does the project depart from the CPF in content or in other significant respects?

Yes  No

Does the project require any waivers of Bank policies?

Yes  No

**Safeguard Policies Triggered by the Project**

**Yes**

**No**

Environmental Assessment OP/BP 4.01

✓

Natural Habitats OP/BP 4.04

✓

Forests OP/BP 4.36

✓

Pest Management OP 4.09

✓

Physical Cultural Resources OP/BP 4.11

✓

Indigenous Peoples OP/BP 4.10

✓

Involuntary Resettlement OP/BP 4.12

✓

Safety of Dams OP/BP 4.37

✓

Projects on International Waterways OP/BP 7.50

✓

Projects in Disputed Areas OP/BP 7.60

✓

**Legal Covenants**

**Sections and Description**

MoF is to establish, by not later than two (2) months after the Effective Date of the Project, and thereafter maintain throughout the implementation of the Project, the Project Steering Committee, chaired by the Deputy Minister in charge of the AFD, with membership, mandate, composition, and terms of reference acceptable to the Association, to be responsible for overall guidance and oversight of the Project.

**Sections and Description**

MoF shall, by no later than 2 months after the Effective Date appoint a Project Management Team within AFD's regular structure, headed by a project director and provided with sufficient resources and competent staff in adequate numbers, under terms of reference satisfactory to the Association, comprising, inter alia, a chief technical expert and a banking expert, and staff responsible for the financial management, procurement,





monitoring and evaluation, and gender and social safeguards activities of the Project.

Sections and Description

MoF shall establish, by not later than two (2) months after the Effective Date, and thereafter maintain throughout Project implementation, a grievance redress mechanism for the Project, with staffing and operating procedures acceptable to the Association, for monitoring and addressing the concerns of people affected by the Project and building public and stakeholder support for the Project.

**Conditions**

Type

Disbursement

Description

No withdrawal shall be made under subcomponent 2(b) until and unless to the satisfaction of the Association:

- i. Recipient shall have issued a Presidential Decree to: (A) define the state ownership policy for SBs; (B) set up the ownership unit at MoF with clearly defined core functions; (C) define terms of reference of boards of supervisors and executive management of SBs; (D) promulgate guidelines for the nomination, appointment, removal and remuneration of members of the board of supervisors and key executive management positions in SBs in line with relevant DAB and banking laws and regulations; and
- ii. The Recipient, through MOF, shall have properly staffed the ownership unit, including at least one full-time banking expert, one full-time financial expert and one legal expert; and
- iii. The Recipient, through MOF, shall have appointed at least five members to serve as members on the board of supervisors for each SB, in full compliance with the Presidential Decree above and relevant regulations of DAB; and
- iv. Performance contracts for SBs senior management – as defined in the Operations Manual - are executed.

Type

Disbursement

Description

No withdrawal shall be made under subcomponent 2(c) until and unless:

- i. the Recipient through MOF shall have issued a policy, satisfactory to the Association, for modernizing information technology infrastructure of the SBs in accordance with the recommendations of the diagnostic assessment carried out under Component 2(a) of the Project; and
- ii. The Recipient shall have caused the general assembly of each SB shall have approved a business plan, satisfactory to the Association, in alignment with Recipient’s Principles of State-Owned Bank Reform – Strategic Vision approved by the HEC in December 2017.

**PROJECT TEAM****Bank Staff**

<b>Name</b>	<b>Role</b>	<b>Specialization</b>	<b>Unit</b>
Ahmed Mohamed Tawfick Rostom	Team Leader(ADM Responsible)		GFCSN
Rehan Hyder	Procurement Specialist(ADM Responsible)		GGOPZ
Mohammad Asif Qurishi	Procurement Specialist		SACKB
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Abayomi A. Alawode	Peer Reviewer		GFPCN
Ahmad Shakeeb Safai	Counsel		SACKB
Aminata Ndiaye	Team Member		GFCSN
Andreas Grimminger	Team Member		GFCSN
Anu Bakshi	Counsel		LEGES
Aza A. Rashid	Team Member		GFCSN
Eva M. Gutierrez	Peer Reviewer		GFCEE
Folad Hashimi	Team Member		SACKB
Harish Natarajan	Team Member		GFCSI
Huria Sunbol Waheed	Team Member		SACKB
Ilias Skamnelos	Peer Reviewer		GFCSN
Jose De Luna-Martinez	Peer Reviewer		GFPCN
Juan Carlos Alvarez	Counsel		LEGES
Karol Karpinski	Team Member		GFCSI
Leila Aghabarari	Team Member		GFCSN
Martin Melecky	Peer Reviewer		SARCE
Michael J. Goldberg	Peer Reviewer		GFCSO
Mohammad Arif Rasuli	Environmental Safeguards Specialist		GEN06
Najla Sabri	Team Member	Gender	GSU06



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Pasquale Di Benedetto	Team Member		GFCFN
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Zakir Hussain Gulzari	Team Member		GGOAP
<b>Extended Team</b>			
<b>Name</b>	<b>Title</b>	<b>Organization</b>	<b>Location</b>

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**Afghanistan**  
**Modernizing Afghan State Owned Banks Project**

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## I. STRATEGIC CONTEXT

### A. Country Context

1. **There have been substantial improvements in development outcomes in Afghanistan since 2001.** These improvements were particularly in expanded access to essential services such as water, sanitation, and electricity, and improved outcomes in education and health. However, some gains are now being eroded due to growing insecurity. Between January and September 2017, 2,640 people were killed and around 5,380 injured. The number of Internally Displaced People has increased at an alarming pace: in the first half of 2017 alone, more than 200,000 people have been displaced internally due to conflict and more than 296,000 refugees have returned from Iran and Pakistan. The increased conflict appears to be affecting business and consumer confidence as economic activity is continuing to stagnate. The annual economic growth rate is projected at 2.6 percent in 2017, increasing slightly from the 2.2 percent recorded in 2016. Growth is expected to edge up to 3.2 percent in 2018, but only assuming no further deterioration in the security environment. While this constitutes a moderate improvement compared to 2014 and 2015, it is still significantly below the 9.6 percent average annual rate recorded between 2003 and 2012. In the medium term, growth is expected to remain muted, increasing modestly to 3.6 percent by 2020.

2. **Poverty rate remains high and has increased since 2011.** The poverty rate in Afghanistan increased from 36 percent in 2011/12 to 39.1 percent in 2013/14 and is expected to remain high in the medium-term, driven by weak labor demand (despite an increasing labor force) and security-related constraints on service delivery. Rural poverty and living conditions are particularly acute. The unemployment rate is estimated at 22.6 percent. Unemployment is particularly severe amongst women, low-skilled and illiterate workers. With an average annual population growth rate of 3 percent and with an estimated 400,000 Afghans entering the labor market each year, much higher economic growth is required to improve per capita incomes and to provide quality employment opportunities for the expanding workforce.

3. **Stronger growth is predicated on improvements in security, political stability, steady progress with reform, and continued high levels of aid flows.** Growth could also be enhanced with the right combination of fiscal and policy reforms, including improving budget execution and reorienting budget expenditures towards labor-intensive and community-based programs that directly reach the population with the greatest needs and with the highest marginal propensity to consume.

### B. Sectoral and Institutional Context

4. **The financial system of Afghanistan is dominated by private banks.** As of end-2016 the banking sector consists of 15 banks with total assets of US\$4 billion, customer deposits of US\$3.6 billion and a gross loan portfolio below US\$0.7 billion. Banking sector assets represent 21 percent of GDP. The sector is composed of: three State-owned Banks (SBs), which hold 27 percent of banking assets and account for 27 percent of deposits and 6 percent of total loan portfolio; nine full-fledged Private-Owned Banks maintaining 65 percent of banking sector assets, 92 percent of loan portfolio and 65 percent of the sector deposits; and finally, 3 branches of Foreign commercial Banks (FBs) with a 9 percent asset share, a 1 percent share of loan portfolio and 8 percent deposit share. All banks in the three categories are regulated



and supervised by the Central Bank of Afghanistan (Da Afghanistan Bank – DAB). The non-bank financial sector is negligible. Only four operating insurance companies are offering limited general insurance services. The formal microfinance sector, comprised of 5 microfinance institutions (MFIs), manages a total loan portfolio equivalent to almost 20 percent of the banking sector’s loan portfolio (US\$124 million as of end-April 2017). While the microfinance sector has grown significantly in the past decade, its outreach remains modest.

5. **Afghanistan’s banking sector remains underdeveloped and vulnerable as it copes with systemic challenges uncovered by the collapse of Kabul Bank in 2010.** While banks are highly liquid, credit growth is sluggish. Credit to the private sector expanded by only 6 percent in 2015 and 5 percent in 2016, which barely offset the 6.6 percent contraction in 2014. Confidence in the banking sector is yet to fully recover from the Kabul Bank crisis in 2010, during which massive fraud led to a run on the country’s then largest bank, necessitating a government bailout (equivalent to 5 percent of Afghanistan’s GDP in 2010). Just before its collapse, Kabul Bank held 34 percent of total banking assets in Afghanistan, almost three times the amount of its closest competitor. Weak oversight and corruption of all governance functions of the institution allowed for endemic related party transactions and fraudulent loan origination, which in turn led to the eventual loss of over 92 percent – or approximately US\$861 million - of its loan book. The Kabul Bank crisis and its aftermath underscores the need to improve the health of the financial sector, especially considering continuing stresses from deteriorating asset quality and substantial dollarization of banks. Non-performing loans of the overall banking sector have steadily increased over the past four years and, by end-June 2017, reached 16.9 percent, a record high since the Kabul Bank crisis. At the same time, around 69 percent of bank loans and 66 percent of deposits were denominated in US dollars. While banks are required to keep reserves at DAB in Afghanis only, their capacity to lend in local currency is severely constrained.

**Table 1: Key financial soundness indicators – Afghanistan banking sector (2012-16)**

(in %)	2012	2013	2014	2015	2016			
					Q1	Q2	Q3	Q4
<b>Capital adequacy</b>								
Regulatory Capital to Risk-weighted Assets	21.8	26.2	26.5	19.9	21.1	20.6	22.0	28.2
Capital to Assets	7.6	11.6	11.9	9.1	10.4	10.2	10.6	11.4
<b>Asset quality</b>								
Non-performing Loans to Total Gross Loans	5.0	4.9	7.8	12.1	15.2	16.9	13.1	11.1
Non-performing Loans Net of Provisions to Capital	6.6	2.5	3.4	8.3	12.0	15.4	9.9	2.5
<b>Earnings and profitability</b>								
Return on Assets	-0.4	0.6	0.9	0.3	4.4	2.5	1.9	1.7
Return on Equity	-5.5	7.1	7.2	1.7	45.1	24.9	19.1	16.2
<b>Liquidity</b>								
Liquid Assets to Total Assets (Liquid Asset Ratio)	65.7	61.2	73.2	75.0	74.3	73.2	69.7	72.5
Liquid Assets to Short-term Liabilities	79.7	77.0	89.0	90.04	91.9	90.6	87.1	90.2
<b>Efficiency</b>								
Non-Interest Expense to Gross Income	74.7	74.7	71.2	71.5	38.8	46.3	53.1	56.0
Personal Expense to Non-Interest Expense	30.8	25.3	27.3	39.7	40.7	39.9	40.0	38.7

Source: IMF Global Financial Stability database



6. **SBs have the largest outreach among all the banks in Afghanistan but provide only limited financial inclusion and fail to support access to finance.** With about US\$1.2 billion in assets, SBs account for 27 percent of total banking sector assets and thus constitute a crucial component of the sector. However, despite its historically implied mandate, SBs’ intermediation activity is marginal and the loan portfolio equals less than 3.5 percent of total assets. SBs have failed to reach their lending potential and support improved access to finance, which is vital for SMEs, job creation and economic growth. Though SBs operate the most extensive branch network of the banking system, accounting for a total of 164 outlets country-wide (or 40 percent of the banking sector network) their intermediation activity is minuscule compared to their expected potential. On the other hand, the network has allowed SBs to deliver essential banking and payment services (including salary payments) in all provinces in Afghanistan. However, while SBs have an extensive traditional brick & mortar branch network, alternative delivery channels are not at all developed. For example, SBs’ Automated Teller Machines (ATM) network is almost-non-existent.

**Table 2: Selected Indicators of SBs Performance (as of end-December 2016) (Million AFN)**

	<b>New Kabul Bank (NKB)</b>	<b>Bank Mellie Afghan (BMA)</b>	<b>Pashtany Bank</b>	<b>Sector-wide</b>	<b>SBs as % of sector</b>
Deposits	21,972	27,760	16,045	241.48	27%
Loans	0*	3,056.4	0*	45,409	6%
Total assets	24,623	37,770	18,813	270,689	27%
Equity	854.4	8,583.6	1,910.0		
Capital/Assets (%)	3.5%	22.7%	10.1%	11.4%	
CAR (%) **	**	180.8%	**	28.2%	
Net Income (reported)	50.9	3,321.6	757.8		
ROE (%) (reported)	5.96%	38.7%	39.7%	16.2%	
Net Operational Income (adjusted) ***	67.5	325.8	-7.7	n.a.	
Cost Income Ratio (adjusted) ***	95.2%	68.8%	102.1%	n.a.	
Non-Interest Expense to Gross Income (adjusted)	95.2%	61.2%	89.3%	56.0%	
Personal Expense to Non-Interest Expense (adjusted)	43.4%	44.9%	44.8%	38.7%	
Personal Expense to Operational Income (adjusted) ***	41.3%	18.5%	20.4%	n.a.	
Branches	112	34	18	410	40%
Number of staff	1,544	311	434	8,757	26%

Source: DAB; SBs Audited Financial Statements, own calculations

\* NKB and Pashtany Bank are operating under special regulatory regime, limited to only provide savings and payment services

\*\* GLP used as proxy. DAB Capital Notes considered risk free.

\*\*\* Includes investment income from DAB capital notes. Excludes all non-recurring and non-operational income and costs.





7. **SBs' financial performance has been weak, and constraints to the current operating and business model continue to imply latent fiscal risks.** There have been repeated rounds of asset write-downs and recapitalizations over more than a decade for BMA and Pashtany Bank, as well as the state bail-out for NKB. Over the past decade, the cumulative capital contributions to SBs have totaled approximately US\$185.5 million. As of end-2016, all three SBs complied with minimum CAR requirements but pressures on capital levels remain high. Reported positive net income for FY2016 in all three SBs is substantially driven by non-operational or non-recurrent income, including NPL recovery, sale of assets and revaluation effects. Net operating income is negative or barely break-even for two SBs; for the third institution, the equivalent ROA would be approximately 0.3 percent as per 2015 audited financials. Furthermore, for all SBs the net operating income is driven by investment income from the purchase of DAB capital notes. Consequently, even a slight deterioration in the operating environment or interest spread on the investment portfolio will adversely impact financial sustainability.

8. **Poor credit risk management has undermined financial performance.** BMA and Pashtany Bank over the last decade have suffered severe equity losses as the result of poorly originated, controlled and recovered credit risks. Related party lending, as well as constituency driven credit origination and non-commercial considerations in the granting of loans undermined the portfolios' viability, as much as the overall vulnerability of borrowers to external shocks. NKB, in turn, is the institutional remnant following the bail-out of depositors in the wake of the collapse of Kabul Bank. In all cases politicized underwriting practices, insider and related party lending and poor contract enforcement led to substantial losses of credit risk assets; even in the face of formally established best practice policies and procedures as in the case of Kabul Bank. At present, while BMA maintains a rudimentary loan book and has some limited credit risk assessment and underwriting capacities, the corresponding policies, procedures and institutional structures, as well as HR capacities are weak and in need of reform. For their part, NKB and Pashtany Bank have no discernible credit risk management capacity and lack the corresponding institutional arrangements.

9. **Besides the weak credit and risk management capacity, poor governance practices are among the severe deficiencies that have enabled and perpetuated the underperformance of SBs.** Institutional arrangements related to the composition of the General Assembly and Board remain weak, leading to incomplete oversight bodies in two of the three SBs, as well as the absence of important committees (including Audit and Risk) in all SBs. Furthermore, SBs' adoption of existing corporate governance law and regulations, which are deemed sufficient for the country's level of financial development, is severely lacking. Critical governance functions are hence not performed in SBs. Finally, the Ministry of Finance (MoF) lacks the capacity to exercise its ownership rights, which has impeded the adequate definition of a mandate for SBs and implementation of a corresponding business strategy.

10. **Constraints to senior level staffing, as well as management and staff capacity have led to the absence of vital organizational functions.** At present, all three SBs suffer from prolonged unfilled vacancies in senior management and operational positions, including in 'C-Level' roles and heads of risk management. The appointment of senior management in SBs has been delayed by a lack of a clear staffing strategy – including the definition of competitive compensation and performance management regimes – and inability to obtain the regulator's approval of the few prospective candidates. Furthermore, staff capacity in technical areas is lacking in all three SBs, despite a significant headcount as a share of their operations. Deficiencies include significant gaps in SBs' ability to adequately originate, manage and recover credit risks. Staff capacity challenges are compounded by critical gaps in the organizational



structure (e.g. internal control and risk management), and inadequate policies for essential HR elements, such as performance management, training, and staff rotation.

11. **Obsolete Information Technology (IT) systems and infrastructure not only add to efficiency constraints but also compound operational risks.** The three SBs have varying levels of sophistication of IT infrastructure, which, except in the case of NKB, are inadequate to offer modern financial services comparable to those provided by other banks in the region but also in Afghanistan. The IT infrastructure in all SBs is reaching obsolescence and needs to be urgently upgraded. NKB, given its legacy role as the bank used for salary payments of government employees, built a modern IT infrastructure and developed several digital distribution channels. BMA and Pashtany Bank have implemented certain elements of core IT infrastructure in terms of an integrated core banking solution. They have not, however, developed any digital distribution channels and have offered only basic branch-based financial services. Still, for all three SBs, the IT systems were implemented over ten years ago, and are well past their recommended life and, in many cases, are no longer supported by the vendors. The physical infrastructure for housing these systems is primitive and cannot currently support the level of operational reliability expected from modern banking systems. This, when placed against the ongoing modernization of the national payments system components under the FSRRP (P119047), will lead to the SBs being unable to take advantage of these systems to offer efficient and diversified financial services to individuals and businesses.

### **Rationale for Engagement**

12. **Afghanistan's financial sector remains in need of major reforms.** Access to finance is dramatically low. Only an estimated 10 percent of adults (and only 3.8 percent of adult women) own bank accounts; lending to the private sector represents only 3.5 percent of GDP. Just two-thirds of formal enterprises report having access to a bank account; and only around 2 percent of firms use bank loans to finance investments. The exceptionally low penetration rates are reflective, partially, of the very limited networks most banks operate, particularly the private institutions. These banks' activities are concentrated in the three largest urban centers of the country – Kabul, Herat, and Mazar-Sharif, which account for two-thirds of their branch network and essentially the totality of their lending operations. To date, the Afghan banking sector has been unable to play its role in supporting more inclusive economic development and in financing the country's growth, despite its high liquidity.

13. **SBs are systemically important for the Afghan economy because of their outreach and widespread retail presence and the potential to play a larger, catalytic role in financing the Afghan economy.** Given their great outreach potential, especially in peri-urban and rural areas, SBs are well placed to cater to the most credit constrained, typically small and medium enterprises (SMEs), businesses and households in rural areas and the agricultural sector. Market failures and high transaction costs make these segments unlikely to be served by private banks. Reformed and modernized SBs would be better equipped to develop sustainable and innovative financial products for those segments and efficiently reach the financially-constrained. As Afghan authorities progress in the development of the National Financial Inclusion Strategy, improvements in the financial sector infrastructure, the introduction of a wider range of financial instruments, and promotion of innovative financing for the private sector will be considered, with SBs as primary vehicles for state intervention. Key components will also include strengthening consumer protection and education, improving financial literacy, and addressing financial needs of poor Afghan households. Furthermore, SBs also have the unrealized potential of substantially contributing to financial



inclusion, with regards to the national payment systems platform. They already play a major role in terms of government payments. NKB is the depository of several hundred thousand government employee accounts and a primary formal remittance channel for the Afghan diaspora. Two SBs have already joined the Afghanistan Payment System (APS - the national cards payment switch) which is supported under the Financial Sector Rapid Response Project (FSRRP). Upgrading the financial infrastructure in all SBs as they connect to the APS will increase their value-added to the APS, and will boost access points for financial services delivery.

**14. Raising confidence in the banking sector, through improved accountability, good governance and sound commercial business practices is also a prerequisite for stability.** In their current state, SBs pose continued financial sector stability and macroeconomic risks derived from their poor performance and weak operational structures. Their weak governance and management capacity not only deprives SBs of functional decision-making structures to adequately run their businesses, but also removes the necessary checks and balances, thereby exposing SBs to undue government influence on their institutional mandate and operations. Lessons from the failure of the previous ad-hoc privatization of NKB and the attempted merger of Pashtany Bank and BMA point to the need for a comprehensive approach to redefine the role of SBs. Furthermore, as experienced during the Kabul Bank crisis, the contagion risk is very high in the financial sector. A new crisis would shatter public confidence which is only progressively being regained.

**15. The government has embarked on a major reform agenda for SBs to mitigate macro risks, strengthen the financial sector and enhance financial intermediation.** Afghan authorities have approved a long-term strategy for SBs, which was approved by the High Economic Council in December 2017 as a commitment under the ECF program. The Strategy outlines the vision and the overall objective of the State's presence in the financial sector, and the strategic business and operating frameworks for the institutions over the next five years (referred to as the Strategy). As the Strategy is operationalized, strengthening the governance and management systems of SBs, upgrading their operations (processes, policies, and systems), building staff capacity and enhancing the oversight function of the owner (MoF) will be necessary to ensure greater efficiency, accountability, transparency and ultimately competition in the banking sector.

**16. The government is supported by the International Monetary Fund (IMF) for the implementation of significant elements of this reform program.** The IMF Board approved a US\$45 million three-year Extended Credit Facility (ECF) in July 2016. A key pillar of the program is to ensure soundness and efficiency of the financial sector, through strengthening of the regulatory and supervisory frameworks and completing the resolution of the Kabul Bank crisis. After the recapitalization of NKB (set up as a temporary bridge bank, now adequately capitalized), the government is also planning to transfer funds to the Kabul Bank receivership to remove outstanding obligations. This action will contribute to the elimination of the Central Bank's continued lender-of-last-resort exposure. The activities under the proposed project will primarily target strengthening oversight and governance of SBs. This is one of the key objectives of the current IMF ECF program. The WBG and the IMF continue to coordinate on financial sector stability and development, including through the current operation.



### C. Higher Level Objectives to which the Project Contributes

17. **The project is fully aligned with the government priorities and is consistent with the WBG’s strategy.** Providing a credible system for banking regulation and oversight is an identified priority of the GoIRA, in the 2017-21 Afghanistan National Peace and Development Framework (ANPDF). In particular, the ANPDF highlights SBs as an area of reform in order to improve their sustainability, increase their efficiency and enhance the institutions’ contribution to a broader access to financial services for a wider segment of Afghan society and economy. The Afghanistan Systematic Country Diagnostic (SCD, report No. 103421) states that improving banking sector confidence, through enhanced accountability and stronger governance is an essential condition for economic stability and will be critical to boosting job creation and growth. Furthermore, the SCD points to the need to exercise effective regulatory and prudential oversight of the overall financial sector, with a focus on enforcement, to help avoid the recurrence of financial crises. The project directly contributes to Pillar 2 of the FY17-20 Country Partnership Framework (CPF, report No. 108727) which aims to support inclusive growth through a more stable and efficient financial system.

18. **The project aims to strengthen the institutional framework and capacity of the financial sector for enhanced support to inclusive economic growth and job generation in Afghanistan.** As SBs start to operate on commercially-viable terms and under financially sustainable business models, their operations will reflect and complement GoIRA’s efforts to foster private sector development. The private sector will be able to exploit greater economic opportunities by investing, growing, and creating new and better jobs. To sustain the expected gains in poverty reduction and shared prosperity, the project will also help enhance the financial soundness of SBs and thus contribute to overall financial and macroeconomic stability. As market-makers, SBs will be expected to finance productive investments and serve areas and segments of the population that are less attractive or perceived to be too risky by private financial institutions, and at the same time achieve financial sustainability. Closing the financing gap for small and medium enterprises, rural businesses and agricultural entrepreneurs will have significant benefits for the overall economy. Equally, supporting GoIRA efforts in areas such as housing development, social infrastructure improvement and renewable energy/energy conservation through commercially-orientated, sustainable lending products will allow for positive externalities. The current state of development of the private banks makes it unlikely that such gains could be achieved relying exclusively on the private sector. In the long run, the successful establishment of markets through the SBs intervention will allow crowding in of capital and the eventual gradual withdrawal of the state from providing first-tier financial services.

## II. PROJECT DEVELOPMENT OBJECTIVES

### A. PDO

The proposed project development objective is to enhance the corporate governance and operational efficiency of the supported Afghan state-owned banks, thereby contributing to their improved financial soundness and outreach.

### B. Project Beneficiaries

19. The primary project beneficiaries are (a) the three existing SBs; (b) MoF as the owner of SBs, their management, staff; and (c) clients (depositors and borrowers). Secondary beneficiaries and stakeholders, which have an interest in successful outcome and impact of the project include private businesses, the existing clientele of banks which will benefit from more reliable services, households and businesses, as



well as underserved sectors (SMEs, agriculture, and women entrepreneurs) and the currently unbanked population.

20. The Afghan financial sector and the economy at large will derive indirect benefits from the project through its emphasis on improved governance, strengthened operational capacity and information management systems. Enhancing the stability and capacity of a major segment of the banking sector will mitigate potential fiscal risks attached to SBs failures. There will also be spill-over benefits for the banking sector from developing and implementing best practices and improving competition.

### C. PDO-Level Results Indicators

21. The following key results are expected from the project: (i) improved financial health of the SBs; (ii) stronger MoF's capacity as a responsible owner of SBs; (iii) reinforced governance and risk management of SBs; (iv) more efficient operations of SBs through improved IT systems and better operational processes and (v) a growing clientele base offered a wider range of quality financial services.

22. The proposed key results indicators are as follows:

- **SBs' Governance:** Effective governance of state banks as measured by compliance with the key chapters of OECD Guidelines on Corporate Governance of State-Owned Enterprises is identified as priority implementation areas. This is defined through: (i) fully staffed ownership unit; (ii) five-member boards in place and (iii) key internal control policies implemented;
- **SBs' Operational Efficiency:** measured by (i) improved Cost efficiency and (ii) measured by System uptime;
- **SB's Financial Soundness:** measured by adequate capital requirements;
- **SB's Outreach:** measured by number of SBs clients and percentage of female clients.

## III. PROJECT DESCRIPTION

### A. Project Components

23. **The project will include three components:** (1) Improving MOF's Ownership Role and the Corporate Governance of SBs, (2) Institutional Development, Business Strategy, and Information Technology of SBs; and (3) Project Implementation and Monitoring. A proposed sequencing of project activities is presented in Annex 1.

#### **Component 1: Improving MOF's Ownership Role and the Corporate Governance of SBs (US\$ 7 million)**

24. This component will support MoF and the SBs to address the outlined governance issues through TA support to the MoF and each of the SBs. This TA will address six fundamental pillars of good corporate governance for state-owned financial institutions and will strengthen: (a) the exercise of ownership rights by the state; (b) the commitment to good corporate governance principles by the SBs; (c) the structure and function of the SBs' Supervisory Boards to govern the banks in an independent and commercial manner; (d) the control environment including internal and external audit and compliance; (e) the transparency and



disclosure practices of the banks, and (f) the exercise of shareholder rights and relations including dividend policy. The component will also provide capacity building and training to ensure robust design, adoption and implementation of principles, policies and procedures.

***1(a): Strengthening the ownership and oversight role of MoF (US\$3 million)***

25. The project would establish interim and end-project targets for improving SBs governance and the overall ownership function of the government and provide clear disbursement incentives for the authorities to ensure proper sequencing and achieve tangible and measurable results against these targets. The Project Steering Committee in coordination with the ownership unit at the MoF will determine the modernization action plan with prioritizing and sequencing the key steps, specifying the roles and the responsibilities of different parties, projecting budget implications, and setting a timeline for the task of restructuring and consolidation to be completed. While some actions could be developed immediately, others such as building capacity would take time and, therefore, those activities need to start in due course without delay.

26. This subcomponent will finance TA for MoF to establish the legal and institutional framework, as well as the institutional set-up and will allow MoF to establish a dedicated unit for the oversight over its equity interests in SBs. The assistance will strengthen MoF institutional capacity to exercise adequate ownership functions and the regular monitoring of the financial performance of SB. This component will finance TA to establish the institutional mechanism to effectively: (a) prepare the General Assembly (GA) meetings of SBs and monitor the implementation of adopted resolutions; (b) establish and implement a transparent and structured board of supervisor nomination process, as well as rules for board performance and remuneration; (c) monitor the implementation of mandates and the objectives set by the state for the SBs; (d) set-up reporting systems to allow the ownership unit to regularly monitor, audit, assess and evaluate bank performance, and, at the same time, oversee and monitor compliance with corporate governance standards; and (e) develop corporate governance policies and guidelines based on international best practices. The project will also support capacity building at MoF, including through the recruitment and training of specialized staff. Capacity-building of relevant government stakeholders is also expected to enhance buy-in into the reform process and the delineation of governance roles.

***1(b): Strengthening the corporate governance of SBs (US\$4 million)***

27. A primary focus of this subcomponent will be to close the governance loopholes in the SBs. It will seek to strengthen the major governance functions in the institutions, through supporting MoF in adequately staffing and training the board of supervisors, audit and risk management committees and senior management of SBs.

28. Support under subcomponent 1(b) will aim at reviewing current deficiencies, develop processes and structures to address short-comings, establish policies and procedures, identify legal options to enhance the effectiveness of governance structures and independence from influences of outside stakeholders, and design and implement a comprehensive capacity-building (including training) plan. An initial corporate governance assessment of the SBs to identify the primary gaps with regards to the adoption of good international practices in the corporate governance of SBs is being finalized. The assessment will provide concrete recommendations (along with implementation priorities and a roadmap) with the aim to increase accountability and transparency, improve performance and meet the economic and social objectives of the banks. In addition, the governance structure will have to establish the three lines of defense: risk





management, internal audit, and internal controls and ensure that the chief risk officer and the chief internal auditor reporting lines will have secured access to the board when and if needed. The project would provide support to MoF and the SBs to implement these recommendations and help address the outlined governance issues through specialized TA. In particular, it will provide TA in areas relating to the (1) establishment of board processes (board charter, committee charters, communication and evaluations) and board training; (2) design and implementation of key internal policies such as codes of conduct and corporate governance codes, and (3) development and implementation of risk management, internal audit and internal control policies and manuals and provide staff capacitation on their application. Through these activities, this component would complement the reforms planned under the government strategy for SBs and the remaining components of this project.

**Component 2: Institutional Development, Business Strategy, and Information Technology of SBs (US\$ 30 million)**

29. Given the current state of the SBs, this Component will provide support for a full-scale re-engineering of almost the entirety of the banks' operations, based on a defined mission and business strategy. The activities undertaken under the component will benefit from GoIRA's financial sector modernization efforts under the FSRRP, such as the establishment of a Credit Reference Bureau, modernization of property rights systems and mobile money initiatives, as it will allow to improve the origination, management, and recovery of credit assets and to reduce transaction costs. The project will identify training that can be delivered by the Afghanistan Institute of Banking and Finance (AIBF).

***2(a): Building institutional capacity of banks and supporting IT modernization strategy of SBs and immediate IT maintenance (US\$7 million)***

30. This sub-component will provide specialized TA (or "and build capacity") to undertake situational assessments and to stabilize IT capacity.

31. The first activity will be a comprehensive audit of IT infrastructure of the three SBs. This will focus on examining the resilience of the existing architecture, identifying gaps in integration with Afghanistan's financial market infrastructures, including the payment systems, as well as obstacles for scaling up banking operations. A strategy for IT modernization for all SBs will be subsequently developed, on the basis of this comprehensive assessment and the SB's business strategy that would be developed (see paragraph below). This IT strategy will be fundamental and a pre-requisite to kick-start activities under subcomponent 2(c).

32. This subcomponent also supports the required critical and immediate maintenance to the banks' IT infrastructure to mitigate the risks of operational failures. Activities to be support include renewal of expired licences, replacement of obsolete – critical – equipment including servers network equipment.

33. The sub-component will also provide specialized TA to support the immediate institutional capacity building of the three SBs, particularly the development of business strategies and capacity to execute upon the particular mandate. Activities for each SB will include: (a) prepare and support implementation of the detailed business strategy going forward; (b) evaluating the optimal operational size and resources allocation and design the corresponding adjustment strategy and implementation plan; and (c) providing strategic and management support to the institution during the transition process. Furthermore, product development efforts, policy and procedure reforms and training will be geared toward substantially



improving the risk management capacities of the institutions, especially with regards to the origination, management and recovery of credit risks and the management of portfolio risks. Brand positioning support will complement other change management efforts.

***2(b): Supporting the institutional development and implementation of business plans  
(US\$8 million)***

34. Starting activities under this subcomponent is subject to having met the disbursement conditions that provide a strong foundation for proceeding with consolidation of NKB and BMA. The required technical preparation work for the satisfaction of these disbursement conditions will be supported under Component 1. These conditions are:

- A Presidential decree is issued to; (a) define the state ownership policy for State-Owned Banks; (b) set up the ownership unit at MoF with clearly defined core functions; (c) define terms of reference of Boards of Supervisors and executive management of State-Owned Banks; (d) promulgate guidelines for the nomination, appointment, removal and remuneration of members of the Board of Supervisors and key executive management positions in State-Owned Banks that is in line with relevant DAB and banking laws and regulations;
- MoF has properly staffed the ownership unit including at least one full-time banking expert, one full-time financial expert and one legal expert;
- MoF has appointed at least five members to serve as members on the Board of Supervisors for each State-Owned Bank, in full compliance with the Presidential decree above and relevant regulations of DAB; and
- Performance contracts for senior management are in place. A clear definition of senior management positions will be outlined in the operations manual. This means that senior management in SBs have been hired and their performance based contracts signed.

35. In line with GoIRA approved SB Strategy, specialized technical assistance will be provided to accompany the consolidation effort, specifically the envisaged consolidation of NKB and BMA and the rationalization of Pashtany Bank. With regard to the former, specialized merger and acquisitions capacities will be deployed to (a) identify and address the legal and regulatory aspects of the process, (b) support the design and implementation of consolidation, including identifying required resources, (c) devise the roadmap for the implementation of the business strategy and support implementation, and (d) provide hands-on support and guidance to management during the transition process. Furthermore, the component will provide specialized consulting support for the re-positioning of the brand and the development of customer-centric approaches in product design and delivery.

***2(c): Supporting the Modernization of IT Systems and Business Processes of SBs  
(US\$15 million)***

36. The component's change management efforts undertaken under subcomponent 2(a) and 2(b) will be supported by a comprehensive investment in the modernization of the IT systems and business processes of SBs. The implementation of the IT roadmap is to contain the following three components: (i)





procurement and implementation of up-to-date core banking systems for the merged entity and the Pashtany Bank; this would encompass implementation of modern transaction banking suites and an Enterprise Resource Planning (ERP) solution, including its general ledger, HR and financial management components; (ii) set-up of a modern data center; (iii) ongoing capacity building for SBs staff responsible for IT and business processes.

37. IT procurement packages may include core-banking software, auxiliary management and reporting software, hardware, transaction processing systems and devices, communication infrastructure and systems, local area networks/wide areas networks, Anti-money laundering/ combating the financing of terrorism (AML/CFT) systems and automated compliance control and auditing capabilities, IT security, Customer Relationship Management systems, administrative systems, such as HR and inventory management. The envisaged up-grading of core-banking systems, automation of service delivery, and expansion of delivery channels/mechanisms will assist in the roll-out of additional products and the outreach to marginalized segments and sectors, especially outside the urban centers.

38. Investments in IT modernization will only proceed upon finalization of a strategy for IT modernization, funded under subcomponent 2(a). The investments would also require banks to have already significantly advanced in the strengthening of governance, developed robust and well-defined business plans and decided on their operational model. These pre-requisites are disbursement conditions for this subcomponent 2(c) to proceed. These conditions are clearly spelt out as follows:

- Ministry of Finance has issued a policy for modernizing the IT infrastructure of the State-Owned Banks in accordance with the recommendations of the diagnostic assessments carried out under Component 2(a) of the project; and
- A business plan for each State-Owned Bank has been prepared in alignment with the Government Strategic Vision for State-Owned Banks approved by the HEC in December 2017 and has been approved by their respective General Assemblies.

39. The policy that will be issued by MoF will comprise of statement of the overall strategic priorities, approach, principles and roadmap for the IT infrastructure modernization of the SBs. This will include for example, which systems to prioritize, whether to establish shared services arrangements, standardizing the IT architecture across the three SBs, etc.

### **Component 3: Project Implementation and Monitoring (US\$ 3 million)**

40. A standalone PIU will not be established for this project. Component 3 will provide necessary funding for building the required capacity and leveraging specific expertise to support of implementation and coordination of the project at the MoF and SBs.

41. This component would finance the hiring of specific expertise to complement existing MoF team dedicated to this project, as needed for project implementation. It will provide necessary funding for building the required capacity and leveraging specific expertise to support implementation and coordination of the project at the MoF and state banks. This component will also provide support for the monitoring and coordination of project activities undertaken by various beneficiary institutions (SBs and MoF). It will help develop a robust monitoring and evaluation system to be used by the MoF and other stakeholders to assess



implementation progress.

## B. Project Cost and Financing

42. The total cost of the Project is estimated at US\$ 40 million, to be financed by an IDA Grant using Investment Project Financing.

Project Components	Project cost. US\$ millions	% IDA Financing
<b>Component 1: Improving MOF's Ownership Role and the Corporate Governance of SBs</b>	<b>7</b>	<b>100%</b>
1(a) Strengthening the ownership role of MoF	3	
1(b) Strengthening corporate governance and oversight framework of SBs	4	
<b>Component 2: Institutional Development, Business Strategy, and Information Technology of SBs</b>	<b>30</b>	<b>100%</b>
2(a) Building institutional capacity of banks and supporting IT modernization strategy of SBs and immediate IT maintenance	7	
2(b) Supporting institutional development and development of business plans	8	
2(c) Supporting the modernization of IT systems and business processes of SBs	15	
<b>Component 3: Project Implementation and Monitoring</b>	<b>3</b>	<b>100%</b>
<b>Total Costs</b>	<b>40</b>	<b>100%</b>

## C. Lessons Learned and Reflected in the Project Design

43. The project's design and implementing arrangements incorporate lessons learned from previous and ongoing operational work in Afghanistan and other relevant contexts, including financial sector reforms, modernization of state financial institutions, as well as sequencing of components during implementation. The latter reflects the lessons learned in different countries where financial sector reforms (SBs in particular), especially in fragile contexts, require a combined approach which addresses policy, governance and operational issues. In the absence of strong fundamentals in the beneficiary institutions (in terms of mandate and corporate governance), efforts to modernize policies, processes, and systems will not achieve optimal results. Similarly, policy and governance reforms alone cannot improve the financial and operational performance of SBs as long as outdated process and procedures remain entrenched (for example in risk management, internal control, credit underwriting and HR management).



44. **The political economy of reform programs has shown to be of vital importance to the success of SB modernization programs.** In general, reforms are often prone to delays or challenges due to lack of government commitment and constituency support, the large size of the institutions, extensive insider and related party transactions, significant non-performing assets, governance constraints and poor staff skills. The program and project activities dovetail with the efforts already undertaken by GoIRA to establish adequate capital levels for the SBs through the write-off of NPLs and recapitalization. Furthermore, the government's SB Strategy outlines the commitment of authorities to the modernization of the sector, stressing the need for policy, governance and operational reforms. Also, whereas staffing levels are substantial relative to operational magnitude, adjustment needs pose a lesser constraint than in similar reform and modernization programs in other countries.

45. **The project design also takes into account the lessons related to the implementation of projects in Afghanistan, particularly the constraints on implementation capacity.** Project activities will be supported through sequenced and targeted expert support to the MoF and each SB. Furthermore, the establishment of an oversight unit for SBs within MoF as part of the project's activities will support the monitoring of corporate governance reforms and ensure sustainability of project outcomes.

## IV. IMPLEMENTATION

### A. Institutional and Implementation Arrangements

46. **The Administration and Finance Directorate (AFD) at the MoF, which is currently responsible for the oversight of all state-owned enterprises will be the responsible for implementing the project on behalf of the GoIRA.** A Project Steering Committee (PSC) will be formed, and chaired by the Deputy Minister, in charge of the Administration and Finance Directorate. The PSC would provide overall guidance on key implementing decisions and project planning and oversee overall implementation progress. The PSC would be comprised of high-level representatives and include the central bank, Da Afghanistan Bank (First Deputy Governor), relevant directorates of MoF (e.g. SoEs), the Project Director, the CEOs of the SBs, and other entities that the PSC may decide to include. Responsibility for project management will be entrusted to a dedicated Project Management Team (PMT) attached to the AFD and led by an experienced Project Director (PD) with adequate and relevant knowledge of WBG operations. The PD will be supported by a Chief Technical Specialist (CTS) and a Banking Expert (BE) with strong knowledge of and experience in the Afghan Banking Sector. Subject to operational needs, PMT would be strengthened with dedicated expertise in procurement, financial management and gender to build the required capacity within AFD and ensure smooth implementation. PMT will closely coordinate activities with the SB ownership unit to be set-up as part of activities under subcomponent 1(a) once it is established. As per MoF requirements, a standalone Project Implementation Unit (PIU) will not be set up (see Annex 2 for further details).



## B. Results Monitoring and Evaluation

**A strong M&E framework to systematically track inputs, outputs, and outcomes is integrated into the various components of the project.** The World Bank will evaluate progress on the proposed indicators through regular reporting by the implementing agency and through implementation support visits, including the midterm review. The midterm review is expected to be around the 18<sup>th</sup> month of project implementation and will assess overall implementation progress. Quarterly reports, with results for output and outcome indicators, and semi-annual FM reports will be submitted to the World Bank to monitor outcomes. A project audit will be undertaken annually in line with the terms of reference (TORs) that will be included in the Operations Manual (OM). Also, a beneficiary feedback mechanism will be integrated into the project and monitored during implementation through an indicator on citizen engagement as well as clients' satisfaction of services provided by SB's. With regards to the later, a baseline client satisfaction survey is to be conducted at outset of the project within 6 months of project effectiveness. The project will also include gender-disaggregated SBs' client survey results in the results framework. Adequate staffing and resources allocated within the Ministry of Finance will ensure the provision of monitoring data.

## C. Sustainability

47. **The Afghan government is committed to strengthening the corporate governance of SBs, reinforcing the MoF's capacity to monitor them and investing in their infrastructure and business processes** with the aim of improving their operations so they can finally play their role in the overall banking sector, and the economy in general. Moreover, the government's long-term SB Strategy lays out a vision for the banks as commercially orientated institutions with a clear development approach to its business.

48. **The proposed activities in the areas of governance improvements, business re-engineering and IT systems upgrade are expected to be embedded in the SBs' corporate governance arrangements, processes, workflows and systems.** The reforms will position the SBs for a long-term, sustainable and viable development, whether still publicly owned or partially or fully divested by the state. Sustainability of the project's outcomes will depend on several factors including (i) availability of qualified resources to improve governance, including Board of Supervisor appointees, (ii) capacity of SBs to implement their new business strategies; (iii) regular maintenance and upgrading of IT infrastructure; sound fiscal and financial position of SBs.

## D. Role of Partners

49. **The project builds upon efforts that aim to promote financial stability and access to finance supported by the WBG and other development partners involved in the financial sector** such as the IMF, United States' Treasury Office of Technical Assistance, and Agency for International Development, as well as the U.K. Department for International Development. Supported activities include strengthening financial regulation and supervision (through DAB), preparation of a National Financial Inclusion Strategy (jointly by DAB and MoF, with all relevant stakeholders), financial infrastructure development, and expansion of digital financial services. Close collaboration with development partners will continue during project implementation.



## V. KEY RISKS

### A. Overall Risk Rating and Explanation of Key Risks

50. **Key risks have been identified and rated in the Systematic Operations Risk-Rating Tool (SORT) presented in the project data sheet.** The overall risk of the project is rated “Substantial”, mainly due to the fragile country context, the high political and governance risks; as well as substantial risks associated with the institutional capacity for implementation and sustainability; and substantial fiduciary risks. While key risks are mitigated, most remain at the “Substantial” level. The environmental and social risks are rated Low.

51. **The high political and governance risks come from the possibility of a reversal of policy commitment and failure to go through with the necessary reforms.** Policy and governance, macroeconomic and stakeholder risks are high because of the country’s fragile and deteriorating security environment, limited government capacity, overall fiscal uncertainties and the declining foreign aid budget. Under these circumstances, improving governance and tackling corruption could foster political uncertainty and opposition from some constituencies. Nevertheless, GoIRA consistently signaled its strong commitment to reforming the financial sector, most recently in the ANDPF and the IMF ECF program. Moreover, the project will directly support the implementation of GoIRA’s long-term SB strategy. Reversal of support for the objectives and activities proposed under the project is thus not expected. As a mitigation measure, the project design includes well defined and sequenced disbursement conditions for the implementation of key reforms required to strengthen the SB sector in a sustainable manner. The project was also designed in close consultation with the MoF, DAB, high-level advisors to the government, and SB’s senior management. Finally, the project team proactively coordinated with other important donors such as the IMF, United States Treasury Office of Technical Assistance to solidify broad-based advocacy and support for the reforms.

52. **The risks associated with sectoral strategies and policies is rated substantial.** The SB Strategy provides much-needed clarity and commitment to the business model of SBs going forward. However, constituency pressures to direct lending to preferred or priority sectors, such as agriculture, housing and infrastructure, will remain. Mitigation measures during implementation will be the continued consultations with stakeholders.

53. **The substantial institutional capacity for implementation, fiduciary and sustainability risks arise from the lack of sufficient qualified personnel at MoF and within SBs to implement the core, technical project activities.** MoF has a strong record of implementing several ARTF and IDA projects and proposals, and as a result has decided not to set up a Project Implementation Unit, but rather to appoint current MoF staff to support project implementation in their respective capacities. Additional staff will be recruited by MoF (based on NTA scale) as well as qualified consultants to supplement the core MoF team on highly specialized topics. With regards to fiduciary requirements, the hiring and training of required staff to undertake fiduciary functions at MoF, and the centralization of procurement at MoF will help mitigate fiduciary risks.



54. **The substantial technical design risk stems from the number, technicality, and sequencing of the proposed activities, as well as reliance on qualified consulting firms for several important activities.** First, the project design is informed by and will support the implementation of the government’s ten-year strategy for state banks, as approved by the High Economic Council in December 2017. There is some concern in ensuring proper sequencing and capacity building of relevant parties involved in the implementation of the Strategy. This risk will be mitigated by the phased implementation of reforms, and the provision of technical assistance through the proposed project. Second, several consulting firms – on banking advisory and IT – will be recruited to operationalize the SBs’ strategy and undertake additional diagnostics. The success of the strategy lies in the MoF’s ability to recruit capable, qualified and committed consultancy firms and individual consultants. To mitigate these risks, a pool of potential companies will be approached at every call for expression of interests to encourage their applications. Finally, the implementation of project components, which will be at times sequential or concomitant, will present a substantial challenge for the team at MoF, including in terms of coordinating, monitoring and reviewing technical inputs. This risk will be mitigated by extensive implementation support by the World Bank.

55. **The stakeholder risk is substantial, given the strategic importance of state banks and their legacy in the country.** The risk has been mitigated by the team through extensive consultations with all stakeholders during project preparation.

## VI. APPRAISAL SUMMARY

### A. Economic and Financial Analysis

56. **The modernization of SBs is a prerequisite for both financial system stability and financial inclusion.** Strengthening the financial institutions through the adoption of a sound policy framework will contribute to mitigating financial stability and macroeconomic risks. A stable, sustainable transparent and efficient financial system will foster financial inclusion, and ultimately help people build resilience, pursue economic opportunities and mitigate risks and uncertainties. The literature on the positive correlation between financial development and economic growth, poverty alleviation and inequality reduction is substantial and growing. Strengthening SBs mitigates financial sector stability risks, reduces fiscal outlays, improves the quality and outreach of banking services to the economy, and contributes to job creation and growth. Furthermore, it will increase the institutions’ (intrinsic) value and reduce potential contagion effects on the private banking sector.

57. **Among expected benefits are enhanced focus, transparency, and efficiency of SBs’ operations.** The project will contribute to building blocks as it provides support to the Afghan government in its efforts to increase the ability of SBs to play a more active role in the economy. This goal will be achieved through improved governance (in line with international good practices); definition of clear mandates and implementation of sound business strategies, and modernization of IT infrastructure to enhance efficiency and mitigate operational risks, as well as capacity building for sustained improvement in bank operations and the environment. The IT modernization will also complement governance reforms by providing reliable information for bank management, boards, regulator, auditors, and the general public, thus further





contributing to greater transparency.

58. **The assessment approach contrasts the costs of the program and the benefits of loss avoidance by not reforming the SBs.** A qualitative analysis, in terms of cost-effectiveness, was undertaken for cross-cutting TA resources allocated to foster governance and transparency as well as the modernization of the infrastructure of these banks which would directly reflect on their operational efficiency. The proposed intervention comes out as the most efficient given the current challenges inherent in the sector.

## B. Technical

59. **The rationale for the proposed technical design is strong.** The approval of the SB Strategy for SBs provides a strong momentum to redefine the business models of SBs, structurally address operational inefficiencies and risks, and strengthen the institutions. Also, as SBs turned to profit in 2016, attention can shift from reducing losses to taxpayers to increasing the entrenched low-level of intermediation and spur financing of productive sectors. The proposed design seeks to address the situation comprehensively and sequentially tackle the primary challenges to SBs' effective participation in the Afghan economy. The project will, in a first stage, address core institutional and governance deficiencies before modernizing the business policies, processes, and systems of SBs.

## C. Financial Management

60. **The overall fiduciary risk for the project is rated as Substantial based on the assessment of the fiduciary arrangements in MoF.** Ratings will be reviewed at every implementation support mission and will be adjusted as necessary. The overall responsibility for project FM will rest with the head of Finance and Administration Directorate. MoF will assign focal staff to carry out the FM activities of the project. MoF finance staff have significant years of experience working on the World Bank-funded projects. One additional staff (senior financial management specialist) will be hired under the project. The fixed assets purchased for the State-Owned Banks will be counted as capital increase in their books of accounts accordingly. The detailed FM arrangement of the project can be seen in Annex 2.

## D. Procurement

61. **Procurement for the proposed project will be carried out in accordance with the Bank's Procurement Regulations** for Borrowers for Goods, Works, Non-Consulting and Consulting Services dated July 1, 2016 (revised November 2017) hereinafter referred to as "Procurement Regulations". The project will be subject to the Bank's Anticorruption Guidelines, dated October 15, 2006, and revised in January 2011 and as of July 1, 2016. Since the Project is being prepared under OP 10 paragraph 12, a high level, simplified Project Procurement Strategy Document (PPSD)<sup>1</sup>; required in situations of urgent need of assistance, is being finalized. Based on PPSD, procurement plan has been prepared which sets out the selection methods to be followed implementation for procurement of goods, non-consulting and consulting services financed by the Bank. The Procurement Plan represents the time slice of first eighteen months of

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<sup>1</sup> PPSD is a deliberative document and not annexed to PAD as PAD is classified as 'Public' after finalization



project implementation. It will be updated at least annually or as required; to reflect the actual project implementation needs and improvements in institutional capacity, through Systematic Tracking of Exchanges in Procurement (STEP) [World Bank's planning and tracking system].

**62. MoF will have overall responsibility for all procurement under all components of the project.**

The Procurement Directorate (PD) of the MoF would be the procurement focal point for implementation of all procurement activities under the project. An assessment of the capacity of the current procurement staff of the Procurement Directorate of the MoF that will have the primary responsibility to conduct the procurement under the Project has been carried out.

### **E. Social (including Safeguards)**

**63. Citizen Engagement.** A third-party firm will be hired as part of the M&E activities to conduct client surveys with the primary and secondary level beneficiaries identified in above sections. Particular attention will be dedicated to feedback from small and medium enterprises; the agriculture, agro-based and rural sectors; and the unbanked population of the country, especially women. In addition, the client will also establish an effective GRM system to address grievances related to project activities. Since the project does not directly affect the population and the project activities are mainly focus on the efficiency of state-owned banks, possible grievances would likely be limited to banks' staff and SBs. The following are the key CE indicators for the Modernizing Afghan State-Owned Banks project that will be monitored in addition to the results framework:

- Percentage of SMEs and other beneficiaries that are satisfied with the service level: 80%
- Number of grievances addressed within stipulated time: 80%

**64. Gender.** The project activities will – to the extent possible – ensure that adequate attention is given to support efforts economic empowerment of women in consultation with WEE-NPP and facilitate women access to finance. Women access to finance remains an acute challenge in Afghanistan. According to Global Findex 2014, only 10 percent of adults in Afghanistan have a transaction account that allows for payments and store of value. These accounts are by regulated financial institutions. At the same time, the gender gap in account ownership is the most acute in Afghanistan. In general, men are almost 4 times more likely to have an account at a formal financial institution in Afghanistan. This can be attributed to many factors including: (i) distance, cost and lack of documentation such as ID, and (ii) lack of trust in and awareness about financial institutions. Moreover, AREU 2012 research shows that women's access to loans/financial products enhances their decision-making responsibilities in the household and increases their self-confidence. The project activities will extend the outreach of state banks to female beneficiaries, develop robust business plans and enhance its operational efficiency and accordingly reduce transaction costs for them. The new business plans will explore incorporating a gender friendly dimension in banks operations to facilitate women access to financial services. This will be closely monitored through gender disaggregated data as part of the project's results framework. This will be reflected in tracking the progress on number of accounts held by women in the three banks as well as supporting women friendly products that these banks will offer under the new business strategies that will be supported under the project. Moreover, the data collected as part of the feedback for citizens engagement will also be disaggregated on basis of gender to track women satisfaction with services that SB's provide.





## **F. Environment (including Safeguards)**

65. **The project is rated Environmental Category C according to OP 4.01, due to minor environmental impacts.** No environmental safeguard policy is triggered due to no or minor environmental impacts. A climate and disaster risk screening, which was carried out during project preparation, shows that climate change poses low risk to project development outcome/service delivery. E-waste generation issues in the context of the proposed IT system improvements will be limited and addressed according to best practice. Upon request the World Bank can have capacity building and training for the banks staff to enhance their capacity on relevant issues and impacts of possible future credits, lending by the Central Bank or the commercial banks and screening climate related projects as many central banks become accredited and function as focal agencies for climate fund projects.

## **G. Other Safeguard Policies**

n/a

## **H. World Bank Grievance Redress**

66. Communities and individuals who believe that they are adversely affected by a World Bank (WB) supported project may submit complaints to existing project-level grievance redress mechanisms or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address project-related concerns. Project affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit <http://www.worldbank.org/en/projects-operations/products-and-services/grievance-redress-service>. For information on how to submit complaints to the World Bank Inspection Panel, please visit [www.inspectionpanel.org](http://www.inspectionpanel.org).



**Results Framework**  
**COUNTRY : Afghanistan**  
**Modernizing Afghan State-Owned Banks Project**

**Project Development Objectives**

The proposed project development objective is to enhance the corporate governance and operational efficiency of the supported Afghan state-owned banks, thereby contributing to their improved financial soundness and outreach.

**Project Development Objective Indicators**

Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
<b>Name:</b> Effective Governance of SBs in line with key OECD guidelines		Text	Non-compliant	Fully compliant with key chapters	Quarterly	Board appointment letters;  Board Minutes;  Board Approved internal control policies	MoF

**Description:** Measured by: compliance with the following chapters of OECD Guidelines on Corporate Governance of State-Owned Enterprises that have been identified as priority implementation areas:

Board composition: Board has at least 5 members in line with fit and proper DAB requirements; Majority of the board independent according to DAB definition of independence

Board operations: frequency of meetings (monthly), balance of decisions between strategic and operational issues (at least 25% of board meetings on strategy issues)

Board decision making: Board approves strategy and risk management guidelines; sets executive remuneration competitive with commercial competitors



Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
<b>Name:</b> Improved operational efficiency of SBs (Measured by System uptime)							
		Percentage	90.00	99.00	Annual	State Banks	MoF
Description: The total time (in hours) when all critical IT systems are available for use, divided by the total time when all critical IT systems are expected to be available (i.e. with the exception of planned closures due to specified bank holidays and scheduled maintenance), averaged for all SBs.							
<b>Name:</b> Improved Financial Soundness of SBs (SBs meet the central bank's minimum capital requirements)							
		Percentage	33.00	100.00	Quarterly	State Banks (audited financial statements)	MoF
Description: Percentage of State Banks that meet the central bank's minimum capital requirements							
<b>Name:</b> Increased outreach of SBs (measured by number of SBs clients served)							
		Number (Thousand)	2206.00	3200.00	Annual	State Banks	MoF
Of which percentage of female clients							
		Percentage	9.00	15.00	Annual	State Banks	MoF
Description: Total number of SBs clients							



**Intermediate Results Indicators**

Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
<b>Name:</b> Improved oversight capacity of MoF as per OECD Guidelines		Text	None	Fully operational ownership unit	Quarterly	Quarterly performance and monitoring reports issued by the ownership unit	MoF
<p><b>Description:</b> Improved Ownership Oversight Capacity of MoF - measured in terms of compliance with OECD Guidelines Chapter I.D; II. C, D</p> <p>In particular:            State dedicate budget to ownership unit            Issuance of decree to establish ownership unit            Defined clear ToR for ownership entity            State participate at general shareholder meeting and exercise voting rights            Set nomination policy            Set reporting systems on a monthly, quarterly, and annual (aggregate) basis            Set disclosure policy            Set competitive remuneration policy for board members</p>							
<b>Name:</b> Improved efficiency (Measured by average adjusted Operating Income Margin)		Percentage	65.00	77.00	Quarterly	State Banks (audited financial statements)	MoF
<p><b>Description:</b> This is the operating income margin adjusted to reflect true operational capacity</p>							



Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
<b>Name:</b> Percentage point increase in SB client satisfaction rate (disaggregated by gender) over baseline survey		Percentage	0.00	15.00	Annual	State Banks satisfaction surveys	MoF
Description: This indicator measures the improvement in client satisfaction for the services provided by State Banks. The end-project target is 15 percent increase from the level recorded in the first survey.							
<b>Name:</b> Increase in the number of Digital Financial Services users in SBs (disaggregated by gender)		Percentage	0.00	15.00	Annual	State Banks	MoF
Description: Percentage, cumulated increase in DFS users in SBs over the life of the project							
<b>Name:</b> Improved Soundness of SBs (Measured by average adjusted ROE)		Percentage	3.40	10.00	Quarterly	State Banks (audited financial statements)	MoF
Description:							
<b>Name:</b> Savings in Staff time		Percentage	0.00	50.00	Annual	State Banks	MoF
Description: Reduction in the sum of person-hours of staff time required to perform the following four activities: (i) prepare all monthly reports required by the central							



Indicator Name	Core	Unit of Measure	Baseline	End Target	Frequency	Data Source/Methodology	Responsibility for Data Collection
bank; (ii) prepare an unaudited balance sheet; (iii) open a checking account for an individual and (iv) process a secured business loan. The final value of the indicator is the percentage decrease of this sum, averaged for all SBs, on the day of measurement, compared to the sum on the project effectiveness date.							

<b>Name:</b> All senior management functions have been filled and performance contracts in place for CEOs		Text	Vacancies in senior management functions of SBs. No Performance contract in place.	All senior management functions are filled in SBs; Performance management contracts in place for CEOs.	Annually	State Banks	MoF
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**Description:** Senior Management functions that will be monitored are : 1. Chief Executive Officer; 2. Chief Finance Officer; 3. Chief Audit Officer 4. Chief Risk Officer; 5. Chief Operations Officer.

Performance management contracts will be implemented for CEOs.

<b>Name:</b> Improved credit risk management policies		Yes/No	N	Y	Annual	State Banks	MoF
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**Description:** The credit risk management policies of all SBs have been revised and improved.



**Target Values**

**Project Development Objective Indicators**

Indicator Name	Baseline	YR1	YR2	YR3	YR4	YR5	End Target
Effective Governance of SBs in line with key OECD guidelines	Non-compliant	Board Composition: Board nomination Guidelines approved; Recruitment in process	Board composition: Five member board in place, majority independent  Board decision making: Board approved bank strategies; Draft Risk management guidelines and Board Charter; executive remuneration approved	Board operations: Monthly board meetings; Board minutes reflect balance of discussion on strategy  Board decision making: Risk management guidelines approved	Board decision making: Semi-annual risk reports approved by Board	Boards are fully compliant with key chapter of OECD Guidelines	Fully compliant with key chapters
Improved operational efficiency of SBs (Measured by System uptime)	90.00						99.00
Improved Financial Soundness of SBs (SBs meet the central bank's minimum capital requirements)	33.00	33.00	33.00	33.00	100.00	100.00	100.00



Indicator Name	Baseline	YR1	YR2	YR3	YR4	YR5	End Target
Increased outreach of SBs (measured by number of SBs clients served)	2206.00			2300.00	2800.00	3200.00	3200.00
Of which percentage of female clients	9.00	9.00	9.00	9.00	11.00	15.00	15.00

**Intermediate Results Indicators**

Indicator Name	Baseline	YR1	YR2	YR3	YR4	YR5	End Target
Improved oversight capacity of MoF as per OECD Guidelines	None	Steering Committee for bank modernization established  Scope and Structure (TORs) for ownership entity established	Unit legally established  Key Staff in place according to HR plan	Unit operational, with monitoring reports now being produced	Full reporting system in place allowing the effective execution of ownership rights	Fully operational ownership unit with the capacity to monitor SBs performance in fulfillment of their objectives	Fully operational ownership unit
Improved efficiency (Measured by average adjusted Operating Income Margin)	65.00	65.00	65.00	67.00	69.00	77.00	77.00
Percentage point increase in SB client satisfaction rate (disaggregated by gender) over baseline survey	0.00	0.00	0.00	5.00	12.00	15.00	15.00

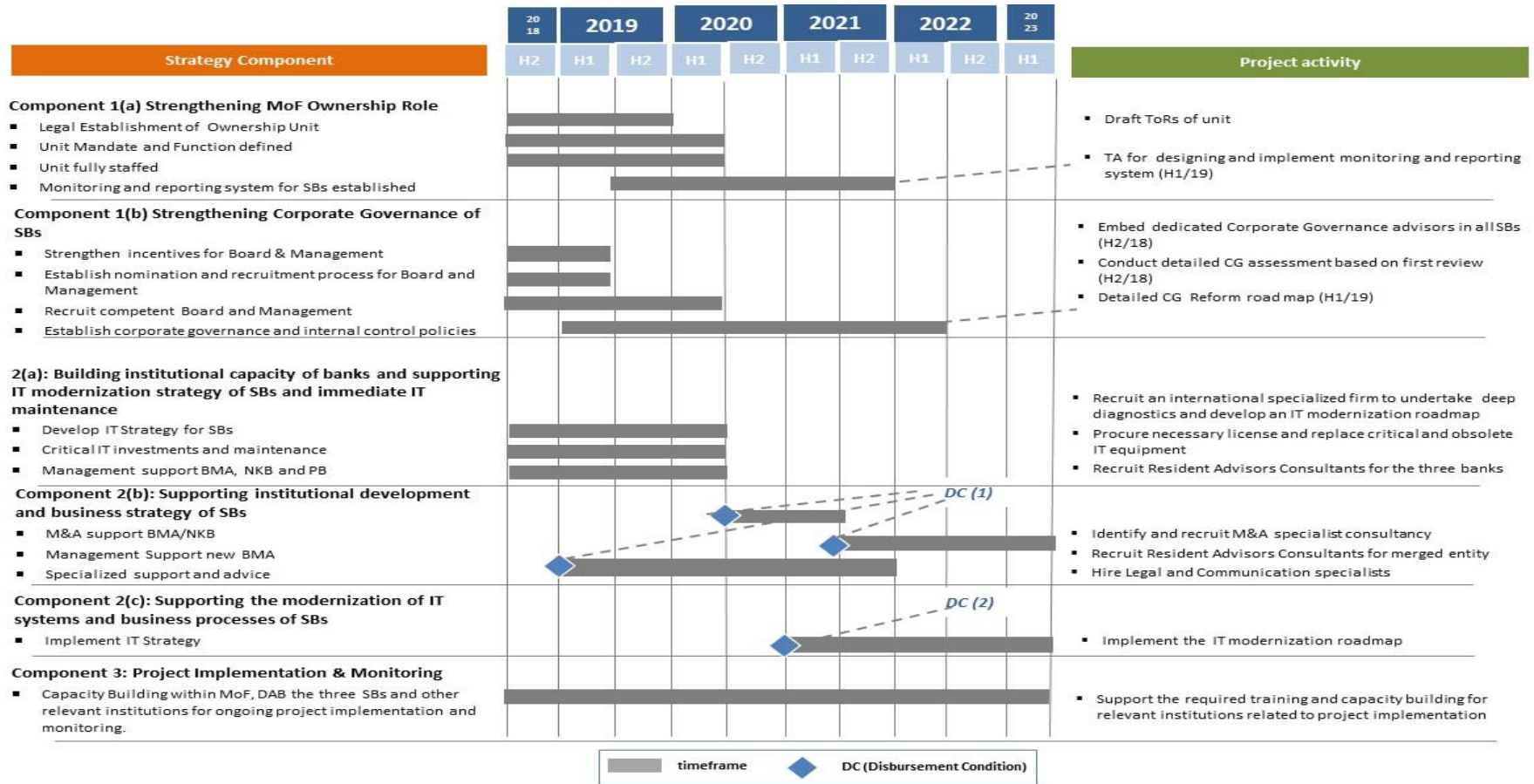




Indicator Name	Baseline	YR1	YR2	YR3	YR4	YR5	End Target
Increase in the number of Digital Financial Services users in SBs (disaggregated by gender)	0.00	0.00	0.00	5.00		15.00	15.00
Improved Soundness of SBs (Measured by average adjusted ROE)	3.40						10.00
Savings in Staff time	0.00						50.00
All senior management functions have been filled and performance contracts in place for CEOs	Vacancies in senior management functions of SBs. No Performance contract in place.			Senior management vacancies have been filled.	Performance contracts have been executed for all CEOs of SBs.		All senior management functions are filled in SBs; Performance management contracts in place for CEOs.
Improved credit risk management policies	N	N	N	Y	Y	Y	Y



## ANNEX 1: PROPOSED SEQUENCING OF PROJECT ACTIVITIES



\* Provisional time line.

\*\* (H1) refers to first half of the fiscal year and (H2) refers to the second half of the fiscal year.



## ANNEX 2: IMPLEMENTATION ARRANGEMENTS

### Project Institutional and Implementation Arrangements

1. **Organization responsible for the project.** The Administration and Finance Directorate (AFD) at the Ministry of Finance (MoF), which is currently responsible for the oversight of all state-owned enterprises, will be the responsible entity for implementing the project on behalf of GoIRA. It will act as the implementing agency; all funds flow for project activities will be through the Administration and Finance Directorate. As per GoIRA's decision, there will be no dedicated PIU for this project.
2. **Policy and overall guidance.** A Project Steering Committee (PSC) will be formed within two months after effectiveness and chaired by the Deputy Minister in charge of the Administration and Finance Directorate. The PSC would be comprised of high-level representatives and include the central bank, Da Afghanistan Bank (First Deputy Governor), relevant directorates of MoF (e.g. SoEs), the Project Director, the CEOs of the SBs, and other entities that the PSC may decide to include. The PSC would provide overall guidance on key implementing decisions and project planning and oversee overall implementation progress.

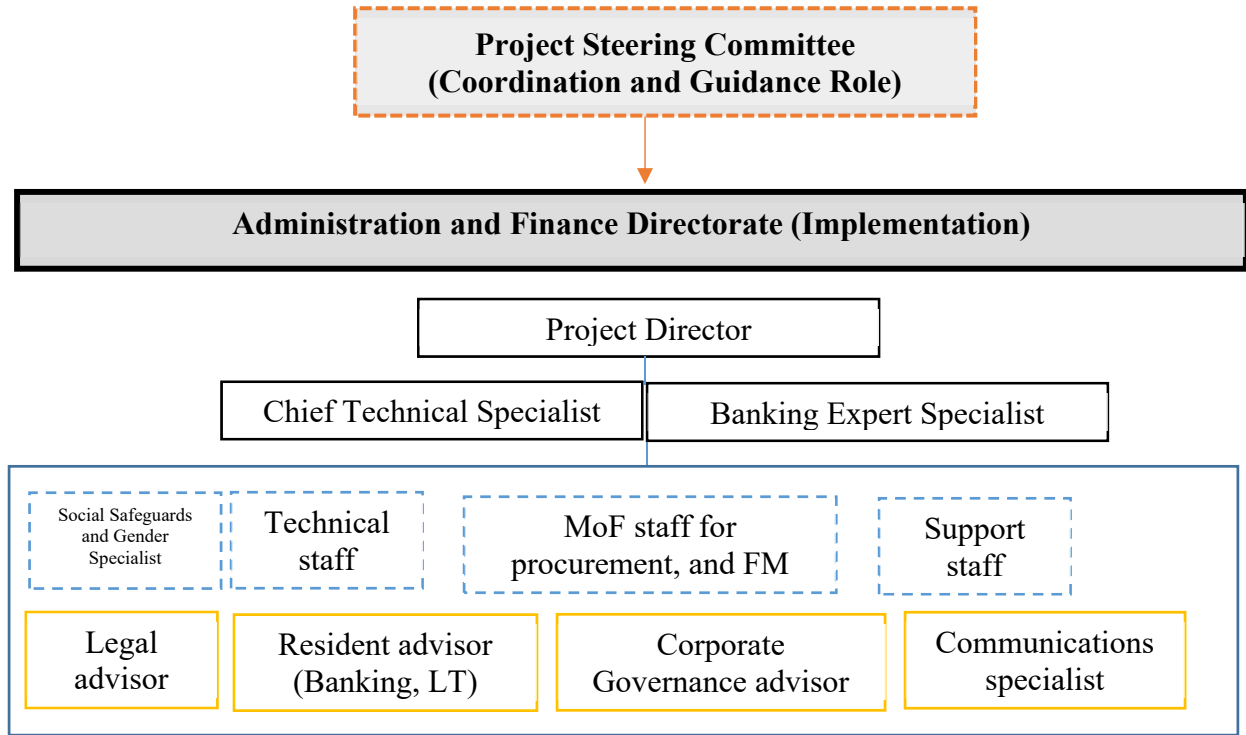
### Project Implementation Arrangements

3. Responsibility for project management will be entrusted to an experienced Project Director (PD) with adequate and relevant knowledge of World Bank operations. The PD will coordinate overall project activities and will be seconded by a Chief Technical Specialist (CTS) and a Banking Expert (BE) with strong knowledge of and experience in the Afghan banking sector. ToRs for both positions have been prepared and staff have been recruited as per NTA guidelines as part of the Project Preparation Advance (PPA). The PD, CTS, and BE will coordinate and monitor the activities of the various components, beneficiary institutions, and technical experts. All experts that will be recruited under the project will work under the direct supervision of the PD, BE and CTS.
4. More specifically, to provide support to AFD staff in implementing the strategy for SBs through the various project components, a number of technical experts and consultants will be hired. For example, under subcomponent 2-1, resident advisers will be hired and placed in each SB and the AFD for at least two years. One or multiple consulting firms will be hired to implement the strategic approach for state banks going forward and to build the capacity of SB staff and MoF to play their respective roles fully. Additional consultants and/or part-time specialists or contractors will need to be hired to complement AFD staff in specific technical areas to carry out specialized project activities (legal, IT, governance, risk management and loan administration, communications etc.), general project management as well as social and environmental safeguards (fiduciary, M&E).
5. The AFD will be responsible for the overall procurement and contract management under the project. For the effective implementation of the components, the AFD will coordinate project activities among participating and implementing departments of SBs. SBs are the project beneficiaries and will be accountable to AFD for their part in the implementation of relevant project activities. No funds will be transferred to SB under the project.



6. A PPA of US\$5 million has been provided to the Afghan Government to undertake essential preparatory activities: project staff, IT and governance assessments, recruitment of advisors and any other expertise required for project preparation purposes. PD, CTS and BE were already appointed and hired and playing a pivotal role in setting the stage for full project implementation.

Figure 1: Project Implementation Arrangements



**Integrated Fiduciary Assessment**

7. **Background:** Afghanistan is a unitary government and has a centralized PFM architecture. The Public Finance and Expenditure Management Law 2005 (PFEML), sets out the responsibilities, authorities and obligations related to the management of public finance in the country. Ministry of Finance (MOF) has a dominant role in preparing and managing annual government budget. It is also responsible for treasury functions, government financial reporting as well as tax policy and administration. The central line ministries have the mandate of country wide public service delivery. Accordingly, they prepare and after approval of the Parliament execute their annual budgets. The central line ministries are also responsible to maintain an internal audit function as required by PFEML.

8. The last Public Expenditure and Financial Accountability (PEFA) Assessment for Afghanistan was conducted in 2013 and the PEFA update is in process, expected to complete by June 2018. Afghanistan’s PEFA ratings portray a public sector where financial resources are, by and large, being used for their intended purposes as authorized by the budget. However, the budget credibility, particularly for development budget, remains low; for development budget, actual expenditure is about 50% of the



budgeted expenditure. Also, control over contractual commitments is not very effective, creating a risk of generating further expenditure arrears. Bottlenecks in the budget execution system, no practice of budget ceilings for line ministries and approval of budget after 2 months from the start of the fiscal year are the major reasons for low budget utilization. To improve the strategic allocation of resources, there is need for a stronger link between the medium-term perspective in expenditure budgeting and strategic plans. While the government's Chart of Accounts caters for a multi-dimensional analysis of expenditure, it was last updated in 2009 and has no dedicated functional segment. Internal and External Audits report significant issues of non-compliance with the prescribed internal control framework; however, the audit follow-up mechanism is not effective and most of the audit recommendations are not implemented.

9. The Bank has gained substantial experience and understanding of the FM environment in Afghanistan through the large number of projects under implementation over the past years. The PFMRP II (under the series of PFMRPs) is the primary instrument to continue and enhance the fiduciary measures put in place during the past years to help ensure transparency and accountability for the funding provided by the Bank and other donors.

10. The Bank is financing an FM advisor to assist the MoF, and an audit advisor to assist the Supreme Audit Office (SAO). The internal audit function is being strengthened within the MoF with Bank financing. The activities carried out under the series of PFMRPs have helped the government to ensure that appropriate fiduciary standards are maintained for public expenditures, including those supported by the Bank and the donor community.

11. The overall fiduciary risk for the project is rated as Substantial. The details of the assessment are in the following paragraphs. This rating will be reviewed at every implementation support mission and will be adjusted as necessary.

#### *Joint Fiduciary Aspects (FM and Procurement)*

12. **Fiduciary capacity.** The overall responsibility for project FM will rest with the head of Finance and Administration Directorate. MoF will assign focal staff to carry out the FM activities of the project. MoF finance staff have significant years of experience working on Bank funded projects. One additional staff (senior financial management specialist) will be hired under the project who will be reporting to project director.

13. MoF will have overall responsibility for all procurement under all components of the project. The Procurement Directorate of the MoF would be the procurement focal point for implementation of all procurement activities under the project. An assessment of the capacity of the current procurement staff of the Procurement Directorate of the MoF that will have the primary responsibility to conduct the procurement under the Project has been carried out.

14. The current Procurement Directorate; that would be entrusted with procurement responsibilities, is staffed with 20 senior staff (civil servants and contractual employees), that are undertaking major and minor procurements. The civil servants are staff are - Procurement Director, Procurement Manager, Head of Procurement Department of Goods, General Contract Manager, and two Contact Managers, additionally there are five contract staff who are responsible for procurement of goods, works non-consulting and



consulting services.

15. Most of PD Staff hold bachelor degrees with over 5 years of experience in procurement of small value goods, works and consultant services. Moreover, MoF needs to get accreditation of National Procurement Authority to handle procurement independently without going through National Procurement Authority (NPA).

16. During the implementation of the project, the capacity of the project procurement unit will be periodically assessed, and thresholds for various categories of procurement will be reviewed and updated accordingly. However, based on the above procurement capacity assessment the threshold of High Risk Implementing Agency will apply for the prior review of the contracts under the project. The same is elaborated in the procurement plan.

17. **Planning and budgeting.** Annual budgets for the project will be prepared in line with MoF regulations and according to the Afghanistan fiscal year. The project budget will be prepared based on procurement plan and work plan. The annual budget will be broken by quarters for effective monitoring. The quarterly IUFRRs will compare actual expenditures to budgeted expenditures, and explain significant variances. MoF will ensure that temporary budget at the beginning of the fiscal years will be provided while new budget is pending approval. The procurement plan for implementation shall be prepared; Bank's Systematic Tracking of Exchanges in Procurement (STEP) will be used to capture and track transactions. Prior review by Bank and post review by third party consultants will enable consistent implementation of procurement

18. **Accounting and Financial Reporting:** Cash basis of accounting will be followed for the project and the project will report under Cash Based International Public Sector Accounting Standards (IPSAS). The project will have the book keeping records on MS Excel. A specific accounting software will be procured for the project based on needs. The project will submit quarterly Interim Unaudited Financial Report (IUFRR). IUFRRs will be submitted to the Bank within 45 days of the close of each quarter. The financial management manual will provide details of accounting records and book of accounts to be maintained that at minimum will include;

- (a) Cash/ Bank Book – to record all cash/ bank receipts and payments
- (b) General Ledger – to record all receipts and payments
- (c) Asset Register – to maintain up to date record of assets procured
- (d) Invoice Register – to track payments
- (e) Contract Register – to record all contract payments
- (f) Vouchers and supporting for all receipts and payments

19. **Internal control (including internal audit).** The internal control mechanism at MoF is acceptable. There is a proper segregation of duties. MoF will ensure that the processing cycle for allotments (B27s) and payment requests (M16s) is streamlined to avoid delays, these timelines will be reviewed by the Bank during supervisions. An FM manual applicable across portfolio is in the pipeline to be outsourced. This manual will include details on the FM arrangements and disbursements procedures, including but not limited to staffing arrangements at various levels, reporting lines, disbursement arrangements, simplified allotment and payment processes, documents retention and control mechanism at various levels, oversight arrangements, service standards for document processing, payment triggers and documentation



requirements for grants, etc. At the central level, there is a Treasury Accounting Manual applicable across the government. All project bank accounts (including the clearance accounts, and advances extended for project operations) will be reconciled by MoF at least monthly with AFMIS and DAB records.

20. The internal audit of the project will be carried out by the internal audit department of MoF and reports will be shared with the Bank on semi-annual basis. MoF will ensure that the observations from the audit are addressed satisfactorily in a timely manner.

21. Fixed assets register will be maintained by MoF for assets purchased from project funds this includes the assets (either physical assets or soft assets) that are purchased for state banks. Assets will be coded categorically and a system of annual physical inventory verification will be maintained. The fixed asset verification of the project will be conducted at least once in a year and the verifying committee will produce a systematic report as the output of the verification. The fixed assets purchased for the state banks will be counted as capital increase in their books of accounts accordingly. The procurement of the fixed assets for the state banks will involve (to the extent possible) concerned stake-holders to avoid any post-purchase dispute on quality, specifications, and standards.

### **Contract Management**

22. PD will be responsible for overall project/contract management. Bank will conduct trainings.

### ***Governance and Oversight Arrangements***

23. **Audit arrangements - external audit of project financial statements.** The SAO, with support from the Audit Agent, carries out the annual audit for all Bank-funded/ administered projects; it will also be responsible for annual audits of this project. Annual audited project financial statements will be submitted within six months of the close of the GoIRA's fiscal year<sup>2</sup> (December 22 to December 21). The financial statements for the project audit will be prepared by the MoF based on AFMIS records. There is a common ToR for the audit of all projects that is reviewed by the Bank on a yearly basis.

### **Mitigating Fraud and Corruption, Transparency Accountability and Participation**

24. The project will be subject to the Bank's Anticorruption Guidelines, dated October 15, 2006, and revised in January 2011 and as of July 1, 2016. All the contract opportunities and contract awards will be widely published on NPA, MoF and; when required, on UNDB websites (websites [www.npa.gov.af](http://www.npa.gov.af), [www.acbar.org](http://www.acbar.org), [www.devnetjobs.org](http://www.devnetjobs.org) & [www.reliefweb.int](http://www.reliefweb.int)). The PD will set up a system to ensure that the staff/consultants who handled the procurement process/contract management/contract execution do not have an interaction with the consultants/contractors. This will be reviewed during supervision missions. Other actions are: (a) implementing agencies' officials / staff to be alerted about any fraud and corruption issues; (b) bidders to be alerted against adopting fraud and corruption practices; (c) award contracts within the initial bid validity period, and closely monitor the timing; (d) take action against any corrupt bidder in accordance with law of the Government of Afghanistan; (e) preserve records and all documents regarding

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<sup>2</sup> Current fiscal year is 1396 and covers the period December 22, 2016 to December 21, 2017.





public procurement, in accordance with the Procurement Law provisions; (g) publish contract award information in UNDB online, NPA’s website and agencies’ websites within two weeks of contract award; (h) ensure timely payments to the suppliers/contractors/ consultants and impose liquidated damages for delayed completion and, (i) enforce a procurement filing system.

**Grievance Redress Mechanisms: Complaints Handling**

25. With regard to procurement complaints, MoF will be guided by provisions of Procurement Law-October 7, 2015 and Bank Guidelines. MoF will inform the bank as soon as the procurement complaint is received and the final outcome subsequently. MoF should have a system to register and monitor the receipt and resolving of complainants. The progress of such action will be reviewed by Bank during supervision missions.

**Procurement Considerations in the Fiduciary**

**Category-wise Procurement Layout:**

Contract Title Description & Category	Estimated Cost US\$/ Risk Rating	Bank Oversight	Procurement Approach/ National International Open Limited Direct Sole Source	Selection Methods: Pre/Post Qualification SPD (RFP/RFB) Competitive Dialogue Framework Agreement E-reverse Auction QCBS/QBS/CQS Negotiation BAFO	Evaluation Method Rated Criteria (VfM) Lowest Evaluated Cost
Banking system infrastructure upgradation	US\$4.2 m	Prior	International	RFB	Lowest Evaluated Cost
IT (Hardware & Software)	US\$3 m	Post	National	RFB	Lowest Evaluated Cost
Datacenter modernization	US\$2 m	Prior	International	RFB	Lowest Evaluated Cost
Various Office Equipment	US\$4 m	Post	National	RFB	Lowest Evaluated Cos
Hiring of Advisory Firm	US\$2.7m	Prior	International	QBS	Rated
Hiring of Firm for IT assessment of/ 1 remaining SB	US\$0.1	Post	National	CQS	
Hiring of Firm for Governance Assessment of 1 remaining SB	US\$0.1	Post	National	CQS	





26. In addition to above about \$6-7 million will be charged to IOC for hiring of staff and consultants under NTA and training expenses

**Category-wise Procurement Layout:**

**Procurement of goods:**

**Provisions for National Open Bidding for Goods and Non-consulting:**

- i. Standard bidding documents approved by the Bank shall be used.
- ii. Invitations to bid shall be advertised in at least one (1) widely circulated national daily newspaper and bidding documents shall be made available to prospective bidders, at least twenty-eight (28) days prior to the deadline for the submission of bids.
- iii. Bids shall not be invited on the basis of percentage premium or discount over the estimated cost.
- iv. Bidding documents shall be made available, by mail or in person, to all who are willing to pay the required fee.
- v. Foreign bidders shall not be precluded from bidding.
- vi. Qualification criteria (in case pre-qualifications were not carried out) shall be stated in the bidding documents, and if a registration process is required, a foreign firm determined to be the lowest evaluated bidder shall be given a reasonable opportunity of registering, without any hindrance.
- vii. Bidders may deliver bids, at their option, either in person or by courier service or by mail.
- viii. All bidders shall provide bid security or a bid security declaration form as indicated in the bidding documents. A bidder's bid security or the declaration form shall apply only to a specific bid.
- ix. Bids shall be opened in public in one place preferably immediately, but no later than one hour, after the deadline for submission of bids.
- x. Evaluation of bids shall be made in strict adherence to the criteria disclosed in the bidding documents, in a format, and within the specified period, agreed with the Bank.
- xi. Bids shall not be rejected merely on the basis of a comparison with an official estimate without the prior concurrence of the Bank.
- xii. Split award or lottery in the award of contracts shall not be carried out. When two (2) or more bidders quote the same price, an investigation shall be made to determine any evidence of collusion, following which: (A) if collusion is determined, the parties involved shall be disqualified and the award shall then be made to the next lowest evaluated and qualified bidder; and (B) if no evidence of collusion can be confirmed, then fresh bids shall be invited after receiving the concurrence of the Bank;
- xiii. Contracts shall be awarded to the lowest evaluated bidders within the initial period of bid validity so that extensions are not necessary. Extension of bid validity may be sought only under exceptional circumstances.
- xiv. Extension of bid validity shall not be allowed without the prior concurrence of the Bank (A) for the first request for an extension if it is longer than four (4) weeks, and (B) for all subsequent requests for extensions irrespective of the period in case of prior review.
- xv. Negotiations shall not be allowed with the lowest evaluated or any other bidders.
- xvi. Re-bidding shall not be carried out without the Bank's prior concurrence in the case of prior review; and
- xvii. All contractors or suppliers shall provide performance security as indicated in the contract documents. A contractor's or a supplier's performance security shall apply to a specific contract under which it was furnished.



27. **Selection of consultants.** The project includes hiring of consultancy services for procurement, financial management,

**Procurement Documents:**

28. Bank's Standard Procurement Documents July 2016 will be used. National SBDs agreed with IDA, or satisfactory to Bank, will be used for the procurement of goods following National Open procurement

**Procurement Capacity and Risk Assessment of Implementing Agencies:**

***Procurement Risk Assessment***

29. Bank procurement staff will provide procurement training to the procurement staff if required, for high and complex procurement the MoF will process their procurement through the National Procurement Authority (NPA).

30. By applying the above mitigation measure the procurement Risk under the project will be "Substantial"

***Mitigation Measures***

31. **Record keeping.** All records pertaining to award of contracts, including bid notification, register pertaining to sale and receipt of bids, bid opening minutes, bid evaluation reports and all correspondence pertaining to bid evaluation, communication sent to/with the Bank in the process, bid securities, and approval of invitation/evaluation of bids by Procurement Team of DP (as the IA).

***Oversight and Monitoring by the Bank.***

32. Due to challenges mentioned above the prior review threshold of High Risk Implementing Agency will apply.

33. All contracts not covered under prior review by the Bank will be subject to post review during implementation support missions and/or special post review missions, including missions by consultants hired by the Bank. Bank may conduct, at any time, Independent Procurement Reviews (IPRs) of all the contracts financed under the grant.

34. Frequency of procurement **supervision.** Two missions a year, at an interval of six months, are envisaged for procurement supervision of the project.

***Procurement Plan***

35. The project will use Systematic **Tracking of Exchanges in Procurement (STEP)** a World Bank planning and tracking system, which would provide data on procurement activities, and establish benchmarks. The Procurement will be sent to Bank through this tool.



**Procurement Methods and Review Thresholds:**

Procurement Category	Contract Value (Threshold) US\$	Procurement Method	Contracts Subject to Prior Review US\$ thousands
<b>1. Goods, IT &amp; Non-consulting Services</b>	>1,500,000	Open International	All
	<1,500,000	Open national	First Contract and all subsequent contracts estimated to cost > 1,500,000
	<50,000	RFQ	First Contract; if undertaken prior to first Open International or National Contracts
<b>2. Consulting Services (Firms)</b>			All TOR and Training Programs to be prior reviewed by Association's TTL regardless of value and review threshold
	>1,000,000	QCBS/QBS /FBS/LCS	First contract (remaining contracts > \$1,000,000 shall be mandatorily post reviewed
	<500,000	CQS,	First contract

ICB = International Competitive Bidding; NCB = National Competitive Bidding; QCBS=Quality- and Cost-Based Selection; CQS = Selection Based on Consultants' Qualifications.

***FM Considerations in the Fiduciary Assessment***

36. Funds flow. Project funds will flow through a designated account to be set up in the DAB (Central Bank) and controlled by MoF.

37. All project expenditures are expected to be paid centrally. Petty/ operational cash imprest for the project will be limited to a maximum US\$15,000 as per an earlier agreement between the Bank and MoF. Any increase to this limit, if justified, will have to be approved by the Bank explicitly and communicated to MoF. Such imprest funds will be subject to adequate petty cash management procedures (for custody, control, limits, physical cash verification, and replenishment). The custodian of the imprest cash will be the cashiers in Finance and Administration Directorate. The reporting mechanism of the project will ensure that the unacquitted advances are not reported as incurred expenditure.

38. Advances will be made to the DA and disbursements from the grant will be made using advances and direct payments. The project will follow IUFRR based disbursement arrangements. Request for six months' advance will be made in IUFRR along with withdrawal application. The advance request will be based on the six months forecasted expenditures and DA will be replenished based on the advance request indicated in the IUFRR. Further details of disbursement arrangements for the project, including supporting documentation requirements are spelt out in the Disbursement Letter.

39. All payments from the DA will be made through check or bank transfer. Requests for payments from DA funds will be made to the Special Disbursement Unit (SDU) in the Treasury Department of the MoF. In addition to payments from the DA, request can also be submitted for direct payments from the grant. All withdrawal applications to the Bank, including advances and direct payment applications, will be



prepared by the Finance and Administration Directorate and submitted to SDU.

40. Accounting. All accounting is centralized in the AFMIS in the MoF. Subsidiary books of project records such as bank book, cash book, contract register, asset register, the record of grants' transfers and utilization, etc. will be maintained by Finance and Administration Directorate. An off-the-shelf accounting software will be adopted for the project. Cash basis of accounting will be followed for the project.

41. Financial reporting. Quarterly IUFRRs (Interim Unaudited Financial Reports) will be required for the project. These reports will be submitted in form and substance agreed with the Bank. The reports will have to be submitted to the Bank within 45 days from the end of each quarter as per the government fiscal year. The Finance and Administration Directorate at MoF will be responsible for IUFRR submission to the Bank. The IUFRRs will include Statement of Cash Receipts and Payments, Statement of Uses of Funds by Project Activity, bank and advances reconciliation, and the bank statements. Customized formats for the project for MoSB will be shared during negotiations.

42. With the above arrangements in place, the residual FM risk is rated as "Substantial". Review of the risks will be carried out during implementation support missions with a view to adjust the risk ratings if necessary.

43. There are no overdue audit reports, no overdue IUFRRs and no ineligible expenditures under ongoing or closed projects implemented by the MoF.

44. Monitoring of fiduciary performance and implementation support plan. The fiduciary performance will be assessed through the following indicators: (a) timely and quality submission of quarterly IUFRRs; (b) maintenance of adequate books of records and supporting documents of project transactions; (c) timely submission of audited financial statements; (d) timely resolution of FM issues raised during Bank supervision, internal audit, external audit, and any other reviews; (e) maintenance of adequate internal controls; (f) timely processing of allotments/ payment requests & project expenditures; (g) adherence to service standards, etc. The Bank will carry out two FM reviews annually. The implementation support will include monitoring of fiduciary performance based on identified indicators, review of IUFRRs and audit reports, review of compliance with legal covenants, review of progress on agreed actions, and review of FM risks.



**Integrated Fiduciary Assessment  
Modernization of Afghan State Owned Banks (project)  
Dated: February 2017**

<b>Fiduciary Element</b>	<b>Responsibility FM, PR or Joint</b>	<b>Risk Rating</b>	<b>Comments &amp; Risk Mitigation</b>	<b>Residual Risk Rating</b>	<b>Key Performance Indicator (to be established by the Fiduciary Team)</b>
<b>1. Joint Fiduciary Aspects</b>					
<b>1.1 Fiduciary Capacity (PRAMS RF4 &amp; FME 7)</b>	<b>Joint</b>				
1.1.1 Is there adequate fiduciary staff based on the profile of the project, in terms of numbers and experience, to implement the project, with clear definition and segregation of functions between PR and FM?	FM		Affirmative		
	PR				
<b>1.2 Planning and Budgeting (PRAMS RF5 &amp; FME 1)</b>	<b>Joint</b>				
1.2.1 Are realistic budgets and procurement plans prepared and reconciled?	FM	H	MoF will ensure that the project funds are allocated in the annual Government Development Budget, the approved carried forward budget is used at the	S	



Fiduciary Element	Responsibility FM, PR or Joint	Risk Rating	Comments & Risk Mitigation	Residual Risk Rating	Key Performance Indicator (to be established by the Fiduciary Team)
			<p>beginning of the new year, and that disbursements are made while waiting for the Parliament’s approval of the new year’s budget.</p> <p>MoF will be responsible for the preparation of annual work plans, procurement plans and the derivation of annual budget there from for the project.</p>		
<b>1.3 Internal Control (including Internal Audit) (PRAMS RF 1,2 &amp;3; FME 3)</b>	<b>Joint</b>				
1.3.1 Are effective internal controls in place, as jointly assessed by financial management and procurement staff? These include internal audit, clearly defined accountability, quality control processes, and availability of complete records of the procurement and financial management processes.	FM	H	MoF will utilize staff in Finance and Administration Directorate same like for other projects. Internal audit directorate will review the internal control systems through periodic internal audit. Relevant controls exist at the implementing agency level, and allow for segregation of duties, these controls will be reviewed periodically for effectiveness. The TORs for the internal audit will be defined in the FM manual	S	
<b>1.4 Contract Management (PRAMS RF10, FME 2 &amp; 3)</b>	<b>Joint</b>		The contract management capacity will be augmented through focused trainings		



<b>Fiduciary Element</b>	<b>Responsibility FM, PR or Joint</b>	<b>Risk Rating</b>	<b>Comments &amp; Risk Mitigation</b>	<b>Residual Risk Rating</b>	<b>Key Performance Indicator (to be established by the Fiduciary Team)</b>
<b>1.5. Project Management and Governance:</b>	<b>Joint</b>				
<b>1.5.1 Audit Arrangements:</b>	<b>Joint</b>				
1.5.1.1 External Audit of Project Financial Statements (PRAMS RF 11, FME 6)	<b>Joint</b>  <b>FM</b>	S	project will be audited by the Supreme Audit Office with support from Audit Advisor	S	
1.5.1.2 Technical Audits (PRAMS RF 11, FME 6)	<b>Joint</b>				
<b>1.5.2 Mitigating Fraud and Corruption – Transparency, Accountability and Participation (PRAMS RF 7 &amp; 11, FME 6)</b>	<b>Joint</b>		Project will be subject to Bank’s Anti-Corruption Guidelines		
<b>1.5.3 Grievance Redress Mechanisms – complaints handling (PRAMS RF 9) and grievance redress (PRAMS RF 11, FME 6)</b>	<b>Joint</b>				
<b>2. Procurement Processes and Procedures (PRAMS RF 6,7 &amp;8)</b>	<b>PR</b>		A Procurement Manual may be prescribed		
<b>3. FM Considerations</b>					
<b>3.1 Funds Flow (FME 4)</b>	<b>FM</b>	M	The project will follow standard funds flow arrangements being utilized by other projects in Afghanistan. A designated account will be set up for the project, this DA will be managed by MoF.	M	
<b>3.2 Accounting and Financial Reporting (FME 2 &amp; 5)</b>	<b>FM</b>	H	Strengthening the SDU is a priority under the FM Advisor contract, to provide required information to facilitate project reporting. project reporting will be done by Finance and Administration Directorate. This will be facilitated by the	S	



<b>Fiduciary Element</b>	<b>Responsibility FM, PR or Joint</b>	<b>Risk Rating</b>	<b>Comments &amp; Risk Mitigation</b>	<b>Residual Risk Rating</b>	<b>Key Performance Indicator (to be established by the Fiduciary Team)</b>
			accounting system to be adopted by the same, and initially through excel records maintained by Finance and Administration Directorate and AFMIS		
<b>FM Risk rating</b>	<b>FM</b>	<b>High</b>		<b>S</b>	<b>H, S, M, L</b>
<b>Procurement Risk rating</b>	<b>PR</b>	High	See the mitigation measure	S	H, S, M, L
<b>Overall Fiduciary Risk Rating</b>	<b>Joint</b>			S	H, S, M, L





## **ANNEX 3: IMPLEMENTATION SUPPORT PLAN**

### **Strategy and Approach for Implementation Support**

1. The World Bank (WB) will support the implementation of the project (Ministry of Finance mostly, and to some extent the State Banks (SBs)) and provide the technical advice necessary to facilitate the achievement of the PDO. Consultants will mostly provide technical assistance support under the project, and the WBG team will review their terms of reference and the deliverables and engage in reviewing the TA performance during implementation support missions. The project will involve several high-value contracts, as a centralized procurement by MoF of IT infrastructure and services—IT systems and goods, and servicing will be followed for all SBs.

2. During project implementation, and to reflect the implementation context, the WB team will closely monitor the project through semi-annual implementation support missions (ISMs). More frequent support missions (at least quarterly) are anticipated during the early years of project implementation. During the ISMs, the World Bank will ensure that the financial arrangements agreed on are respected and will assess if any additional training or support is needed. The World Bank team will review and clear the audit terms of reference, review the audit reports and Interim Financial Reports (IUFs) received, and provide its feedback in a timely manner. The project team will also be responsible for reviewing all prior review procurement contracts.

3. The WB's implementation support will follow a risk-based approach. At least two missions will be carried out annually in addition to follow-up visits as deemed necessary. The audit reports and the interim and annual financial statements, respectively, in addition to the management letter, will be reviewed on a regular basis by the WB financial management (FM) specialist, and the results or any issues will be followed up during implementation support missions. Also, during the World Bank's implementation support missions, the project's financial management and disbursement arrangements will be reviewed to ensure compliance with the World Bank requirements and to assess the financial management performance for the Implementation Status and Results Report (ISR).

4. The WB's fiduciary team, based in Kabul, will advise and support the MoF in FM and procurement. MoF staff will receive training and capacity building support under other core public financial management and procurement programs financed by the Bank. Project staff will also be provided specific training on issues such as WB procurement and strengthening financial controls, including internal audit.

### **Implementation Support Plan**

5. The WB implementation support team will consist of technical specialists from its Finance, Competitiveness and Innovation Practice as well as specialists in operations, procurement, financial management, safeguards, and monitoring and evaluation. The external communications specialist will advise on the project's communications strategy. Technical specialists will review project documents, including terms of reference, bidding documents, and consultant reports. They will also conduct site visits to assess progress in the field and consult with the financial sector stakeholders, including think tanks, research centers, and professional associations, on project implementation progress.



## ANNEX 4: ECONOMIC AND FINANCIAL ANALYSIS

1. **The proposed project development objective is to enhance financial stability through improved corporate governance and operational efficiency of Afghan state-owned banks.** The objective will be achieved by a series of well-defined activities intended to: (a) support and advice MoF in strengthening the exercise of ownership functions, (b) support MoF, DAB and SBs in establishing appropriate and effective corporate governance structures in each SB, including the adequate constitution and functioning of oversight and supervisory organs and independent risk management structures, (c) review and design of an efficient business model for each SB, implementation of strategy goals, and capacity building, (d) modernization of systems and IT infrastructure, and automation of operational and (risk) control processes, and (e) support of project implementation and monitoring.

2. The project will contribute to building blocks to support the Afghan government – the ultimate owner of SBs – in the exercise of its ownership rights and foster good corporate governance practices, and define a clear mandate and feasible business model for these banks, both of which are currently absent. This is meant to achieve PDO’s objective to enhance the transparency of managing the banks. This will create synergies with the investments in the modernization of the banks’ IT systems to enable more efficient banking operations, foster cost savings and lead to higher efficiency. The IT modernization will complement governance reforms by providing reliable and timely information for bank management, boards, regulators, auditors and the general public, thus further contributing to more transparency of SB’s operations.

3. **Methodology.** Given that there will likely be no significant attributable changes to state banks’ loan portfolio (lending is not supported directly by this project); the team adopted a least cost approach for the economic analysis. The proposed approach focuses on the least cost for a given output/outcome level that would be more appropriate for the context of this project. In other words, the analysis focuses on losses avoided or minimized/costs minimized to achieve the contemplated institutional changes, as well as the value of the implied benefits of increasing the SBs intrinsic value and the minimization of the contagion effect for the private sector.

### Mapping out the Project’s Activities and Beneficiaries

4. The project’s direct beneficiaries are the owner of the State-Owned banks, the MoF, the State-Owned Banks themselves and their clients. The MoF will be the recipient of the TA financed through the project. This is in addition to investments in the IT infrastructure of the banks. The TA will focus on strengthening oversight, exercising responsible ownership rights, strengthening corporate governance in addition to developing relevant internal processes and regulations and building institutional capacity that is supportive of this reform effort. The banks will be recipients of substantial investments in IT infrastructure. These investments will primarily aim at mitigating risks stemming from the current low capacity and weak governance. These risks are threatening the sustainability of SBs and through potential contagion effects the financial sector at large. By promoting more transparent and efficient operations of the SBs compared to status quo the risk for SBs and the financial sector generally will be reduced.

5. Indirect beneficiaries include customers of the SBs: (a) depositors and other creditors whose risks of entrusting their funds to the SBs will be reduced and (b) borrowing clients who can expect to get a



broader menu of products and services, delivered with higher efficiency and at lower costs compared to the current choice. Resulting benefits to the overall population are unquantifiable but certainly positive.

### **Rationale for Public Funding (for Overall Project)**

6. The primary rationale for approaching IDA and investing these public resources in the banks is public ownership of these banks. GoIRA endorsed a national strategy for reforming SBs for the next ten years. This plan was endorsed by the High Economic Council (HEC) in December 2017. HEC is chaired by the President and includes the Governor of the Central Bank and Economic Cabinet Ministers. Moreover, the government fulfilled its commitment to the IMF that the strategy should be finalized and approved and presented to the IMF for the scheduled review of Extended Credit Facility (ECF). The plan will lay out the government's vision for the state bank's objectives and operational model as well as critical reforms that the government will commit to for achieving sound corporate governance, minimizing operational risks within these banks as well as their potential areas of focus to ensure robust support to the real economy. This project will support the government's vision to reform SBs through (i) strengthening the role of the owner in overseeing its asset performance, (ii) practice of responsible ownership as well as (iii) enhancing corporate governance with the objective of improving transparency, boosting efficiency and protecting the public investments in these institutions. Moreover, the IT modernization will ensure minimizing the operational risk and increasing operational efficiency of the SBs, as well as leveraging technology to enhance outreach and financial intermediation. The alternative options to this project was (i) for the government to refrain from critical investments especially in infrastructure perpetuating current inefficiencies and ineffectiveness and increasing operational risks, (ii) divest and crowd in private capital which failed to take place for NKB during the past five years and - given the current financial position of these institutions – is not considered a viable option until serious reforms are considered to transform these institutions towards viability.

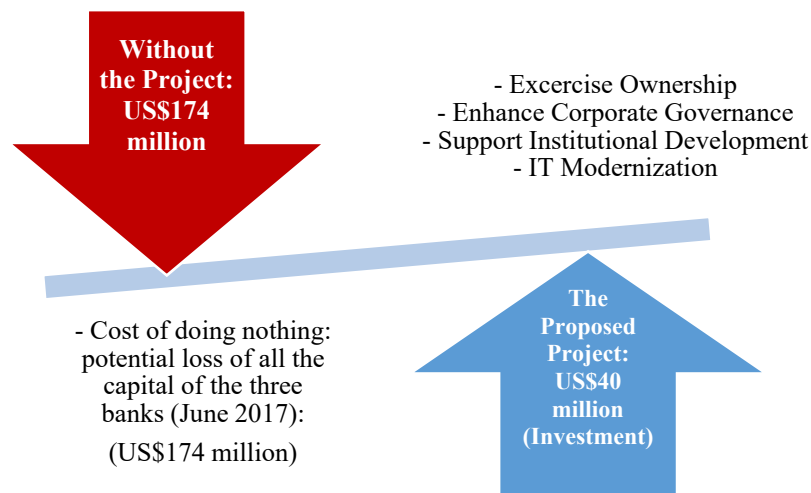
### **Financial Analysis: Least Cost Method**

7. While the economic and financial benefits of the investments in modernizing operations of each bank can be readily quantified, the wider ranging – indirect – benefits of improved financial inclusion for the economy and society cannot be easily quantified and assigned. Equally, the benefits derived from strengthening the MoF's exercise of ownership rights and in their hypothetical fiscal impact through the banks' financial performance are difficult to measure. But they are unmeasurable regarding the benefits derived from strengthening Afghan institutions in general by establishing 'best practice'. Furthermore, while the project stands to realize some benefits already during project execution the more substantial part will continue to accrue after the completion date. Project costs, however, are heavily front-loaded and diminish significantly after project completion date.

8. For this purpose, a qualitative cost-effectiveness analysis approach that encompasses the whole project has been applied. That approach contrasts the projected project costs with the losses avoided when no reform is undertaken in absence of the proposed intervention. The proposed financing amount of 40 million is meant to transform the sector towards effective contribution to financial stability, economic growth and development through enhancing the outreach of financial services. In the absence of undertaking the proposed modernization activities, the sector will be exposed to remarkable losses derived from potential deterioration of risk assets and continues high operating costs and efficiencies, and the corresponding loss of equity of the three banks that read about US\$174 million as at end June 2017.



9. The positive financial and economic benefits of the project depend on the joined execution of the three fundamental project components, i.e. strengthening of governance, process and system modernization and implementation of a coherent mandate and business approach. Segregating or eliminating any one of the areas of reform will diminish the overall returns on the investment significantly. Reforming governance without addressing the underlying deficits in the business model deficiencies in process and systems might reduce the risks of additional fiscal burden derived from a deterioration of risk assets, but will not allow capturing efficiency gains in operations. Likewise, addressing system reform efforts solely will not contribute to reducing the risks to risk asset origination derived from inadequate oversight and risk management, exacerbating the potential for future losses. Expanding business activities without addressing the governance and system challenges will perpetuate the risks and magnify potential losses.



10. The expected positive financial and economic outcomes of the project depend on the joined execution of the three fundamental project components, i.e. strengthening of governance, process and system modernization and implementation of a coherent mandate and business approach. Segregating or eliminating any one of the areas of reform will diminish the overall returns on the investment significantly. Reforming governance without addressing the underlying deficits in the business model deficiencies in process and systems might reduce the risks of additional fiscal burden derived from a deterioration of risk assets, but will not allow capturing efficiency gains in operations. Likewise, addressing system reform efforts solely will not contribute to reducing the risks to risk asset origination derived from inadequate oversight and risk management, exacerbating the potential for future losses. Expanding business activities without addressing the governance and system challenges will perpetuate the risks and magnify potential losses.

11. As discussed earlier, the benefits of modernizing state banks are expected to reflect on higher efficiency gains and stronger support to the real sector. These benefits can be portrayed as follows: (i) investments in these banks will span enhancing the trust in the banking sector, fostering financial inclusion through digital technology and outreach leading to an increase in the deposit base. Moreover, (ii) the new business strategies would support access to finance and hence expected to reflect on the growth in the loan portfolio. The (iii) governance reform and the stronger oversight functions should lead to higher operating



income and minimize the fiscal risk posed by these banks. Finally, (iv) given the potential focus on SMEs, addressing the constraints on the segment's access to finance will unveil the growth potential for this sector that can be captured in the potential growth in turnover and reflect on jobs creation. The quantification of these benefits, however, is challenging.

### **Project Impact**

12. Improved financial sector performance and a strengthened oversight and Governance culture create significant externalities and vital public good in the Afghan context. Improving financial inclusion and access to finance for firms and households has shown to have a substantial potential positive impact on growth and employment. Particularly closing the financing gap for SMEs can provide significant economic, financial and social benefits, while improving financial inclusion for households contributes to reducing vulnerabilities.

13. Strengthening Oversight and Governance of SBs will allow to establish a major benchmark for the overall institutional development of the Financial Sector. This in turn will reduce the likelihood of a repeat of past poor performance and banking failures in the private and public sector with their corresponding fiscal costs and economic and social disruptions. Although external supervision has been strengthened in recent years, the poor historical performance of SB and the collapse of Kabul Bank have been aided and abetted by significant shortcomings in the banks' Ownership and Governance structures and performance, and the attendant inadequate risk management approach. The exemplary strengthening of ownership oversight and formal, independent Governance structures and arrangements in the SB will not only reduce the likelihood of a repeat of the past politicization of risk management decisions with the corresponding negative impact on net equity and fiscal costs, but also serve as a useful comparator and incentive for the private financial sector to improve its corresponding oversight and governance performance.

14. Improved SB performance and strengthened institutional arrangements will enhance market function through competition. Modernizing SB will allow them to effectively engage in financial intermediation and banking businesses improving the supply of financial services and the level of competition in the sector, allowing for additional benefits for consumers. A more dynamic and better functioning financial sector will improve its attractiveness to private capital, whereas the development of a competitive SME sector will enable the crowding in of private financial institutions and capital. This will allow for a gradual reduction of the State's involvement in the direct supply of financial services and the crowding-in of private capital, as outlined in the Government of Afghanistan SBs' strategy.



**Table 4.1 State of the Afghan Financial Sector**

	2015/2016 US\$ million or %	Private Banks (12 PBs)	Average PBs	State Banks (3 SBs)	SBs as % of FS	BMA Jun-17	NKB Jun-17	Pashtany Jun-17
<b>STABILITY</b>	Assets	2,937	244.7	1,292.80	44.00%	680.7	323.1	289
	Equity	291.4	24.3	173.7	-	128.7	15.5	29.5
	GLP	631	52.6	43.2	6%	43.2	0 (KBR)	0 (off BS)
	Deposits	2,515	209.6	1,076.30	42.80%	529.9	299.4	247
	NPL	82.6	6.9	-	-	n.a.	0	0
<b>EFFICIENCY</b>	Profitability: ROaE	Est. 15.5%	-	-	-	3.90%	35.90%	9.90%
	ROaA	Est. 1.6%	-	-	-	0.70%	1.70%	1.00%
	Staff	6,468	539	2,289	26%	311	1,544	434
<b>ACCESS</b>	Loans/Deposits	25%	-	4.00%	-	8.1	0	0
	Delivery Channel: Number of Branches	414	34	131	24%	34	112	18
	Coverage	33 Regions (Rg)	-	-	-	21 Rg, 41% Kabul	33 Rg 28% Kabul	8 Rg 61% Kabul
	Outreach: Number of Accounts			2,206 K	61%	35 K	2,073 K	98 K



**Table 4.2. SBs Current Status - P&L Reclassification: Threats to Financial & Operational Sustainability**

	BMA (2016)		NKB (2016)		Pashtany (2016)	
	In '000 AFN	% of Ops. Income	In '000 AFN	% of Ops. Income	In '000 AFN	% of Ops. Income
Interest Income	992,084	94.90%	107,519	7.60%	371,303	99.80%
- From lending	32%					
- From investment	67%		100%		96%	
<b>Interest Expenses</b>	<b>131,203</b>	12.60%			<b>53,332</b>	14.30%
Net Interest Income	860,843	82.30%	107,519	7.60%	317,971	85.50%
Net Fee Income	103,156	9.90%	<b>1,158,300</b>	<b>81.60%</b>	54,000	14.50%
- Salary Payments			64%			
Net FX Income	81,448	7.90%	0		0	
Net Operating Income	1,045,447	100.00%	1,420,344	100.00%	371,971	100.00%
<b>Operating Expenses</b>	<b>719,629</b>	68.80%	<b>1,352,790</b>	95.20%	<b>379,626</b>	102.10%
<b>Operating Profit</b>	<b>325,818</b>	31.20%	<b>67,554</b>	4.80%	<b>-7,656</b>	-2.10%
Other income	<b>350,651</b>	33.50%			<b>413,133</b>	111.10%
- Debt recovery	50%				90%	
Share in profit associate	147,916	14.10%				
Revaluation gains	<b>3,436,838</b>	328.70%				
Sale of Assets/collaterals					<b>384,062</b>	103.20%
Net Profit (after tax)	3,321,595	317.70%	50,889	3.60%	757,808	203.70%



**Table 4.3. SBs Current Status - P&L Reclassification: Threats to Financial & Operational Sustainability**

	BMA (% of Ops. Income)		NKB (% of Ops. Income)		Pashtany (% of Ops. Income)	
	Dec-16	Jun-17	Dec-16	Jun-17	Dec-16	Jun-17
Interest Income	94.90%	184.70%	7.60%	22.60%	99.80%	95.00%
- From lending	32%					
- From investment	67%		100%	98.90%	96%	
<b>Interest Expenses</b>	12.60%	34.30%		0.00%	14.30%	7.60%
Net Interest Income	82.30%	72.70%	7.60%	22.60%	85.50%	87.40%
Net Fee Income	9.90%	26.50%	<b>81.60%</b>	66.40%	14.50%	12.60%
- Salary Payments			64%	63%		
Net FX Income	7.90%	2.90%	0	5.80%		
Net Operating Income	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
<b>Operating Expenses</b>	68.80%	71.30%	95.20%	71.70%	102.10%	98.10%
<b>Operating Profit</b>	31.20%	28.70%	4.80%	28.30%	-2.10%	1.90%
Other income	33.50%	43.00%			111.10%	74.40%
- Debt recovery	50%				90%	94%
Share in profit associate	14.10%					
Revaluation gains	328.70%	0.00%				
Sale of Assets/collaterals					103.20%	
Net Profit (after tax)	317.70%	50.60%	3.60%	22.60%	203.70%	59.30%