PROJECT INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

Report No.: PIDA1306

<table>
<thead>
<tr>
<th>Project Name</th>
<th>Afghanistan Access to Finance (P128048)</th>
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<td>Region</td>
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<tr>
<td>Country</td>
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<td>Sector(s)</td>
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<td>Theme(s)</td>
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<td>Implementing Agency</td>
<td>MISFA</td>
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I. Project Context
Country Context

1. Afghanistan will experience a major security and development transition over the next years. At the Kabul and Lisbon Conferences in 2010, NATO and the Afghan government agreed that full responsibility for security would be handed over to the Afghan National Security Forces by the end of 2014. The country now faces the drawdown of most international military forces over the coming several years with an expected accompanying decline in civilian aid as international attention shifts elsewhere and aid budgets come under increasing fiscal pressure. The decline in external assistance is likely to have widespread ramifications for Afghanistan’s political and economic landscape well beyond 2014. Falling aid flows in Afghanistan will have the most impact on public spending as present levels of expenditure will be fiscally unsustainable for Afghanistan once donor funds decline. The main issue is how to manage this change, mitigate impacts, and put aid and spending on a more sustainable path. At the Tokyo Conference on July 8, 2012, the international community committed to US$16 billion of aid to Afghanistan (annual average of US$4 billion over the next four years) and agreed to the Tokyo Mutual Accountability Framework with the Government of Afghanistan (GoA) that focuses on (i) Representational Democracy and Equitable Elections, (ii) Governance, Rule of Law and Human Rights, (iii) Integrity of Public Finances and Commercial...
Banking Systems, (iv) Government Revenues, Budget Execution and Sub-National Governance, and (v) Inclusive and Sustained Growth and Development.

2. The GoA’s 22 National Priority Programs (NPPs) identified private sector development as one main driver of the diversified growth strategy. The private sector is currently dominated by micro, small and medium enterprises (MSMEs) both in urban and rural areas, with 91 percent of enterprises employing 5 workers or less and half of the private firms have been operating for 4 years or less. Self-employment is also preponderant reaching 43 percent in rural areas and 50 percent in urban areas. These MSMEs are labor intensive, and have the potential to absorb part of the growing labor force, estimated at 400,000 to 500,000 new entrants per year. Moreover, they could also help address the significant under employment of Afghans, which is six times larger than unemployment rate at 48 percent in Afghanistan, especially in rural areas, due to seasonality of farming.

3. GoA has recognized that MSMEs face several challenges in access to finance and that it is one of the main business constraints hampering firms’ growth. Only 3.4 percent of firms in Afghanistan held a bank loan or line of credit in 2008 compared to 30 percent in South Asia on average, and only 1.4 percent of Afghan firms use banks to finance their investments, compared to a south Asian average of 15 percent. Capacity development of MSMEs through improved access to finance is one of the key objectives of the “Integrated Trade and SME Support Facility” in NPP.

**Sectoral and institutional Context**

4. Commercial banks and the microfinance sector have the potential to provide increased access to finance to SMEs and MSEs respectively, but the underdevelopment and the fragility of the financial system in Afghanistan have prevented them to do so on a significant scale.

A. An overall weak commercial banking sector shaken by the Kabul Bank crisis

5. The banking sector is composed of 3 state-owned banks (including the newly created bank following the Kabul Bank crisis, New Kabul bank, currently under privatization), 9 private full-fledged banks and 4 branches of foreign commercial banks. The assets of the banking system have grown tenfold since 2005, from US$388 million in March 2005 to US$4.32 billion in July 2013, although from a very low base. Total outstanding loans amount to US$818 million in July 2013 with loans mainly concentrated in the trade and service sectors (respectively 29 and 19 percent) and geographically concentrated in Kabul (81 percent). The banks sustain high liquidity, with US$3.72 billion in deposits as of July 2013. The banking sector registered US$8.75 million of profits between July 2012 and July 2013, resulting in a Return on Assets of 0.36 percent. The regulatory capital ratios of all but one (New Kabul Bank, under privatization) commercial banks are above the minimum regulatory threshold (12 percent of risk-weighted assets), as of July 2013.

6. The banking sector is still dealing with the aftermath of the Kabul Bank crisis. The crisis threatened the overall stability of the banking sector (as the bank held about one-third of the system’s assets of US$4 billion) and has raised concerns regarding the capacity of the Central Bank to adequately supervise the banking sector. The government had to shoulder US$825 million for the cost of the lender-of-last-resort facility loans that covered the deposit guarantee (about 5 percent of GDP). Kabul Bank was subsequently put into receivership, revoking shareholders’ rights altogether. Kabul Bank has been split up into a good bank and a bad bank. The bank’s deposits and good assets
were transferred to a bridge bank, New Kabul Bank (NKB, owned by the Government of Afghanistan). NKB privatization is on-going. About US$935 million (principal and interest) in the asset portfolio are sought for recovery. However progress on asset recovery has been slow, with cash recoveries amounting to US$173 million (as of June 2013) out of US$935 million total receivables. A detailed report of the public inquiry into the Kabul Bank crisis was released in November 2012 by the Independent Joint Anti-Corruption Monitoring and Evaluation Committee. The conclusions are severe and highlight critical weaknesses in governance in the financial sector and more broadly (including the judiciary).

7. With a banking sector still fragile and underdeveloped, SMEs remain financially underserved and only few banks have specialized SMEs financing window, most notably First Microfinance Bank (FMFB, a commercial bank), which focuses on the SME market segment. An SME Credit Guarantee Facility (with initial funding from USAID and the German Government) has been operating in Afghanistan since 2006 and is showing promising results: the Facility has mobilized loans of a total value of US$108.2 million to more than 3,000 businesses (cumulatively), as of July 2013. This Credit Guarantee Facility has been implemented by DEG, a German Government-owned development financial institution.

B. A microfinance sector emerging from a major consolidation phase

8. MSEs (the lower end of the market) also suffer from limited access to finance as the microfinance sector went through a boom and bust cycle, with a steep consolidation of the sector since 2008. It is expected that, with the exit of BRAC and ASA from the microfinance sector in March 2013, the consolidation of the sector would be completed.

9. The World Bank has supported the development of the microfinance sector in Afghanistan since 2003 (with both ARTF and IDA funding), through the establishment of a microfinance apex institution: MISFA (Microfinance Investment Support Facility for Afghanistan). The ARTF funded project (US$168 million disbursed) provided on-lending funds to microfinance institutions (MFIs) as well as grants for capacity building of MFIs. The IDA funded project (US$16 million disbursed) provided further on-lending funds to MISFA. From 2003-08, growth of the microfinance sector was steady with 373,080 active borrowers (and around 450,000 clients) reported by March 2008 and a cumulative US$204 million of loans disbursed by MISFA’s 16 microfinance partners. During that period, the main focus was to scale outreach of MFIs. The microfinance experience in Afghanistan was considered a unique success as it had managed to build a microfinance sector from scratch in five years.

10. However, the extremely rapid growth of the sector with fragile institutions led to a repayment crisis in 2008 (which is not unique to Afghanistan and also happened in countries such as Nicaragua, Bosnia and Herzegovina and Pakistan). The rapid client outreach had come at the expense of proper due diligence in lending, compliance with internal control processes and internal monitoring of performance. These factors, combined with cost inflation and a deteriorating security environment, contributed to a decline in portfolio quality of most MFIs. Following this crisis, MISFA focused more attention on direct monitoring and supervision of MFIs to verify the accuracy of their reporting and supported a consolidation of the sector, as it appeared that a number of small MFIs were not viable. As of 2011, from the initial 16 MISFA partner institutions, 2 of the weakest institutions exited the sector, 1 merged with FMFB – a sister organization, 2 institutions remained in country, but discontinuing as MISFA partners, 6 of the small MFIs had their operations merged
into Mutahid (a new entity created by MISFA), 5 MFIs remained as independent institutions: FMFB, BRAC, ASA, Oxus and HFL. However, in 2012, it emerged that BRAC and ASA had serious difficulties, which led to their exit of the sector. As of August 2013, MISFA has four partner MFIs: FMFB (which is a commercial bank), Oxus, HFL and Mutahid, representing 148,111 active clients and 81,970 active borrowers with US$ 93.4 million in loans outstanding.

11. A few financial institutions are not MISFA partners: FINCA, Islamic Investments and Finance Cooperatives (IIFC Group) and Afghanistan Rural Finance Company. In addition, the microfinance sector also includes “Community-based Savings Promotion Institutions” (CSPIs), which promote savings groups. Altogether, these institutions (including MISFA’s partners) represent 362,968 clients and 156,203 active borrowers, with US$137.3 million in outstanding loans (as of June 2013).

12. This project will also take into account the lessons learnt from over ten years of efforts to develop the financial sector in Afghanistan. The recent crises in both the banking and microfinance sectors have shown the need for an incremental and long term approach towards financial sector development. In particular, learning from the MISFA experience (as described in paragraphs 10 and 11), it will be important to avoid a too heavy focus on increasing outreach and disbursements, at the expense of building solid and sustainable institutions, offering financial products that meet the need of the Afghan populations and MSMEs. This project would aim at better positioning the financial sector at large to seize opportunities post transition.

II. Proposed Development Objectives
The proposed Project Development Objective of the project is to build institutional capacity to improve access to credit of micro, small and medium enterprises.

III. Project Description
Component Name
Improving access to financial services for micro and small enterprises
Comments (optional)
Sub-component 1.1: Strengthening of the microfinance sector through MISFA ($13m)
Sub-component 1.2: Targeting the Ultra Poor (TUP) Program ($15m)
Sub-component 1.3: Strengthening of MISFA ($4m)

Component Name
Improving access to financial services for small and medium enterprises
Comments (optional)
Sub component 2.1: Supporting the expansion of the Afghanistan Credit Guarantee Facility ($13m)
Sub component 2.2: Providing technical assistance to the Facility partner financial institutions ($5m)

IV. Financing (in USD Million)

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V. Implementation

13. The proposed project will include two components: (i) improving access to financial services for micro and small enterprises, which aims to provide continuing support to the microfinance sector through MISFA, as well as, supporting MISFA to take on a broader role as a catalyst for innovations to increase access to financial services to the lower end of the market, and (ii) improving access to financial services for small and medium enterprises (SMEs), which aims at increasing commercial bank and MFI lending to SMEs.

A. Institutional and Implementation Arrangements

14. The project will be implemented by two implementing entities: MISFA, for Component 1, and the Ministry of Finance, for Component 2. The following paragraphs will provide further details on the implementation arrangements.

MISFA: implementing entity for Component 1

15. MISFA has been a long term partner of the World Bank, first through an ARTF funded project (Microfinance for Poverty Reduction Project, P091264, closed in June 2010) and then through an IDA funded project (Expanding Microfinance Outreach and Improving Sustainability Project, P104301, closed in June 2012). MISFA has evolved into a strong institution, recognized as being de facto regulator of the microfinance sector. In recent years, MISFA took on the difficult task of cleaning and consolidating the microfinance sector in Afghanistan and should be commended for these efforts. MISFA is established as a limited liability non-profit company wholly owned by the Ministry of Finance. It has a robust governance structure, with the Minister of Rural Rehabilitation and Development as Chairman of the Board. The members of the Board include the Deputy Minister of Finance (as Vice-Chair), the CEO of the Afghanistan Chamber of Commerce and Industry and three international microfinance experts. MISFA is currently competitively recruiting a new Managing Director and the former Operations Director has been named Acting Director.

16. MISFA will be responsible for component 1 of the Project: Improving access to financial services for micro and small enterprises. As per the previous IDA project, a Project Agreement will be signed between MISFA and the World Bank and a Subsidiary Agreement will be signed between the Government of Afghanistan (MOF) and MISFA. MISFA, as the Project Implementing Entity, will have fiduciary responsibility for the overall component.

Ministry of Finance: implementing entity for Component 2

17. Component 2 will be implemented by the GoA Ministry of Finance which will enter into a contractual arrangement with the Afghanistan Credit Guarantee Facility. As a first step, the contractual arrangement will be between the GoA Ministry of Finance and DEG, which is currently managing the Afghanistan Credit Guarantee Facility. Under this first step, DEG will therefore be an implementing partner. DEG intends to institutionalize the Afghanistan Credit Guarantee Facility through the establishment of the Afghanistan Credit Guarantee Foundation in the near future. Once the Foundation will be established, the contractual arrangement will be reviewed, so that the contractual arrangement will be between the GoA Ministry of Finance and the Afghanistan Credit Guarantee Foundation.
Guarantee Foundation. Under this second step, the Afghanistan Credit Guarantee Foundation will become the implementing partner (thus replacing DEG).

18. An agreement will be signed between the Ministry of Finance and DEG, which will stipulate the legal and fiduciary conditions of the partnership. DEG will (i) manage, on behalf of GoA, the capital contribution financed by IDA to the Guarantee Fund (as it currently does with BMZ) through the Afghanistan Credit Guarantee Facility Trust Fund and (ii) manage the technical assistance provided to ACGF and partner financial institutions.

19. The institutional and implementation arrangements will be carried out according to the rules and procedures agreed in the Operations Manuals of each component. The Operations Manuals will be subject to periodic reviews.

B. Results Monitoring and Evaluation

20. MISFA and ACGF will be responsible for monitoring and evaluation (M&E) for their respective components. Both institutions have already developed strong M&E systems. The two institutions will make limited adjustments to be able to regularly report on the project’s indicators.

21. MISFA produces a Monthly Performance Report for internal purposes, which gathers key financial information on MISFA partner institutions (building on international good practices in microfinance): income statement, balance sheet, portfolio summary (with detailed information on the loan and savings portfolio of each institution with geographical and gender data). In addition, MISFA provides public information on the performance of its partner institutions on its website: http://www.misfa.org.af.

22. MISFA will however need to strengthen the M&E mechanism for the TUP program, considering its significant scale up. Support from the World Bank Development Impact Evaluation Unit (DIME) has been sought, during project preparation, to conduct a robust impact evaluation of this program, with support from the CGAP (Consultative Group to Assist the Poor) which has been conducting in-depth research on Targeting the Ultra Poor programs internationally (http://graduation.cgap.org/research/).

23. Afghanistan Credit Guarantee Facility already tracks detailed financial information on the performance of its partner financial institutions. For each financial institutions, it tracks on a monthly basis (and on a cumulative basis) the following: loan disbursement, guarantees issues, loans outstanding, guarantees outstanding, write-offs, claims disbursed, claims refunded, Non-Performing Loans (over 30 and 90 days). Furthermore, a financial scorecard shows the revenues/expenses and gives operational as well as total financial results for the Facility. It also tracks the number of jobs created by the SMEs benefiting from the guarantees. ACGF intends to undertake a thorough impact assessment during project implementation to further measure the impact of increased access to finance on SMEs.

C. Sustainability

24. MISFA was created with the view to become a sustainable microfinance apex institution. The World Bank (through ARTF) has provided the bulk of MISFA’s on-lending capital. MISFA’s equity (share capital and reserves) amounts to US$123.8 million as of December 2012. MISFA has been
able to develop into a sustainable institution, in spite of recent difficulties of the microfinance sector over the last five years. The current challenge of MISFA is to be able to make an effective use of its on-lending resources (MISFA has an outstanding portfolio to MFIs of US$34 million, but has an additional US$85 million it could use for on-lending). In addition, MISFA’s role is to support the development of sustainable microfinance institutions. As of March 2013, only one partner institution (First Microfinance Bank) has reached Operation Self Sufficiency (while a second institution is close to reaching Operation Self Sufficiency). The Targeting the Ultra Poor Program also aims at providing the required support to ultra-poor households to ultimately reach sustainable livelihoods after 24 months of support.

25. A well-managed Credit Guarantee Facility can also be financially sustainable, as risk and market oriented guarantee fees, up-front fees, refunds from claims payment, interest income on the capital stock and grant Technical Assistance (TA) funding should be able to cover the operational costs, such as claims paid, local operating expenses and TA activities provided by the Guarantee Facility to PFiPs. Generally, TA should be grant funded or (partially) co-financed by PFI. The challenge for the Afghanistan Credit Guarantee Facility is to balance sustainability and risks. A Guarantee Facility can be too conservative and take very limited risks, therefore limiting its development impact, but safeguarding its sustainability (as long as partner financial institutions find the coverage it offers useful). Conversely, a Guarantee Facility can take too many (uninformed) risks and therefore rapidly erode its sustainability (as many state-run Credit Guarantee Facilities). So far the Afghanistan Credit Guarantee Facility has been able to manage risks adequately and has a strong financial position. However the Facility recognizes the challenges of operating in an uncertain and high risk environment, such as Afghanistan in the forthcoming years. In addition, the Credit Guarantee program supported under this project aims to demonstrate to commercial banks that lending to SMEs can be profitable. As such it is expected that commercial banks will become interesting in lending to SMEs, even in the absence of a guarantee mechanism, once they have become more familiar with the characteristics of this market.

VI. Safeguard Policies (including public consultation)

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Comments (optional)

VII. Contact point

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