

The Financial Sector in Afghanistan

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Managing the Post-conflict Reform Process



The World Bank
South Asia Finance and
Private Sector Unit



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FOREWORD

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sectors, postconflict countries face many challenges, among them damaged physical infrastructures, deskilled staff, and outdated technological capacity.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

This is the first comprehensive study of the financial sector in Afghanistan. It details the state of the financial sector after the fall of the Taliban regime in 2001; the reforms that have taken place in the period 2002–2003, and outline the medium- to long-term financial sector development strategy for Afghanistan. Although this study is specific to Afghanistan, it sheds some light on some of the common macroeconomic and financial sector challenges facing governments of countries emerging from conflict, and some of the possible solutions that would allow for successful financial sector reconstruction.

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

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

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EXECUTIVE SUMMARY

I. BACKGROUND

This is the first comprehensive study of Afghanistan's financial sector. It details the state of the financial sector after the fall of the Taliban regime in 2001; it discusses the reforms implemented since 2002–03; and it outlines a medium- to long-term financial sector development strategy. Although specific to Afghanistan, it sheds light on general factors that contribute to successful financial sector reform in postconflict countries.

Afghanistan has faced more than 25 years of international and domestic conflict. When the Taliban regime fell in 2001, the country was one of the poorest in the world. Its financial sector, like the rest of the economy had collapsed—infrastructure, human, and technological capacity was weak and in most cases absent.

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

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

Written over two years (March 2002 –March 2004), this study is based on six field visits to Afghanistan—two in 2002 (March and August), three in 2003 (January, June, and December), and one in March 2004.¹ The second field trip, in August 2002, included visits to the provincial cities of Jalalabad and Herat. During the visits, team members conducted extensive interviews on the state of the financial sector and the reforms required to strengthen its performance. They talked with staff at the Ministry of Finance, Da Afghanistan Bank (DAB, the central bank), the Ministry of Rural Development, the Ministry of Planning, the Afghan Chamber of Commerce, other government ministries and departments, and several international aid institutions and nongovernmental organizations (NGOs). Discussions also were held with numerous private sector financial entities, particularly the management of the state commercial and development banks, the newly licensed foreign commercial banks, and the money exchange dealers, including the chairperson of the informal, Kabul-based Money Exchange Dealers Association and a Jalalabad-based member of the association's executive committee. The January 2003 visit included the

¹ World Bank Policy Notes prepared during these visits include: *Inviting Foreign Banks into Afghanistan* (July 31, 2002), *The Money Exchange Dealers of Kabul: An Analysis of the Hawala System in Afghanistan* (June 2003), *Bank Restructuring Options* (June 2003), and *Voluntary Staff Rationalization Options* (June 2003).

preparation of detailed assessments of Da Afghanistan Bank and the state commercial and development banks — Agricultural and Development Bank, Bank Pashtany and Terjaraty, Banke Millie, Export and Import Bank, Industrial Development Bank, and Mortgage and Construction Bank.

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

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

Progress has been made since 2002. The central bank has been furnished with needed equipment; the government has adopted two presidential decrees that provide a basic legal framework for a modern two-tier banking system; and more than three new banks have been licensed on standards consistent with the new legal framework. But much remains to be done before the financial system can play a meaningful role in the economic development of the country. This study documents efforts toward this goal and recommends measures to improve the effectiveness of the reform process in the central bank, the state commercial and development banking sector, the microfinance industry, and the informal financial sector.

II. THE CENTRAL BANK

Chapter 2 focuses on Da Afghanistan Bank, discussing the state of the country's central bank since the fall of the Taliban government. It describes the absence of meaningful central banking structures and functions and the inadequacy of the human and technological resources to implement much-needed financial sector reforms. It then traces the reform efforts of multilateral and bilateral partners during 2002–03. The chapter's conclusion reiterates the difficulties of establishing sound monetary and supervisory policy and frameworks in postconflict countries.

State of the central bank after the fall of the Taliban

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

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

2. *Monetary policy framework:* No functioning monetary policy framework was in place. Confidence in the national currency was low, as the Afghani had lost much of its value during years of high inflation. Moreover, DAB had little or no control over the issuance of currency—at least three versions of the national currency were in circulation.
3. *Banking supervision structure:* Banking supervision in a modern sense did not exist. DAB's staff had almost no knowledge of the objectives and techniques of modern banking supervision. Banking data had not been collected in years and no assessment had been made on the health of the banking sector.
4. *Commercial banking activities and the national payments system:* The central bank had no capacity to play its role in international and domestic payments systems. With a single, **unreliable** telephone connection, it had no SWIFT or related connections with the rest of the banking world. Domestically, the central bank branch network faced serious structural and operational problems that made it difficult to achieve quick interbranch connectivity.
5. *Operational capacity:* DAB's staff did not have the banking and technical skills needed to conduct non-cash-based banking business. Consequently, the central bank had not prepared **audited** financial statements since 1996. Although accounting data for financial transactions had been, and continued to be, collected, the data was not processed in a manner that **enabled** the preparation and audit of financial statements in accordance with international accounting and audit standards.

Central banking reforms in 2002–03

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

- A new central banking law is now in place that **guarantees** the central bank's autonomy.
- A new commercial banking law is in place that **requires** of banks prudent entry, conduct of banking operations, and exit from the financial sector.
- A rudimentary monetary policy regime is emerging after the successful issuance of a **new** currency.
- A new banking supervision department is in place and has commenced on-site inspections of banks.
- The central bank's SWIFT connection is **functional**—**one-third** of the central bank branches are now connected electronically for domestic payments.
- The central bank's operational capacity has been substantially improved.

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

- *Legal and regulatory framework:* After an exhaustive consultation process, numerous revisions, and a presidential decree the government passed a new central bank law in September 2003. The law provides a strong framework for a two-tier banking system in Afghanistan. Significantly, the law also provides for full central bank independence in the design and implementation of monetary and banking supervision policy. Article 4 of the central bank law states that the management of Da Afghanistan Bank shall enjoy *autonomous* regulatory powers, be entirely independent from any other authority in the pursuit of its objectives and the performance of its tasks, and must refrain from political activities.
- *Monetary policy:* The government made a crucial step in establishing financial stability with its introduction of the new currency on January 2, 2003. With it, the country will be able to create an environment conducive to restoring sustainable economic growth in Afghanistan. The exchange rate of the Afghani has remained broadly stable since the completion of the conversion process, reflecting both sound financial policies and popular confidence in the new currency. The central bank also has chosen to adopt a floating exchange rate regime because, at least for the near term, the economy is undergoing large structural changes, and the equilibrium exchange rate will change as a result.
- *Banking supervision:* The Banking Supervision Department was created in July 2002. By December 2002, the central bank had begun to design and implement specific policies and procedures for licensing, off-site analysis, enforcement of laws and prudential standards, reporting, accounting, and off-site examinations. Training for the department's 38 staff members was done concurrently with the realignment of its activities into three sections:
 - Supervision of banks and non-banks
 - Special supervision of troubled banks
 - Licensing and regulation.

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

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

III. THE STATE COMMERCIAL AND DEVELOPMENT BANKS

Chapter 3 analyses the financial condition of the state commercial and development banks and considers the feasibility of restructuring some of them. In the absence of any recent financial statements, annual reports and regulatory information, this chapter is exploratory and necessarily investigative. More detailed assessments are required prior to the implementation of a comprehensive restructuring program.

The state banking sector after the fall of the Taliban

Afghanistan has a very old banking tradition oriented toward the private sector. Bank Mille, Afghanistan's first private bank, was established in 1933; and the second, Pashtany Terjaraty Bank (PTB), in 1955. It was only in the 1970s that the state, under the Daoud government, took an ownership interest in both financial institutions. PTB was nationalized in 1974, and Banke Mille in 1976. During the 1970s the government also established two development banks — Industrial Development Bank (1973) and Export Promotion Bank (1975), in addition to the Agricultural Development Bank, which had been established in 1954. By December 2001, however, all these state-owned banks were plagued by the same problems as DAB — weak corporate governance and management structures, unskilled human resources, outdated technological capacity and accounting systems, and grave liquidity and solvency problems:

- *Corporate governance and management structures:* Political interference in the banks' operations, management, and control (including lending decisions), lax legal and regulatory oversight, poor incentives for sound banking, the lack of banking experience among the clerics and mullahs appointed to management positions, the transformation of the banking system into mono-banking during the Soviet era, and inappropriate applications of Islamic banking practices during the Taliban period resulted in unclear organizational and departmental policies, procedures, information and data flows, decision-making responsibilities, and accounting systems.
- *Human resource capacity:* Unqualified and inexperienced bank personnel staffed all levels of banking operations, including the managing board and department heads in most, if not all, banks. There was little understanding of the components of profit and loss, cash and funds flows, financial intermediation, branch management and operations, computer and automation technology, accounting, loan administration, and risk assessment and management. The Taliban ordered the termination of all qualified staff and top management, as well as anyone educated in the Soviet Union, any member of pro-Soviet political parties, and all women.
- *Computing technology:* In 2001 the few personal computers in use in Afghanistan's banks were old, slow, and had little storage capacity. They were used primarily as word processors in the chief executive's office. Occasionally, a fax machine was found, but they too were of little use, given the unreliability of telecommunications. Until the early 1990s a few banks used NCR machines to record ledger and statement entries, but these machines had fallen into disuse. Universally, transactions were processed and recorded by hand. Customers were given passbooks and ledger cards, which were maintained manually.
- *Accounting systems:* Weaknesses in the banks' accounting systems (for financial reporting, management, budgeting, and decision-making), made it almost impossible for management and staff to perform any meaningful financial analysis and disclosure. Given the ineffective corporate governance structures, the weak financial and management accounting systems in the banks resulted in their failure to:
 - Comply with the existing financial, operational, and management regulatory requirements (poorly designed as they were)
 - Assess credit worthiness and manage risk
 - Observe appropriate loan accounting policies, practices, and reporting consistent with sound credit and risk analysis, and asset and liability management

- Ensure that minimum capital requirements, capital adequacy, required liquidity, credit concentration, and foreign currency exposure levels are properly accounted for and measured
 - Provide for the timely recognition of identified losses and credit risks.
- *Financial condition:* The first financial assessment of the banks conducted in January 2003 concluded that all the banks were in dire financial condition. Using incomplete financial data, the reconstructed the balance sheets and income statements of all the banks first suggested adverse capital, asset quality, earnings, and liquidity positions. A subsequent financial review by the central bank conducted at the end of the year yielded slightly better results—all the banks had positive capital:

Bank Millie	\$61 million
Banke Pashtany	\$18 million
Agricultural Bank	\$127 million
Export Promotion Bank	\$4 million
Mortgage and Construction Bank	\$0.037 million

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

Bank Millie	\$42 million
Banke Pashtany	(\$11 million)
Agricultural Bank	\$1 million
Export Promotion Bank	\$3 million
Mortgage and Construction Bank	(\$0.016 million)

The state commercial and development banking reforms of 2002–03

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

Owing to their present impaired condition (see above), all six of the existing commercial banks are required to submit, as part of their license reapplication, a restructuring plan to bring them into line with the prudential and management standards specified in the banking law. Formulation of these restructuring plans should be the task of the banks' management or board of supervisors (from which employees of DAB, the Ministry of Finance, and all other state authorities and municipal bodies are legally excluded). Shareholders (including the Ministry of Finance, if it is a shareholder) are to have the opportunity to consider and vote on the restructuring plans prior to their submission to DAB for approval. Assent or dissent is to be conveyed by a majority vote of an extraordinary general meeting of shareholders.

DAB has the sole authority to review and pass judgment on the applications for new bank licenses—and thus sole responsibility for evaluating whether the restructuring plans submitted with the applications are adequate. In its evaluation, DAB is bound to ensure that the banks will meet the conditions and standards specified in the banking law, and that each bank will be treated equally in this regard.

Should DAB reject an individual bank's relicensing application, the bank's operations are to be suspended immediately. The owners of the bank must then dispose of the bank's assets. DAB is bound by the banking law to ensure that operations of the subject bank are terminated, and its assets liquidated in compliance with legal requirements. Should the bank fail in this task, DAB is to appoint a conservator to carry out or complete the liquidation of the bank under DAB's supervision.

IV. THE MICROFINANCE INDUSTRY

Chapter 4 traces the growing importance of microfinance institutions (MFIs) in providing capital to small- and medium-scale enterprises (SME) to strengthen their businesses, and small loans to families to improve their livelihoods. This chapter details the state of the microfinance sector at the end of the Taliban regime, discusses the reforms of 2002–03, and concludes with recommendations on how to strengthen the sector and increase its contribution to private sector development. Providing innovative financial services to the poor can be effective in countries like Afghanistan, where most families consider themselves too poor to use conventional financial services from formal banks.

The microfinance sector after the fall of the Taliban regime

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

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

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

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

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

Microfinance reforms in 2002–03

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

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

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

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

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

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

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

capital of US\$5 had been paid in by the Aga Khan Fund for Economic Development and the IFC. The pilot microfinance program started earlier by the Aga Khan Foundation with 2,000 clients, will be transferred to FMBA starting in the first half of 2004. In five years, FMBA intends to reach approximately 23,000 clients.

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

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

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

The study participants make the following recommendations:

Credit-only NGO MFIs should not be subject to prudential regulation and supervision. That is, the central bank should not have a statutory role in licensing or supervising NGOs doing microfinance, because they do not deal in public money and create no risk to the safety and soundness of the financial system.

The central bank should consider developing specialized legislation for membership-based savings and credit institutions over the next one or two years.²

V. THE INFORMAL FINANCIAL SECTOR

Chapter 5 focuses on the current practice of the *hawala* system in Afghanistan. An informal mechanism for transferring money, *hawala* operates in parallel to the conventional banking system and offers many similar services.³ Its advantages over formal financial institutions include convenience, cost-effectiveness,

² See CGAP, "The Rush to Regulate: Legal Frameworks for Microfinance," Occasional Paper, April 2000, for a good discussion of legal and regulatory issues from the perspective of a supervisory body.

³ The term *hawala* simply means "transfer" in Arabic. For purposes of this paper, "*hawala* system" refers to the mechanisms for transferring funds from one location to another that exists in parallel to the money-transfer mechanisms of the conventional banking system. A *hawala* transaction, as defined here, encompasses transfers that are made through *hawala* system service providers (money exchange dealers) regardless of the use or purpose of the transaction and the country of remittance or destination. It is an operation that consists of making a financial transfer between principals located in countries A and B, using intermediaries, *hawaladars* HA and HB, who operate in the informal sector. HA receives funds in one currency from a principal (nongovernmental organization) and asks HB to advance the equivalent of the paid amount to a designated

speed, and access to regions not served by formal financial institutions. The chapter describes the operational characteristics that make the *hawala* system vulnerable to financial abuse and presents regulatory and supervisory options for informal funds transfer systems in Afghanistan.

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

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

The informal money exchange dealers offer a diverse range of financial and nonfinancial businesses opportunities stratified into local, regional, and international markets. Presently, more than 300⁴ registered money exchange dealers in the market have organized themselves into an impressive open market offering foreign-currency exchange, funds transfers, microfinance, trade finance, and deposit taking. Nonfinancial activities may include telephone and fax services, regional and international trade, and, more recently, Internet services.

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

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

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

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

The developmental role of money-exchange dealers

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

beneficiary in the local currency. Since HA instructs HB by phone or fax, funds are delivered in a matter of hours. HA is remunerated through a fee or the spread on the exchange rate, but normally a *hawala* transaction remains less expensive than payments made through the formal banking sector.

⁴ Estimates of the number of unregistered money exchange dealers in Kabul and around Afghanistan vary widely, from 500 to 2,000.

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

Vulnerabilities to financial abuse

The general inaccessibility of the customer records of money exchange dealers and ambiguities in the settlement process make the *hawala* system vulnerable to abuse. There are no standard documentary requirements for conducting business in the market. Neither the central bank nor the *hawala* dealers' association requires dealers to open their books for external inspection, nor do they require periodic financial reports. (Standardized documentation and reporting are considered unnecessary because of the high level of trust upon which the informal system is founded.) There are no standard requirements for keeping records of completed transactions and no regulatory requirement for customer identification. Consequently, *hawala* transactions may leave no audit trail for law enforcement agencies investigating predicate offenses of money laundering, tax evasion, corruption, or other related activity.

It is difficult to quantify and document the degree to which *hawala* is used to launder money in Afghanistan. It is equally difficult to trace illegal money flows, to separate legal from illicit flows, and to establish the financial links to criminal activities. Law enforcement agencies are often unable to penetrate informal financial systems because of cultural and linguistic barriers or the close business or kinship ties of the participants. Additional constraints in Afghanistan include:

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

Regulatory and supervisory options

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

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

In light of intense international efforts to combat money laundering and the financing of terrorism, the first option was not feasible. Regulatory authorities immediately began considering, instead, how current *hawala* practices will be brought into closer compliance with international regulatory and supervisory standards. Could the registration process be strengthened? Could client information the *hawaladars*

already collect be standardized? Could *hawaladars* begin to report suspicious activity to their own association or directly to the central bank? What about the records *hawaladars* keep? Could agreement be reached about external oversight and access to these records?

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

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

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

VI. CONCLUSION AND RECOMMENDATIONS

Over the last two years, progress has been made in reforming the financial system in Afghanistan. Compared to December 2001, when the legal framework was outdated, no commercial banks were operating, and a handful of NGOs competed with the informal financial sector, the outlines of a formal financial system are emerging. Much remains to be done, however, before Afghanistan realizes the shared vision of a market-oriented, private-sector-owned financial system in which:

- The autonomous central bank is fully equipped to carry out its regulatory and supervisory responsibilities;
- Financial infrastructure provides full access to modern information technology and telecommunications;
- Financial institutions, instruments, and services meet the needs of the government, NGOs, businesses, and households in both rural and urban communities
- The country's financial institutions are sound, efficient, and competitive.

Achieving those goals is hindered because Afghanistan still lacks prudential regulations, because DAB remains far behind the standards of modern central banking, and because the publicly owned commercial banks—lacking basic management systems, procedures, controls, and skilled personnel—remain in critical need of rehabilitation or liquidation.

To address the key issues constraining the financial sector and achieve the long-term vision outlined above, the central bank's reform efforts must now focus on:

- Strengthening the legal and regulatory framework of the entire financial system and enhancing regulatory capacity to enforce that framework.
- Enhancing the quality of corporate governance in the banking system and of financial sector infrastructure.
- Improving access to financial services for small and medium enterprises and rural communities, and diversifying financial services and products.
- Broadening and deepening the financial sector.

Strengthening the legal and regulatory framework and regulatory capacity

In the short to medium term a strong legal framework is a priority. Sustainable financial sector growth and stability require a framework based on strong creditor rights. Weaknesses in the legal and judicial framework governing the enforceability of commercial contracts, and slow and biased functioning of courts, are common problems in developing countries, particularly postconflict countries. Developing an appropriate legal environment for financial sector development will require attention to the following actions in the short term (table 1):

- **Central bank:** The recently passed central bank and commercial banking laws need to be augmented with specific prudential regulations for monitoring bank performance with respect to capital adequacy, asset quality, liquidity, and loan classification. Simultaneously the ability of bank supervisors to conduct on- and off-site inspections should be strengthened.
- **State commercial banks:** Until the state commercial banks are privatized, the central bank should focus its reform efforts on strengthening corporate governance structures through a variety of options including: guidelines for the appointment and dismissal of managers and board members, new organizational structures, revised credit policy and controls, new procedures for credit-risk evaluation, improved internal documentation and monitoring systems, enhanced asset/liability and treasury-management techniques, and automation.
- **New commercial banks:** Afghanistan needs stronger bank licensing criteria and procedures to provide for detailed assessment of new banks' ownership and management structures, their operating plan and internal controls, and their projected financial condition, including their capital base. If the new bank is foreign, it is good practice to obtain prior consent from the home country regulator.

Table ES.1 Legal and regulatory reforms needed in Afghanistan's financial sector

Area	Short term	Medium term	Long term
Central bank			
	<ul style="list-style-type: none"> • Introduce prudential regulations for monitoring bank performance—capital, asset quality, and liquidity • Strengthen the ability of banking supervisors to conduct on- and off-site inspections 	<ul style="list-style-type: none"> • Strengthen prudential regulations, including loan classification standards, capital adequacy; increase minimum bank capital requirements • Establish competent commercial courts 	<ul style="list-style-type: none"> • Continue progress on financial sector reform including strengthening the regulatory framework and modernizing the central bank
Banking			
State banks	<ul style="list-style-type: none"> • Strengthen corporate governance structures; process of appointing and dismissing board members and management 	<ul style="list-style-type: none"> • Sever state ownership of banks 	<ul style="list-style-type: none"> • Continue progress on financial sector reform including resolution of state-owned commercial banks and entry of private sector banks. • Strengthen risk-based prudential regulations
New private banks	<ul style="list-style-type: none"> • Strengthen criteria and procedures for new banks to clarify capital entry requirements, the scope of individual operations, management and shareholder requirements, impact on banking sector competition, and reporting requirements 	<ul style="list-style-type: none"> • Introduce anti-money laundering legislation • Introduce product/service specific regulations to ensure safe banking practices 	
Microfinance			
	<ul style="list-style-type: none"> • Establish a more effective system of NGO and microfinance registration and monitoring • Facilitate entry and expand outreach 	<ul style="list-style-type: none"> • Adopt new NGO legislation encompassing microfinance activities, cooperatives, and other savings and credit associations 	<ul style="list-style-type: none"> • Continue progress on financial sector reform including entry of nonbank financial institutions
Informal financial sector			
	<ul style="list-style-type: none"> • Recognize the self-regulatory potential of the Money Dealers Association to introduce prudential regulations required by law • Work with the association to draft a code of ethics and standards of conduct, and to adopt disciplinary procedures 	<ul style="list-style-type: none"> • Introduce prudential regulations for licensing or registration, suspicious activity reporting, and record keeping 	<ul style="list-style-type: none"> • Continue progress on financial sector reform including entry of nonbank financial institutions

- Given the growing concerns over resurging poppy production and the terrorist threat in some parts of the country, the government will soon be expected to pass legislation to combat money laundering and the financing of terrorism.
- *Microfinance institutions:* The new banking law includes no provisions for regulating and supervising microfinance institutions. Despite the increasing number of NGOs entering this field, microfinance is still at an early stage; it needs to be nurtured within the parameters of an accommodating legislative and regulatory structure. Reforms must focus on establishing a basic but effective system for NGO and microfinance registration and monitoring. A legal framework that is too detailed may stifle rather than develop the sector.

- *Informal financial institutions:* Although DAB lacks the capacity to regulate money exchange dealers, it should recognize the potential of the Money Dealers Association to act as a self-regulatory body and work with it to introduce the new prudential regulations called for in recent legislation. The central bank should encourage the association to draft a written code of ethics and standards of conduct, and to develop disciplinary procedures.

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

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

Improving corporate governance and the quality of financial sector infrastructure

In coming years, DAB should strive to improve the corporate governance structures of state banks that are relicensed. Particular attention should be given to the composition and personal qualifications of the board, the directors' remuneration, the board's relationship with the shareholders, and its accountability to shareholders. Every financial institution, including DAB, should be headed by an effective board capable of leading the institution — and every board should have a balance of executive and nonexecutive directors. Every institution should have a formal and transparent procedure for the appointment, remuneration, and removal of new directors to the board; every one should hold an annual general meeting to communicate with private investors and encourage their participation; and every board should have procedures for regularly reviewing all controls — notably financial, operational, and compliance controls and risk-management procedures. In addition to improving corporate governance structures, the reforms need to address the overall quality of the financial sector's infrastructure: human resources policy and processes, accounting and auditing standards that meet international standards, technology-based management information systems, and an effective interbank and national payments system (table 2).

- *Human resources:* Significant investment is needed in human resources in the central bank, especially in the areas of monetary policy and banking supervision. Immediate solutions include (i) identifying a core cadre of young prospective managers for accelerated training in key aspects of central banking activities, and (ii) establishing a separate bankers' training institute, jointly financed and managed by the central bank and the rest of the financial sector.
- *Accounting and auditing procedures:* Present weaknesses in accounting and auditing practices must be addressed immediately. Information on DAB's financial position and the financial condition of the state banks is unreliable, because internationally accepted accounting standards are not used. The

central bank should phase in such standards for banks and nonbanking financial institutions, starting with basic rules for asset and liability recognition, provisioning, writing-off, and depreciation and then moving on to more complex standards such as consolidated accounting. In the medium term, DAB should begin producing externally audited financial statements.

- *Computing technology:* Substantial investment is required in the central bank's technological capacity. DAB should start the computerization process at the points of data entry—in the banking hall, computer departments, research and statistics, and other operational departments. The hardware rollout should be matched with a systems development process that will enable DAB's departments to communicate electronically.
- *Interbank transactions:* DAB must create and strengthen the operational infrastructure for new banks, which will need physical and technological infrastructure for interbank transactions, international payments and settlements, and day-to-day treasury operations. Presently, the necessary infrastructure is significantly lacking, and it is unclear whether the central bank has the resources to provide it.
- *Payments system:* Infrastructure investment must also focus on key branches of the domestic payments system. Developing basic payment mechanisms and savings facilities in postconflict countries is a key step toward enabling the population to participate fully in the formal economy. The absence of effective rural payments systems is particularly acute. Given the absence of private investment in rural financial infrastructure, DAB must improve its rural physical infrastructure and the capacity of some of its key branches to facilitate basic financial transactions between Kabul and the regions. In the medium to long term, there should be a conversion from state central bank branches to privately owned commercial bank branches.

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

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

Improving access to financial services for small and medium enterprises, and for rural communities

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

Table ES.2 Strengthening the infrastructure of Afghanistan's financial sector

Area	Short term	Medium term	Long term
Central bank			
	<ul style="list-style-type: none"> • Board and management: strengthen the central bank's corporate governance structure • Human resources: Identify a core cadre of prospective managers for accelerated training • Accounting: Complete the introduction of a new chart of accounts • Banking and information systems: Install hardware and software 	<ul style="list-style-type: none"> • Human resources: Establish a dedicated international and domestic management training program • Accounting: Prepare externally audited financial statements in accordance with international accounting standards 	<ul style="list-style-type: none"> • Continue progress on financial-sector reform including strengthening the financial sector infrastructure within the central bank
Banking			
State banks	<ul style="list-style-type: none"> • Board and management: strengthen the central bank's corporate governance structure • Complete the relicensing process • Introduce independent management in banks to be rehabilitated • Revive safe and sound operations • Install accounting and financial controls 	<ul style="list-style-type: none"> • Complete the resolution of the unlicensed state banks • Commence the Voluntary Retirement Scheme, taking into account the government's fiscal commitments 	<ul style="list-style-type: none"> • Complete the privatization of the remaining relicensed state banks
Private banks	<ul style="list-style-type: none"> • Establish a legal framework with appropriate regulations for payments system and domestic interbank market • Revive retail payments systems including the use of checks 	<ul style="list-style-type: none"> • Improve check clearing and settlement systems 	<ul style="list-style-type: none"> • Convert to real-time gross settlement systems
Microfinance			
	<ul style="list-style-type: none"> • Begin licensing microfinance institutions under the new legislation 	<ul style="list-style-type: none"> • Entrust larger, well managed institutions to expand their range of products, including deposit taking among members 	<ul style="list-style-type: none"> • Consider the transformation of some of the large microfinance NGOs into banks or nonbank financial institutions
Informal financial institutions			
	<ul style="list-style-type: none"> • Accept applications for banking licenses from large money exchange dealers that have a strategic banking partner and meet legal licensing requirements 	<ul style="list-style-type: none"> • Consider licensing compliant money exchange dealers as nonbanking financial institutions, thus permitting them to engage in a wider range of well-regulated financial activities 	<ul style="list-style-type: none"> • Consider the transformation of some of the larger money exchange dealers into banks

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

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

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

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

Broadening and deepening the financial sector

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

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

To enhance competition and make the intermediary role of the banks and nonbanks more efficient, DAB should ensure that the banking industry is not dominated by a single bank or group of banks. Conventional means of enhancing competition within banking systems — such as bank privatization and changes in laws and regulations affecting companies, banks, foreign ownership, and bankruptcy — should constitute the basis of such a policy.

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

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

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

In arriving at the conclusions and recommendations made in this chapter, we recognize that financial sectors in postconflict countries vary in their levels of development and capacity for reform. Therefore, reform efforts must continue to accommodate Afghanistan's unique characteristics and circumstances. Specifically, the government and its development partners must bear in mind:

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

- *Proper sequencing of reforms is essential⁵:* Financial sector reforms achieve the best results when the macro economy is stable. Price stability depends on low inflation rates; fiscal stability on no more than modest deficits. A conducive environment is needed to promote investment only from "fit and proper" sources, domestic and foreign, into the system. And financial infrastructure—in the form of laws and regulations, institutions that implement policy effectively, skills formation, information systems, and accounting and audit capacity—must be in place. All of these components are essential for effective implementation of financial reforms. In some cases, results can be achieved relatively quickly, whereas in others they will take time. Because a stable and sound environment will make it easier to meet the longer-term challenges of institutional development, reforms should be appropriately sequenced.
- *Financial reforms are incomplete without well-conceived measures for introducing and supporting a competitive environment.* Reforms should be designed to have long-term effects, always keeping in mind the ultimate objective of establishing a competitive environment based on principles of safe and sound banking under stable financial conditions. Financial sector legislation and regulations (along with appropriate tax policies and open current and capital accounts) constitute the basis for a competitive policy.
- *Efforts to recapitalize previously existing and troubled banks should be pursued only as a last resort (resulting from the absence of new investment and in the interest of broad provision of banking services), and within the context of a time-bound privatization program.* It takes a long time for private banks to tool up in an environment like Afghanistan. But because the costs of recapitalizing troubled state banks are high relative to monetary and fiscal returns, any move to rehabilitate any of the existing troubled banks should be carried out using performance-based contracts.

⁵ Mathieu, N. (1998) Financial Sector Reform: A Review of World Bank Assistance, Washington D.C: World Bank, pp 54-55.

- *Financial reforms are not sustainable unless they are comprehensive and penetrate institutional structures.* Strengthening financial infrastructure requires several developments. A good starting point is to ensure the central bank's ability to supervise banks. Attention must next be given to infrastructure, including the payment and settlement system, accounting and auditing standards, the framework for secured transactions, and institutional capacity to comply with and enforce prudential norms. Professionalism in banking, combined with steady development of accounting and audit standards and capacity, should help to implement the reform process.
- *Reforms will not succeed without development of the system for payments and settlements.* The lack of a formally functioning payments system for international and domestic funds transfers has been an important obstacle to the timely and effective delivery of reconstruction assistance in Afghanistan. It has also impeded support of central authority, as the government has had problems paying civil servants. Action to improve the payments system should be accelerated.
- *Security risks hamper implementation and private sector competition.* So far, few private sector bidders have responded to government tenders. Perceived security risks have led firms to withdraw their offers, even after being selected through competitive bidding. Where tenders attract too few bidders, external consultants and contractors should be sought to implement the reform strategy.

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

1. INTRODUCTION

1.1 BACKGROUND

Afghanistan has endured more than 25 years of war and civil strife with devastating results. When the Taliban regime fell in 2001, the country was ranked as one of the poorest in the world. The financial sector, like all other sectors in the economy, had collapsed. The country's infrastructure and human and technological capacity were weak and in most cases absent.

The process of reconstruction has been hindered by a difficult security environment and a complex political reality. The government and its development partners faced substantial challenges, which continue to be exacerbated by an increasingly pervasive drug economy that undermines the security environment and detracts from the state-building agenda.

Fortunately, Afghanistan has opportunities and resources, which it has drawn on over the past two years, including its strategic location between Asia and Europe, and, within the region, between central and South Asia; its natural resources; a government committed to reform and development; full multilateral engagement by the international community; and most important, the determination and entrepreneurial spirit of the Afghan people themselves.

By December 2003 the impending humanitarian disaster was largely resolved. Agriculture is slowly being revived, in large part due to welcome rainfall the previous winter. Small-scale farm and irrigation investments are expanding in many places. Small business is likewise expanding, particularly in cities like Kabul where security is good. Government capacity has increased, particularly in the economic and key ministries responsible for reconstruction. Many of these have energetic ministers and advisors. Government has been able to prepare its own development strategy and budget, endorsed by its development partners.

To sustain the progress, concerted efforts are required on all fronts. Political stability, economic growth, and national security are fundamental to stability and prosperity. Improvements in the security situation are reinforced by a functioning, representative, and inclusive political system. Economic growth will occur only if security continues to improve and the political situation becomes more stable. But increased economic growth is itself the foundation upon which a sustainable political and security outcome can be built over the longer term. Robust economic growth alone will generate the employment needed to bring people out of perpetual poverty.

This study has been prepared as part of the ongoing financial sector reform dialogue. It is the first comprehensive study of the financial sector in Afghanistan. It details (1) the state of the financial sector after the fall of the Taliban regime in 2001; (2) the reforms that have taken place in the period 2002–2003; and (3) Afghanistan's medium- to long-term financial sector development strategy.

Although this study is specific to Afghanistan, it sheds some light on general factors that contribute to successful financial reform in postconflict economies. The study highlights common macroeconomic and financial sector challenges facing such governments and discusses possible solutions that would allow for successful reconstruction.

This chapter will provide a brief background on Afghanistan's financial sector at the end of the Taliban regime and summarize the research methodology used to review the sector reforms that have since been implemented.

1.2 THE FINANCIAL SECTOR

As of December 2001, the formal financial sector was virtually nonoperational. By then, the conflict had resulted in an operationally weak central bank, a moribund state commercial and development banking sector, and an active but ill-funded microfinance sector; taken as a whole, these conditions produced a vibrant informal sector.

Da Afghanistan Bank (DAB)

Under the Taliban, the central bank (DAB) was governed by a weak legal and regulatory framework under the outdated 1994 money and banking law. In addition to possessing serious practical weaknesses, the law also presented impossible compliance hurdles and was largely inconsistent with international best practices. It had no functioning monetary policy framework and thus no way to provide any meaningful monetary and financial stability. High inflation and multiple versions of the same currency further eroded confidence in the currency. The central bank had no regulatory or supervisory capacity to monitor the operations of the remaining six state commercial and development banks. Operationally, the central bank was poorly designed and resourced to function as both a central and commercial bank. Its head office and reported 89 branches possessed poor physical infrastructure, unskilled (and often deskilled) staff, inadequate telecommunications capacity, incomplete financial records, and weak overall governance structures.

State commercial and development banks

The six state-owned commercial and development banks were physically destroyed, technologically outdated, and operationally nonfunctional. What remained of the six commercial banks were frail and dilapidated buildings without the infrastructure to sustain the most basic business operations. In addition to their poor physical state, the banks were in bad and often insolvent financial condition. Loan portfolios were virtually unrecoverable, and the only source of income for many of the banks was foreign currency accounts held outside of the country. Many of the banks still employed a significant number of the personnel hired before the hostilities began in the mujahedin (anti-Soviet) era. They lacked the skills and training required to run modern financial institutions. From an accounting perspective, the banks still relied on handwritten book ledgers and had not prepared audited financial statements for many years. These factors all contributed to the decline in public confidence in the banking system. The public no longer used the banks to place deposits or for other basic transactions, which in turn severely reduced the resource base for banks to lend. With the exception of a few minor directed-lending transactions and a special loan program in one of the provinces, the banks had ceased all lending operations. They had been left with loan portfolios that, in most cases, had been originated more than 15 years ago.

Microfinance institutions

Nongovernmental organizations (NGOs) provided a limited amount of microfinance for small and medium enterprise development. Cumulatively, microfinance programs in 2002 served only 10,000 clients. Their operations geographic reach extended to selected rural villages less than half of the provinces. Loan sizes ranging from US\$20 to US\$300 were provided using various methodologies including individual lending, group lending, and community-based savings and credit approaches. By and large, however, the microfinance programs were not sustainable. First, the NGOs' humanitarian missions and financial inexperience meant that few if any had clear long-term strategies for developing institutional and financial sustainability. Second, hyperinflation had led to regular decapitalization of loan funds as NGOs did not charge interest rates that would cover inflation. The long-term downward trend in the value of the Afghan currency had also led to devalued loan portfolios in dollar terms, as NGOs were not able to protect or hedge against this, while religious restrictions on usury curtailed the volume of loans.

Informal financial institutions

The money exchange dealers, however, remained active financial intermediaries in Afghanistan at the end of the Taliban regime, offering a diverse and reliable range of financial and nonfinancial business services stratified into local, regional and international markets. The more than 300⁶ registered money exchange dealers in the Kabul money exchange market organized themselves into an impressive open market. Their financial activities include foreign currency exchange transactions, funds transfers, microfinance, trade finance, and deposit taking. Nonfinancial activities may include telephone and fax services, regional and international trade, and more recently internet services. The informal international and domestic payment system they provide was also the only reliable, efficient, safe and inexpensive means of transferring funds in and out of Afghanistan and to its provinces.

Effecting funds transfers into Kabul from Peshawar, Dubai, and London, for example, take an average 6 to 12 hours. Commonly, 24 hours are required for transfers between Kabul and any of the regional centers. Slightly more time is usually required for payments sent to more rural regions or villages where the money exchange dealer has no local office or representative. The cost of making funds transfers into and around Afghanistan averages 1 to 2 percent. The final quotation depends on the volume of the transaction, the relationship between the client and the hawala dealer, currency of exchange, security environment in Kabul, the destination of funds, and the negotiating skills of both parties based in part on their understanding of the market.

The government recognized Afghanistan's urgent need for investment in the financial and private sectors for the country to alleviate any poverty, create jobs, or realize any trade and overall economic growth. To this end, the government, in consultation with its multilateral and bilateral partners, embarked on reforms targeting the central bank, commercial banks, and microfinance institutions.

1.3 CONCLUSION

The thesis of this study is that financial sector reforms in Afghanistan will take a long time to implement; further, these reforms will continue to face significant challenges. The sector had so deteriorated by the end of 2001—namely, the absence of a legal framework; poor and outdated infrastructure; lack of trained personnel; inappropriate governance and ownership structures in the state banks; inadequate collateral and

⁶ Estimates of the number of *unregistered* money exchange dealers in Kabul and around Afghanistan vary widely from 500 to 2,000.

bad debts; low depositor confidence; absence of clear accounting standards; and an ineffective formal payment system—that only focused and unrelenting reform efforts can help.

Although progress has been made in since 2002, this study argues that much remains to be done. The central bank now has some equipment, but it needs more. The government has issued two presidential decrees. These provide at least the basis for a modern legal framework for a two-tier banking system. Although three new banks have been licensed on standards consistent with the new legal framework, the financial sector remains severely undeveloped. Substantial reforms must be implemented if the financial system can play a meaningful role in the country's economic development. This study documents efforts toward this goal and lays out a strategy for enhancing the effectiveness of the reform process.

2. THE CENTRAL BANK⁷

2.1. INTRODUCTION

After the fall of the Taliban regime in 2001, the central bank (Da Afghanistan Bank, or DAB) was a moribund institution. Operating in a legal vacuum, it could offer not even the most basic financial services and was staffed with unskilled, and often deskilled, employees. Without basic technology resources, the central bank was not equipped for conventional, modern-day central banking functions. Its headquarters was in serious disrepair, and the branches lacked electricity, running water, and modern plumbing. Perhaps most important, DAB branches had no vaults for the safe storage of cash. Perhaps no more than 20 of its reported 89 branches across the country had the infrastructure required for basic central banking operations.

With the help of international organizations and bilateral partners,⁸ the central bank began to restructure and modernize in mid-2002, albeit with immediate challenges including legal difficulties regarding its independence; ill-funded attempts at improving the international and domestic payment systems; and a number of hurdles in its efforts to build internal human and technological capacity. These and other issues have stalled the pace of the hastily devised reforms of 2002 and 2003 (which were designed largely to address immediate concerns with payment systems) have failed to fulfill the goals that reformers first envisioned. By December 2003 DAB still lagged far behind even basic standards of modern central banking. More comprehensive reforms are urgently required.

2.2 STATE OF THE CENTRAL BANK AFTER THE FALL OF THE TALIBAN, 2001

Legal and regulatory framework

As of December 2001 the 1994 Law on Money and Banking provided the legal framework for the financial sector. A March 2002 IMF review found that the legislation had serious practical weaknesses, insuperable compliance problems, and was largely inconsistent with international best practices. The 1994 law was designed on the now-outdated socialist principle that the purpose of monetary policy is to direct credit, making it unsuitable for a market economy. Second, the law created a number of conflicts of interest between the government, central bank, and commercial banks. Third, it contained no modern prudential standards and enforcement tools. For most of its life, however, the law was irrelevant in practice, as the Taliban largely ignored it. So, in order for the financial sector to develop in Afghanistan, there is an urgent need to replace the law in its entirety (See Annex 2.1 for a summary of the issues surrounding the 1994 law.)

⁷ This section draws extensively on the work of the IMF presented in IMF (2003) *Islamic State of Afghanistan: Rebuilding a Macroeconomic Framework for Reconstruction and Growth*. IMF Country Report No. 03/299, and IMF and World Bank Mission reports prepared during the period 2002–2003.

⁸ The three main organizations involved with this effort are the IMF, USAID, and the World Bank

Monetary policy framework

In 2001 Afghanistan's postconflict monetary policy framework faced grave challenges. Reconstruction efforts in Bosnia and Herzegovina, Liberia, Congo, and East Timor suggest a few of the immediate and longer-term challenges it needed to address, among them:

1. Lack of a stable currency—the extreme uncertainty and instability afflicting postconflict countries create weak and unstable currencies.
2. High inflation—unstable currency and political instability produce high inflation, which often leads to economic collapse.
3. Commodity-based economy—high inflation often leads to heavy reliance on barter or on commodities as a form of payment.
4. Lack of savings—the lack of confidence in the currency and the absence of a sound banking system, combined with high inflation, generally leads to reduced savings.
5. Lack of a centralized (or *effective*) monetary authority to shape and enforce monetary *policy*—ineffective monetary authority often leads to badly designed or implemented monetary policy and inadequate supervision of the banking system.
6. High unemployment—war and conflict often cause high unemployment, which makes postconflict countries highly susceptible to renewed conflict.

As of December 2001, Afghanistan had no functioning monetary policy framework in place. Confidence in the national currency, the afghani, was low owing to years of high inflation, which led to devaluation. Moreover, DAB, had little or no control over the issuance of currency—at least three versions were circulating in the country. First, there was the official afghani, issued prior to the Taliban rule and which they continued to issue from the remaining stocks in the central bank vaults. In addition, duplicates of the official banknotes were placed into circulation during the Taliban years by the then internationally recognized government in exile, which had ordered reruns of earlier issued series from the country's regular printer and had issued these in the northern parts of the country.

By using the same serial numbers as used in earlier years, the government-in-exile ensured that the new notes could not be distinguished from those already in circulation. Furthermore, two warlords had issued their own counterfeit versions of the official currency. Although very similar to the official currency, the counterfeit currency did possess some distinguishing features and typically traded at a discount in the Kabul money markets. Reflecting the limited confidence in the afghani, foreign currencies were widely used, especially the U.S. dollar and the currencies of neighboring countries and especially in the case of larger transactions and as a store of value.

The structure of banking supervision

When the Taliban regime fell, Afghanistan had no functioning structure for banking supervision. DAB staff had almost no knowledge about the objectives and techniques of modern supervision. Banking data had not been collected in years and no assessment of the sector's health had been made.

For a long time, the sole supervisory obligation of banks was to submit statistics on a number of topics, even though the data collected were largely irrelevant for two reasons. First, the accounting rules under which the data were produced did not correspond to international practice; thus, the data could not be assessed against prudential benchmarks. The misleading and imprudent treatment of loans is a prime example. Second, the data had no bearing on or relation to prudential considerations, while other data relevant for risk assessment were not collected. For example, data were collected on the number of bank

employees, including their profession, gender, etc., and on the number of bank-owned buildings and vehicles, while their income statements were not. During the Taliban regime, bank supervision simply stopped. In essence, bank supervisory functions had to be built from scratch after a long period of neglect dating from before the Taliban period.

Retail banking activities and the national payment system

DAB was designed to function as both a central and commercial bank. In fact, it began as a commercial bank before assuming the responsibilities of a central bank in 1939. In 2001, besides being the government's bank, the DAB still offered commercial banking services, extended long-term loans to banks and enterprises, and accepted deposits from the public through its vast network of branches.

Officially, in addition to its headquarters in Kabul, DAB reportedly reportedly operated 89 branches across the country, six desks in hotels and other public places, and four toll desks on highways. Each of the 30 provinces had a main provincial branch headed by a general director and one or more district level branches headed by a director. The general director in the province oversaw and supported the district branches in that province. As a result of the civil and military upheavals, 24 of 89 branches were closed.⁹ In practice, as of January 2002, it was near impossible to verify the number of functional branches or desks.

Although most of the commercial banking operations were discontinued in 1995, a number of DAB accounts were still current in 2001. At DAB headquarters there were only 5,000 active accounts out of a total of 1010,000 accounts (35,000 of which had a zero balance). In the first 30 branches assessed in May 2002, fewer than 6,000 accounts were found to be active¹⁰.

Further, despite assuming the role of international and domestic payment systems provider, DAB had no capacity to do so. Internationally, DAB did not have any SWIFT or related connection with the rest of the banking world. DAB only had one unreliable telephone connection. Domestically, the central bank branch network faced serious structural and operational problems which made it difficult to achieve quick inter-branch connectivity over the short term. These problems varied between regions and branches but generally included:

- *Poor infrastructure:* Many central bank branches were completely dilapidated. They lacked the basic amenities, electricity, and, most important, vaults for the safe storage of cash and equipment.
- *Staff:* The DAB branches had limited staff capacity; staff did not have the required banking and technical skills to conduct non-cash-based banking business.
- *Inadequate telecommunications capacity:* The central bank branches did not have the telecommunications equipment required for basic financial transactions. In most cases, branch offices did not even have telephones (and certainly not ones that could communicate with Kabul). Urgent messages to central bank branches were sent via telegram. Until early 2002 the central bank headquarters had only one direct telephone line and a few analog lines capable of calls within Kabul.

⁹ This left the provinces of Bamyan, Maidan Shar, Qala E Naw, Zabul, and Nimroz without any functioning branch at all. The provinces of Gardez, Khost, Kapisa, Logar, Ghazni, Kunurha, Qalat, Urazghan, Ghorat, Farah, Badghis, Sar-e-Pol, Baghlan, and Taluqan emerged with only one branch each. Apart from Kabul, which has 15 official branches, the provinces least affected were Nangarhar (with five branches), Kandahar (four), Herat (five), Mazar-i-Sharif (seven), and Kunduz (three). DAB owned 30 branches. The remaining properties belonged to other state institutions and private investors.

¹⁰ Active accounts are defined as those that had any movements since the beginning of the year or that had a customer who declared an interest for his or her account.

- *Transportation:* The central bank lacked suitable vehicles for the delivery of cash to the provinces. Branches relied on their local provincial authorities and private sources—which were ill-suited for this purpose.

Operational capacity

At the time the reforms commenced, the central bank had not prepared audited financial statements since 1996. Although accounting data for financial transactions had been, and continued to be, collected, the data were not processed in a manner that enabled the preparation and audit of financial statements in accordance with International Accounting and Audit Standards. There are three primary reasons for the poor state of the accounting function and the lack of up-to-date central bank accounts.

- *Accounting policies and procedures:* DAB had a clear set of accounting policies and procedures, which were applied consistently bank staff across the bank and its branches, and from one period to the next. The rules and regulations, however, for recognizing, classifying, recording, and reporting central bank assets and liabilities were vague. The criteria for recognizing current and capital expenditures were undefined. The quality of financial data across departments was therefore varied with no identifiable audit trail from one department to the next.
- *Branch and departmental communications:* In addition to ill-defined departmental and accounting staff duties, there was no accounting system to convey information between departments and individuals. Grave weaknesses in the telecommunication system meant unreliable telecommunication, fax, and voice messaging. In some instances, information from provincial branches was delayed for periods in excess of three months.
- *Double-entry booking and accruals accounting:* Because staff members recorded most transactions in single-entry fashion, they did not adhere to common rules of double-entry bookkeeping and accruals accounting; neither the branch accounting records nor records of departments within the central bank could be reconciled with the records maintained by DAB's central accounting department.
- *Incomplete records:* Even in instances with a rudimentary system in place, incomplete records were common. For the past six years, no efforts were made to reconcile the balance of branches, and of departments, with that of the central bank. The last available balance sheet of DAB is for the year ending 31 March 1996.
- *Computerization:* Every transaction in the bank was manually written into source documents and accounting records. Computer hardware and software were nowhere in evidence. The accounting department had only four nonoperational NCR data-processing machines. There were no computers, accounting, or bookkeeping software applications, nor any suitably trained, computer-literate accounting staff.

The lack of reliable accounting information about the central bank's financial condition impeded the design of an appropriate long-term restructuring and modernization program and undermined the planned departmental and branch reforms. It was not possible, for example, to determine DAB's capital or liquidity position on a daily basis, as required in conventional, modern-day central banking practice. It was a matter of extreme urgency for reformers to address the constraints listed above.

Finally, it was estimated that DAB's total staff complement exceeded 2,500. The central office had 1,191 employees; Kabul branch employees, including those at its airport counters, Ibne sina Hospital, the government pharmacy, and the provincial governor's office, number 560, with 1,098 staff members in its provincial branches. Prior to the war, as many as 622 employees were working as tax collectors on

highways. When the Taliban regime fell and the ban on women working was lifted, approximately 300 women returned to the DAB. Most, however, worked in the central office and its Kabul branches.

2.3 CENTRAL BANKING REFORMS, 2002–2003

Given the woeful state of the 1994 banking law, the need for new legislation was immediately apparent, and the consequent debate commenced in earnest. A key reform objective, which garnered immediate consensus, was the need to create a two-tier banking system by providing an unambiguous distinction between central and commercial banking operations. Although the DAB carried out both, the separation of the commercial banking operations was a *sine qua non* under a two-tier banking system. The other broad objectives agreed to were: (1) establishing a strong legal framework to ensure the autonomy and accountability of DAB in its monetary and financial supervisory activities; (2) enhancing and deepening financial intermediation in Afghanistan in efforts to encourage competition in the banking sector, improve governance through better disclosure, transparency, and international standards in accounting and auditing, and (3) Providing the legal framework for regulating various financial institutions and services.

Legal and regulatory framework

It was widely agreed that quick promulgation of key financial legislation was critical for reestablishing confidence in the Afghan banking system. This was important both within the country and with regard to the international community, including donors and the commercial and financial sectors. The initial expectations of a speedy drafting and enactment of the legislation proved overoptimistic. This was unfortunate because a series of reforms hinged on passage of the legislation. It had been expected that, once the laws were passed in early 2002, steps would be taken to modernize the central bank, consistent with the provisions of the new legislation, followed by efforts to relicense the commercial banks, in accordance with prudent entry requirements and strengthened supervision rules. The laws were not passed until September 2003.

One of the key issues to surface in 2002⁴³, and which delayed the legislation, was a dispute over the autonomy of the DAB. The Ministry of Finance argued that DAB's institutional capacity was still sufficiently weak to warrant limits on its independence. Unsurprisingly, the central bank thought otherwise. The debate is common to developed and developing countries; the structure defining the statutory relationship between the central bank and government usually proceeds from political and economic realities.

Central bank independence

A common element of modern central banking is that such institutions are lenders of last resort, serve as banker for the government, and operate in a fiat money system where the issue of money is monopolized by government. Beyond that, wide variations occur in both the nature of the relationship between the government and the central bank and in the range of responsibilities for the conduct of monetary policy, autonomy from the Treasury, and requirements to supervise the banking system and insure financial system stability. (See Annex 2.3 for a summary of five key aspects governing the statutory relationship between the executive and the central bank, along with sample countries that have satisfied each of the criterion.)

A critical aspect of the executive–central bank relationship (the executive is usually represented by the Ministry of Finance) involves the function of the supervisory board (which oversees operations) and the authority of the central bank governor in appointing senior officials.

An effective supervisory board serves, at a minimum, to provide some distance between the executive and the central bank either by facilitating the appointments process or by ensuring that the head of the central bank, the governor or president—the CEO—operates within the limits of his or her mandate and does not violate codes of good conduct (i.e., ensures competence). Beyond that, the board's effective degree of authority, and its appointments procedures, can vary considerably from country to country. Generally, the executive retains the authority to appoint senior central bank officials. In several countries, however, the appointment may require ratification by the legislature. There seem to be no net benefits in adopting one system over another. In most developing or emerging markets, the executive makes these senior appointments.

More important is the degree of legislative oversight over the central bank's operations and performance. Also controversial is whether the relatively common practice of making a government official an ex officio board member (at least in developing countries) is beneficial. Initially, such membership was believed to contribute to the harmony between fiscal and monetary authorities. More recently, in line with the increased emphasis on central bank autonomy, board involvement by a government official is believed to represent a constraint on the free flow of discussion among decision makers. Moreover, as transparency and accountability have gained currency as synonymous with good monetary policy, the lines of communication between the central bank and the executive are preferably handled more at arms length.

After an exhaustive consultation process and numerous revisions, the government finally passed, by Presidential Decree, the Central Bank Law in September 2003. The law provides a sound framework for a two-tier banking system in Afghanistan. Significantly, the law also provides for full central bank independence in the design and implementation of monetary and banking supervision policy.

Article 4 of the Central Bank Law states that the management of Da Afghanistan Bank shall enjoy *autonomous* regulatory powers; be entirely independent from any other authority in the pursuit of its objectives and the performance of its tasks; and not engage in political activities. Specifically, Article 4 states:

1. In carrying out its tasks, Da Afghanistan Bank shall enjoy *autonomous* regulatory powers, including those to pass regulations to facilitate orderly electronic transactions between Da Afghanistan Bank and banks and their respective customers. All regulations, guidelines and instructions issued by Da Afghanistan Bank that apply to more than one institution shall be published in the [*Official Gazette*] and shall take effect on the date of such publication or on such later date as such regulation, guideline or instruction shall specify. Da Afghanistan Bank shall maintain a public register of such regulations, guidelines and instructions.
2. Da Afghanistan Bank shall be empowered to enter the offices and to examine the accounts, books, documents and other records of any bank, foreign exchange dealer, payment system operator, money service provider, securities service provider, securities transfer system operator or other person who is licensed by, or registered with, Da Afghanistan Bank, and to obtain such information from such person as Da Afghanistan Bank shall deem necessary or advisable for the proper discharge of its supervisory responsibilities.
3. When exercising the powers and carrying out the duties and tasks conferred upon it by law, Da Afghanistan Bank shall be entirely independent from any other authority in the pursuit of its objectives and the performance of its tasks. The autonomy of Da Afghanistan Bank shall be respected by all and no person shall seek to exercise improper influence on members of the decision-making bodies of Da Afghanistan Bank in the performance of their tasks or interfere in any other way in the activities of Da Afghanistan Bank.

4. Each member of the Supreme Council and the Executive Board and each other employee of Da Afghanistan Bank shall have the duty to promote the reputation of Da Afghanistan Bank as a politically autonomous central bank serving all of Afghanistan with impartiality, and shall refrain from any activity that is incompatible with that duty.

5. While serving in the supreme council, members of the supreme council of Da Afghanistan Bank shall not engage in political activities.

The law did not, however, grant the central bank full and immediate political independence. Article 135 (regarding deferred enactment of articles governing political activities) permits persons to continue as officers of the central bank who would otherwise have been disqualified on account of their political activities under Article (4) paragraph (5) and Article (12) paragraph (1) subparagraph (h) regarding political activities until there is a successor administration to the Transitional Islamic State of Afghanistan.¹¹

Overall, the recently passed legislation provides a firm foundation upon which to build an active financial sector. The DAB law articulates the central bank' objectives and tasks, organization and administration structure, financial arrangements and provisions, currency, monetary functions and operations, exchange rate policy and foreign exchange controls, relations with the state and with banks, payment/ clearing settlement, securities, financial audit and reporting, financial services tribunal, and other miscellaneous but important provisions.

The central bank's effectiveness in exercising its independence will be determined in large measure by the quality of Supreme Council appointed to oversee its operations.¹² Articles 7 and 8 of the Central Bank Law, which defined the Council's functions and powers, give it wide-ranging authority in this regard (see Annex 2.3).

Monetary policy framework

With no functioning monetary policy framework, the government faced a number of key policy questions. Working with the International Monetary Fund, the Ministry of Finance and the central bank focused on identifying ways to best establish financial stability,¹³ and to do so quickly. Currency was one of the most pressing issues in this regard. Should Afghanistan temporarily adopt a foreign currency as legal tender, or introduce a new national currency. The latter option would take time to implement, and thus require an interim plan. It would also require the central bank to adopt a framework for monetary policy. What would be the objectives and intermediate targets of that policy? Would it be better to fix the exchange rate, or to let it float? And in the absence of a functioning banking system, what instruments could the central bank use to implement monetary policy?

Currency conversion

One interim plan was a full dollarization until the successful launch of the new afghani. The temporary use of a stable foreign currency would have provided immediate monetary stability, as well as time to establish credibility and to build up the necessary capacity at DAB. Full dollarization, however, would have entailed an upfront redemption of all existing afghanis, which would have required considerable

¹¹ At the time of writing the national elections were expected to be held in September 2004.

¹² At the time of writing the Supreme Council had not yet been appointed.

¹³ This section draws on the work of the IMF presented in IMF (2003) Islamic State of Afghanistan: Rebuilding a Macroeconomic Framework for Reconstruction and Growth. IMF Country Report No. 03/299. pp 97

organization. Moreover, this approach would have been expensive, requiring significant additional donor assistance, and might have been difficult to reverse.

Another option, recommended by IMF staff based on pragmatic economic and technical grounds, was to use a foreign currency to conduct government transactions until the new currency could be introduced. Meanwhile, the public would have been free to use any mutually agreed currency for any transaction and to hold any currency. Existing afghanis would have continued to circulate until redemption by the new currency, within a floating exchange rate regime, but the central bank would not issue more afghanis. The government would have announced its commitment to redeem existing afghanis for the new currency at a rate to be determined later. The risk of counterfeits would have remained, but would have had less impact. This approach would have imposed a substantial degree of transparency and discipline on both fiscal and monetary policy, thus contributing to financial stability.

The authorities decided, however, to continue to use the existing afghani and to introduce a new currency as soon as technically possible. The authorities viewed the afghani as an important symbol of sovereignty and unity and were concerned that even a partial and temporary dollarization would be difficult to reverse. While the authorities recognized the risks posed by the various counterfeits to financial stability, they believed these risks had diminished, based on information received from at least some of the printers involved regarding volumes printed, and their assurances that printing had stopped. As the value of the old afghani had been eroded by inflation—the largest denomination (Af10,000) was worth about \$0.25 and people had to carry around large bundles of cash for anything other than the smallest of transactions—one new afghani would replace 1,000 old ones.

The introduction of the new currency was a crucial step in the authorities' efforts to establish financial stability and create an environment conducive to restoring sustainable economic growth in Afghanistan. The plan for the introduction of the new currency was made public on September 4, 2002, and the conversion process started on October 7, 2002. Replacing all banknotes in a postconflict country such as Afghanistan within a fairly short period posed tremendous logistical challenges (details of the currency conversion are provided in Annex 2.4). Nevertheless, the authorities, assisted by the international community, managed to complete the changeover successfully on January 2, 2003. The exchange rate of the afghani has remained broadly stable since the completion of the conversion process, reflecting not only sound financial policies but also the population's confidence in the new currency.

Exchange rate policy

With a new currency in place, DAB's attention shifted to the task of choosing an exchange rate regime appropriate for Afghanistan. After much debate, the authorities decided to adopt a floating exchange rate regime, at least for the near term. The rationale for this decision was based on the following factors:

First, Afghanistan's economy is undergoing large structural changes; the equilibrium exchange rate will change as a result. Thus, there would be a considerable risk of an exchange rate misalignment in a fixed regime. The reconstruction phase has been attracting large foreign exchange inflows, both from donors and repatriation of funds by Afghans, which may cause the real exchange rate to appreciate. A more practical matter is that in present-day Afghanistan, it would be very difficult to get a firm idea as to what the appropriate exchange rate level would be in a fixed regime, not in the least because of the lack of reliable data.

Second, Afghanistan continues to be very vulnerable to shocks, both external and domestic, real and financial. These include, inter alia, trade shocks, droughts, earthquakes, and political tensions. Under a

fixed regime, labor and product markets would need to be flexible. Although these markets are expected to show a certain flexibility, perhaps they should be allowed to absorb shocks rather than letting the exchange rate adjust.

Third, the central bank authorities have yet to establish credibility. In the eyes of economic agents, the government has at best no track record for its economic policies; at worst it has a poor track record of high inflation. A firmly fixed rate, such as in a currency board arrangement, could help to establish credibility, but such a board would not automatically confer credibility. In particular, the authorities' commitment to fiscal discipline had not yet been put fully to the test.

Finally, it is important to choose the right reference currency. In the case of Afghanistan, to which foreign currency should the domestic currency be pegged—the U.S. dollar or the currency of a neighboring country? There is only limited information on the composition and direction of trade, but it appears that a large share of Afghanistan's trade is with neighboring countries. But at the same time, a significant share of trade flows seems to be denominated in U.S. dollars. On the one hand, fixing the rate against the U.S. dollar could result in a real appreciation against neighboring countries, adversely affecting Afghanistan's competitiveness. On the other hand, fixing the rate against the currencies of neighboring countries could adversely affect stability.

The authorities saw the benefits associated with exchange rate stability because it instills confidence in the new currency and supports price stability. Since the introduction and float of the new currency in early 2003, DAB has therefore aimed to limit volatility by holding the exchange rate within a range. This range is not firmly set or announced, however, and DAB does not intend to resist persistent exchange rate pressures (should these emerge) and risk losing its reserves. The exchange rate regime can therefore be described more accurately as a de facto managed float—that is, more of an intermediate regime somewhere in between a pure float and a firmly fixed rate. Minimal financial integration and market development in Afghanistan allow DAB to pursue this approach, although the informal financial markets are such that consumers can quickly substitute one currency for another if they wish.

Monetary policy committee

The success of Afghanistan's monetary policy will in part be determined by the effectiveness of the administrative structures and decision-making mechanisms in place within DAB, and the role of the Supreme Council. Four types of structures are typical.

Many central banks—referred to as single decision-making institutions—invest their CEOs with final authority over monetary policy. A major concern with such a system is that the central bank's position and influence may become too closely tied to the personality of the CEO (and perhaps that of the counterpart in the executive, usually the finance minister), increasing the potential for conflict between the government and the bank. Until recently, developing nations have tended to vest authority for monetary policy with the CEO; a committee structure is now replacing the single decision-making model.

A variant of this structure retains an authoritative CEO, whose role is supported by a group of monetary experts (e.g., Canada's Governing Council). The head of the central bank resorts to a quasi-formal mechanism to obtain support for policies he or she is legally responsible for implementing. Developing countries follow either the single decision-making model or the committee model, with the CEO often *primus inter pares*.

Two other types of decision-making structures formally invest a committee with the ultimate responsibility to implement monetary policy. These are becoming increasingly common, as the public, markets, and even governments demand—often in exchange for considerable autonomy in carrying out monetary policy—that central banks make decisions based on varied views. Statutes differ according to the degree of openness with which deliberations are carried out and announced. Some countries provide limited information about committee members' positions or voting preferences (e.g., the European Central Bank [ECB]). In other countries, their votes and positions are announced (e.g., the United Kingdom); disagreements are represented in carefully chosen language. In the case of the ECB it is important to recognize that it serves as the sole central bank for a group of loosely organized sovereign countries. Hence, regional influences will be important in the decision-making process, not unlike federations with a relatively weak center.

The bank's decision-making structure can be influenced by the country's government structure. Hence, in unitary states there is no formal statutory recognition of regional concerns. In weak federations with powerful central governments, regional concerns may enjoy some formal recognition, perhaps for historical reasons. But even if regional concerns receive a hearing, central bank decision-making, as in the United States, is highly centralized. In other countries, relatively few mechanisms exist for regional concerns to have a decisive influence on the conduct of monetary policy (e.g., Australia or Mexico). In stronger federations—namely, where the relative power of the provinces or regions is significant—there may exist more formal means of providing a role for the regions. The German Bundesbank, prior to the start of European Monetary Union, is one such example. There the German regions, or Lander, were given formal, though rarely decisive, roles in decision-making. In other countries, subnational states can directly or indirectly thwart the national government's ability to interact with the central bank (e.g., Argentina).

Another variation arises from decisions on whether to make the legislation governing the central bank organic—explicitly defining its authority in a country's constitution—or leave the matter, as in many countries, to an act of Parliament with amendments or revisions easy or difficult. In the case of easy changes, the act usually requires a simple majority to implement amendments (e.g., as in many parliamentary democracies such as Canada or New Zealand). Elsewhere, passage of amendments is more difficult either because more than 50 percent-plus-1 vote is required for passage, the executive's power is restricted by the Constitution in such matters (e.g., the United States), or the regions have a powerful legislative voice, or automatic recourse to the judiciary that may limit the executive's ability to shepherd new legislation (e.g., as in Germany). In other countries, no matter whether legislation defining the authority of the central bank is organic or not, it may nevertheless be relatively straightforward for governments to change the Constitution either because the judiciary is weak or because no effective tradition hinders governmental interference in defining the role of the central bank in national affairs (e.g., in Latin America or Africa).

In one model or another, the relative autonomy of the central bank may be influenced by whether the political system is a two-party system with a bicameral legislature (as in the United States), resulting in executive appointments and legislative supervision. Multiparty systems with proportional or mixed representation can conceivably weaken the authority of the central bank if amendments can be easily implemented. More likely, such changes will be difficult to introduce if the legislation governing the central bank has special status requiring a large majority, which can be difficult to generate if coalitions are unstable or difficult to build. Finally, in Westminster-style parliamentary democracies, the majority party will usually find it relatively easy to implement its preferred central bank structure in principle.

In short, several political forces can shape the overall structure of the relationship between the executive and the central bank. Consequently, the eventual political makeup of Afghanistan and, in particular, the relative administrative authority of the regions may have important effects on the implementation of the new central banking legislation. In any case, a variety of central bank structures can accommodate the delivery of good standards in the implementation of monetary policy.

Banking supervision

The Banking Supervision Department was created in July 2002 to protect depositors, promote safe and sound banking practices, and prevent systemic financial instability. Until the new banking law was passed in September 2003, there was no legal basis for these responsibilities nor the resources and skills required to achieve them.

In its August 2002 report, the IMF identified the following capacity-building priorities for the Banking Supervision Department: (i) internal audit and controls; (ii) corporate governance, (iii) reporting requirements, disclosure, and transparency; (iv) analysis of prudential ratios; and (v) twinning arrangements for the department in all areas of supervision, regulatory oversight, staffing and training requirements, drafting of regulations, manuals, procedures, and handbooks, organization and administration, building and operating facilities, and modernization tool, equipment, and IT. The IMF also recommended that the Supervision Department adopt the **functional** approach, i.e., off-site and on-site divisions, as opposed to the 'institutional approach', arguing that it was a more efficient use of human resources, and that, with a few exceptions, foreign bank branches and domestic banks should receive even handed treatment.

Strengthening the Banking Supervision Department required substantial support in establishing an appropriate regulatory framework and supervisory with respect to **bank entry** (licensing requirements, minimum capital requirements and fitness and probity tests), **bank supervision** (capital adequacy, loan loss provisioning, and liquidity management), and **bank exit** (curatorship, receivership, and liquidation procedures). The department urgently required new guidelines, policies and procedures for evaluating bank license application, conducting onsite and offsite supervision for banks and nonbank financial institutions, and facilitating the orderly exit of distressed banks; It also needs appropriate computing hardware and software, and continued local and foreign-based training to attain the standard required of modern financial sector supervision departments.

In December 2002 USAID started addressing some of these needs. Its technical assistance project components include support for the comprehensive design and implementation for sound policies and procedures for licensing, off-site analysis, enforcement of laws and prudential standards, reporting, accounting and offsite examinations. It started this process with daily half-day training sessions on banking and supervision to the department's 38 staff. It also realigned the department's activities into three sections, namely, Supervision —Banks and Nonbanks, Special Supervision —Troubled Banks, and Licensing and Regulation. By June 2003, it had a **semi-functional** supervision department performing basics regulation and supervision. By July 2004 the USAID program aims to have an accredited bank supervision training program in place, written a detailed supervision manual, and automated the off-site analysis of bank data. Finally, by 2005, it aims to have replaced all expatriate staff with local central bank staff.

Retail banking activities and a national payment system

Establishing an efficient payment and settlement system is critical to the stability of any economy, because it "reduces the cost of exchanging goods and services, and is indispensable to the functioning of the interbank, money and capital markets. A weak payment system is a severe drag on the stability and developmental capacity of an economy; its failures can result in inefficient use of financial resources, inequitable risk-sharing among agents, actual loss for participants and loss of confidence in the financial system and in the very use of money."¹⁴ An efficient and effective payment and settlement system is one of key reform challenges for any developing financial sector. Due to the fragmented nature of the banking system in postconflict economies, the payment system (if one exists) is often in need of significant improvements. Above all, reforms must anticipate that the vast majority of transactions are of comparatively small value. Fortunately, technologies and software packages have been designed to make implementation of effective payment systems attainable around the globe. This is essential not only for broad market confidence and basic transactions but also to contain money laundering and other financial crimes. For these reasons, one of the immediate demands for policymakers in postconflict countries is establishing a strong, efficient, reliable, safe, and stable payment system that facilitates a country's economic development.

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

Under the circumstances, this decision was grudgingly accepted because there were no functioning banks under sound regulation and supervision. Thus, DAB strengthened its commercial payments capacity to ensure that government, NGOs, private businesses, households, and other parties had access to the system to make payments and transfers. Likewise, DAB provided letters of credit and other trade finance facilities to businesses, organizations, and others to handle such needs through its existing network of bank branches.

The status quo raised several developmental concerns. First, losses in trade financing might risk undermining DAB's financial position, weakening its role in devising and implementing monetary policy. Second, it might send an adverse market signal to potential commercial banks: they might be competing with the central bank. For DAB to retain its commercial functions could, in other words, deter investment. Finally, there were concerns about the inevitable conflict of interest resulting from DAB acting as both a commercial bank and bank supervisor.

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

The Central Bank Law passed in September 2003 recognized DAB's overall strategy, particularly the need for commercial banking services in areas where there are no banks or services, and establishes an exit strategy for the central bank once others begin to provide these services. Article 129 (Da Afghanistan Bank's commercial banking services) states that:

¹⁴Bossone, (July 2001). pg 7

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

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

For a while, Crown Agents Financial Services Limited (CAFSL) provided the only formal secure arrangements for effective bank transfers to Afghanistan and for making afghanis and U.S. dollars (USD) available in-country. The procedure was simple. The remitting client paid the fund to CAFSL and completed a form advising it of the sum to be transferred to Afghanistan and the name and passport number of the individual who will collect the funds in Kabul. On receipt of the fund, CAFSL sent an instruction to the central bank in Afghanistan, to pay a fixed amount of dollars to a named individual on application and identification at the central bank counters in Kabul. Funds were normally available for collection immediately, subject to banking hours in Kabul. The local Kabul office manager accompanied the named individual to Da Afghanistan Bank for first collection and assisted with any queries on subsequent collections. The fee for each transaction was 1 percent of the sum to be transferred with a minimum of USD250 and a maximum of USD500. If, however, the recipient client had an account at the central bank, the transfer charge was only \$50. In its first three months of operation, CAFSL remitted over US\$4 million on behalf of well over twenty clients.

But this service suffered some limitations. First, it is available only to international organizations engaged in development activities in Afghanistan. Second, the funds can be made available only to DAB counters in Kabul. CAFSL could not arrange the transfer of funds to other areas of Afghanistan. Third, the funds had to be withdrawn in full as soon as possible after the client's local representative has been advised that the funds are available. It was not possible to withdraw the funds in installments — unless, of course, the client has an account at the central bank, or requests CAFSL to hold the funds in London and make the funds available as required.

Consequently, the central bank continued to strengthen its payment system capability. By September 2003, it had reconnected 35 of its main provincial branches to DAB's head office in Kabul. These branches had been connected by laptops with Immarsat connections, and by end-December 2003 they were expected to be able to report to the center their balances and account movements, with the capacity

to do so on a daily basis. Bank branches in Kabul were already reporting to the head office on a daily basis under the existing communication system. In the near future they were to be connected by a computer network.

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

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

2.4. CONCLUSION

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

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

The central bank still faces ill-funded attempts at improving the international and domestic payment system; and less than adequate steps at building internal human and technological capacity, all of which have significantly stalled the pace of reforms. In a hasty effort to address the immediate payment system related problems in the financial system, the reforms of 2002 and 2003 failed to realize the full reform aspirations envisioned at the beginning of the process. By December 2003 DAB still lagged behind even basic standards of modern central banking. A more comprehensive approach to the central bank reforms is urgently required.

Much remains to be done before DAB develops into a truly competent, efficient, and effective conventional central bank that seeks to reduce urban and rural poverty and to improve economic development through the use of market-oriented financial operations within a well-regulated and stable financial environment throughout the country. More aggressive reforms are required to strengthen the institutional and operational capacity of the Afghanistan Central Bank, and in turn, the banking sector's efficiency and effectiveness in financial intermediation activities, including resource mobilization, resource allocation, and international and domestic payments. To attain these goals, the government of Islamic Republic of Afghanistan needs to strengthen both (1) the legal and regulatory environment in which financial institutions are operating in by building on the recently passed financial sector legislation, with specific prudential regulations, and (2) the operational capacity of the central bank to carry out its

central banking functions relating to macroeconomic and monetary policy, banking supervision, national payment systems.

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

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

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

Monetary Policy

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

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

1. The central bank should have instrument independence. International organizations ought to assist the country in forming a viable and liquid market for bonds and in producing a commercial-type study so that an interest rate becomes a useful signal, when combined with inflation, for monetary policy purposes. The use of an interest rate instrument need not be inconsistent with Islamic practices since a discount rate of some form is used, for example, in Kuwait, Qatar, and Saudi Arabia. In the current environment, borrowing tends to occur on an informal scale at times between the central government and the regions in view of the current political situation. In the short-term—lasting, say, 10 years—consideration should be given to permitting the central bank to discount private sector study. If the experience of the transition economies in central and

eastern Europe is taken as a guide, one would anticipate loans to be short term. If the state of Afghanistan returns to complete stability it will take at least a decade, likely longer, to establish markets for longer term instruments (i.e., five years or more) which could provide an indication of market expectations for future short-term inflation. Considering the existence of a well-functioning internal market for credit in Afghanistan but an essentially nonfunctioning banking system and, again following the example of the transition countries, the central bank should be encouraged to create quasi-banking institutions to permit the intermediation of savings and borrowing with a view to facilitating the growth of a private sector for debt (see also items below). One bank might focus its activities on the export sector, another on the domestic retail deposit market (e.g., through a post office bank), still another on domestic industrial activities. Serious thought should be given to preparing for the eventual weaning of such specialist banks from the central bank. Several models for this transition exist; the Hungarian model is one of the most successful recent example.

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

3. The central bank should intervene in foreign exchange markets only to maintain orderly markets. Any intervention should be publicly announced and explained. An important question in the design of central banking legislation is the exchange rate system and the authority of the central bank in this sphere. Some flexibility is necessary at first; determinations about whether to operate under a crawling peg or an adjustable peg can be made at a later date. The crawling peg, followed by countries such as Hungary, may be a useful model because exchange rate movements signaled the implicit inflation objectives of the central bank and the government. Such measures would provide some externally imposed credibility on domestic monetary policy while retaining some domestic control. Ideally, an exchange rate system will be chosen jointly by the central bank and the executive and openly reviewed on a periodic basis thereafter. If there are persistent failures in achieving a stable inflation rate because of exchange rate policies, then a more rigorous fixed exchange rate (or narrower crawl) might be necessary. Policymakers should know, though, that such regimes tend to fail more often than they succeed and are rarely a permanent means to achieve a stable inflation rate.
4. The central bank's mandate should include maintaining financial market stability in cooperation with an independent supervisory authority as well as via public announcements of any actions the monetary authority deems necessary to advance that objective. Given the shortage of competent personnel, it may be useful, again for at least a decade, to combine the monetary policy and supervisory functions. This is a common approach in most developing and Islamic countries. Eventually, however, experience has shown that financial stability is more likely to be guaranteed if the central banking and supervisory functions are separated.
5. The central bank will be entirely responsible and accountable for the day-to-day implementation of monetary policy free from any government direction unless the government states publicly

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

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

3. STATE COMMERCIAL AND DEVELOPMENT BANKS

3.1 INTRODUCTION

At the end of the Taliban regime, in the beginning of 2002, Afghanistan was left with a banking system that was physically destroyed, technologically outdated, and operationally nonfunctional. The six state-owned commercial banks remain in frail and dilapidated buildings. They lack the basic infrastructure to sustain business of any sort and are in bad and often insolvent financial condition. Loan portfolios are virtually unrecoverable, and the only source of income for many of the banks is foreign currency accounts held outside of the country.

Many of the banks still employ many personnel hired before the hostilities began in the mujahedin (anti-Soviet) era. Such employees generally lack the skills and training required to run modern financial institutions. Management relies heavily on the central bank for basic operating instructions and guidance, a reflex that has hindered the banks' ability to evolve into commercially viable financial institutions. Incidentally, this practice predates the decades of hostilities and civil collapse and must be changed if the banks are to function properly.

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

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

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

3.2 HISTORICAL BACKGROUND

Afghanistan has a private sector banking tradition (see Table 3.1) going back to 1933, when the country's first commercial bank (Bank Millie Afghan [BMA]) was established. A second commercial bank was founded in 1955 (Pashtany Terjaraty). Initially capitalized with Af9.6 million (old afghanis), BMA was a mixed-ownership financial institution—72 percent of its shares were held by private shareholders and the rest by government. Pashtany Terjaraty Bank (PTB) was established as a joint venture between the government of Afghanistan and private Afghan investors, with initial paid-up capital of Af120 million (old afghanis). A portion (58.3 percent) of this shareholding was held by the government through various state-owned organizations, namely the central bank (Da Afghanistan Bank—DAB), the Ministry of Finance, and the Ministry of Commerce. Another portion (33.3 percent) of the shareholding was held by more than 1,000 private shareholders with the Agricultural Bank. An employee provident fund under Ministry of Finance administration held the remaining 8.4 percent. Interestingly, even the Industrial Development Bank was initially established as a private institutibn. Sixty percent (or Af144 million) of the bank's shares were held by 203 domestic shareholders, and 40 percent by six foreign investors.¹⁵

Table 3.1 The State Banks as of March 20,2002

General Info	Bank Millie	Pashtany Terjaraty	Agricultural Bank	Export Promotion	Mortgage and Construction	Industrial Development
Established	1933	1955	1954	1975	1948	1973
Branches	28	17	15	2	2	0
Domestic (Foreign)	23 (5)	14 (3)	15 (0)	2 (0)	2 (0)	0 (0)
Employees	800	564	219	178	75	40

It is only in the 1970s that the state, under the Daoud government, took an ownership interest in both financial institutions. PTB was nationalized by the Daoud government in 1974. All the shares of the original shareholders were purchased by the Ministry of Finance, at a discount of 30 percent to face value. Government organizations, mainly the Ministry of Finance and DAB, assumed ownership of PTB's equity. The nationalization of PTB does not, however, appear to have resulted in any major change in its operations. Controls and procedures were not diluted, and normal business activity continued. Before 1974, private individuals and companies owned at least 49 percent of the Mortgage and Construction Bank. Their names and identities are not known as most of the bank's records were destroyed during the civil war between 1992 and 1996. After nationalization in 1974, the shareholding was divided between DAB (40 percent), the Afghan Chamber of Commerce (30 percent), Ministry of Finance (20 percent), and BMA (10 percent) (Table 3.2).

Table 3.2 Bank Ownership Structure (in percentages)

General Info	Bank Millie	Pashtany Terjaraty	Agricultural Bank	Export Promotion	Mortgage and Construction	Industrial Development
Ministry of Finance		44.6	69.67	80	20	100
Da Afghanistan Bank		49.7	30.03		40	
Bank Millie			0.30		10	
Chamber of Commerce				10	30	
Associate of Carpet and Dry Food Traders				10		

¹⁵ Chase Manhattan Bank, First National City Bank of New York (predecessor of Citicorp), the International Finance Corporation of the World Bank Group, National Westminster Bank of London, Ltd., Industrial Bank of Japan, Ltd., and Crédit Lyonnais of France.

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

Bank Millie Afghan

BMA is the oldest and largest commercial bank in Afghanistan, having its roots originally in the Afghan Millie Company. By decree of the prime minister and the Council of Ministers, BMA was legally established in 1933 by Abdul Majid Zabouli, a prominent Afghan businessman, to provide credit facilities for the export and import activities of traders in Afghanistan. BMA preceded the founding and establishment in 1939 of Da Afghanistan Bank (DAB), and it is believed to have undertaken some core central banking activities from 1933 to 1939.

Between 1933 and 1976, BMA pursued a fairly aggressive domestic and international intermediation and expansion program. In 1933, the first foreign branch opened in Berlin, Germany, followed by one in Peshawar and Chaman in Pakistan. In 1934, BMA opened its London branch, followed by the Panama City branch in 1940. The first six branches of BMA in Afghanistan included Herat, Kandahar, Andkhol, Mazar-e-Sharif, Gazni, and Agcha. Adverse political, economic, and environmental conditions, particularly during the 1970s through the mid-1990s, brought an end to this earlier success. Currently, BMA has only five foreign branches (a Hamburg, Germany, branch having recently been closed), 10 branches in Kabul, and 13 provincial branches.

In 1976, BMA was nationalized as a state bank by the Daoud government, bringing private ownership to an end. The bank went through tumultuous times during the Soviet, *mujahedin*, and Taliban periods. Today, it is weak, lacking in liquidity, and basically unable to lend. Like all the banks in the financial system, BMA lost public confidence, and the Afghani people reverted to the informal banking system, namely *hawala*, for money transfers and exchange, and to a lesser extent, deposit placement and loans. Bank Millie Afghan is now fully owned by DAB and effectively operates as a subsidiary—with no policy, operational, or management autonomy. Although its legal status as a state-owned bank is not quite clear, BMA is licensed under the 1994 Banking Act of Afghanistan. New legislation adopted in mid-2003 provides a framework for the bank's resolution.

Pashtany Terjaraty Bank

PTB was set up in 1955 to meet the growing trade-financing needs of a thriving business community, especially importers and exporters. In particular, the government was keen to generate foreign exchange by supporting the export of cotton and dried fruits from Afghanistan to China and the Soviet Union. PTB was set up to focus on this. In its early years as a trade-focused bank, PTB performed well, benefiting from its close relationships with the merchants of Afghanistan. The bank had several thousands of customers, offered savings, current and time deposit accounts in local and foreign currencies, made and received domestic and international funds transfers, issued letters of credit, handled trade collection documents, provided freight forwarding services, extended loans to the trading community, and paid

bonuses to staff. Its trading client base expanded to cover exporters of carpets and karakul skin to Europe, dried fruits and medicinal herbs to India, and the import of Soviet equipment and machinery into Afghanistan.

The bank experienced two periods of financial deterioration. The first began in 1979 during the Communist regime. Large businesses and properties were taken over by the state, imports/exports by private traders were replaced by intergovernment trade (mainly barter trade with other communist countries), and trade relations with the western world diminished. Afghan traders lost interest and confidence in the economy, triggering out-migration, which led to a contraction of PTB's volume of business. The second period started in 1992 when the *mujahedin* forces took control of the country. Government assets were plundered by troops, and the government restricted PTB's business with the trading community. Political appointees with little knowledge of banking were given control of financial institutions. PTB began to encounter problems with liquidity, and could not always honor its commitments, including encashment sought by depositors. Virtually every check payment had to be authorized by the bank president, who in turn needed to seek the approval of government "intelligence" officers. Needless to say, those with greater political influence were given priority.

Taliban rule accelerated the bank's demise, along with that of Afghanistan's other banks. Mullahs were appointed to key executive positions, and the bank was not permitted to pay or charge interest. Attempts were also made to plunder the bank's assets by arbitrarily instructing bank officials to withdraw foreign currency deposits placed with banks overseas. (This was thwarted by the freezing of PTB's deposits by the international community.) Deposit mobilization stopped due to the lack of confidence in the banking system, and PTB discontinued lending due to the lack of business transactions and credit worthy borrowers. Loan portfolios saw major defaults on account of the political turmoil, the flight of traders overseas, and PTB's inability and incapacity to recover debt. PTB, along with the other commercial banks, came to a virtual halt in performing banking operations.

The Agricultural and Development Bank

AgBank was established by the government in 1954 as the Agricultural and Handicraft Bank, with a mandate to serve small farmers and handicraft producers. The bank originally operated on a very small scale, and was neither active nor successful. In 1968 it was reorganized and renamed pursuant to an agreement between the government, the UNDP, and the World Bank. It included (i) refocusing its business on financing the agricultural supply chain, from production through processing and export; (ii) an IDA credit facility for re-lending; (iii) appointment of a German general director; and (iv) related technical assistance, including several on-site advisors.

According to AgBank management, the period from 1968 to 1979 was one of high growth and successful operations. Short-term (up to one year) loans were made to individual and cooperative producers for seed, fertilizer, fuel, repairs, and other agriculture-related services (e.g., other inputs, storage, maintenance, distribution) and for operating expenses. Borrowers were diverse: farmers, horticulturalists, poultry farmers, and livestock (mainly sheep) producers. Medium-term loans of up to five years were made to the same client base for the purchase of tractors, pumps, harvesting and irrigation equipment, and other capital purposes. Long-term loans for more than five years were made to processors for plant and equipment. Letters of Credit and related trade financing were provided to processors and traders. AgBank operated as more than a bank. It also served as an equipment dealer, importing tractors, pumps and other production and irrigation machinery from the Soviet Union and, to a lesser extent, India, Iran, Japan and Italy. Stocks of equipment and spare parts were maintained in warehouses in Kabul and at outlying branches, and sold with related supplier credit. The Bank also handled the current accounts and savings

deposits from these client bases. The International Development Agency provided additional loan funds; Tractor Export USSR supplied funds via supplier credit in connection with equipment purchases), and DAB did the same via support from Japanese and other donors.

After the 1979 Soviet invasion, the German general director and other technical advisors departed the bank and business volumes declined. For the next 10 years, AgBank continued to import and sell Soviet-made equipment and to provide some fertilizer and operating expense financing, under the effective control of DAB and its Soviet advisors. After the Soviet departure in 1989, with the exception of two brief periods of directed loan activity, the bank was basically shut down. No imports were received. Stocks of equipment and parts in the branches were looted, and only a small inventory of very old parts remains in a Kabul warehouse today. Currently, there is little ongoing loan or deposit activity. Management reported that total deposit inflows in 2002 were about US\$4,300 (new Af200,000) in the branches and US\$2,200 (NAf100,000) in the head office, a total of about US\$6,500 (NAf300,000). There were no inflows before or during the Taliban era, apart from when DAB loaned AgBank approximately \$56,000 (old Af2.6 billion) for one-time re-lending to producers, just before the Taliban took power. More recently, in the summer of 2002, Herat governor Ismail Khan gave the bank about US\$650,000 (NADO million) for re-lending to local farmers, which is in the process of being disbursed.

Export Promotion Bank

EPB was established in 1975 by the government to specialize in financing Afghanistan's foreign trade. Despite its name, there has been no special emphasis on exports. In fact, import letter of credit financing was actually the highest volume activity. Management explained that the bank operated actively until 1992. Because its operations were mostly in three major cities (Kabul, Herat, and Mazar), they were able to operate throughout the Soviet occupation. After 1992, operations were disrupted by civil strife and then effectively suspended under the Taliban regime until late 2001.

Prior to 1992, EPB offered two kinds of credit. It opened import letters of credit, which were funded from their foreign correspondent accounts. Typically import clients paid a 40 percent cash deposit at the time the LIC was opened, and the balance against release of documents when the goods arrived. The EPB also made pre-export loans to producers and traders, which were repaid from sales proceeds which were paid through the Bank under letters of credit issued by foreign correspondents. It had demand and savings accounts from this customer base as well as from the general public, although no loans other than these specialized trade facilities were offered.

Since 2002 some banking activity has resumed. Savings accounts from individuals have increased from about US\$61,000 (NAf2.8 million) to about US\$78,000 (NAf3.6 million). The bank also made two loans to exporters in 2002. There have been no foreign transactions, and no activity of consequence through EPB's foreign accounts since 1992. Other than receiving statements from time to time, the bank apparently makes no effort to manage these accounts.

The Mortgage and Construction Bank

Established in 1948 to finance residential and commercial construction in Afghanistan, the MCB underwent operational change after nationalization. It continued to provide loans for the construction of private homes, providing commercial property loans to traders. Loans were also made available for the purchase of land and construction materials. The only other product MCB offered was savings accounts. Customers who had savings accounts with MCB were given priority in the processing of mortgage loan applications.

MCB's performance began to decline in response to political and civil strife seen during the Taliban period, which also affected the other financial institutions in Afghanistan. The situation significantly worsened after 1992, particularly as MCB was more vulnerable because of its location near the western entrance to in western Kabul, where intense fighting took place. In 1995 most of the bank burned down during the fighting and most of its records were destroyed; MCB's management was able to rescue only the loan files.

Although the bank was partially rebuilt, it now scarcely resembles a bank. Its head office is housed on the first floor of a rundown building, the ground floor of which is a DAB branch. Today, MCB is largely inoperative. Operationally, its last loan was made seven years ago. Since then, its principal activity has been recovering interest totaling US\$11,000 that accrued but was not paid by customers during the Taliban period. This applies to an estimated 300 loans and rent (US\$29,000 annually) on mortgaged properties repossessed by the bank. Its assets are valued at less than US\$100,000.

The Industrial Development Bank of Afghanistan

IDBA was incorporated in 1973 as a fully private financial institution under a government charter, with initial paid-up capital of Af40 million. It was established primarily to provide financial assistance to the country's industrial sector. In 1977 the Daoud government nationalized the bank, fully compensating all private shareholders.¹⁶ Its legal status, although unclear, is said to be based in an industrial development law specifically promulgated to establish the bank. Today, shareholders include Da Afghanistan Bank, the Ministry of Finance, Pashtany Terjaraty Bank, Bank Millie Afghan, and the Afghanistan Chamber of Commerce. Like all banks in Afghanistan, IDBA was devastated by the turmoil of the past two decades and is now a defunct and bankrupt financial institution. It has only 40 employees—10 percent of its original banking staff. The bank never recovered after the fall of the Taliban, while its two sole branches, in Mazar-e-Sharif and in Kabul, had to be closed. IDBA has since 1996 ceased all banking and financial intermediation.

¹⁶ It is understood that all shareholders were fully paid at book, although upon inquiry, there was no accounting evidence that the shares were repurchased by Government.

3.3 CORPORATE GOVERNANCE AND MANAGEMENT STRUCTURES

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

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

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

3.4 HUMAN RESOURCE CAPACITY

Given the levels of activity (or rather, inactivity) in the state commercial and development banks, all the banks are highly overstaffed, and underutilized. In 2002 the number of staff at BMA (including those in local and foreign branches) was 800, 25 percent of whom are female (of whom two are in management positions). Pashtany Terjaraty Bank has a total of 564 staff, 31 of whom are managerial personnel. Seventeen managers are at the head office, eight are at the Kabul branches, and an additional six are at the provincial branches. Of the total employees, 191 have completed high school (12 years of schooling), 47 have completed "Grade 14," 59 have completed "Faculty of Economics" (similar to a bachelor's degree), four have a master's degree, and as many as 263 have had no education at all. From a peak of approximately 1,500 employees, AgBank now employs a total of 219 people. Of these, 155 are staffed in the head office, and 64 work at the 15 branches still open. It is important to note that the bank has not hired anyone new since 1979, so the average age of the staff is approximately 50 years old. EPB employs 178 people, 150 at head office, eight in another branch in Kabul, and 20 in its remaining outlying branch in Mazar. Of these, 48 are female. MCB has a total of 75 staff, of whom 22 are women and 12 are managerial personnel. Fifteen employees have college degrees in economics or engineering.

There is an obvious lack of qualified and experienced bank personnel at all levels of banking operations, including the managing board and department heads. There is little understanding of the components of profit and loss, cash/funds flows, financial intermediation, branch management and operations, computer and automation technology, accounting, loan administration, and risk assessment and management. Although most of the staff have long tenures in the banks, this has not translated into genuine banking experience owing to more than two decades of economic and banking inactivity owing to war and internal strife. Hardly a single employee has been exposed to modern organizational systems, technologies, or accounting systems. Very little English is spoken or understood (essential for many new technologies and related training), even at the highest levels in the bank. In part, the absence of qualified staff can be traced to the Taliban regime's decision to remove top management who had been educated in the Soviet Union, were members of pro-Soviet political parties, or women.

Recognizing the need to upgrade staff skills, some banks introduced training programs after the fall of the Taliban regime. BMA has introduced an English-training program, with 52 staff participating and 16 already having completed the first course. Computer training began in August 2002, with 24 currently enrolled at BMA, while another 30 are taking the computer training program at the Ministry of Labor and Social Affairs. Pashtany Terjaraty has arranged for 20 staff members to receive English language and information technology (IT) training through courses conducted at the DAB's Banking Institute and at the Ministry of Planning, the Ministry of Foreign Affairs, and the Ministry of Labor. A further 15 staff are currently being similarly trained, and a large number of other staff are also waiting for these opportunities. Twelve staff members from the AgBank were receiving English training at the DAB in mid-2003.

3.5 COMPUTING TECHNOLOGY

One of the key operational constraints for the banks is the low level of computer technology. As of 2002 there were few personal computers in the banks. Where present, they were old, slow, and had little storage capacity. They were used primarily as word processors in the chief executive's office. There was the occasional fax machine, although these too were only as reliable as Afghanistan's telecommunication lines. All transactions were therefore processed and recorded by hand. Customers have passbooks; individual customer ledger cards are maintained manually.

The lack of modern equipment, automation, and computerization technology also affected the banks' accounting, bookkeeping operations, and management information systems. The banks employed very elementary accounting methods, did not code their accounts, and did not accrue income and expenses. They generally use outdated accounting systems that were not in accordance with international accounting standards. As an example, PTB did not classify loans according to prudent loan classification standards and principles. The bank's outstanding loan portfolio is almost totally nonperforming, even under Afghanistan's earlier accounting practices, which allow banks to consider unpaid loans up to 12 months as current. Yet most of these loans are retained on the balance sheet at face value instead of being fully provisioned according to international standards.

Box 3.1: Examples of the Operational Challenges at PTB Branches

The organization of processes and workflows are archaic and sometimes illogical. To complete a cash withdrawal/deposit transaction, a customer needs to visit two to three counters, first to fill out forms and then to physically deposit/withdraw cash. PTB claims, however, that the average transaction time is less than 10 minutes. To make payment of a bill under an L/C, a customer has to first go to the IC Department, which issues a credit advice, then to the cash counter, which issues another receipt. A copy of the receipt then is sent to the Accounts Department, which makes entries in a ledger, which is then signed by all concerned department heads. Again in the L/C department, all L/C copies, documents, etc. are maintained here, but customer ledgers are kept in the Accounts Department. This department was also holding on to some 300 files containing documents of title to goods shipped more than six years ago.

At the AgBank, which lacks basic electronic equipment, management communicates with its Herat and Mazar branches by cell phone, but otherwise it relies on the post and telegrams. All bank records are handwritten and stored in book ledgers. Instead of cell phones, the management at the Export Promotion Bank relies on DAB facilities to communicate periodically with foreign correspondents and to update time deposits and income data. All records there too are maintained manually on book ledgers.

3.6 ACCOUNTING SYSTEMS

The banks' financial systems and accounting records constitute perhaps the most desperate aspect of all the financial institutions. Weaknesses in their financial and management accounting systems made it nearly impossible for management and staff to perform any meaningful financial analysis and disclosure. Given the weak corporate governance structures, the banks' weak financial and management accounting systems resulted in their failure to (i) comply with the existing financial, operational, and management regulatory requirements (poorly designed as they were); (ii) assess creditworthiness and manage risk; (iii) observe appropriate loan accounting policies, practices, and reporting consistent with sound credit and risk analysis, and asset and liability management; (iv) ensure that minimum capital requirements, capital adequacy, required liquidity, credit concentration, and foreign currency exposure levels are properly accounted for and measured; and (v) provide for the timely recognition of identified losses and credit risks.

Making sense of the available financial systems was a tortuous effort: none of the banks had recent financial statements. The PTB's latest available audited accounts were for the year ending March 20, 1998. The AgBank had not produced an audited financial statement since 1994. Further, the accounting systems/procedures in all the banks were underdeveloped, as staff members did not follow or even understand basic standards, such as accrual accounting and provisioning. The financials provided by management were difficult to understand and were inconsistent with international accounting standards (IAS). Sometimes, the banks maintained two balance sheets, one with afghani-denominated assets and liabilities, and another with foreign currency assets and liabilities, both with various reserves and capital accounts, neither of which reconciled with the other.

Beyond the lack of the most basic technology, let alone a basic management information systems, management cited a number of obvious reasons why accurate accounting and performance monitoring have been impossible in recent years. One of the most significant factors affecting the quality of the banks' financial information was that many accountants had left their positions, a brain drain that contributed to the banks' poor performance and their inability to hire more qualified personnel. The destruction attending two decades of civil strife also destroyed many of the banks' records, which some of the banks were unable to reconstruct. The AgBank, for example, made 135,000 "fertilizer loans," the accounting for which was automated at the government's Central Statistical Organization. But that group was shut down 15 years ago; manual copies of the loan records were updated only sporadically.

3.7 FINANCIAL CONDITION

A January 2003 World Bank diagnostic review of the financial condition of the banks concluded that all the banks were in dire financial condition. Using incomplete financial data, the World Bank reconstructed the balance sheets and income statements of all the banks for a preliminary assessment of their financial condition.

Bank Millie Afghan

At the January 2003 USD-afghani exchange rates, the bank appeared to have total assets of around US\$81.2 million. BMA had around US\$60 million in foreign bank deposits, owned considerable foreign assets in its foreign branch holdings¹⁷ and had foreign investments of some Af730.7 billion equivalent (US\$162.4 million), of which 60.6 percent are in USD, 39.1 percent in GBP, and .30 percent in Euros. All foreign assets were unfrozen by the international community in early 2002, permitting full access by Bank Millie Afghan. In addition, BMA owned shareholding in four of the banks in Afghanistan, 3.31 percent in PTB, 13.57 percent in the IDBA, .43 percent in the AgBank, and 6.40 percent in MCB. Similarly, it held considerable investments in textiles, insurance, oil, carpets, and the national airlines, Ariana, and so forth, amounting to about Af 1.3 billion (book value)—although only three of 21 companies in which it has investments are operating today at 50 percent capacity.¹⁸

Domestic loans were a relatively small component of BMA's total assets, while the entire loan portfolio was considered nonperforming¹⁹ because of political and economic conditions over the previous decade. Although some level of provisioning was practiced, albeit insignificant, the bank did not classify nonperforming loans by term delinquency in order to apply appropriate risk-based loan loss provisions. As a general practice, a 1 percent penalty is applied to the loan's original interest rate on all loans delinquent after one year. As loan servicing was extremely weak in BMA, collections in 2000 (the latest profit and loss) amounted to a paltry less than 1 percent of total interest income, the rest of which were fees for banking services such as money transfers, goods forwarding, and rental income. Aggressive collections are not pursued, as a practice, although BMA claims to have a policy of collateral seizure upon the default of a loan.

¹⁷ These include branches in New York, Hamburg (closed), London, Karachi, Peshawar, and Chaman. It was earlier thought the BMA owned the 5-storey building which housed its branch in Manhattan, New York. However, no records exist indicating BMA's ownership of the building (although this is still being researched). While New York is a branch, no rent is being paid for the branch facilities as the bank claims part ownership in the building. In the bank's balance sheet, the New York branch office is not reflected.

¹⁸ A table of BMA local and foreign investments will accompany the BTO.

¹⁹ By IAS standards, BMA's entire loan portfolio would be classified as LOSS, with 100 percent loan loss provisions applied. Overdue, on the average, is about 10–12 years.

Pashtany Terjaraty Bank

The reconstructed balance sheet for the period ended 20 January 2003, and a profit and loss for up to 10 months of the current financial year, suggested an income of Af5.8 million (US\$120,043) and total expenses of Af2.8 million (US\$66,536). The main sources of revenue appeared to be interest income on its deposits with other banks of Af2.1m (US\$45,000) and rental income Af3.2m (US\$69,543). Expenses were essentially salaries and office expenses. Both income and expenses were accounted for on a cash basis. PTB's balance sheet primarily comprises foreign currency (FCY) (mainly USD) assets and liabilities. FCY deposits with foreign banks are the largest single component at US\$34 million with FCY-denominated customer liabilities being significantly lower at US\$16.8 million. The single biggest source of funding and the largest liability item was foreign exchange gains of around US\$61 million essentially on PTB's FCY assets. FCY customer deposits comprised a further US\$14.5m (mainly unclaimed deposits/excess payments made by customers in respect of L/Cs issued). USD customer-related assets (around US\$38 million) are essentially nonperforming, with all loans being overdue for over one year. No provisions have been made for these nonperforming assets in line with generally accepted accounting practices. This notwithstanding that it did appear on its face that PTB was solvent and profitable (even excluding foreign exchange gains on FCY nonperforming assets). Unfortunately, however, this financial position was largely on account of foreign currency assets (deposits) and foreign exchange gains rather than due to recurring profits from commercial banking activities.

The Agricultural and Development Bank

Based on the reconstructed financial statements:²⁰ the AgBank had nominal liquidity and virtually no income from operations. The only real financial value for the bank seemed to be in its offshore accounts, totaling US\$2.4 million, along with some real estate assets the bank is currently holding onto in Afghanistan. Simple analysis of the profit and loss statement indicated that the bank had virtually no interest income from its loan operations primarily because most of the bank's 147,000 loans were more than 15 years old. Given the decades of conflict Afghanistan has endured, it was virtually impossible for AgBank to locate all the borrowers of these loans. Management believed, however, many of these loans could still be recovered. The bank therefore carried these loans on its balance sheet. From an accounting point of view, these loans should have been fully reserved. Operationally, it was not economically prudent to invest much in their collection.

The bank's reconstructed balance sheet suggested foreign currency deposits in excess of US\$2.4 million. (It has no other foreign currency-denominated assets or liabilities.) Cash receipts during the 12 months ending March 20, 2003, were estimated at US\$140,000 (or 6.5 million in new afghanis—NAfs). Salary and other cash expenses in this period were projected to be about US\$98,000 (NAf4.5 million). The bank was not repatriating interest income on foreign deposits (about US\$42,000, or NAf1.9 million), which is available if necessary. Earnings from the Herat loan program are expected to be recognized in calendar 2003 (FY 2003–04). Rental income included only amounts actually received on leases signed during the year. The full annual amount of current rents was expected to be received in 2003.

The Export Promotion Bank

The EPB appeared to have substantial liquidity in the form of cash and due from banks. With individual foreign asset and liability items estimated at US\$12.3 million and US\$8.8 million respectively, there are

²⁰ The reconstructed Profit and Loss statement was based on a "sources and uses" cash flow statement. The income statement does not contain any non-cash items such as depreciation and amortization, since these items are meaningless in view of the obsolete valuations.

about US\$3.5 million of net foreign assets and probably more that will accrue over time. In addition, DAB and other local commercial banks have more than NAF38 million, about US\$3 million, in current accounts. Many of DAB's deposit liabilities were very old, thus the likelihood of customers making claims was small. In the past 15 months some banking activity had resumed. Savings accounts from individuals have increased from NAF 2.8 million to 3.6 million. There are a total 12,000 savings account holders, and the interest rate is 13 percent, as specified by DAB. There still are 6,300 current accounts on the books totaling NAF16.8 million. Perhaps 200 of these are "active" according to management, meaning a transaction every week or so.

In mid-2002 EPB made two loans, their first since 1992, to exporters, one of fruit the other of leather. Each was in the amount of NAF4 million (about US\$85,000) for six months at 20 percent interest, secured by real property. Besides these two loans, the bank still had claims on borrowers of more US\$15 million. The bank's management claimed that some large part of their loan portfolio was still collectable. The reasons to doubt this were obvious. The claims are more than ten years old and it is hard to believe many borrowers are around and can pay. The security would have been imported items, either long consumed or sold or depreciated in value. The bank has been defunct and borrowers have had no incentive to pay.

Mortgage and Construction Bank

The MCB's profit and loss statements reflected gross income of NAF1.1 million (US\$24,000) and total expenses of NAF1.7 million (US\$37,000). The only source of revenue on a cash basis was from rentals on mortgaged property repossessed by the bank. PTB's major expenses were salaries and food for staff. MCB's funded its ongoing operational losses by drawing down its cash balances with other domestic banks. It had no foreign currency assets and liabilities, while its main assets were properties in Kabul valued (historically) at NAF1.5 million (US\$33,000), and cash balances with other domestic banks totaling NAF1.4 million (US\$31,000). Customer-related assets were only NAF500,000 (US\$11,000), comprising unpaid interest on some 300 loans. Although overdue, no provisions had been made for these past-due loans. MCB's main sources of funding were its capital of NAF2.0 million (US\$43,000), and borrowings of NAF1.5 million (US\$33,000) from DAB.

Effectively, MCB was inoperative and engaged only in the recovery of outstanding interest totaling US\$11,000 and in collecting rent of US\$29,000 per annum on properties repossessed by the bank, which made for losses owing to overhead. Staff strength is small, at 75, and skill levels (especially mortgage lending) are low. This weakness is further exacerbated by the absence of technology and automation. Bank premises are in a poor state. MCB was certainly not a going or growing concern and a early candidate for liquidation, or merger with another bank.

The Industrial Development Bank

Based on the bank's reconstructed financial statements, the IDBA is insolvent, deeply illiquid, and bankrupt. In January 2003 its total assets were estimated at US\$54,000; its entire loan portfolio of approximately US\$14,400 was nonperforming. Before 1996, when the last loan was made, IDBA financed a variety of industrial activities—medical, textile, carpet, and other development projects—at interest rates determined by DAB. Although collections on past due loans were said to have resumed, they were insignificant relative to the size of potential collections from nonperforming assets. In 2001 and 2002, about US\$27,000 equivalent were collected from 14 and 37 defaulted clients, respectively. Although the bank had a policy of provisioning against potential losses, most of the classified loans were

not appropriately provisioned according to their risk weights. Though penalties on loan delinquencies were applied on the original loan rates, they were rarely, if ever, marked for collection.

IDBA's sources of funds primarily were from DAB and IDA²¹ borrowings, surplus if any, funds from the Union of Farmers Cooperatives, and to a much lesser extent from project appraisal fees. It has neither any foreign assets and, except for the IDA credit, no foreign liabilities. In 1974 and 1994, however, IDBA received two loans from DAB for financing business loans, as well as to cover administrative and overhead expenses. With virtually no collections from loan servicing of nonperforming assets, it is assumed that DAB is covering most of the administrative and overhead costs. The bank's fixed asset base included the land and building of its headquarters, transport and office equipment, furniture, and fixtures at cost net of depreciation and estimated at less than US\$15,000.

3.8 COMMERCIAL BANKING REFORMS, 2002–2003

In January–February 2003, the World Bank undertook a diagnostic review of the state commercial and development banks. This review led to an assessment of the banks' financial condition and reform options. The immediate recapitalization of all state banks was the first option, which the World Bank rejected in view of the commercial banks' poor state, the government's limited financial resources, and the risks associated with resuscitating state banks. Instead, it decided to focus on a narrower reform agenda. Initial steps in that agenda will focus on a few core areas in the central bank, while addressing the major difficulties at the two larger state commercial banks

The second option was to seek the liquidation of all state banks and to concentrate on inviting new banks into the country. Apart from its political insensitivity, this option ignored the risk that the potential for new foreign entrants into Afghanistan's banking environment remained low until the investment climate improved. In any case, the entry of such banks was unlikely to open retail/consumer bank operations with much-needed rural branch networks, meaning that the vast majority of Afghans would gain little access to basic intermediation services for quite some time—unless and until other banks with a greater retail focus opened for business.

The third option was to wait for the enactment of the new banking legislation and then seek the relicensing of all commercial banks. The thinking was that new licensee requirements would separate good banks from bad banks. The outcome of such a process was foreordained—none of the banks would meet the new licensing requirements. Effectively, it was no different from the second option and would only serve to delay the reform process.

A fourth option was to establish an Asset Management Company to dispose of problem assets and institutions. Anticipated complexity and the costs of such a restructuring effort led the Bank to reject this option too.

A fifth option was to establish one or two new state commercial banks, composed of the good assets of the six banks. The Bank chose this option for reasons of cost effectiveness, operational efficiency, and the likelihood that at least one good consumer bank would emerge from the restructuring.

²¹ The IDA credit of US\$2.0 million has been fully disbursed and loaned out. No recoveries have been effected against the IDA sub-loans, which today, are all non-performing. These loans were lent at 10 percent as determined by DAB, and penalized with an additional 4 percent for non-performance. Collections have resumed but collections are insignificant, about 1 percent of total potential collections, as the bank has virtually no capacity for aggressive loan servicing.

Working closely with the Ministry of Finance, Da Afghanistan Bank, and bilateral and multilateral agencies, the World Bank identified two strategic issues: (1) the number of state banks to rehabilitate in order to provide basic financial services throughout the country, and (2) what to do with the excess staff. After much debate with the central bank and its reform partners—the IMF and USAID—the World Bank presented the following:

The first strategic issue was the most challenging—namely, how many state banks to rehabilitate? Once that decision was made, DAB would have to decide how to manage the rehabilitation process, with one restructuring team or two? The World Bank prepared a plan based on the five following goals: (i) restructure only those banks with reasonable prospects for commercial viability and privatization within a three- to five-year window; (ii) build capacity at the banks thus identified (and targeted for eventual privatization) so that they cater to the Afghans' retail banking needs, including households and small businesses; (iii) ensure that technical assistance, mentoring, and training complies with soon-to-be-implemented laws and regulations; (iv) contribute to the ongoing modernization of the payment system; and (v) support the banks' broader efforts to promote economic development and reinforce the civil authority's national development objectives.

The second strategic issue was equally challenging but could be delayed. A key reform objective was to improve the banks' operational capacity and efficiency; like a number of public sector enterprises, commercial and development banks both suffered from a vastly overstuffed bureaucracy. Improvements in the banks' human resource base were seen as key. This required training and some bureaucratic streamlining. But it also involved large-scale staff reductions—a politically and socially difficult reform for Afghanistan at the moment.

In its initial proposal, the World Bank recommended the issuance of a single management contract to rehabilitate one state commercial bank, and encouraged the liquidation of all insolvent state development banks. This recommendation was based on the World Bank's technical experience in rehabilitating state banks. The central bank rejected this proposal, however, signaling its preference for a two-bank rehabilitation. The World Bank proposal was therefore revised. Instead of one state bank, and even the merger of the two largest commercial banks into a single reconstituted entity, the Bank has elected to consider the rehabilitation of two banks. (See Annex 3.1 for a summary of the options presented to the central bank.)

Decisions were also expected on how best to rationalize the human resource pool in the banking sector and DAB without causing major dislocations for redeployed individuals or for government fiscal capacity. The restructuring team(s), once appointed, would need clear policy guidance and government commitment in determining the appropriate human resource needs and skills mix for the restructured bank(s).

A much-reduced complement of staff was considered essential if the rehabilitated bank(s) were to achieve operational efficiency and effectiveness, profitability, and sound foundations for timely privatization. Annex 3.2 summarizes the options presented to the central bank. Given the political sensitivities involved in staff layoffs—and the fact that elections were to be held mid-2004, the team recognized that although layoffs were best delayed until after the elections, layoffs were nevertheless inevitable, and required agreement sooner rather than later.

Ultimately, the government decided against the World Bank–proposed reforms, citing concerns that the costs of the management teams exceeded the value of the assets of the banks to be rehabilitated. Instead of appointing dedicated management teams to rehabilitate the selected banks at an estimated cost of

US\$8m each, the central bank decided to implement the rehabilitation of selected banks using its own staff and team of advisors. As of December 2003 the central bank had conducted fresh inspections of all the major banks and prepared revised financial statements for five banks.”

DAB’s assessments of the banks’ financial condition produced a more favorable picture than that provided by the World Bank’s January 2003 diagnostic review. Each bank had positive capital (Bank Millie, US\$61m; Bank Pashtany Terjaraty, US\$18m; Agricultural Bank, US\$127m; Export Promotion Bank, US\$4m; Mortgage and Construction Bank, US\$0.037m), and with the exception of Pashtany Terjaraty Bank and the Mortgage and Construction Bank, had positive net liquid assets (Bank Millie, US\$42m; Pashtany Terjaraty, US\$11m; Agricultural Bank, US\$1m; Export Promotion Bank, US\$3m; Mortgage and Construction Bank, US\$0.016m).

3.9 THE RELICENSING OF STATE COMMERCIAL AND DEVELOPMENT BANKS

Following the September 2003 enactment of the new commercial banking law, the central bank now has to decide which banks will be allowed to submit applications for relicensing, stipulated in the Act.²³ All banks that operated with a license granted by Da Afghanistan Bank prior to implementation of the new banking law are required to apply for a new license no later than six months after implementation of the law (i.e., by March 15, 2004). The Presidential Decree for a Banking Law (Banking Law) requires DAB to render decisions on these applications no later than three months after submission — June 15, 2004.

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

Formulation of these restructuring plans should be the task of the management or board of supervisors of these banks (from which employees of DAB, Ministry of Finance [MOF], or of any other state authority or municipal body are legally excluded).²⁴ Shareholders (including MOF, if a shareholder) should have the opportunity to consider and vote on these restructuring plans prior to their submission for DAB approval. Shareholder assent or dissent could be conveyed by a majority vote at an extraordinary general meeting of shareholders.

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

Should DAB’s decision on an individual bank’s relicensing application be negative, the bank’s operations should be suspended immediately, and a decision by the owners of the bank would then have to be taken

²² No inspection was conducted of the Industrial Development Bank

²³ By implementing the rehabilitation of the commercial banks itself, the central bank has placed itself in a clear position of conflict of interest. Not only will it be submitting the license application on behalf of the commercial bank, it will be responsible for its evaluation.

²⁴ Under the Banking Law, no employee of the DAB, MOF, or any other state or municipal authority may be part of the management, board of directors, or board of supervisors of these or any other commercial bank. The technical assistance in formulating some of these restructuring plans is being provided by DAB consultants, would not appear to be inconsistent with the provisions of the Banking Law, as their role is not a decision making one

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

3.10 CONCLUSION

The state commercial and development banking sector was practically nonoperational at the end of 2001. Political interference in the banks' operations had left them with weak governance and organizational structures. Most of the banks were highly overstaffed, while technological capacity was abysmal. Perhaps most desperate of all, their financial systems and accounting records were in dismal shape.

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

Following the September 2003 enactment of the new commercial banking law, the central bank now has to decide which banks will be allowed to submit applications for relicensing by March 2004; and make a decision on which banks to relicense by September 2004. Though the central bank has committed itself to meeting these targets, much remains to be done. Further, more aggressive reforms are required to strengthen the institutional and operational capacity of the selected banks. They need to become more efficient and effective in their financial intermediation activities, including resource mobilization and allocation, and international and domestic payments. To attain this goal, the central bank needs to implement a more comprehensive and better-funded reform strategy that includes: (1) the introduction of independent management teams in the banks to be rehabilitated; (2) the commencement of Voluntary Retirement Scheme that takes into account the government's fiscal commitments, and the liquidation of the remaining banks.

When implementing the reforms, the government's focus must be on restructuring commercial and development banking functions—agricultural finance, mortgage finance, trade finance, export promotion, and so forth—rather than institutions. These functions are desperately needed for Afghanistan's reconstruction effort. The institutions responsible for providing them, however, are no longer financially or operationally viable. The reforms must ensure that the financial services, and not necessarily the institutions, survive.

Ultimately, the reform objectives must be to develop a competitive, market-oriented, and privately owned banking sector that contributes to urban and rural poverty reduction and economic development through the use of efficient and innovative financial products and services, and increased levels of financial intermediation within a well regulated and stable financial environment. Given their intermediary role in the economy, Afghanistan's banks are in critical need of rehabilitation and reconstruction. Although some of the banks are beyond recovery, others have the potential to return to good financial health provided they pursue sound recovery programs.

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

- First, the banking system in Afghanistan has a history of private-sector ownership. It was not until the mid-1970s, under the Daoud regime, that the banks (and other economic activities) were nationalized. Prior to that, the vast majority of the banking sector had a long, proud history of private ownership and operation. Although the sector's current state is dismal, Afghanistan's memory of efficient private banking is sufficiently recent, and these memories will help both the Afghan authorities and the general public. Moreover, for the many Afghans with experience in neighboring countries, they have witnessed the buoyant commercial banking systems there.
- Second, the government's commitment to reforms, to date, has been impressive. Considerable progress has been achieved. Most notably, a major currency conversion was completed within a three-month time frame. Although implementation difficulties inevitably emerged, contributing to exchange rate pressures, these were quickly resolved. Today, there is a regular weekly auction system whereby DAB sells dollars for afghanis, regular trading continues unabated in the private money market, and the afghani has stabilized for nearly half a year at roughly Naf50 to US\$1. These activities gave Da Afghanistan Bank the opportunity to assess the condition of the financial system and to identify areas urgently in need of reform.
- Third, while the commercial banks have excess staff and a shortage of skilled employees, the total numbers of people who will be encouraged to find other jobs (in the private sector, or elsewhere in the government) are not overwhelming. Total state bank employment levels (including DAB and the commercial banks) are estimated at around 5,000 to 6,000. Meanwhile, with average pay of around US\$50 per month, and very little differentiation in pay between top and bottom grades, voluntary separation packages will not be overly expensive. This minimizes the potential costs of a comprehensive restructuring program for the sector as a whole.

4. MICROFINANCE INSTITUTIONS²⁵

4.1 INTRODUCTION

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

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

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

The sections below detail the state of the microfinance sector at the end of the Taliban regime (Section 4.2), discuss the reforms implemented in 2002–03 (Section 4.3), and conclude with recommendations on MSE sector development in Afghanistan (Section 4.4).

²⁵ This chapter draws on CGAP, "Microfinance Review of the Microfinance Industry in Afghanistan," by Sarah Foster and Doug Pearce, May 2002. The CGAP commissioned study analyzed the sector in May 2002 and recommendations for the development of sustainable microfinance in Afghanistan. It also draws on extensive analytical work prepared by Ursula Jung in 2003.

4.2 THE MICROFINANCE SECTOR AFTER THE FALL OF THE TALIBAN REGIME, 2001

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

Nongovernmental Organizations

In 2002 about 25 NGOs and U.N. agencies had developed small-scale microfinance (mostly microcredit) schemes in Afghanistan over the previous five to seven years, under very challenging circumstances and with limited funding (see Box 4.1). Given the anti-usury laws imposed by the Taliban, NGOs developed financing approaches modeled after Islamic finance practices, which are founded on the core belief that money is not an earning asset in and of itself. Islamic law emphasizes ethical, moral, social, and religious factors to promote equality and fairness for the good of society as a whole. Islamic finance models encourage risk sharing and wealth distribution. The principles of Islamic finance and microfinance have much in common. Both systems advocate entrepreneurship and risk sharing and believe that the poor should take part in such activities.²⁶ Afghanistan has in many ways provided a testing ground to develop Islamic microfinance enterprises.

A brief summary of the main features of NGO programs at the time is provided below (see Annex 4.1 for key facts of selected schemes):²⁷

- **Goals.** All existing NGO microcredit programs were managed as part of more integrated programs typically focused on community development or income generation, with development goals including poverty reduction, livelihood promotion, employment creation, building self-reliance, microenterprise development (see Box 4.2) and agricultural development (see Box 4.3). Most NGOs had linked credit to productive uses, and tended not to provide household, consumption, and emergency credit needs.
- **Target populations** were often specific vulnerable groups, such as:
 - women, with some programs having a focus on war widows
 - refugees, returnees, and internally displaced persons
 - the disabled, primarily victims of armed conflict
 - small farmers
 - landless labor, unemployed, and local poor
- **Products.** Most NGOs focused exclusively on the provision of microcredit to support income-generation activities and microenterprises. A few schemes, however (e.g., Habitat, UNDP/UNOPS Bait-ul-Mal scheme), also integrated savings.

²⁶ See UNDP Technical Note in cooperation with the World Bank, "An Application of Islamic Banking Principles to Microfinance" for a good discussion of Islamic microfinance.

²⁷ This section draws heavily on the report by Professor Raja Ehsan Aziz: "Microfinancing in Afghanistan: Strategies and Options" (October 2000), prepared for the ACBAR Microcredit Task Force. This report gives an overview of NGO microfinance programs and a perspective on Islamic microfinance development in Afghanistan.

- *Nature of Loans/Islamic Financing.* As mentioned, many NGOs in Afghanistan experimented in Islamic finance practices driven both by the Taliban's usury laws but also by local tradition and norms. Others, such as Save the Children (SCF), which had the largest existing program, adapted forms of mainstream microfinance. SCF charged clients for the loan application form or passbook, but did not charge interest in a conventional form.²⁸
- *Delivery Methodology.* NGOs experimented with a number of methodologies, including individual lending, group lending and community-based savings and credit approaches. In the first two methodologies, the NGO typically owned or managed the loan capital, making the lending decisions and taking the credit risk. In the community-based approach, the NGO typically helped communities to organize savings and credit associations, with capital ownership, lending decisions, and loan fund management in the control of the community.
- *Business Support Services.* Several programs were also linked to vocational or business training—e.g., UNOPS's Comprehensive Disabled Afghans Program (CDAP)—which provided microcredit for self-employment as well as vocational training/apprenticeships for disabled Afghans. Others provided assistance with product development and marketing, particularly those NGOs that linked microcredit to carpet weaving and handicrafts production.
- *Geographic Reach.* Existing microfinance programs provided limited coverage—programs reached about 10,000 clients in 2002. The largest NGO microfinance program, run by Save the Children, had 1,800 clients. The geographic reach of the programs was largely rural, operating in selected villages in 10 to 15 provinces out of a total of 29.
- *Depth of Outreach.* Most NGOs focused on improving the livelihoods of impoverished and vulnerable groups, with loans ranging from US\$20 up to around US\$300.
- *Impact.* Anecdotal evidence pointed to the impact of microfinance programs on self-employment, business productivity/profitability, self-reliance and self-esteem, household incomes, and rural indebtedness.
- *Sustainability.* The NGO programs achieved low levels of sustainability, which is to say, income earned from interest and other fees did not cover the costs of operating the program. These low sustainability levels are in large part due to three facts. First, the implementing NGOs had a humanitarian mandate and little experience in microfinance, which meant none of them, except perhaps for Save the Children, had clear objectives or a well-founded strategy to develop institutionally and financially sustainable microfinance services. Most of the NGOs, in fact, took a charitable approach to loan provision and did not consider how to earn revenue to cover costs. Second, hyperinflation led to the regular decapitalization of loan funds as NGOs did not charge interest rates that would cover inflation. The long-term downward trend in the value of the Afghan currency also led to devalued loan portfolios in dollar terms, as NGOs have not been able to protect or hedge against this. Finally, Islamic usury laws restricted the charging of interest.

²⁸ The most common Islamic finance schemes used by NGOs (and traditionally in Afghan communities) appeared to be: (1) *mudaraba*, under which the lender/NGO provides the capital and the entrepreneur the labor and expertise; profit and losses are shared at a fixed ratio; (2) *murabaha*—cost plus markup sales, whereby an NGO purchases certain goods required by the beneficiary, e.g., livestock or seeds, and sells with a cost mark-up for the purchasing service. Payment is usually made in installments in-cash or in-kind; (3) *Bai salaam*—advance cash payment against deferred commodity delivery; (4) *Bni 'mua'jjal*—sale of goods on deferred payments; and (5) *Ijara*—leasing, e.g., of communally owned tractors.

Box 4.1 Microfinance institutions

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

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

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

- *Performance Data/Reporting.* Until 2002, the NGO community had only limited knowledge of microfinance good practice; focus on record collection and performance monitoring was minimal. Few NGOs kept operational or financial reports that would allow any in-depth performance analysis of their microfinance programs.
- *Coordination.* In 1999–2000 the Agency Coordinating Body for Afghan Relief (ACBAR) launched a task force to assist with the various NGO microcredit schemes. It disbanded in 2001, however, and several NGOs have expressed an interest in reviving the group in an effort to help develop microfinance programs.

Box 4.2 Vocational Training + Programs

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

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

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

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

Box 4.3 Agriculture + Programs

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

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

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

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

Overall, the microfinance sector provided financial services where the formal banking sector was clearly failing. Yet because of the scale of the humanitarian disaster in Afghanistan, none of the NGOs specialized exclusively in the provision of microfinance services. Many provided a number of other social services and business support services. Unfortunately, the microfinance experience in Afghanistan has not been well informed by microfinance lessons learned elsewhere in the world. Most NGOs active in Afghanistan treated microfinance as a charitable undertaking and were less concerned about sustainable financial service delivery to the poor. The focus on end-clients, instead of on institutional clients, has led to low repayment rates and very limited outreach. A number of microfinance service providers have recognized the need for sustainable service delivery and are starting to be more aware of cost-effectiveness, efficiency, and the possibilities to lend on a cost-recovery basis while not contradicting Islamic principles. Few microfinance programs, however, incorporated what are considered good-practice principles in microfinance (CGAP, May 2002).

4.3 MICROFINANCE REFORMS, 2002–2003

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

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

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

The Microfinance Support Facility for Afghanistan (MISFA)

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

Four main donor-supported approaches to microfinance development have emerged elsewhere in the world: microfinance NGOs; microfinance banks created *from* NGOs; start-up microfinance banks; and downscaled commercial banks (or developing microfinance delivery through an existing infrastructure). A fifth approach—credit unions and community-based credit and savings associations—has also played an important role in microfinance provision throughout the world.²⁹

All five approaches have succeeded in achieving both scale and sustainability. BRAC is a prominent example of a microfinance NGO; as of the end of 2001, it had an outstanding loan portfolio of over \$145 million and 3.5 million active clients. BancoSol, a bank created from an NGO (PRODEM), had a loan portfolio of almost \$80 million at the end of 2000, with 61,000 active clients. As of end 2001, a greenfield microfinance bank created in 1996, the Microenterprise Bank in Bosnia, had an outstanding loan portfolio of \$17 million, and 4,300 active clients. Perhaps the best known example of a down-scaling bank is BRI of Indonesia, with a loan portfolio of almost \$1 billion and 2.8 million active clients, as of end 2001. Credit unions are the primary provider of microfinance in some regions, including parts of eastern Europe and Latin America. In Ecuador, for example, 23 of the largest credit unions have a combined outstanding loan portfolio of \$66 million, and more than 450,000 active borrowers, whereas NGO and bank MFIs have in the region of \$24 million in outstanding loans, with 80,000 active clients.

²⁹ Such models often get less attention given they are savings-based and are less dependent on donor support.

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

Against this background, it was felt that given the plethora of NGOs there was room for a national apex institution or microfinance support facility. In an environment with many existing or planned microfinance programs, and a range of approaches, donors, and priorities, a Microfinance Support Facility—a wholesale mechanism that provided financing and technical support to retail MFIs—can help coordinate and rationalize donor support for microfinance within a sector development framework, provided a mechanism for introducing good microfinance practices and standards, and support the development of institutional microfinance provider capacity. It could also provide donors with an efficient funding mechanism that met national market needs. It was with these goals in mind that CGAP—the Consultative Group to Assist the Poor—initially suggested the model of a national-level microfinance support facility for Afghanistan. The World Bank expressed interest in supporting such a facility and conducted a project identification mission in May 2002, which led to the creation of the Microfinance Support Facility for Afghanistan (MISFA).

In designing MISFA, the Bank and CGAP heeded lessons learned from apex institutions elsewhere. There are few examples of such institutions established to support the start-up and development of MFIs, and the experience has been mixed.³⁰ PKSF in Bangladesh is sometimes cited as a regional model, but this apex was established in an environment with a critical mass of microfinance institutions. The challenge in Afghanistan is quite different: to develop the microfinance sector practically from scratch. This required a long-term investment approach and a strong focus on building the capacity of microfinance institutions. In Bosnia and Herzegovina the apex was successfully managed to support the development and start-up of a viable microfinance sector. The apex, which was a World Bank-funded Local Initiatives Project, provided financing and technical support to NGO MFIs in Bosnia for their start-up, growth, and development. The Bank project combined performance-based financing with intensive, well-tailored capacity-building support.

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

The overall objective of a Microfinance Support Facility was to actively support the development of a strong, sustainable microfinance sector in Afghanistan that provided widespread access to high-quality

³⁰ CGAP, "Apex Institutions in Microfinance," Occasional Paper, January 2002, for an analysis of the experience of apex institutions.

³¹ More sustainable sources of finance that might be available in Afghanistan in the next five years or so include savings, socially responsible investors, and domestic or foreign commercial banks.

financial services to economically active low-income people. In summary, the Microfinance Support Facility for Afghanistan was to undertake the following roles:

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

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

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

In the months leading up to December 2003, real progress has been made in the microfinance sector. MISFA has \$25.2 million in committed funding: \$1 million from CGAP, \$5 million from the World Bank, \$5 million from the U.S. Agency for International Development, \$7 million from Canada, \$5.2 million from Great Britain, and \$2 million from Sweden. The \$15.7 million from this total sum that has been disbursed to date has already financed small loans for more than 17,000 Afghans, with thousands

more to follow in the coming months. MISFA has signed funding agreements with three microfinance institutions (BRAC, FINCA, and Mercy Corps) and is close to finalizing two more. Because of higher-than-expected demand, the facility is actively seeking for additional funds.

New microfinance programs

During the period 2002–2003 there was continuing interest in developing larger-scale, sustainable microfinance programs among local as well as international organizations. The Aga Khan Foundation, for example, decided to set up a microfinance bank. The First Microfinance Bank of Afghanistan (FMBA) is sponsored by the Aga Khan Fund for Economic Development, AKFED, with additional sponsorship taken by other bilateral shareholders and institutional microfinance investors. The bank will cater initially to urban micro and small businesses in the Northeastern Province and, if security improves, develop a nationwide branch network in the main economic centers with extension into semi-urban and rural areas. FMBA aims to be incorporated as a full-service financial institution, providing both credit and savings products. The bank will be capitalized by US\$3 million; one of the investors will be the IFC. In five years time, FMBA intends to reach out to approximately 23,000 thousand clients.

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

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

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

Several large international NGOs with specialist microfinance capacity have submitted proposals to donors for programming in Afghanistan and have recruited or are planning to recruit microfinance specialists: Mercy Corps, CARE, Save the Children, CHF, WfW, and so forth. In addition, Aschiana, ACTED, PHO, Ockenden International, and others have also expressed interest. (See Box 4.4.)

Box 4.4 New NGO microfinance operations

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

CHF: CHF International is a relative newcomer to Afghanistan (with one year of operation, mostly construction projects). It conducted a market study in Bamian and Kabul province, interviewing 580 households and businesses. Major findings included indebtedness (often only to buy food or clothing). CHF intends to start a microfinance program and is interested in combining microfinance with gender and IT for marketing. The country director intends to stay four to five years.

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

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

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

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

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

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

4.4 CONCLUSION

Although microfinance sector development is highly challenging in the Afghanistan context, the sector could take off quite rapidly. If the country's unique challenges are addressed—operating efficiently in scarcely populated areas, currency instability, human resource recruitment among a workforce that has not been working for many years, female home-based businesses—outreach can increase significantly. To facilitate this growth, two key ingredients are necessary: funds to fuel the loan portfolio growth and capacity building. Chapter 5 elaborates on capacity-building needs; see Table 5.2 for outreach (current and potential) based on growth rates and for capacity of existing organizations and growth plans of new entrants.

Two scenarios were run, a conservative scenario and one showing more aggressive sector growth. Table 4.1 shows—even with conservative figures—sector growth is expected to be rapid. The presence of BRAC is a major factor in this regard, with its proven ability to reach hundreds of thousands clients quickly.

Table 4.1: Client growth and loan portfolio funding needs

	Active clients			Loan portfolio (in US \$)		
	June 2002	Year 1	Year 5	June 2002	Year 1	Year 5
Current	11,000	31,000	236,000	1 million	7.8 million	69 million
New entrants		5,000	61,000	1 million	0.5 million	10 million
Total		36,000	297,000	1 million	8.3 million	79 million

Afghans have shown remarkable entrepreneurship. It is expected that loan volumes can be scaled up quite quickly, and with MISFA in place to facilitate loan funds and adequate investments in capacity building of the microfinance institutions, a critical mass of institutions can reach sustainability within four to five years. MISFA is well placed to channel funds like the above-mentioned UNDCP and possibly ILO-mobilized program funds in an effective, coordinated and durable manner.

Legal and regulatory reforms

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

- **NGOs:** NGOs are currently regulated under a 1998 law adopted by the Taliban. According to NGO representatives, this law is unclear on the matter of microcredit, providing no mention of what activities are permissible, and therefore not prohibiting NGO microcredit in any way. NGOs are required to register with the Ministry of Planning; foreign NGOs register with the Ministry of Foreign Affairs. The existing procedures seem fairly straightforward, with little if any ongoing monitoring by the Ministry of Planning owing to lack of government institutional capacity. The interim authority has

proposed drafting new NGO legislation and establishing a more effective registration system, which would provide the government with information on what NGOs are doing where. The timeframe for drafting of the new legislation was not clear.

- *Savings and Credit Associations*: Afghanistan reportedly does not have a strong tradition of informal savings and credit associations, and no legal framework currently exists for membership-based savings and credit institutions. Some donor or NGO-supported savings and credit associations and (farmer) cooperatives do exist, however, and are expected to increase with the further development of microfinance.

It is therefore recommended:

- *NGOs*: Credit-only NGO microfinance institutions (MFIs) should not be subject to prudential regulation and supervision; i.e., the central bank would not have a statutory role in licensing or supervising NGOs undertaking microfinance, given they do not mobilize the public's money and create no risk to the safety and soundness of the financial system (the main concern of bank regulators). Microfinance specialists should be involved in the drafting of the new NGO law to ensure that microcredit is a permissible NGO activity. The tax status of NGO MFIs will need to be clarified (including sales tax and profit tax). Very often there is confusion in countries over the tax status of NGO MFIs, which have a social purpose but earn income (through fees or interest) off their activities. Such issues will likely need discussion and clarification in Afghanistan over the medium term.
- *Savings and Credit Associations*: In the immediate term, the central bank does not seek to regulate such nonbank financial institutions.³³ The central bank will need to focus on establishing a new legal framework and developing the capacity to supervise the commercial banking system. This in itself will be a challenging task. The central bank should, however, consider developing specialized legislation for membership-based savings and credit institutions over the next one to two years. This is currently envisaged under Article 2 of the draft Banking Law. Given the likely large number of informal community-based savings and credit associations, it is suggested that only organizations above a certain size would be required to get a license and be supervised by the central bank. This could be based on asset or equity size of the organization, and/or number of members. Technical assistance could be provided to the government to help develop such legislation and the capacity of the central bank to supervise such institutions. In the short term, if an apex/microfinance support facility were to be formed (see Section IX), this could play a role in keeping track of all forms of nonbank microfinance institutions (NGOs, savings and credit associations, etc.) and their basic performance.

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

³³ See CGAP, "The Rush to Regulate: Legal Frameworks for Microfinance," Occasional Paper, April 2000, for a good discussion of legal and regulatory issues from the perspective of a supervisory body.

5. INFORMAL FINANCIAL INSTITUTIONS³⁴

5.1 INTRODUCTION

Postconflict countries invariably play host, often by necessity, to a sophisticated and vibrant informal financial sector. In the absence of effective legal and regulatory frameworks, consumers are compelled to create financial networks that help them make international and domestic payments.

In Afghanistan, an informal market developed, and expanded, in response to two decades of war and civil strife. Money exchange dealers, or *hawaladars* as they are known in South Asia, provide a well-organized, convenient, and cost-effective means of making international and domestic payments. They have had lots of practice, for the Afghan population has relied on the informal sector to access financial services for hundreds of years. For many years, operating primarily from open-air markets, *hawala* has provided the most reliable, convenient, safe, and inexpensive means of transferring funds to far-flung regions. The quality and utility of the *hawala* service³⁵ have led some observers to suggest that the Afghan financial authorities should consider encouraging some of the *hawaladars* to convert their thriving enterprises into formal banking enterprises.

The Kabul money exchange market, where most of the city's *hawaladars* operate, has an 80-year-old history. Established along the Kabul River, it is near the gold and silver bazaars and the financial service offices used by the precious-metal traders; Kabul's other specialized markets all are within walking distance. The money exchange dealers have traditionally provided traders with a range of banking conveniences, including currency conversions, international and domestic money transfers, deposit-taking services, and more recently, communication facilities — for example, satellite telephone, fax, and e-mail.

Before the communist revolution in the 1970s, *hawaladars* from India and Pakistan dominated the Afghan money market. Following the revolution, though, and the flight of most foreigners, the market became dominated almost solely by Afghani dealers who had operated in Kabul, although outside the traditional market. Presently, the more than 300 registered *hawaladars* have organized themselves into a self-regulating market. Unregistered money exchange dealers in Kabul and around Afghanistan are estimated to number between 500 and 2,000.³⁶

³⁴ This Chapter is based on: Maimbo, S. (2003) The Money Exchange Dealers of Kabul: A study of the Hawala System in Afghanistan. *World Bank Working Paper* No. 13

³⁵ A *hawala* transaction encompasses financial transfers made by principals, or customers (Customer A, or CA, and Customer B, or CB) located in countries A and B, through *hawala* service providers in their respective countries. These providers (designated *hawaladars* HA and HB) operate outside the formal financial sector, regardless of the use or purpose of the transaction and the country of remittance or destination. Typically, HA receives funds from CA and asks HB to advance the amount to CB in the local currency equivalent. In a prototypical *hawala* transaction (figure 5.1), an expatriate worker (CA) uses a *hawaladar* (HA) to arrange a remittance to his home country. He makes payment in dollars or another convertible currency to this intermediary. This individual contacts a *hawaladar* counterparty (HB) in the receiving country, who arranges payment in local currency to the remitter's family or other beneficiary (CB). Obviously, some network of family or connections among *hawaladars* is required to make such a system work consistently and on a large scale.

³⁶ In the absence of regional records, and given the open nature of the Kabul money exchange market, these estimates must be viewed as speculative.

The operational characteristics of this informal financial market—the system's geographic characteristics, convenience, effectiveness, cost, and its relationship with the formal financial system—are discussed below (see section 5.2). Section 5.3 presents case studies of the domestic transfer of development funds by international aid institutions and nongovernmental organizations. It discusses the *hawala* system's benefits as well as the operational characteristics that make it vulnerable to abuse. Section 5.4 presents regulatory and supervisory options considered by the central bank, and also the option finally selected. Finally, Section 5.5 presents research conclusions and policy advice on the developmental role of informal financial institutions in the Afghan financial system; the implications for financial management practices of donor-financed development programs; and the regulatory and supervisory options for DAB.

5.2 OPERATIONAL CHARACTERISTICS

Scope

The money exchange dealers provide a range of financial and nonfinancial business services in local, regional, and international markets. Financial activities include money exchange transactions, funds transfers, microfinance, trade finance, and deposit taking. Nonfinancial activities may include telephone and fax services, regional and international trade assistance, and, more recently, internet services. No clear delineations exist among any of these business activities, nor are there distinct geographic and business classifications. The classifications below are meant to help identify general patterns and trends rather than set out consistent, ongoing operational realities.

Local money exchange dealers can be found in almost every community in Afghanistan. Traditionally, these dealers provide numerous financial services in addition to funds transfers, for which they have attracted much attention. They also provide deposit-taking facilities for those who want to save;³⁷ microfinance for informal entrepreneurs; trade finance for wholesalers and retailers; and currency exchange services for international business and personal transactions. *Hawala* tends to be one of the cheaper financial services provided by local money exchange dealers.

Regional *hawaladars* tend to be located in a regional rather than a provincial village, town, or city, and serve more than one province. For example, Kandahar-based dealers may concentrate on the southern Afghan regions of Helmand, Oruzgan, and Zabol; Herat-based dealers may cover the western regions of Badghis, Farah, Faryab, and Ghowr. Apart from serving the eastern regions of Vardak, Parwan, Kapisa, Laghman, and others, Kabul-based dealers may serve the national market through the regional dealers in Kandahar (south), Herat (west), and Mazar-e-Sharif (north). Regional dealers may offer the usual types of auxiliary financial services provided by local dealers. Their principal clients are traditionally regional traders. In some instances they may engage in trade themselves, or they may be retired traders who have chosen to settle in one community but retain valuable regional contacts and counterparts.

International dealers, most of whom are based in Kabul, connect the domestic financial system to the rest of the world. Their counterparts are found in traditional trading cities on the Asian subcontinent: Tehran (Iran), Islamabad (Pakistan), and New Delhi (India); and in the Gulf cities and states of Riyadh (Saudi Arabia), Doha (Qatar), Abu Dhabi and Dubai (United Arab Emirates), and Muscat (Oman). These dealers target international traders and investors, and more recently, international aid institutions and NGOs disbursing development funds for the rebuilding of Afghanistan.

³⁷ Deposit facilities are unlikely to include an accumulation of interest—often because *hawala* dealers view this as contrary to the principles of the Muslim faith, but also because such facilities are usually used for safekeeping rather than as investment tools.

Transaction volumes

There is no limit on the volume of funds transfers the money exchange dealers can transfer; individually or severally. Since the fall of the Taliban regime, the volume of financial flows through the *hawala* system has grown significantly. NGOs alone are estimated to have channeled at least US\$200 million in emergency, relief, and development funding through the *hawala* system. Single transactions in excess of US\$500,000, especially between Peshawar in Pakistan and Kabul, are not uncommon. The larger international aid institutions and NGOs have made individual transactions of US\$1,000,000. Because there are limited storage facilities in Kabul for large sums of money, however, organizations included in this study remit funds through the *hawala* system in smaller amounts of US\$100,000 to US\$200,000. The smaller organizations regularly remit US\$20,000 to US\$30,000 to cover operational expenses.

Internally, the funds remitted to the provinces tend to be smaller, ranging from US\$10,000 to US\$20,000. Owing to security concerns, these *hawala* transactions are made only when the regional offices have ready invoices for payment. This minimizes the volume of cash the regional offices have to store on their premises. The regional offices keep minimum cash reserves to meet their daily operating expenses.

Speed

Transferring funds to Kabul from Peshawar, Dubai, and London usually takes 6 to 12 hours. Less time is required if both the sender and recipient are in the dealers' respective offices at the same time. Then confirmation and payment are instantaneous, and the entire transaction can be concluded in minutes. Commonly 24 hours are required for transfers between Kabul and any of the regional centers. Slightly more time is usually required for payments in the more remote regions or villages where the money exchange dealer has no local office or representative.

Cost

The cost of making funds transfers into and around Afghanistan averages 1 to 2 percent. As is common with every bazaar in South Asia, however, the final quotation depends on the negotiating skills of both parties and their understanding of how the market operates. Some money exchange dealers quote a flat fee of 2 percent on both international and domestic transactions. Yet this is usually only a starting point for discussion. Discounts and premiums are offered and charged depending on the volume of the transaction, the relationship between the client and the *hawala* dealer, the currency of exchange, the security environment in Kabul, and the destination of the funds. The larger international aid institutions transferring US\$200,000 or more per month pay less in fees than local NGOs transferring US\$7,000 or less per month for their administrative expenses. Under the Taliban regime, *hawaladars* charged higher fees among the different regions, and few dealers were willing to transfer funds within the country. Trade itself was difficult and even dangerous. Presently, however, there are so many dealers in the market that the fee structure has come down significantly to the stated average of 1–2 percent. In rare circumstances the fee may exceed 2 percent of the transaction amount, typically when the customer is new and fails to comparison-shop among the other dealers first. Rates also climb in provinces, where the security situation remains tenuous. The fee structure might also change if the customer requires additional services not normally provided—for example, an emergency transaction that must be expedited.

Box 5.1 *Hawaladar Operations in Afghanistan*

Hajji Mustafa, Jalalabad

Background: Hajji Mustafa (not his real name) has been a money exchange dealer for 14 years. His shop is located in the Jalalabad *hawala* market among 180 other dealers. Like the central *hawala* market in the capital city, Kabul, the market is located in the center of the city near the major trading markets and the customs office. The 180 money exchange dealers belong to an association that looks after its members' affairs. Mustafa's father was primarily a trader of goods from and to China, Azerbaijan, Turkmenistan, India, and Pakistan. Alongside his trading activities, he provided financial services to his colleagues, using his excess cash reserves. Mustafa chose to concentrate on providing financial services while occasionally investing in trade.

Financial services: Besides facilitating money transfers, Mustafa provides loans, takes deposits, and cashes checks. Loans are available to traders for trade finance, to NGOs for emergency relief activities, and to shop owners for paying customs duties and taxes on imported goods.

Geographical coverage: Mustafa has a brother in Kabul, a cousin in the commercial hub, Herat, and a brother in Melbourne, Australia. He also has partners in Tokyo, London, Peshawar, and Dubai. Although he occasionally conducts money transfers to other cities, this is exceptional. Barring communication problems, money transfers are completed within 24 hours.

Settlement: In most cases, end-of-month outstanding balances are between Mustafa and his brother in Melbourne, with whom he conducts the most business. If his brother owes Mustafa money, he uses his bank account in Japan to purchase second-hand cars for export to Afghanistan. Once the cars reach Afghanistan, Mustafa sells them and keeps the proceeds. If Mustafa owes his brother money, he uses his bank account in Peshawar to remit the money to his brother's account in Japan. Occasionally, he may export some Afghani products, such as carpets, for sale abroad.

Amanullah Mohammed, Kabul

Background: Amanullah Mohammed (not his real name) has been a money exchange dealer in the Shahzada market for 25 years. He started the business after retiring from a career as a road construction engineer in the government and is now one of the largest money exchange dealers.

Financial services and geographic coverage: Apart from currency exchange, Mohammed's main business is money transfers. Recently, this business has received a significant boost with the influx of foreign nongovernmental organizations. Occasionally, he will provide safekeeping facilities for businessmen with excess currency. He does not pay interest on these cash holdings. Neither does he charge interest on the loans he makes, owing to his adherence to the Islamic proscription against charging or receiving interest on loans and deposits.

International coverage: Mohammed has a well-established international network of correspondent partners in all the major financial centers in the world—among them Tokyo, London) and New York—and regional contacts in every South Asian country. He maintains bank accounts in Dubai and London for making transfers to cities and countries where he lacks local contacts.

Domestic coverage: Within Afghanistan, Mohammed is able to make transfers to all major cities—Herat, Jalalabad, Kunduz, Mazar-e-Sharif, and Kandahar. Domestic transfers usually include at least two currencies, even if both the transferor and the transferee are dealing in afghani. By moving, for example, from afghani to Pakistani rupee to afghani, Mohammed can make gains on the foreign exchange differences between the cities.

Expectations: Mohammed is keen to receive approval for his bank license application. He is confident that he can provide good financial services to the Afghan population. He recognizes that local Afghan banks can not match international banking standards and recommends that international banks be invited into the country as soon as possible.

Source: Research interviews.

Reliability

The *hawala* system is reliable. Dealers seldom fail to effect payment. Beside the expected high standard of adherence to unwritten but nevertheless well-established codes of business practice, default risk is eliminated through a variety of *hawala* dealer selection criteria adopted by users (see Appendix 8.7 for some criteria), and operational usage procedures (see Appendix 8.8 for some of these procedures), particularly the "confirmation before payment" procedure. In all cases reviewed in the study, the remitter pays the *hawala* dealer the value of the funds remitted only after the recipient has confirmed receipt of the money. Because of the large sums involved, NGOs typically make bank transfers into the *hawaladars'* accounts in either Pakistan or Dubai. When interviewed, the international agencies and NGOs expressed general satisfaction with the delivery of funds. The rare incidents of client dissatisfaction were limited to occasions when the customer paid a slightly higher fee than that offered by competitors for that particular route or region.

Documentation

There are no standard documentary requirements for conducting *hawala* transactions, and the *hawala* association does not require its members to open their books for external inspection, nor does it require periodic financial reports. Standardized documentation and reporting are considered unnecessary because of the high level of trust that makes the system viable. Dealers know that any failure to honor contracts will result in immediate blacklisting, and possible expulsion, from the market.

Each *hawaladar* designs, develops, and maintains independent documentary policies and procedures. Some of the procedures have been in use for many years and adapted to the changing business environment. Each business develops its own system for keeping track of transactions and balancing their accounts with international and domestic business partners. Some dealers maintain detailed records for each *hawala* transaction for purposes of remittance and settlement. Dealers know exactly how much cash they have, how much has been transferred, and how much is owed to them. During the research, the money exchange dealers routinely provided the following documents in varying combinations:

Hawala slips: Each customer is provided with a *hawala* slip, which indicates a *hawala* number or code. The dealers use the code to identify customers and for payment and settlement purposes. Although this is the primary bill of exchange, some dealers require the holder to produce a secondary identification document when presenting the note for cashing.

Customer identification documents and records: Some *hawaladars* implement rudimentary due diligence, "know your customer" banking procedures. Dealers maintain photocopies of customer passports or identity cards from hospitals, the army, and other institutions that issue such cards. Some of the data collected for records are: (i) date of transaction; (ii) name and address of sender and recipient; (iii) passport number or other identification number; (iv) *hawala* number; and (v) name of counterpart dealer. The last piece of information is important because there are so many players in the market. The customer must be able to identify the correspondent party at the other end of the transaction.

Accounting records: For established organizations such as NGOs and international aid institutions, the dealers maintain files with invoices and quotations, copies of receipts, and transaction contracts and agreements. The accounts between the organization and the dealers are reconciled periodically. For their correspondents, *hawaladars* maintain debit and credit columns in an accounting ledger book or computer. Each transaction is meticulously recorded, with columns for the date, *hawala* number, currency, amount,

destination, fee, and the date of settlement. Dealers maintain a separate book that customers at both ends sign when a transaction is completed and funds received. Separate receipts for the sender and payment confirmation documents can also be arranged if the customer so desires.

Settlement

Outstanding accounts between *hawaladars* are balanced weekly or monthly. When the volume of transactions is high, dealers have been known to settle their accounts daily. The nature of the relationship between dealers appears to determine how frequently accounts are settled.

The many settlement options include simple monetary settlement (cash transfers), trade in licit and illicit goods, smuggling, and other forms of bilateral or multilateral settlement. In the past, when the banking system in Kabul was operational, dealers settled their accounts through the exchange of checks. Now, if dealers need to transfer cash from one region to another, it is moved over traditional trading routes that have been in existence for years. A good many international settlements, however, appear to be done either through cash or bank accounts in Peshawar or Dubai.

All international *hawala* dealers maintain one or two accounts with formal financial institutions. The usual locations used by Kabul money exchange dealers are Peshawar, Islamabad, Dubai, London, and New York. These accounts are used for effecting funds transfers for customers and for settling with other *hawaladars*. Many of the dealers in Kabul use their Peshawar-based bank accounts to receive dollars from NGOs that want afghani payments made in Afghanistan. Also, to avoid having to carry cash within Afghanistan to settle accounts, dealers credit and debit each other's Peshawar or Dubai accounts via satellite communication. The London and New York accounts are also used to make normal bank transfers to cities where the *hawaladar* has no correspondent relationships with another nonbank institution or partner. Conventional money transfers from that account are made for customers, who are then charged the normal banking fees and subjected to formal sector documentation, procedures, and delays.

The recent surge in the volume of foreign currency entering Afghanistan through international aid institutions and NGOs presents researchers with a number of unique questions. How are the regional counterparts able to finance payments on behalf of the international aid institutions? What is the source of the afghani equivalent paid out in the regions? In the past 12 months, for example, international aid institutions have individually transferred amounts in excess of US\$10 million. Where is the afghani equivalent coming from?

For example, if the afghanis are being generated by legitimate trade in legitimate goods among regions, then there is no legal reason for suppressing the *hawala* system of funds transfers. Yet if the settlement process is in part completed with funds from illegal activities such as the smuggling of gold or weapons, drug trafficking, or trafficking in girls and women, or if the process involves international terrorist financing, then users carry a high reputational risk of inadvertently helping to launder the proceeds of criminal activities. This risk is particularly acute because of the difficulty of separating legal from illegal money flows.

Potential for financial abuse

Like the formal banking system, the *hawala* system is vulnerable to abuse by money launderers and those seeking to finance terrorism. The number and variety of methods used to launder the proceeds of criminal

activities, especially opium production, continues to become increasingly complex. Money launderers employ diverse methods that employ both banking and nonbanking channels. Recently, the abuse of informal remittance systems by those who would finance terrorism has received a great deal of attention in the media.

Criminals use similar techniques to launder the proceeds of crime through the formal and informal financial systems. First, neither formal nor informal financial systems necessarily transfer funds from one jurisdiction to another. Instead they depend on a sequence of accounting debits and credits among accounts kept by a network of individuals, companies, accountants, lawyers, and other partnerships and companies. Second, much as banking secrecy laws have been implicated in money laundering crimes, the anonymity built into *hawala* means that it, too, is vulnerable to charges that criminals or terrorists use this traditional, informal system to move or launder money and commit crimes.

The primary difference between the formal and informal systems lies in the amount of documentation required of each. Laundering money through the formal financial system leaves a paper trail, making it vulnerable to detection by law enforcement agencies during an investigation. Placing funds (from criminal activities) into a bank results in deposit documentation; transferring funds from one account to another requires transfer request forms that provide details about the transferor and the transferee. Finally, financial investments require the signing of deposit and withdrawal records, such as checks, by the withdrawer or his nominee.

Hawaladars minimize detection by limiting external access to or oversight of their records. Where documents are maintained, and money exchange dealers often noted this during interviews, they are rarely accessible to third parties, especially to law enforcement agents. Funds can be placed anonymously when a money exchange dealer accepts funds for remittance without establishing either the identity of the remitter or the source of the funds. The recipient can receive monies without producing identity documents other than a previously agreed code. Thereafter, a money exchange dealer can initiate or facilitate a number of transfers, all of which conceal the original source of funds through a network of *hawaladars* operating in many different jurisdictions, with each dealer requiring little or no formal documentation. Finally, the recipient of funds can reintegrate the funds into the formal, legitimate financial system by making a "legitimate" business investment on behalf of the funds' owner. Or the funds can be reintegrated into the formal financial system through imports and exports by transferor and transferee, or even by third parties. Once the transaction is complete, there is no regulatory requirement for customer identification documents, nor are codes or references preserved for a specified period. Consequently, *hawala* transactions leave no audit trail for law enforcement agencies to establish predicate offenses for money laundering, tax evasion, corruption, or other related activities. The absence of financial transactions records and business documents could therefore make the use of the *hawala* system attractive for laundering the proceeds of criminal activities.

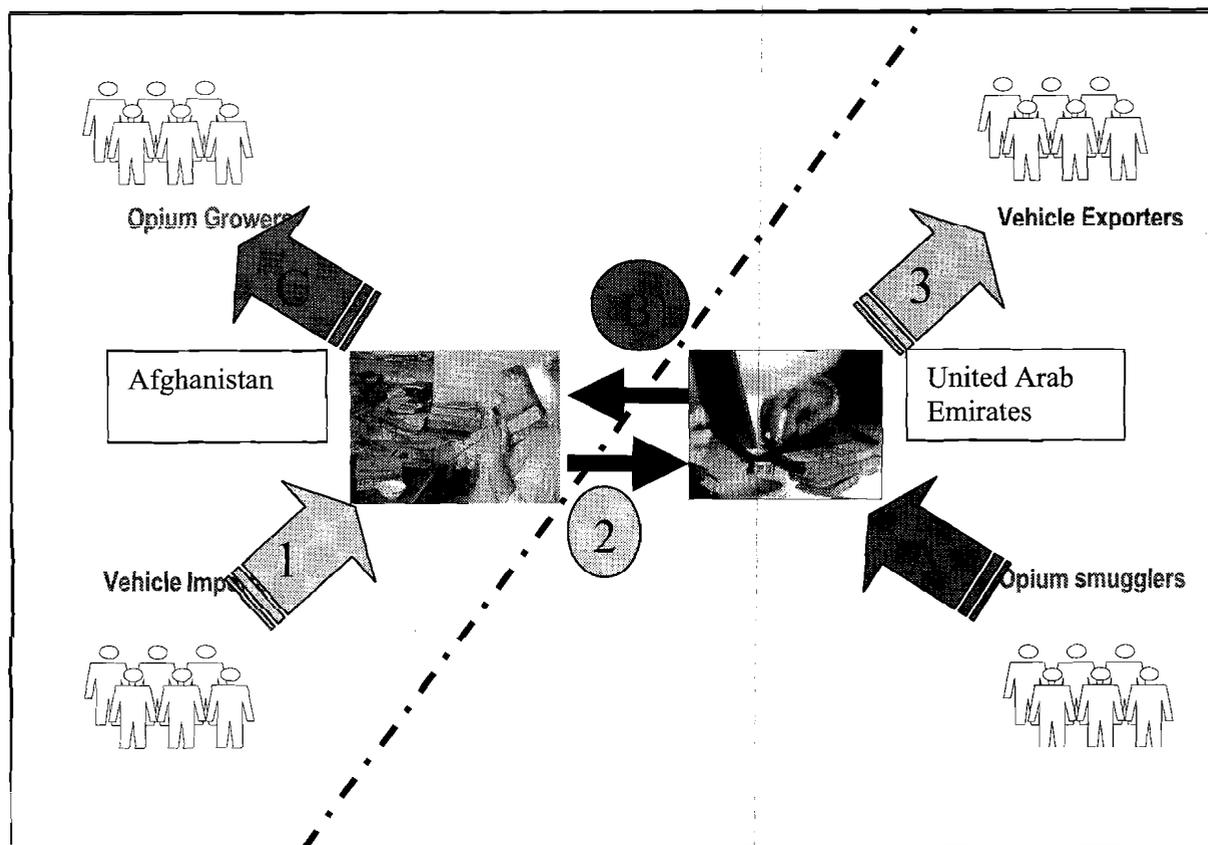
Is *hawala* used to launder money in Afghanistan? If so, to what extent? The lack of documentation makes both questions difficult to answer. Illegal money flows are difficult to track. It is also difficult to separate legal from criminal money flows and to establish, as law enforcement agencies must, actual financial links to actual criminal activities. Further, law enforcement agencies face significant cultural and linguistic barriers when investigating the informal financial systems. Business, tribal, or kinship ties among the participants also complicate investigations. Additional constraints in Afghanistan include:

- ineffective monitoring of cross-border currency movements;
- few if any reporting requirements for large cash transactions, or a pattern of inconsistent reporting under a voluntary system;

- varying guidelines used to identify suspicious transactions;
- parallel black market economies;
- little ability to share financial information with foreign law enforcement authorities.

These constraints are likely to continue in Afghanistan for many years. Although the hawala system in Afghanistan is convenient and appears to serve a number of legitimate remittance purposes, its anonymity and its aversion to record-keeping, particularly in the reverse transactions, make it vulnerable to those seeking to launder the proceeds of criminal activities. As Figure 5.1 shows, it is possible that by remitting funds through *hawaladars*, a legitimate second-hand car import business, for example, may find itself aiding opium merchants to purchase heroin from Kabul.

Figure 5.1. Hawala Transactions Combining Legitimate and Illegal Activities



Legitimate Transaction

1. Vehicle importer in Afghanistan approaches a *hawala* dealer in Kabul with afghanis for the import of vehicles from a Dubai-based car exporter.
2. *Hawala* dealer in Kabul communicates payment instructions to a Dubai-based *hawala* dealer.
3. Dubai-based *hawala* dealer gives the vehicle exporter US\$ equivalent as requested by the vehicle importer in Kabul.

Illegal Transaction

- A. Drug dealers approach a *hawala* dealer in Dubai with US\$ for the purchase of opium from Kabul-based opium dealers/growers
- B. *Hawala* dealer in Dubai communicates payment instructions to a Kabul-based *hawala* dealer.
- C. Kabul-based *hawala* dealer gives the opium dealers/growers afghani equivalent as requested by the opium smugglers in Dubai.

Settlement of Accounts between *Hawala* Dealers

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

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

The diagram above offers a possible, yet still speculative, network. The field research did not find evidence that *hawala* transactions facilitate opium transactions — nor for that matter that the formal banking sector does *not* handle illicit proceeds. The diagram merely highlights possibilities that law enforcement groups might ponder in the absence of clear information about the *hawala* transaction process. In both transactions, it is important to remember that the neither *hawala* dealer needs necessarily to know the purpose for the financial transfers to execute them.

Interestingly, before the national currency change in late 2002, the study found substantial volumes of freshly printed, shrink-wrapped afghani notes. When questioned about the source of the new notes, the *hawala* dealers said the monies were printed in Russia and were available to dealers selling dollars. It was not possible to determine the legality of the notes. Distinguishing between genuine and counterfeit notes was complicated by the presence of three legal versions of the afghani then in circulation. One version of the note found in northern Afghanistan was worth just half the currency used elsewhere in the country. Another currency was also in use in a small corner of northeastern Afghanistan; it dated to when the region remained in the hands of the Northern Alliance while the Taliban regime held sway over the rest of the country. The possibility of organized criminals printing the old afghanis and purchasing genuine foreign currency in the money exchange market was real at that time.

5.3 INTERNATIONAL AND DOMESTIC USE OF THE *HAWALA* SYSTEM

International aid institutions

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

Box 5.2 International Aid Agencies and the *Hawala* System

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

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

Agency C: When Agency C requires US\$1 million for use in Kabul, the *hawala* remittances are divided into tranches of US\$200,000 to \$300,000. Occasionally, remittances of US\$500,000 are made. Agency C asks its local suppliers and contractors to collect their money as soon as the Kabul-based *hawaladar* is ready to make payment. Internally, funds transfers average US\$20,000 to US\$30,000. For security reasons, all transactions take place on Agency C premises. The entire process is well documented. The recipient sends e-mail confirmation to the sender before the money is given to the money exchange dealer. No payment is made until the e-mail or fax is received, even where oral communication has taken place and confirmation has been given. Receipts are issued to money exchange dealers when they deliver cash. The receipts act as settlement documents for the dealer. Each receipt states clearly that the transfer has been made through the informal market because of security concerns and the absence of a functioning banking system in the country.

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

Source: Research interviews.

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

International aid institutions now work with several dealers. Under the Taliban regime, agencies worked with perhaps one or two *hawaladars*, with whom they established long-term relationships (see Annex 5.1 for some selection criteria). But the competition is now such that the *hawaladars* regularly send agencies dealing in large volumes of cash periodic bids for their services. With each round of bids, rates and services become more competitive (see Annex 5.2 for sample operating procedures). Responding to these inducements, agencies are working with a number of different dealers on different routes. In some cases, the dealer may provide the service at no charge on one route on the understanding that he will receive the contract for another route (see Annex 5.3 for an example of a contract). The cases below illustrate a few aspects of the *hawala* system that institutions and NGOs must address, including the volume of cash, the confirmation process, concerns about counterfeit cash, and the security of the cash when the local *hawala* operator gives the transferee cash in response to instructions from his counterpart in Pakistan or Dubai.

The transfer arrangements of the four agencies reflect their size and area of operation. Generally, funds are remitted from Pakistan (Peshawar or Islamabad) in tranches that meet the organizations' periodic program requirements. Smaller amounts are then remitted to the provinces using the same or a different dealer. In each case, the agency pays the dealer only upon confirmation that the transfer has been made.

Nongovernmental organizations

Nearly 700 NGOs are now operating in Afghanistan—about 127 international groups and 467 local ones. Government officials estimate that these NGOs have channeled more than US\$200 million into the country in the form of humanitarian relief, emergency aid, and development financing in the year following the fall of the Taliban regime. *Hawala* was used to channel much of this aid, as the system is particularly well suited for NGOs operating in rural Afghanistan, where the formal banking system is absent. Some of the less well funded NGOs are especially grateful for the low costs associated with the system. Although they lack the resources of international aid institutions, these NGOs are still able to implement life-saving relief and emergency assistance programs. The two cases below show the similarities and differences in NGO use of *hawala*.

Box 6.3. NGOs and the *Hawala* system

NGO A: NGO A uses the local money exchange market to conduct banking business with its regionally based groups. Most of its community development programs involve regional representatives purchasing equipment from local markets and handing them over to the community. No cash is given to the community directly. The NGO's regional representatives collect cash from local money exchange dealers who may be shopkeepers or traders, depending on the community in which the NGO is working. The commissions are minimal, and the organization has never had a problem with money exchange dealers. The volume of funds remitted through the system depends on the number and type of programs the NGO is implementing in a given region. For example, the eight agricultural cooperatives NGO A works with have approximately 800 members who borrow an average of US\$100 per person. In 115 communities, individual loans average between US\$250 and US\$450.

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

Source: Author research interviews.

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

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

5.4 REGULATORY AND SUPERVISORY OPTIONS

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

In October 2001, the Financial Action Task Force (FATF) agreed to Special Recommendations on Terrorist Financing, which included extending anti-money laundering requirements to alternative remittance systems (See Annex 5.4). At a conference on *hawala* in the UAE in May 2002, a number of governments agreed to adopt the FATF recommendation. Shortly thereafter, the UAE government announced it would soon impose a licensing requirement on *hawalas*. Participants at the UAE meeting drafted and agreed upon the Abu Dhabi Declaration on *Hawala*, which set forth five complementary principles (see Annex 5.5).

The fundamental questions for the Afghan central bank at the beginning of 2002 were whether money exchange dealers required regulation and supervision. Did they pose such systemic risks as to require formal regulatory and supervisory regimes similar to those being developed for the banking sector? Could they be left alone without endangering the long-term stability of the financial sector and monetary policy?

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

Option #1: No Regulation or Supervision

Various parties, particularly the *hawala* dealers, have argued against regulation or supervision. First, they note that except for dealers with shops at the market, *hawaladars* are difficult to identify or locate for regulatory and enforcement purposes. Grocers, merchants, individuals, and a host of other individuals conduct *hawala* transactions. Second, the dealers have no incentives to declare their activities for external monitoring and supervision. Third, even if it were possible to identify, register, or license *hawaladars*, their transactions are so varied and multifarious it would be impossible to develop a consistent set of regulations for the sector. Fourth, even if it were possible to develop regulations, guidelines, and

standards for the sector, the central bank simply does not have the resources to implement them. Finally, attempts to regulate an informal financial system will alter the system's original characteristics and push it farther away from the formal sector, especially as long as the primary reasons for its existence—foreign exchange arbitrage opportunities and poor banking services—have not been addressed.

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

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

Option #2: Formal banking-style regulation and supervision

Given the country's socioeconomic and political conditions, a comprehensive extension of existing banking regulations and supervision practices to the money exchange dealers was not a realistic option. Such practices affect four key areas: licensing requirements,³⁸ customer identification,³⁹ suspicious activity reporting,⁴⁰ and record keeping.⁴¹

In the first instance, regulatory requirements beyond basic registration are not feasible in countries that have inadequate or nonexistent supervisory capacity. As noted earlier, Afghanistan's central bank faced several basic but fundamental challenges when the Taliban regime fell—all of which made regulating the *hawaladars* less urgent by comparison—loss of key personnel, weak reporting framework, both in the central bank itself and between the bank and other institutions, lack of office automation, and the seriously damaged physical infrastructure weakened the supervisory capacity of the bank. Even when compared with other conflict-afflicted countries, Afghanistan's authorities face great challenges.

³⁸ Bank licensing requirements are designed to prevent the control or significant ownership of financial institutions by criminals or their associates. In determining the suitability of applicants, regulators need to consider, first, the skills and experience commensurate with the intended activities, and, second, records of criminal activities and adverse regulatory judgments.

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

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

⁴¹ Record-keeping requirements make it mandatory for banks to maintain records regarding customer identification and individual transactions for a reasonable period, typically not less than five years. For this requirement to be enforceable, the legislation, regulations or guidance notes should define which identifying documents are to be maintained and the minimum period the records are to be maintained. At a minimum, the records should be such that regulators and law enforcement agencies will be able to reconstruct individual transactions.

Option #3: Self-regulation and supervision

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

The report also encouraged, however, a move toward formal, written rules and regulations, which offered four advantages. First, if money exchange dealers perceived a tangible value from registering with the association, more might volunteer to register and be identified. Second, dealers operating under formal rules might be better equipped (than external authorities) to identify the hawala practices in particular need of regulation and supervision. Third, under formal rules, regional or local association committees might be in a better position to share the administrative and financial burdens of checking compliance. Finally, regulations and standards designed and administered by the hawala dealers themselves might work to bring them closer to the formal financial system (whereas rules imposed by external authorities might push the system further underground). As with all self-regulating bodies, however, there is a high risk of self-serving regulations, perverse incentive structures, and regulatory forbearance.

Option #4: Special regulations and supervision techniques

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

Hawala dealers would be registered, but not licensed. The central bank could continue its current policy of registering dealers in Kabul. Beside normal business registration procedures, money exchange dealers would not have to comply with further legal and institutional requirements. Registration could be extended to the provinces, and the central bank could refuse registration only if an applicant provided false information, failed to produce the documentation required by law, or did not pay the registration fee. The bank would not conduct fitness and probity tests of applicants. Nor would it seek to determine the reasonableness of the applicant's business plan or the adequacy of the capital proposed for the business.

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

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

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

5.5 CONCLUSION

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

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

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

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

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

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

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

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

In the long term, successful regulatory policies will recognize the operators' interests and create more transparent systems—bringing them closer to the formal financial sector without altering their nature. Meanwhile, national authorities must address weaknesses that may exist in the formal sector (see Annex 5.6 for more detailed recommendations). The formal and informal financial systems tend to benefit from each other's deficiencies. As long as the cost, speed, and convenience of remitting funds through the formal sector are incompatible with the needs of migrant workers, the informal remittance industry will continue to prevail.

⁴³ See Maimbo, “*Hawala* system in Afghanistan,” 2003, for further details.

⁴⁴ See Sander and Maimbo (2003) for further details.

⁴⁵ The IMF–World Bank study examined the: (i) historical and socioeconomic context within which hawala has evolved; (ii) operational features that make the system attractive for both legitimate and illegitimate purposes; (iii) fiscal and monetary implications for informal hawala-remitting and hawala-recipient countries; and (iv) current regulatory and supervisory responses.

6. CONCLUSIONS AND RECONIMENDATIONS

6.1 INTRODUCTION

Over the past two years, Afghanistan has made progress in reforming its financial system. Compared with conditions in December 2001—an outdated legal framework, no functioning commercial banks, a handful of NGOs competing with a vibrant informal financial sector—a basic formal financial system appears to be emerging.

- A new central banking law now guarantees the central bank's autonomy; after the successful issuance of a new currency, a rudimentary monetary policy regime is emerging; a new banking supervision department, which has commenced on-site inspections of banks, is in place; the central banks SWIFT connection is functional, and one-third of the central bank branches are now connected electronically for domestic payments; and the central bank's operational capacity has improved dramatically.
- Although decision makers initially wavered in the face of difficult reform questions (how many state and commercial banks to rehabilitate, for example, and the number of staff members to be redeployed), the bank relicensing process has resumed in earnest. Following the September 2003 enactment of the new commercial banking law, the central bank has committed to deciding which banks will be allowed to submit applications for relicensing by March 2004; and which banks will be re-licensed by September 2004.
- In the months leading to December 2003, real progress has been made on microfinance. MISFA has \$25.2 million in committed funding: \$1 million from CGAP, \$5 million from the World Bank, \$5 million from the U.S. Agency for International Development, \$7 million from Canada, \$5.2 million from Great Britain, and \$2 million from Sweden. MISFA has signed funding agreements with three microfinance institutions (BRAC, FINCA, and Mercy Corps) and is close to finalizing two more. Due to higher-than-expected demand, the facility is actively seeking for additional funds.

Much remains to be done, however, before Afghanistan realizes the shared vision of a market-oriented, private-sector-owned financial system in which:

- The autonomous central bank is fully equipped to carry out its regulatory and supervisory responsibilities;
- Financial infrastructure provides full access to modern information technology and telecommunications;
- Financial institutions, instruments, and services meet the needs of the government, NGOs, businesses, and households in both rural and urban communities;
- The country's financial institutions are sound, efficient, and competitive.

But these goals are hindered by the lack of prudential regulations. In addition, DAB has not instituted modern central banking standards and the publicly owned commercial banks—lacking basic management systems, procedures, controls, and skilled personnel—urgently require rehabilitation or liquidation.

The central bank and the supporting international development agencies acknowledge that Afghanistan's financial sector requires a multidimensional approach. While ensuring the implementation of medium- and long-term goals, reforms must address urgent short-term needs, particularly the restoration of a formal international and domestic payments system and the provision of basic retail financial services in secondary cities and outlying areas. The central bank's reform efforts must now focus specifically on:

- strengthening the legal and regulatory framework of the entire financial system and building regulatory capacity to enforce that framework;
- improving corporate governance in the banking system and the financial sector infrastructure as a whole;
- Improving access to financial services for small and medium enterprises and rural communities, and;
- Broadening and deepening the financial sector.

6.2 STRENGTHENING THE LEGAL AND REGULATORY FRAMEWORK AND REGULATORY CAPACITY

In the short to medium term, a strong legal framework is a priority for Afghanistan. Sustainable financial sector growth and stability require a framework based on strong creditor rights. Weaknesses in the legal and judicial framework governing commercial contracts and their enforcement, and the slow and biased court system, are common problems in developing countries, particularly postconflict ones. Developing an appropriate legal environment for financial sector development will require attention to the following actions in the short term (see Table 6.1):

- *Central bank:* The recently passed central bank and commercial banking laws need to be augmented with specific prudential regulations for monitoring bank performance with respect to capital adequacy, asset quality, liquidity, and loan classification. Simultaneously, the ability of bank supervisors to conduct on- and off-site inspections should be strengthened.
- *State commercial and development banks:* Until the state banks are privatized, the central bank should focus its reform efforts on strengthening corporate governance structures through a variety of options including: guidelines for the appointment and dismissal of managers and board members, new organizational structures, revised credit policy and controls, new procedures for credit-risk evaluation, improved internal documentation and monitoring systems, enhanced asset/liability and treasury-management techniques, and automation.
- *New commercial banks:* Afghanistan needs stronger criteria and procedures for bank licensing; these would provide for more detailed assessment of new banks' ownership and management structures, their operating plan and internal controls, and their projected financial condition, including their capital base. If the new bank is foreign, it is good practice to obtain prior consent from the home country regulator.

Table 6.1 Legal and regulatory reforms for Afghanistan's financial sector

Area	Short term	Medium term	Long term
Central bank			
	<ul style="list-style-type: none"> • Introduce prudential regulations for monitoring bank performance—capital, asset quality, and liquidity • Strengthen the ability of banking supervisors to conduct on- and off-site inspections 	<ul style="list-style-type: none"> • Strengthen prudential regulations, including loan classification standards, capital adequacy; increase minimum bank capital requirements • Establish competent commercial courts 	<ul style="list-style-type: none"> • Continue progress on financial sector reform including the regulatory framework and modernizing the central bank
Banking			
State banks	<ul style="list-style-type: none"> • Strengthen corporate governance structures; process of appointing and dismissing board members and management 	<ul style="list-style-type: none"> • Sever state ownership of banks 	<ul style="list-style-type: none"> • Continue progress on financial sector reform including resolution of state-owned commercial banks and entry of private sector banks.
New private banks	<ul style="list-style-type: none"> • Strengthen criteria and procedures for new banks to clarify capital entry requirements, the scope of individual operations, management and shareholder requirements, impact on banking sector competition, and reporting requirements 	<ul style="list-style-type: none"> • Introduce anti-money laundering legislation • Introduce product/service specific regulations to ensure safe banking practices 	<ul style="list-style-type: none"> • strengthen risk based prudential regulations
Microfinance			
	<ul style="list-style-type: none"> • Establish a more effective system of NGO and microfinance registration and monitoring • Facilitate entry and expand outreach 	<ul style="list-style-type: none"> • Adopt new NGO legislation encompassing microfinance activities, cooperatives, and other savings and credit associations 	<ul style="list-style-type: none"> • Continue progress on financial sector reform including entry of nonbank financial institutions
Money dealers sector			
	<ul style="list-style-type: none"> • Recognize the self-regulatory potential of the Money Dealers Association to introduce prudential regulations required by law • Work with the association to draft a code of ethics and standards of conduct, and to adopt disciplinary procedures 	<ul style="list-style-type: none"> • Introduce prudential regulations for licensing or registration, suspicious activity reporting, and record keeping 	<ul style="list-style-type: none"> • Continue progress on financial sector reform including entry of nonbank financial institutions

- Given the growing concerns over resurging poppy production and terrorism in some parts of the country, the government will soon be expected to pass legislation to combat money laundering and the financing of terrorism.
- *Microfinance institutions:* The new banking law includes no provisions for regulating and supervising microfinance institutions. Despite the increasing number of NGOs entering this field, microfinance is still at an early stage; it needs to be nurtured within the parameters of an accommodating legislative and regulatory structure. Reforms must focus on establishing a basic but

effective system for NGO and microfinance registration and monitoring. A legal framework that is too detailed may stifle rather than develop the sector.

- **Informal financial institutions:** Although DAB lacks the capacity to regulate money exchange dealers, it should recognize the potential of the Money Dealers Association to act as a self-regulatory body and work with it to introduce the new prudential regulations called for in recent legislation. The central bank should encourage the association to draft a written code of ethics and standards of conduct, and to develop disciplinary procedures.

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

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

6.3 IMPROVING CORPORATE GOVERNANCE AND THE FINANCIAL SECTOR INFRASTRUCTURE

In coming years, DAB should strive to improve the corporate governance structures of the relicensed state banks. Particular attention should be given to the composition and personal qualifications of the board, the directors' remuneration, the board's relationship with the shareholders, and its accountability to shareholders. Every financial institution, including DAB, should be headed by an effective board capable of leading the institution—and every board should have a balance of executive and nonexecutive directors. Every institution should have a formal and transparent procedure for the appointment, remuneration, and removal of new directors to the board; every one should hold an annual general meeting to communicate with private investors and encourage their participation; and every board should have procedures for regularly reviewing all controls—notably financial, operational, and compliance controls and risk-management procedures. In addition to improving corporate governance structures, the reforms need to address the overall quality of the financial sector's infrastructure: human resources policy and processes, accounting and auditing standards that meet international standards, technology-based management information systems, and an effective interbank and national payments system (see Table 6.2).

- **Human resources:** Significant investment is needed in human resources in the central bank, especially in the areas of monetary policy and banking supervision. Immediate solutions include, first, identifying a cadre of young prospective managers for accelerated training in key aspects of central banking activities, and, second, establishing a separate bankers' training institute, jointly financed and managed by the central bank and the rest of the financial sector.

- *Accounting and auditing procedures:* Present weaknesses in accounting and auditing practices must be addressed immediately. Information on DAB's financial position and the financial condition of the state banks is unreliable, because internationally accepted accounting standards are not used. The central bank should phase in such standards for banks and nonbanking financial institutions, starting with basic rules for asset and liability recognition, provisioning, writing-off, and depreciation and then moving on to more complex standards such as consolidated accounting. In the medium term, DAB should begin producing externally audited financial statements.
- *Computing technology:* Substantial investment is required in the central bank's technological capacity. DAB should start the computerization process at the points of data entry—in the banking hall, computer departments, research and statistics, and other operational departments. The hardware rollout should be matched with a systems development process that will enable DAB's departments to communicate electronically.
- *Interbank transactions:* DAB must create and strengthen the operational infrastructure for new banks, which will need physical and technological infrastructure for interbank transactions, international payments and settlements, and day-to-day treasury operations. Presently, the necessary infrastructure is significantly lacking, and it is unclear whether the central bank has the resources to provide it.
- *Payments system:* Infrastructure investment must also focus on key branches of the domestic payments system. Developing basic payment mechanisms and savings facilities in postconflict countries is a key step toward enabling the population to participate fully in the formal economy. The absence of effective rural payments systems is particularly acute. Given the absence of private investment in rural financial infrastructure, DAB must improve its rural physical infrastructure and the capacity of some of its key branches to facilitate basic financial transactions between Kabul and the regions. In the medium to long term, there should be a conversion from state central bank branches to privately owned commercial bank branches.

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

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

Table 6.2 Strengthening the infrastructure of Afghanistan's financial sector

Area	Short term	Medium term	Long term
Central bank			
	<ul style="list-style-type: none"> • Board and management: strengthen the central bank's corporate governance structure • Human resources: Identify a core cadre of prospective managers for accelerated training • Accounting: Complete the introduction of a new chart of accounts • Banking and information systems: Install hardware and software 	<ul style="list-style-type: none"> • Human resources: Establish a dedicated international and domestic management training program • Accounting: Prepare externally audited financial statements in accordance with international accounting standards 	<ul style="list-style-type: none"> • Continue progress on financial-sector reform including strengthening the financial sector infrastructure within the central bank
Banking			
State banks	<ul style="list-style-type: none"> • Board and management: strengthen the central bank's corporate governance structure • Complete the relicencing process • Introduce independent management in banks to be rehabilitated • Revive safe and sound operations 	<ul style="list-style-type: none"> • Complete the resolution of the unlicensed state banks • Commence the Voluntary Retirement Scheme, taking into account the government's fiscal commitments 	<ul style="list-style-type: none"> • Complete the privatization of the remaining relicensed state banks
Private banks	<ul style="list-style-type: none"> • Install accounting and financial controls • Establish a legal framework with appropriate regulations for payments system and domestic interbank market • Revive retail payments systems including the use of checks 	<ul style="list-style-type: none"> • Improve check-clearing and settlement systems 	<ul style="list-style-type: none"> • Convert to real-time gross settlement systems
Microfinance			
	<ul style="list-style-type: none"> • Begin licensing microfinance institutions under the new legislation 	<ul style="list-style-type: none"> • Entrust larger, well managed institutions to expand their range of products, including deposit taking among members 	<ul style="list-style-type: none"> • Consider the transformation of some of the large microfinance NGOs into banks or nonbank institutions
Informal financial institutions			
	<ul style="list-style-type: none"> • Accept applications for banking licenses from large money exchange dealers that have a strategic banking partner and meet legal licensing requirements 	<ul style="list-style-type: none"> • Consider licensing compliant money exchange dealers as nonbanking financial institutions, thus permitting them to engage in a wider range of well-regulated financial activities 	<ul style="list-style-type: none"> • Consider the transformation of some of the larger money exchange dealers into banks

6.4 IMPROVING ACCESS TO FINANCIAL SERVICES FOR SME'S, AND FOR RURAL COMMUNITIES

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

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

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

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

6.5 BROADENING AND DEEPENING THE FINANCIAL SECTOR

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

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

their funds and through which companies and consumers can obtain access to capital and credit, will spur the overall development of the economy.

To enhance competition and make the intermediary role of the banks and nonbanks more efficient, DAB should ensure that the banking industry is not dominated by a single bank or group of banks. Conventional means of enhancing competition within banking systems—such as bank privatization and changes in laws and regulations affecting companies, banks, foreign ownership, and bankruptcy—should constitute the basis of such a policy.

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

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

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

6.5 CONCLUSION

In arriving at the conclusions and recommendations here, we recognize that financial sectors in postconflict countries have varying levels of development and capacity for reform. Reform efforts must therefore continue to accommodate Afghanistan's unique characteristics and circumstances. Specifically, the government and its development partners must bear in mind:

- *Sustainable financial reforms have a long maturity period.* Enacting legislation, improving governance structures, developing competitive financial practices, building financial infrastructure, and encouraging international and domestic confidence in financial institutions require patience and determination. In postconflict countries, the need for persistence is even greater.
- *Proper sequencing of reforms is essential.*⁴⁶ Financial sector reforms achieve the best results in a stable macroeconomy. Price stability depends on low inflation rates; similarly, fiscal stability depends on no more than modest deficits. A conducive environment is needed to encourage investment from "fit and proper" sources, domestic and foreign. And the right financial infrastructure must be in place—namely, laws and regulations, of institutions that can effectively implement policy, human resources and skills formation, information systems, and accounting and audit capacity. All these components are essential for the effective implementation of financial reforms. In

⁴⁶ N. Mathieu, *Financial Sector Reform: A Review of World Bank Assistance* (Washington, D.C.: World Bank, 1998), 54–55.

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

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

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

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

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8. ANNEXES

ANNEX 2.1 THE LAW ON MONEY AND BANKING

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

2. Part II of the 1994 law relates to the DAB, its objectives, responsibilities, and powers, and its organs. It states that DAB is responsible for the implementation of the government's monetary and credit policy and that it shall maintain the value of the Afghani in order to facilitate banking and commercial transactions. It also empowers DAB to supervise operations of banks and credit institutions and to regulate and carry out foreign exchange operations. It mandates DAB to determine the commercial banks' interest rates for deposits and loans and to set minima and maxima on their commissions. DAB is also mandated to define liquidity and capital requirements and limits on large loan exposure. These provisions are mostly ill-defined, however, and do not comply with international best practice. There are no loan classification or provisioning requirements. Furthermore, the law only empowers DAB to define ratios and to collect information, but no provisions exist on the enforcement of the regulations. Part II further requires DAB to manage government accounts and, if necessary, to finance the government budget deficit, as well as to grant loans to government institutions, agencies, and municipalities. With respect to loans for government projects, DAB is required to check on the projects' economic and financial efficiency.

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

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

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

reports to the MOF and quarterly reports to the Supreme Council. This control function has not been fulfilled for years.

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

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

Source: "Islamic State of Afghanistan: Rebuilding a Macroeconomic Framework for Reconstruction and Growth," IMF Country Report No. 031299, 2003.

ANNEX 2.2 ELEMENTS DEFINING EXECUTIVE-CENTRAL BANK RELATIONSHIPS⁴⁷

Type of representation and authority of Central Bank Board	Decision-making structure at the Central Bank	Type of government	Place of the Central Bank in government	Political structure
Competence, appointment, and supervision e.g., Japan	Single e.g., Reserve Bank of New Zealand, Thailand	Unitary e.g., Reserve Bank of New Zealand, Korea	Organic e.g., Mexico	Two-party system e.g., U.S.
appointment, and supervision e.g., Germany (pre-ECB)	semiformal assistance from committee e.g., Bank of Canada, Bolivia	Federation (weak) e.g., U.S. Fed, Malaysia, Mexico	Legislative (difficult) e.g., U.S. Fed, Japan	Multiparty system (mixed) e.g., Australia
conduct only e.g., ECB, most African and Latin American countries	Committee (closed) e.g., U.S. Fed, Mexico, Hungary	Federation (strong) e.g., Canada, Argentina	Legislative (easy) e.g., Bank of England, African countries	Multiparty system ("Westminster" style) e.g., United Kingdom
Mix competence and regional representation, conduct only e.g., Canada	Committee (open) e.g., Bank of England			Multiparty system (proportional representation) e.g., New Zealand

Notes: "E.g." above means to provide an example of the country or countries that approximately meet the definition appropriate for each cell. A weak federation is one where the power of the regions is small relative to that of the center and vice-versa for the case of a strong federation. The interpretation is not restricted to matters of monetary policy alone. An organic law implies that the country's constitution explicitly defines the role and place of the central bank in governmental institutions. Difficult refers to the legislative hurdles in passing amendments to central banking legislation.

⁴⁷ Each column is to be treated independently of the other. It is therefore possible, in principle, to mix and match items in each column with items in the other columns.

ANNEX 2.3 FUNCTIONS AND POWERS OF THE SUPREME COUNCIL

Article 7. Functions of the Supreme Council

1. The Supreme Council shall be charged with the adoption of the principal policies of Da Afghanistan Bank and the supervision of the administration and operations of Da Afghanistan Bank.
2. In carrying out its functions, the Supreme Council must periodically assess the monetary and economic situation. To that end, the Executive Board shall report, not less than once every calendar quarter, to the Supreme Council on the administration and operations of Da Afghanistan Bank, on the conduct of its monetary and regulatory policies (including domestic price stability), on the soundness of the financial system including in particular the banking and payment systems of Afghanistan, and on the state of the money, capital and foreign exchange markets, including the events and conditions that have or must be expected to have a significant effect on the administration or operations of Da Afghanistan Bank, the conduct of its policies, the financial system or the before mentioned markets.
3. The Comptroller General shall present to the Supreme Council such reports and studies as the Supreme Council shall request for the supervision of the administration or operations of Da Afghanistan Bank.
4. The Governor shall ensure that each member of the Supreme Council shall promptly upon his request receive all such information as he or the Supreme Council shall require for the supervision of the administration or operations of Da Afghanistan Bank.

Article 8. Powers of the Supreme Council

The Supreme Council shall have the following powers:

- a) to formulate and adopt the monetary policy of Afghanistan, including the limits of open market operations by Da Afghanistan Bank, the interest rates for discounts and loans by Da Afghanistan Bank, and the types and levels of reserves that banks are required to maintain with Da Afghanistan Bank;
- b) to formulate and adopt the foreign exchange policy and the exchange arrangements of Afghanistan;
- c) to adopt all regulations, guidelines and instructions of general application that are to be issued by Da Afghanistan Bank pursuant to this Law or other legislation in force;
- d) to approve all reports and recommendations that Da Afghanistan Bank is to make to the government or the parliament of Afghanistan;
- e) to decide on the participation by Da Afghanistan Bank in international organizations;
- f) to determine the face value and design of banknotes and coins, and the conditions of any currency recall;
- g) to decide on the issue of debt securities by Da Afghanistan Bank and the terms and conditions of such securities;
- h) to determine the categories of assets that shall be suitable for investment of the foreign exchange reserves and other financial resources of Da Afghanistan Bank;
- i) to approve the discounting by Da Afghanistan Bank of instruments having a maturity of more than three months from the date of their acquisition by Da Afghanistan Bank;
- j) to approve, with the consent of at least three-fifths of the members of the Supreme Council present, each loan and each guarantee or other contingent commitment of Da Afghanistan Bank to or for the benefit of a bank pursuant to Article 88;
- k) to adopt the by-laws of Da Afghanistan Bank and the regulations applicable to the administration and operations of Da Afghanistan Bank;
- l) to determine the organization of Da Afghanistan Bank;

- m) to approve the appointment of the deputy governors (other than the first deputy governor) and the comptroller general of Da Afghanistan Bank, and to approve subsequent service at another financial institution by the governor and the first deputy governor;
- n) to establish and close subsidiaries, branch offices and agencies of Da Afghanistan Bank,
- o) to decide on the purchase, construction, utilization and sale of buildings and other real estate by Da Afghanistan Bank;
- p) to determine the budget of Da Afghanistan Bank and in general the terms and conditions of employment, including pensions, of the employees, agents and correspondents of Da Afghanistan Bank other than the members of the Supreme Council;
- q) to propose increases in the authorized capital of Da Afghanistan Bank set forth in article 27;
- r) to determine the accounting policies and the financial risk management policies of Da Afghanistan Bank;
- s) to adopt the annual reports and financial statements of Da Afghanistan Bank,
- t) to decide on the depreciation of assets and the rate of depreciation of assets of Da Afghanistan Bank, to establish special reserves on the books of Da Afghanistan Bank, to determine the net income of Da Afghanistan Bank, and to decide what amount of such net income shall be transferred to any reserve; and
- u) such other powers as shall be granted to the Supreme Council by law.

ANNEX 2.4 INTRODUCING THE NEW CURRENCY

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

2. The first stages included the ordering, printing, and delivering the new bank notes. DAB contracted the printing of the new currency in denominations of Af 1, 2, 5, 10, 20, 50, 100, 500, and 1,000 to two reputable banknote printers, building upon the work that had already been done for the Taliban regime. The new notes included several advanced security features to deter future counterfeiting. It was difficult to determine how many new banknotes would be needed. The authorities only had a crude estimate of the existing amount of old notes in circulation. Including the various counterfeits, the face value of the old Afghani in circulation was initially estimated at about Af 16 trillion. For political reasons, it was decided that two types of unofficial notes would be eligible for conversion, but at a 50 percent discount (close to the actual discount at which these counterfeits traded in the Kabul money market). Taking this discount into account, the total value of old Afghani to be exchanged was estimated at about Af 13 trillion. The authorities realized, however, that running out of new bank notes before all old ones would be converted would fatally undermine the public's confidence in the new currency. Because of this, and to be able to accommodate an increase in money demand at least in the first year following the new currency's introduction, the authorities ordered a total value of the new notes of Af 27.9 billion (with 1 new Afghani replacing 1,000 old ones), equivalent to almost 800 million notes or about 500 tons. The first deliveries were received in August 2002 and the last shipments arrived in January 2003. The five smallest denominations make up almost 90 percent of the total volume of notes ordered, but only 15 percent of the total value.

3. A first problem to overcome was the extremely poor condition of DAB's regional facilities. DAB had 89 branches, but most of them did not meet even the most basic requirements in terms of secure vaults and office space. With the assistance from international donors, DAB urgently set out to refurbish or construct a minimum of one currency distribution facility in each province. The country was divided into seven regions, each the responsibility of an area manager. In addition to Kabul, the regions were Kunduz, Mazar-i-Sharif, Herat, Kandahar, Jalalabad, and Gardez. Each region had a number of exchange points, depending on estimates of population size and levels of economic activity. All in all, 47 exchange points were established where the public could exchange their old notes for new ones. An exchange point consisted of one to five units, with each unit having seven windows: five windows to take in the old currency and two to give out the new. With communication still difficult, the success of the whole program depended significantly on the work of the area and the exchange point managers, who often had to act on their own to deal with problems in their regions. Some 2,500 local staff were selected to carry out the operation. They were selected from the most experienced and skilled personnel in the banking sector. In order to motivate staff and to establish reliable operations, staff were paid considerably more than the \$30 to \$40 a month normally earned by a bank employee. In addition, the U.N. and USAID provided international observers to oversee the process, notably the destruction of old notes.

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

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

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

7. During the first two weeks of the exchange period, only the money changers would be allowed to exchange their old notes. This way DAB aimed to collect large volumes of old notes early on. In order to be able to handle the large volumes that were expected to be exchanged this way, a sampling procedure was agreed with the money changers, whereby only 10 percent of the total amount presented was verified to make sure that the count was correct, the denominations were correct, and the notes were indeed eligible for exchange. If the sample count found, for example, 2 percent to be incorrect, this proportion would be discounted from the entire amount that a money changer was presenting.

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

9. In the initial period, large denomination bank notes, 1,000, 500, 100, and 50 afghanis, dominated the exchange, reflecting the early and active role of money changers. This also meant that the weight of bank notes, relative to their value, was much less than in the last month of the exchange, when primarily low

denomination bank notes (1, 2, 5, and 10 afghanis) were exchanged. Af3.9 trillion worth of old official notes were exchanged during the conversion process for new notes, plus Af3.3 trillion in unofficial notes at a 50 percent discount. Thus, Af 15.6 billion of new notes were issued in exchange. An additional Af2 trillion in old official notes were absorbed through the foreign exchange auctions during the conversion period. All in all, some Af19 trillion in old notes were collected, equivalent to some 5 billion banknotes, or more than 2,000 tons, almost 20 percent more than the estimated face value of banknotes based on the information received from the printing companies. This difference may reflect inaccurate or incomplete information received from the printers, "last minute" printing of counterfeits, or round-tripping of old notes during the currency conversion process. To address the problem of round-tripping, initially old bank notes were to be invalidated, using punchers and drills, and to be subsequently destroyed, using shredders. But this approach quickly proved to be ineffective, as the arrival of equipment was delayed and, once it arrived, had a tendency to break down. The solution to the destruction problem was to use incineration as the principal method. Difficulties in transportation and security meant that the best approach was to incinerate the notes locally. The construction of ovens was relatively simple and inexpensive. Also, ovens did not require electricity, which was lacking in many exchange points. A schedule was established for the weekly or biweekly destruction of the old bank notes, with the requirement that there be both international and national observers present to assure the integrity of the process. The exchange ended quietly on January 2, 2003.

ANNEX 3.1 STATE BANK RESTRUCTURING OPTIONS

Background

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

Current Status of the Project

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

Policy Decision Required

In its initial proposal the World Bank recommended the issuance of a single management contract to rehabilitate one state commercial bank, and encouraged the liquidation of all insolvent state development banks. Since that initial proposal, the World Bank has been asked to consider the rehabilitation of two banks for reasons ranging from geographic distribution of branches, to the need for competition, and possible political considerations.

The Bank is willing to proceed with the rehabilitation of either one or two banks and has advised of the cost and management considerations of each approach. Based on discussions with various parties concerned, there appear to be five options for commercial restructuring and privatization (see Table 1).

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

Table 1 Options for Management of the Bank Restructuring Process

OPTION	Description
OPTION 1: UNIFIED MANAGEMENT CONTRACT FOR ONE <u>EXISTING</u> BANK	<p>This option assumes that there will be one contract for one preselected bank, and that the "good" assets of the other five banks will be merged with the selected banks, while the "bad" assets will be sent to some resolution unit for final liquidation/closure. Under such circumstances, other bank(s) could continue to operate, assuming they applied for a license from DAB and are able to meet requirements for relicensing. Technical assistance under the project would apply, however, only to the one pre-selected bank.</p>
OPTION 2: UNIFIED MANAGEMENT CONTRACT FOR ONE BANK <u>SYNTHESIZED</u> <u>FROM</u> <u>SALVAGEABLE</u> <u>PARTS OF OTHER</u> <u>BANKS</u>	<p>A variant on the "one bank" approach in Option 1 is that the bank would not necessarily be pre-selected. Rather, the single bank would represent the organizational outcome of the resolution process by which all salvageable assets from all six banks would be merged into one bank, which would then be the recipient of technical assistance under the project. This would include a blending of liquid assets in correspondent accounts abroad along with real estate (i.e., branches) and other usable assets in Afghanistan.</p>
OPTION 3: UNIFIED MANAGEMENT FOR TWO BANKS	<p>This option would seek out a single management team for two banks along with the aforementioned resolution activity. In this case, one chief of party would oversee three teams: one for each bank, and a third team involved in resolution work for the other four banks, or potentially for all six banks.</p>
Option 4: <u>Three</u> <u>Separate</u> <u>Management</u> <u>Contracts, for</u> <u>Two Banks plus a</u> <u>Third for</u> <u>Resolution</u> <u>Activity</u>	<p>This option would seek out separate management teams for two banks along with a third management team for the aforementioned resolution activity. In this case, the third team involved in resolution work could be involved in the four banks that will not benefit from direct technical assistance (although the resolution work will be financed and would thus constitute technical assistance), or potentially in all six banks as a separate function detached from the rehabilitation and restructuring efforts of the management teams in the two chosen banks.</p>
Option 5: Management Contract(s) plus Establishment of Asset Management Company	<p>This option would have one or two management team(s) for the one or two banks, along with a contract to establish an independent Asset Management Corporation (AMC). The AMC would carry out the resolution work noted above, yet also be conceived as more of a formal institutional structure to help build up the legal and institutional infrastructure needed for problem banks, as well as to establish principles, policies, processes and procedures for future asset and bank resolution.</p>

One-bank rehabilitation/creation approach

- Option 1 A single management contract for the resolution of all insolvent state development banks and the rehabilitation of one existing commercial bank;
- Option 2 A single management contract for the resolution of all insolvent state commercial and development banks and the creation of a new bank;

Two-bank rehabilitation approach

- Option 3 A single management contract for the resolution of all insolvent state development banks and the rehabilitation of two existing commercial banks;
- Option 4 A single management contract for the resolution of all insolvent state development banks, and two additional contracts for the rehabilitation of each of the two existing commercial banks.
- Option 5 The creation of an Asset Management Company for the resolution of all insolvent development banks, and two additional contracts for the rehabilitation of each of the two existing commercial banks.

Recommendation

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

Although the Bank team technically counsels against a two-bank approach, owing to the significant increase in the costs of TA, potential delays in project commencement, and potential additions to the complexity to the implementation process, it understands the central bank's reasons for preferring two banks, and the Bank is prepared to work with the authorities should this remain the preferred approach. Under these conditions, the Bank believes it will be imperative that three separate contracts be issued. Although there is a risk of delay, this is not a certainty. All three RFPs can be issued simultaneously, received simultaneously, and awarded simultaneously. Although being more costly, there is also the possible added benefit of competition among the various contractors to achieve the best possible reputation for performance.

As for Option 1, the main problem is the selection process. As no single bank appears to represent a clear choice, the risk then becomes excessively political and thus potentially divisive. Options 2, 3, and 5 are not recommended owing to complexity and cost and the potential conflicts of interest for the management teams. Detailed analysis of each of the above options is available in a separate Policy Note.

ANNEX 3.2 VOLUNTARY STAFF RATIONALIZATION SCHEME (VSRP)

Key Issues

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

- *Identifying the number of employees targeted for lateral transfer and/or voluntary retirement.* To get a true sense of the costs/benefits associated with the VSRP, extensive analysis must be performed to identify the extent of overstaffing. The total number of staff employed by both the central bank and the commercial banks must be clear, and the percentage of excessive staff targeted for the VSRP must be calculated. Alternatively, if severance is not considered a viable option due to fiscal risks, planners must develop a comprehensive and systematic set of priorities and guidelines for the lateral transfer of surplus personnel to other parts of the civil service, with their ultimate severance or redeployment packages determined within a broader settlement of civil service personnel and compensation issues.
- *Measures to mitigate the risks of insufficient compensation on the one hand, or excessive compensation and the revolving door syndrome on the other, have to be clearly developed.* First, any severance package might be insufficient owing to the larger cost issues involved not only in the banking sector but also in potential fiscal liability. This would result from government pressure to keep severance compensation low to ensure a low cost civil service severance package, introduced more universally. On the one hand, too few bank and DAB employees might voluntarily accept the option, keeping head count too high. On the other, the financial package might exceed a reasonable compensation level, not in line with the rest of the civil service. This latter development would add to the potential fiscal liability, and could lead to excessive exit of bank and DAB personnel. Finally, there is the risk of retired employees being rehired by the same organization or within the same sector, particularly if the severance package is viewed as very attractive and if too many critically needed staff depart. This risk could be managed by requiring that any voluntary severance package be administered on a lump-sum basis; participants would be required to sign contracts attesting to the voluntary nature of the scheme, and contractually requiring that full compensation be remitted should the individual be rehired. More generally, measures such as using a consultative process, having clear eligibility criteria, offering the correct compensation package, and considering political/legal/social issues will have to be considered. More important, in light of the limited data and potential implications for the budget and civil service at large, a lateral transfer option from the DAB and banks to other parts of the civil service will need to be considered.

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

Management autonomy in the restructuring of banking institutions is essential if project objectives are to be achieved. Management autonomy across the board is vitally important given that the AFSSP is focused on making the banking system more professional, competitive, and efficient so that domestic banks have a foundation that allows them to compete. On this basis,

commercial banks will need to be reorganized as commercial institutions. Social considerations with regard to personnel management will need to be subordinated to these priorities and concerns. Thus, arriving at an acceptable solution that provides fair compensation for redeployed individuals, while also safeguarding management autonomy is essential.

- *Dealing with the issue of redundant employees is essential not only for the bank(s) to be restructured but also for the banks to be liquidated.* At a minimum, employees of banks whose licenses will be revoked will need to be reclassified. Under such circumstances, the procedures that apply to these employees should apply to employees of banks that will retain their licenses, but who are subsequently declared redundant. In neither case should employment issues hold up restructuring or liquidation. At the same time, a transparent system needs to be in place to ensure these civil service employees have the possibility of finding an alternative assignment should they not choose a voluntary retirement option.
- *Delays in civil service reform make it more difficult to provide a precise package for voluntary labor redeployment in this project that is consistent with overall measures that will be taken in the public sector.* Efforts are under way to develop an overall program and plan, but these will take time. Meanwhile, the task is complicated by a number of other sensitive fiscal issues, such as weak revenue flows at the central government level and the consequent absence of a clear human resource plan that can deploy people according to the vast range of public sector needs. A database is still being assembled and verified, and longstanding problems persist with documentation efforts to verify skills, qualifications, years of service, etc.
- *Elections scheduled for next year raise the risk that making bold decisions will be nearly impossible, particularly as private investment remains low and private sector employment capacity is essentially informal.* Given the private market's current lack of absorptive capacity, the government is in the difficult position of trying to reduce its labor costs, assign responsibilities to individuals and ministries based on key needs, and simultaneously deliver services in an effort to restore the country's confidence in civil authority. Redeployment schemes at this juncture are politically risky and provide little or no benefit to the public. Even if such programs are essential for building a viable banking system and private sector economy, this is a time-consuming process that will not be significantly visible to the public at large by the time of next year's elections. Thus, the political risk associated with any VSRP that does not at least provide some financial resource cover is untenable.
- Among the most likely candidates for redeployment are those most victimized in recent years. The task is made even more because some of those who are least able to fulfill professional functions in banks or the DAB are those who have been deprived of education and other opportunities. This includes women whose access to public education was banned by the Taliban, as well as individuals who have been imprisoned over the years for political and other reasons. In many cases, these people will not be able to assume professional responsibilities in the financial sector.

General Range of Options

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

- Option 1: **Attrition**: Proceed by freezing new recruitment and waiting for people to retire. This is certainly the least painful approach. But in a bank restructuring scenario, it has the potential of restricting management capacity to acquire the requisite skills for a more efficient banking services. It will also impede prospects for privatization.
- Option 2: **Direct Layoffs with Minor or No Compensation**: This would clearly be affordable from a project and fiscal standpoint, and would enhance and reflect management autonomy. But given the limitations of formal private sector employment and the fragility of whatever safety net exists, this approach is the least socially and politically acceptable.
- Option 3: **Full implementation of a market-based compensation scheme** predicated on the employee's age, years to retirement, experience, and needs for the bank. This approach would have major implications for future civil service packages the government budget may have to absorb. It would raise the risk of a significant contingent liability for the government should the package be used as a precedent for future severance payments to civil servants declared to be excess staff.
- Option 4: **Interim transfer of staff to a government department or ministry**, until such a time that the Civil Service Commission has completed its work. Existing civil service rules require that staff being considered for redundancy join a surplus list maintained by the Ministry of Labor and Social Affairs for six months, while attempts are made to find them employment in other ministries. This amounts to moving employees, in some virtual sense, to the Ministry of Labor and Social Affairs (MOLSA), which then tries to place them in a government ministry. In all probability, MOLSA will not find another willing ministry or department — and so they will sit there.

Recommendation

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

ANNEX 4.1 KEY FACTS FOR SELECTED NGO MICROFINANCE SCHEMES

Name of organization	Institutional Facts	Program Description	Lending Methodology/Financing Terms	Key Performance Indicators (if available)
Agency for Rehabilitation and Energy Conservation (AREA)	Local NGO established in 1993; currently have 350400 staff and a 2002 budget of \$3.5 million from several donors including UNHCR, NOVIB, DFID and Muslim Aid.	Operate an Integrated Community Development Program in 4 regions and 23 districts, which includes a microfinance component. Combination of community-based savings and credit and group lending. Also work with 8 agricultural cooperatives.	In-kind loans, including for agri-inputs, livestock, embroidery, knitting, shop keeping, shoe making and carpet weaving Service fee of 10-12 percent (for the 'service' of buying the item(s) with the loan amount) Average loan amount \$200 equiv. Max. loan amount - \$300 for livestock Group savings	Approx. 1,600 loans disbursed (37 percent to women) Repayments averaged 98.5 percent, however, have recently declined to 85 percent due to drought conditions.
Afghan Development Association (ADA)	Local NGO established in 1990 with a mission to eradicate poverty.	Has established 7 agricultural cooperatives averaging 30 members. Provide credit, training and assistance with packaging and selling products in the market. Trained 120 women in 2001 in embroidery, carpet weaving, knitting, and yarn making and gave loans to purchase raw materials to be able to craft and sell the products.	Interest-free loans to cooperatives mainly for horticulture (apricots, apples, pomegranate, grapes, almonds and raisins); on-lent for one year. Interest free loans to women for Pk Rs 500 to purchase raw materials. Plan to introduce service charges this year.	
CARE	Approx. 550 staff. Community development projects incl. Rural infrastructure, widow's assistance program and umbrella support program for local NGOs.	Currently no microfinance activities, but planning to design a program. Microenterprise expert arriving in mid-June. Expect program proposal to be ready by mid-September.	NA	NA

Comprehensive Disabled Afghans Program (CDAP)	ILO-program, implemented through UNOPS. Started 1996.	Obj: to support economic reintegration of disabled Afghans. Three components: (i) microcredit; (ii) job training; (iii) job placement. Microcredit not linked to job training. Credit mainly given to disabled with existing skills/businesses.	Interest free loans of max. \$250 lent in Afs.	Est. \$200,000 lent out (approx. 1,000 loans). Approx. 80 percent repayment.
CHF	International NGO.	Have developed microfinance project (proposal/plan) with aim to revitalize marketplaces in Bamiyan. Comprises two components: (i) reconstruction of market infrastructure; (ii) loans to stallholders to rebuild their stall and restock their businesses. —group lending to women for carpet making in association w/ local NGO (CCA)	Working capital loans averaging \$100 to stall holders plus \$100 to repair stall. Lending through merchants association that represents stall holders. Elected body. Responsible for screening clients, loan decision and collecting repayments on a fee-basis. Group lending to women for carpet weaving and livestock purchase. Total \$3 million proposal for 1 year. Funding not yet secured at time of visit.	Plan to disburse 3,000 loans total.
Save the Children (SCF)	International NGO	Operate microcredit program for women in Faryab province and six refugee camps in Baluchistan. Have put together a new program proposal for financing together with FINCA to expand their program. This proposal envisages 2 new programs, one supported by SCF (in Kabul) and one by FINCA, for a total of \$6m.	Group lending to women, primarily for carpet weaving. Fee charged for loan application.	Results for Faryab province (as of Nov 01): 1,880 active clients \$205,000 loan outstanding 35 percent portfolio at risk

ANNEX 5.1 SAMPLE SELECTION CRITERIA FOR *HAWALA* DEALERS⁴⁸

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

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

Recognized by the Money Exchange Dealers Association: The market has an informal eight-member Executive Committee that meets regularly to discuss its members' affairs. The committee's executive director and his three assistants direct the activities of the Money Exchange Dealers Association and ensure that each member adheres to the association's unwritten rules of conduct and practices. Membership to the association is voluntary and there are no subscription fees. Membership is also an additional indicator the operator legitimacy

Maintain a physical presence at the Sari Shahzada in Kabul: The physical money exchange market, where most of Kabul's money exchange dealers are currently located, has an eighty-year-old history. Established along side the Kabul River, it is situated close to the gold and silver bazaars and financial service to the metal traders. Kabul's other specialized markets are all within walking distance of the market, where traders conduct and conclude their financial transactions. Operators with a physical presence at the market are likely to have a longer operational history than those who do not.

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

Be able to execute promptly a large number and volume of transactions: There is no limit on the volume of funds transfers the money exchange dealers of Kabul can transfer; individually or severally. The NGOs alone are estimated to have channeled at least US\$200 million in emergency, relief, and development funding through the *hawala* system. Single transactions in excess of US\$500,000, especially between Peshawar in Pakistan and Kabul, are not uncommon. The larger international organizations and NGOs have made individual transactions of US\$1,000,000. A basic assessment of the operator's operational capacity needs to be done before being contracted.

Agree to issue promptly a detailed monthly statement of funds transfer transactions: Contrary to common belief, money exchange dealers maintain comprehensive records for each *hawala* transaction. The financial records the money exchange dealers maintain are detailed, and the entire process of remittance and settlement is very well documented. There are records of everything. Dealers know exactly how much cash they have, how much has been transferred, and how much is owed to them. It is important that the accessibility of these documents for users is improved through an agreed financial statement review process.

Have established a satisfactory domestic and international correspondent funds transfer network: Regional money exchange dealers are generally situated located in a regional rather than village or

⁴⁸ Author interviews.

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

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

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

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

Obtain a written document stating the following: (1) amount to be transferred; (2) funds transfer destination; (3) currency or currencies used for the transaction; (3) expected date of payment; and (4) fee chargeable for the transaction: Each *hawala* dealer designs, develops, and maintains his own documentary policies and procedures. Some of the procedures have been in use for many years and adapted to the changing business environment. Each business develops adequate systems that are sufficient for keeping track of transactions and balancing their accounts with international and domestic correspondent partners.

Establish monetary limits for individual transactions which reflect: (1) capacity of the money exchange dealer; (2) security situation at the origin and the intended destination of the funds, and; (3) capacity of the recipient to maintain cash holdings on their premises: Because there are limited storage facilities in Kabul for large sums of money, most organizations remit funds through the *hawala* system in smaller amounts of US\$100,000–US\$200,000. The smaller organizations regularly remit US\$20,000–US\$30,000 to meet operational expenses.

Agree that the remitter will only pay the *hawala* service provider after (1) the correspondent *hawala* service provider has made payment of the agreed amount to the intended recipient, and; (2) The recipient has acknowledged receipt of the funds. The confirmation of receipt must be both verbal *and* in writing (fax or e-mail): The *hawala* system is extremely reliable. Seldom do dealers fail to effect payment. Besides the expected high standard of adherence to codes, default risk has been eliminated through the "confirmation-before-payment" process. In all cases reviewed during the study, the remitter paid the *hawala* dealer the value of the funds remitted only after the recipient had confirmed receipt of the money. There was 100 percent satisfaction rate with the delivery of funds. The isolated incidents of client dissatisfaction were limited to occasions when the customer paid a slightly higher fee than competitors were offering.

Agree that, with the exception of small transactions, all financial transactions must be conducted in a secure location, preferably on the premises of the remitting and recipient organization. Carrying large amounts of cash around Kabul is not advisable, especially in a busy open market. *Hawala* dealers are often willing to come to the premises to collect/pay funds from/to the user/recipient.

⁴⁹ Author interviews

**AGREEMENT BETWEEN ISMAIL RADWAN RELIEF FUND
AFGHANISTAN
AND
HASSAN ZAMAN MONEY EXCHANGE⁵¹**

This contract is drawn up between Ismail Radwan Relief Fund and Hassan Zaman Money Exchange desiring to set forth the following understanding that will govern supplying of US\$, Pakistan rupees, and afghanis to Ismail Radwan Relief Fund. As crossing the border is still an unresolved issue, it was agreed through both sides that the payment will be done in Peshawar office based on electronic communication system, that is fax plus password file for confirmation.

Responsibilities of Hassan Zaman Money Exchange

1. To provide Ismail Radwan Relief Fund offices with afghanis, Pakistani rupees and USD in 6 hours from Kabul and within 12 hours for the respected provinces after tequisition through Ismail Radwan Relief Fund as:
 - For Kabul office: by faxing through Ismail Radwan Relief Fund, with commission of 0.65 percent.
 - For Ghazni office: by faxing through Ismail Radwan Relief Fund, with commission of 2.0 percent
 - For Loghar office: by faxing through Ismail Radwan Relief Fund, with commission of 1.0 percent
 - For Gardez office: by faxing through Ismail Radwan Relief Fund, with commission of 2.0 percent
2. To provide Ismail Radwan Relief Fund with exchange rate of afghanis/Pakistan rupees equal or higher than the Money Changers in the open currency exchange market. Hassan Zaman will be requested to observe collection of exchange rate quotations through Ismail Radwan Relief Fund key staff.
3. To inform Ismail Radwan Relief Fund about any problem, which may cause delay in, the cash being delivered beyond 24 hours of the time of requisition.
4. In the case of cash being provided late (i.e., more than 24 hours after being requested despite Hassan Zaman signing that he will provide the money), than, the exchange rate offered will be revised again (at the time of delivery). If the second exchange rate is unfavorable to Ismail Radwan Relief Fund, then Hassan Zaman should agree to provide at the original agreed rate.
5. The bank notes that are provided must be legal tender and must not be damaged.
6. Invalid/damaged notes of all types of currencies should be changed with newer ones.
7. In case Hassan Zaman cannot provide the amount Ismail Radwan Relief Fund wants, he should submit something in writing stating his excuse based on which Ismail Radwan Relief Fund can ask the second money dealer to provide the needed amount onwards.

⁵⁰ Source: NGO in Afghanistan.

⁵¹ Names of parties have been changed for reasons of confidentiality.

Responsibilities for Ismail Radwan Relief Fund

1. To request money from Hassan Zaman 6 hours in advance for Kabul and 12 hours in advance for different provinces of the time being required informing Hassan Zaman of the exchange rate to be used.
2. Reimbursement of the same amount plus commission charge as mentioned in the first item of Hassan Zaman's responsibilities.
3. IF the money paid to Ismail Radwan Relief Fund is in Rupees and Afghanis, then the refund will be in Pakistani rupees and if the money paid to Ismail Radwan Relief Fund is in USD, then the refund will be in USD.
4. Ismail Radwan Relief Fund faxes the receipt documents to its main office in Peshawar and it bears the fax charge too.
5. Ismail Radwan Relief Fund will undertake to count the money it received as quickly as possible.

General

This contract will remain valid for three months effective from signing date onward. If either party wishes to change the contract, then, they must inform each other in written notice at least three weeks in advance by either side. This contract will be extended with the same terms and conditions when both sides agree after the validation of the contract.

For Ismail Radwan Relief Fund Afghanistan For Hassan Zaman

Name:

Name:

Title:

Title:

Date:

Date:

ANNEX 5.4 FINANCIAL ACTION TASK FORCE (FATF) SPECIAL RECOMMENDATIONS⁵²

Recognizing the vital importance of taking action to combat the financing of terrorism, the Financial Action Task Force (FATF) has agreed these Recommendations, which, when combined with the FATF Forty Recommendations on money laundering, set out the basic framework to detect, prevent and suppress the financing of terrorism and terrorist acts.

I. Ratification and implementation of U.N. instruments

Each country should take immediate steps to ratify and to implement fully the 1999 United Nations International Convention for the Suppression of the Financing of Terrorism.

Countries should also immediately implement the United Nations resolutions relating to the prevention and suppression of the financing of terrorist acts, particularly United Nations Security Council Resolution 1373.

II. Criminalizing the financing of terrorism and associated money laundering

Each country should criminalize the financing of terrorism, terrorist acts and terrorist organizations. Countries should ensure that such offenses are designated as money-laundering predicate offenses.

III. Freezing and confiscating terrorist assets

Each country should implement measures to freeze without delay funds or other assets of terrorists, those who finance terrorism and terrorist organizations in accordance with the United Nations resolutions relating to the prevention and suppression of the financing of terrorist acts.

Each country should also adopt and implement measures, including legislative ones, which would enable the competent authorities to seize and confiscate property that is the proceeds of, or used in, or intended or allocated for use in, the financing of terrorism, terrorist acts or terrorist organizations.

IV. Reporting suspicious transactions related to terrorism

If financial institutions, or other businesses or entities subject to anti-money laundering obligations, suspect or have reasonable grounds to suspect that funds are linked or related to, or are to be used for terrorism, terrorist acts or by terrorist organizations, they should be required to report promptly their suspicions to the competent authorities.

V. International co-operation

Each country should afford another country, on the basis of a treaty, arrangement or other mechanism for mutual legal assistance or information exchange, the greatest possible measure of assistance in connection with criminal, civil enforcement, and administrative investigations, inquiries and proceedings relating to the financing of terrorism, terrorist acts and terrorist organizations.

Countries should also take all possible measures to ensure that they do not provide safe havens for individuals charged with the financing of terrorism, terrorist acts or terrorist organizations, and should have procedures in place to extradite, where possible, such individuals.

⁵² See <http://www.fatf.org>

VI. Alternative remittance

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

VII. Wire transfers

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

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

VIII. Nonprofit organizations

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

- a. by terrorist organizations posing as legitimate entities;
- b. to exploit legitimate entities as conduits for terrorist financing, including for the purpose of escaping asset-freezing measures; and
- c. to conceal or obscure the clandestine diversion of funds intended for legitimate purposes to terrorist organizations.

ANNEX 5.5 ABU DHABI DECLARATION ON *HAWALA* (MAY 2002)⁵³

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

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

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

Regulations should be effective but not overly restrictive.

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

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

⁵³ Source: Conference proceedings.

ANNEX 5.6 WORLD BANK–IMF CONCLUSIONS ON *HAWALA* SYSTEMS⁵⁴

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

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

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

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

Because *hawala* transactions are unrecorded in national accounts and other statistics, the data available to policymakers would not offer an accurate description of the economic and monetary situation of a country and would tend to limit the effectiveness of their policies. A *hawala* transaction is a balance-of-payment transaction, not because "money is sent" across borders or there is any recorded

⁵⁴ M. El Qorchi, S. Maimbo, and J. Wilson, 2003.

purchase or sale of foreign exchange, but because the transaction is intrinsically linked to changes in international assets and liabilities. Although hawala and other IFT transactions are conceptually part of national BOP accounts, accurate compilation is almost impossible. Nevertheless, even though national authorities are unable to directly maintain records of informal financial transfers, the indirect effects of these transactions on monetary aggregates and operations, as well as on the balance of payments, should be taken into consideration. The system reduces the amount of statistical information available to policymakers on the level of economic activity in the country.

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

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

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

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

Regulators must bear in mind that prescribing regulations alone will not ensure compliance. Regulations are not a panacea for possible abuse of the IFT systems. Specifically, regulators need to possess the appropriate supervisory capacity to enforce the regulations. Also, they must bear in mind that experience shows that restrictive methods will not drive out all businesses involved in unlicensed financial transfer activity from the market. The informal banking system can not be completely eliminated by means of criminal proceedings and prohibition orders. Policymakers should acknowledge the existence

of practical reasons, from the customer's point of view, to resort to informal methods for international payment purposes. As long as such practical reasons exist, hawala and other IFT systems will persist.

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

Clearly, the development of various informal funds transfer systems over many years and across many countries points to the important role these systems can play in the absence of a robust and efficient formal financial sector. Considering the informality inherent in these systems, particularly the anonymity and the lack of records, it is clear that risks of misuse exist. The development of the ability of the formal financial sector to respond to the legitimate market demand for hawala-type transactions, coupled with prudent regulatory policies for hawala operators, requires sound and sustainable macroeconomic policies, a well-developed payments system, and a healthy financial sector. Notwithstanding the progress apparently made by the formal sector in expanding its activity at the expense of informal activity, these gains are not definitive and can easily be reversed. Poorly functioning financial systems, or simply the deterioration in financial or macroeconomic conditions, could produce greater recourse to informal payment systems. A setback in financial and exchange liberalization or the rise in the exchange spread between official and parallel market exchanges can always induce more IFT activity.



