I. Introduction and 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 (ANSF) 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 $16 billion of aid to Afghanistan (annual average of $4
billion over the next four years) and agreed to the Tokyo Mutual Accountability Framework (TMAF) 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. 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. 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. 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

3. 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.

4. 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 $388m in March 2005 to $4.2b in November 2012, although from a very low base. Total outstanding loans amount to $768m in November 2012 with loans mainly concentrated in the trade sector (28 percent) and geographically concentrated in Kabul (76 percent). The banks sustain high liquidity, with $3.6b in deposits as of November 2012. This in turn affected the profitability of the banking sector, with cumulative losses of $24.1m between November 2011 and November 2012 and a negative Return on Assets of -0.89 percent. The regulatory capital ratios of all but one commercial banks are above the minimum regulatory threshold (12 percent of risk-weighted assets), as of November 2012.

5. The banking sector is still dealing with the aftermath of the Kabul Bank crisis during which Kabul Bank suffered fraud and money laundering activities as the bank’s shareholders and top management manipulated the bank’s loan books. 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), at the highest levels.

6. Audits of ten commercial banks, financed under the World Bank’s Financial Sector Rapid Response Project (FSRRP), revealed serious weaknesses at all levels: governance, skills, internal
controls, accounting, credit analysis, risk management, compliance with regulations.

7. With a banking sector still fragile and underdeveloped, SMEs remain financially underserved and only few banks have specialized SMEs financing window. 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 $89.9m to more than 2,500 businesses, as of October 2012. This Credit Guarantee Facility is implemented by DEG, a German Government-owned development financial institution.

8. MSEs 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. 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 $204m of loans disbursed by the microfinance APEX institution (called MISFA: Microfinance Investment Support Facility for Afghanistan)’s 16 microfinance partners. During that period, the main focus was to scale outreach of Microfinance Institutions (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.

9. However, the extremely rapid growth of the sector with fragile institutions led to a repayment crisis in 2008. 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. In 2012, it emerged that BRAC and ASA also had serious difficulties, which led to their exit of the sector. As of December 2012, MISFA has four partner MFIs: FMFB (which is a commercial bank), Oxus, HFL and Mutahid, representing 136,717 clients, with over $92m in loans outstanding.

10. In addition to MFIs, the microfinance sector also includes “Community-based Savings Promotion Institutions” (CSPIs), which promote savings groups. These institutions represent 163,694 clients (with $7m in loans outstanding and $2.2m in savings).

11. The proposed project supports and complements the GoA’s efforts to develop and implement a financial sector development strategy that focuses on increasing access to finance – moving beyond the Kabul Bank crisis. Such a strategy would also aim at ensuring a stronger coherence between the various ongoing efforts to increase access to finance in Afghanistan. The project would complement other World Bank Group initiatives and other donors’ programs focusing on increasing access to financial and non-financial services to MSMEs. This project will also take into account the lessons learnt from over ten years of efforts to develop the financial sector in Afghanistan and MISFA experience. 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, it will be important to avoid a too heavy focus on increasing outreach and disbursements, at the expenses 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.

Relationship to CAS
12. Considering the deterioration in security situation and uncertainty, the World Bank’s strategy strives to maintain flexibility to adjust to events through an Interim Strategy Note (ISN) for the period FY12-FY14. The ISN has three pillars, and the proposed project would directly support the third pillar, focused on inclusive growth and jobs. This pillar is concentrating on foundational investments for growth as one of GoA’s main priorities during the transition period is to build domestic sources of growth and jobs in order to replace donor and military assistance. Aside from the Bank’s engagement around “resource corridors”, this pillar “speaks to addressing the constraints to enterprise development including a weak financial sector (...)

II. Proposed Development Objective(s)

Proposed Development Objective(s) (From PCN)

17. The proposed Development Objective of the project is to increase micro, small and medium enterprises’ access to financial services, notably credit.

Key Results (From PCN)

18. The key results indicators will track the following:

• Outstanding SME finance portfolio (volume and number) of MISFA microfinance partners
• Portfolio at risk for SME finance portfolio of MISFA microfinance partners
• Outstanding guaranteed SME loan portfolio (volume and number) of the Credit Guarantee Facility supported by the project
• Portfolio at risk for guaranteed SME loan portfolio of the Credit Guarantee Facility supported by the project.

19. These indicators are Core Indicators. Additional indicators, to capture the activities supported under the MISFA component, will be included.

III. Preliminary Description

Concept Description
Component 1: Improving access to financial services for micro and small enterprises

16. This component 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 (notably MSEs) as per its new strategic plan under preparation.

17. This component will include the following activities:

• Innovation fund: this fund will allow MISFA to support innovations to improve access to financial services proposed by MFIs and other institutions which have a focus on access to finance. As such, this fund would cover the testing and piloting of new financial products (small enterprise finance, agricultural credit, savings, sharia-compliant products, insurance, etc.) as well as the use of technology to improve access to financial services.
• Systems strengthening fund for MFIs: this fund will support efforts from MFIs to strengthen their systems and their human resources based on a detailed capacity strengthening plan. This fund will also support systems strengthening of MFIs aiming to become Deposit taking MFI (DMFI), once the regulation is approved.
• Research and development at MISFA: this sub-component will help MISFA develop
innovative programs, as incubator, to better serve under-served groups, notably women and youth. Under its proposed new strategic plan, MISFA intends to develop a Women Empowerment Program as well as a Youth Entrepreneurship Program. This component will also support the establishment of a Knowledge Management Department at MISFA to document best practices, lessons learned, and provide timely and relevant information to stakeholders by commissioning research and studies.

- **Targeting the Ultra Poor (TUP) Program:** This sub-component will support the national scale up of the TUP program piloted by MISFA. Building on the lessons learned from the pilots and from international experience, the program will provide TUP beneficiaries a two-year package of inputs which includes the transfer of productive assets as well as training, a subsistence support (monthly stipend), and basic health care through community-based health workers.

- **Support to Policy, Regulation and Advocacy:** this sub-component will provide support to agencies in charge of policy, regulation and advocacy, namely: the Ministry of Finance, which has the responsibility to set the policy direction for financial sector development in Afghanistan; the Central Bank of Afghanistan (DAB) which once the DMFIs regulation will be approved will be responsible for regulating these institutions; and the Afghanistan Microfinance Association (AMA) which is the representative body for the microfinance sector.

- **Institutional strengthening:** This sub-component will support institutional strengthening at MISFA to ensure it is able to fully implement its new strategic plan. It will also support project implementation at MISFA, as well as coordination efforts between various initiatives with a focus on access to finance supported by development partners and the World Bank.

Component 2: Improving access to financial services for small and medium enterprises

18. **The aim of the component is to increase commercial bank lending to SMEs, as well as to strengthen commercial banks from within.** This component will therefore support the expansion of the DEG credit guarantee facility, along the following activities: (i) Operational improvements and volume growth with existing partner; (ii) Cooperation with additional partner banks; (iii) Regional expansion; and (iv) New product development, including trade finance, rural/agricultural SME lending, sharia compliant SME lending, start-up lending, as well as adapted products to female entrepreneurs.

19. **This component will provide a contribution to the guarantee fund managed by DEG.** It will also finance technical assistance for new product development and support the Guarantee Facility operating costs in Afghanistan

20. A critical aspect of the Credit Guarantee Facility – and a key reason of its success – is the technical assistance provided by the Facility to partner commercial banks to lend to SMEs. Under this component, the Credit Guarantee Facility will provide technical assistance on SME lending to partner banks, until the Facility considers that the partner banks no longer require the technical assistance, as well as technical assistance on new product development. Under this component, the Credit Guarantee Facility also intends to pilot reverse factoring (also known as supply chain financing).

### IV. Safeguard Policies that might apply

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V. Financing (in USD Million)

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VI. Contact point

World Bank

Contact: Guillemette Sidonie Jaffr
Title: Senior Private Sector Development Specialist
Tel: 5232+3365 /
Email: gjaffrin@worldbank.org

Borrower/Client/Recipient

Name: Ministry of Finance
Contact: 
Title: 
Tel: 
Email: 

Implementing Agencies

Name: MISFA (implementing agency)
Contact: Katrin Fakiri
Title: Managing Director
Tel: 
Email: 

Name: DEG (implementing partner)
VII. For more information contact:
The InfoShop
The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 458-4500
Fax: (202) 522-1500
Web: http://www.worldbank.org/infoshop