

EXPANDING THE OUTREACH OF FINANCIAL SERVICES: THE EXPERIENCE OF FINANCIAL INSTITUTIONS

Case study prepared for the Enabling Environment Conference

I. CONTEXT AND BACKGROUND

In 2002, the formal financial sector was inefficient and dominated by state-owned commercial banks and certain specialised banks. Most of these banks were bankrupt and too weak to provide efficient financial services. Moreover, the legal framework for the financial sector was essentially non-existent or inappropriate. Da Afghanistan Bank (DAB), the central bank of Afghanistan, had a structure which was moribund and staff which were too unskilled to undertake efficient monitoring and supervision of the financial sector.

There was an urgent need for a strong central bank as well as a legal framework with prudential regulations. Against this backdrop, restructuring and modernisation of the DAB began in mid-2003. In September of the same year, the President issued a decree to pass a new central bank law that would provide a strong framework for a two-tier banking system: state commercial banking activities and private commercial banking activities. It also provided the DAB with autonomous regulatory power to implement monetary and banking supervision policy.

The DAB is in the process of enacting the following three laws to initiate commercial banks to expand their lending programme to the private sector: (a) Secured transaction law; (b) Mortgage

law; and (c) Negotiable instruments laws. These laws are particularly aimed at modernising the financial sector as well as improving the enabling environment for the private sector. Other programmes for reform of the private and financial sector are also underway and include:

- ◆ The establishment of a facilitative legal framework for private sector development, with 10 priority laws to be approved, four of which were signed by the President in January 2007.
- ◆ The strengthening of the supervisory framework for financial institutions with the aims of improving deposit protection and confidence in the financial system, and enhancing the private sector's access to finance. This includes reforms of the banking sector, the bulk of which is scheduled to be implemented by the end of 2008. Regulations for the microfinance sector were introduced at the end of 2006.
- ◆ The broadening and deepening of financial service delivery by building capacity in financial institutions as well as adopting and implementing national accounting and auditing standards. Most of these measures have yet to be implemented, with a target of end of 2008.

Overall, the major reforms of the financial sector are scheduled to be completed by the end of 2008.

In the meantime, however, the outreach of financial services in Afghanistan remains very limited, and small and medium businesses have almost no access to bank credit and only limited access to banking services. In the most recent Doing Business (2007) rankings for Getting Credit, a measure of credit information sharing and legal rights of borrowers and lenders, Afghanistan ranked 174th out of 175 countries.

There has been significant growth of private commercial banks: Fifteen banks have been licensed, while 14 of them are operating in Afghanistan. The banks are mostly concentrated in Kabul and provide services primarily to international donors, large businesses, foreign NGOs and foreign government agencies. There are also a small but ever increasing number of non-bank financial institutions, including one credit union and 13 microfinance institutions that provide limited services and small amounts of credit. Furthermore, a leasing finance company is also operating in Kabul, but with limited capital to employ in the business. Although the extent of financial services is expanding, these institutions are nascent and able to provide only a fraction of what is needed.

As a result, Afghan businesses are almost entirely reliant on internal funds from friends, relatives and money lenders. Informal fund transfer systems (*hawala*) used to make payments and transfer funds are also dominant. Although informal financial sector credit may be playing an important role in manufacturing and commercial activities, it is not adequate for long-term private sector development because such funds are often costly and short-term. There is therefore a pressing need for bank and non-bank financial institutions to provide viable alternatives to the informal sector. As the economy expands, the inability of firms to obtain reliable external financing at competitive costs could be a serious constraint to growth.

In summary, while some considerable advances have been made with respect to basic legislation, some central banking reform, the introduction of a new currency, and the beginnings of a microfinance sector – much work still remains to be done.

These case studies examine the experience of the following five different groups of financial market participants operating in Afghanistan. The examination of each institution will address the factors that have facilitated expansion and the constraints it has faced in further expanding financial services.

- ◆ Reputable private investors
- ◆ Small and Medium Entrepreneurs

- ◆ BRAC, a Microfinance Institution
- ◆ Kabul Bank, a fast growing commercial bank
- ◆ Bank Millie, a state-owned bank

This paper also analyses the constraints and opportunities that are common to one, several or all of these financial market participants, and concludes with recommendations from the perspectives of these institutions.

II. THE CASE STUDIES

Reputable private investors: “Doing business out of my own pocket”

Safi Brothers and Kabul Trade Center are the leading business conglomerates in Afghanistan. However, they remain outside the formal banking system. These businessmen are reluctant to go to the banks as they perceive the process of obtaining loans to be cumbersome and interest rates for long-term loans as being quite high. One of these businessmen is interested in constructing a cement manufacturing plant and expressed interest in seeking one or more bank loans from an international institution. However, often these businessmen do not see the importance of due diligence required from the financial institutions.

Case Study 1: Kabul City Centre (Safi Land Mark)

Safi Brothers Import and Export Company, with its main office in Dubai, is the owner of the Safi Land Mark, the largest shopping complex and hotel in Kabul with UN security clearance. The construction cost of the Safi Land Mark was about US\$ 35 million and was entirely financed by Safi Brothers; no bank loans were taken out. Safi Brothers exports dry fruit and imports construction materials and is building a “twin tower” in Herat province. Safi Brothers recently established a Gypsum factory in Kandahar with a total investment of US\$ 20 million, also self-financed without any bank loan.

Case Study 2: Kabul Trade Centre

Basir Omarzai owns the Kabul Trade Center, a shopping and office complex in Kabul. The cost of construction is estimated to have been about US\$ 20 million. Mr Omarzai met the entire cost from his own resources and was not keen to seek any bank loan. He is a businessman based in Dubai and has a paper manufacturing company there.

Small and Medium Entrepreneurs (SMEs): “Limited access to finance”

Case Study 3: Sabaoon Aryana Construction Company, Kabul

Small businesses are undergoing hardship since they have almost no access to finance. Sabaoon Aryana Construction Company could have expanded its growth by many times if it had had US\$ 250,000 from the bank or leasing company to buy an asphalt machine.

Wahed Ahmad is the owner of Sabaoon Construction Company, which was established in 2004. He invested US\$ 300,000 in the construction business. Initially he started with building construction, but later moved to road construction. In 2005, the company's annual turnover from road construction was US\$ 210,000. However, in 2006, the annual turnover tripled to US\$ 600,000. The construction company created permanent employment for 24 people. Sabaoon lost one large contract of US\$ 1.28 million from the United Nations Office for Project Services (UNOPS) because it did not have an asphalt machine. UNOPS told Mr Ahmad that although they had been very happy with his work, the road contract could not be given to Sabaoon since it did not have an asphalt machine. Currently, he buys asphalt from a supplier, but UNOPS is not happy with the quality. He was told by UNOPS that if Sabaoon procured an asphalt machine in 2007, the company could get road contracts amounting to US\$ 4 to 5 million.

Mr. Ahmad needs US\$ 250,000 to buy this machine. The profit from the UNOPS contracts would enable him to pay for this machine in two to three years. He uses Standard Chartered Bank to cash the checks received from the contracts. The commercial banks are fully aware of his regular cash flow transactions, but are not willing to provide investment or working capital loans. Sabaoon Aryana said the following: “What is the purpose of having so many banks in Kabul, if they do not lend money to the deserving investors?”

Case Study 4: Ahmad Printing Press, Kabul

Ahmad Printing Press, a medium-sized printing company, is also very unhappy with the commercial banks because of their reluctance to help the small businesses and the high interest rates that they charge.

Ahmad Printing Press invested about US\$ 450,000 from its own capital. The owner, Ahmad Hossain Farhad, has about US\$ 400,000 as working capital to do a big order. He always has working capital shortages to bid for large supply contracts for

books. He needs about US\$ 700,000 as working capital to implement a large contract. When Mr Farhad needs working capital, he usually borrows money from friends at a higher interest rate (25 to 30 percent) to execute large supply orders. Ahmad Printing Press has a bank account at the Standard Chartered Bank, which is needed to cash the checks that are received as payment from donor contracts. Although the bank has good knowledge of Ahmad Printing Press' cash flows, it is not keen to extend any working capital loans to it. Mr Farhad commented, “Although I am doing my business transaction with a reputable bank, [...] I cannot receive any working capital loan for my business.” If Ahmad Printing Press had enough working capital, it could expand its printing activities by three to four times. Mr Farhad has good management and marketing skills; however, due to the shortage of funds, he cannot further expand his business and create more employment.

Microfinance Institutions (MFI): “Finding niche market where the current banking system does not work”

Case Study 5: Bangladesh Rural Advancement Committee (BRAC), Small Enterprise Project

BRAC is the largest MFI in Afghanistan. It started the Small Enterprise Program (SEP) in April 2005, targeting small businesses mainly in the Kabul area.

The main objective of the programme is to help generate income and employment in rural and semi-urban areas through enterprise development. The type of enterprises it is extending loans to comprise bakeries, grocery stores, carpet weaving shops, tailoring shops, various types of workshops, goldsmiths, beauty parlours, pharmacies, home appliance delivery stores and shoe-making factories. The typical loan size varies from US\$ 800 to US\$ 10,000. Loan tenure is one year as for the microfinance, but the payment is on a monthly rather than weekly basis in microfinance. Savings from the borrower is mandatory, and is collected at the time of monthly payments. Unlike microfinance, the SEP requires collateral.

Currently SEP has been implemented in 10 provinces and 10 districts. There are 41 Area Offices, but these offices are the same offices used for the Microfinance programme. A Senior Regional Manager is heading the SEP operations, supported by 10 District Managers and 56 Programme Organisers. There are a total of 1,200 borrowers, of which 979 have current outstanding loans. The total amount disbursed so far was US\$ 1.4 million and the current outstanding is US\$ 869,100.

*Case Study 6: Kabul Carpet Store
“Desire to be a client of the BRAC
Afghanistan Bank”*

BRAC SEP is helping small businesses grow, and they are happy with their credit relationship with BRAC. However, they think that BRAC should do more since the size of the fund is not enough to help business expansion. The owner of Kabul Carpet store needs about US\$ 40,000 for his business growth because he imports carpets from Turkey and Iran. The loan amount he received from BRAC SEP programme only amounted to 10 percent of his requirement. However, he wants to continue the credit relationship with BRAC SEP because he believes that this relationship will one day help him to be a client of BRAC Afghanistan Bank.

Ghulam Abbas is the owner of Kabul Carpet Store at Que Marcus. He has been a borrower of BRAC SEP since February 2006. He borrowed US\$ 4,000 and has been paying in installments of US\$ 392 with a monthly savings of US\$ 10. Ghulam employs eight people in the shop and pays US\$ 720 in wages, US\$ 1,300 in rent and US\$ 80 in electricity per month. He imports carpets from Iran and Turkey and wholesales them in the local market. Each import consignment costs about US\$ 95,000 to US\$ 100,000. Total stock of carpets in his shop amounts to about US\$ 200,000 or more. He says that his monthly sale varies between US\$ 25,000 and US\$ 30,000 and his net profit is about 10 to 15 percent of sales value. Ghulam is also a good tax payer. He pays a total annual tax of US\$ 500 and operates through a trade licence from the Municipality which he renews each year.

Given the scale of Ghulam’s carpet business, one wonders why he would borrow US\$ 4,000 from BRAC SEP. His answer to this was revealing: “I cannot get loans from the banks, although I do an honest business with recorded transactions. So I wanted to be a BRAC client and prove my credit record and worthiness.” He also said, “I heard BRAC is opening a bank in Kabul, I want to establish a credit relationship with BRAC SEP to eventually be a client of BRAC bank and borrow about US\$ 40,000 to help consolidate and expand my business.”

*Case Study 7: Brotheren Ittefaq Hardware Store
“Effective use of SEP Loan as working capital”*

Bariwalai Nakshbandi, the owner of Brotheren Ittefaq Hardware Store, is helping other small informal hardware businesses which have no access to any form of loans by providing trade credit to them. Although he borrowed a loan of US\$ 6,000

from SEP, he needed at least US\$ 20,000 to expand his own business and the businesses of the small traders.

Bariwalai is a reputable businessman in the market and has 10 shops selling various types of goods. He received a loan of US\$ 6,000 from BRAC SEP in April 2006. His monthly instalment is US\$ 588 and he contributes a savings of US\$ 12.5. He owns the shop, which has a market rent of US\$ 3,000. He employs two people and has a monthly wage bill of US\$ 200 and an electricity bill of US\$ 20. His monthly sales are about US\$ 18,000 to US\$ 20,000 with a monthly profit of US\$ 1,200 to US\$ 1,500. Total stock is about US\$ 100,000. Bariwalai has a trade licence and pays an annual tax amounting to US\$ 1,600 for all his shops.

Bariwalai has said that the SEP loan is very useful to him, since it perfectly meets his working capital needs. Due to this loan he has been able to increase his stock and provide credit to the small traders. He commented,

“They never fail to pay and I have already provided goods worth US\$ 2,400 on trade credit. I have developed a long-standing credit relationship and trust with the traders. The small traders are very regular to make payments and this trade credit is also profitable business for me.”

He has said that BRAC SEP could make him an agent to disburse funds to the small traders and he would be ready to retail the loans on behalf of BRAC with a small commission and undertake all the credit risk. Bariwalai has also never failed to pay his instalment and wants to maintain a good credit relationship with BRAC. In the future, he would like to borrow US\$ 20,000 from BRAC SEP and would like to increase the range of products and the trade credit, and expand his business.

Kabul Bank: “Constraints to expand the loan portfolio”

Case Study 8: Kabul Bank

Established in June 2004 as the first private Afghan commercial bank, the Kabul Bank has emerged as the leading commercial bank in Afghanistan in the last two and a half years. Its initial capital of US\$ 20 million in 2004 has increased to US\$ 38 million due to infusion of new capital and reinvested profit. The deposit from March 2006 to March 2007 (SY1385) has been increased by about 180 percent, reaching the current deposit of US\$ 348 million. The bank is expecting to steadily improve its deposit and its management believes that there is

ample opportunity to mobilise significant deposits, despite the number of new entrants in the market. The current lending of the bank is US\$ 260 million, with a lending to deposit ratio of 75 percent. The bank sees opportunities to increase this ratio further, but is constrained by the DAB limit of 75 percent ratio. The lending growth from March 2006 to March 2007 was about 167 percent, where most of the loans were extended to traders in the import-export business and about 10 percent of the loans were given to the industry sector including flour mills, steel forging, oil storage tank, tea processing and cigarette packaging. The loan portfolio has been quite sound; only about 1.86 percent of the total loan portfolio constitutes non-performing loans. In 2006, the average interest rate for loans was about eight percent, and its net profit was US\$ 2.3 million.

The management of the bank wants to further expand its loan portfolio; however, there are several factors holding it back from doing so. First, the absence of a Credit Information Bureau (CIB), coupled with the absence of audited balanced sheets makes it very difficult and costly to assess the credit risk of borrowers. This causes banks to require borrowers to provide extraordinary amounts of collateral and consequently to increase the cost of loans. Second, high cost of collateral registration leads borrowers to be hesitant to borrow money from banks. It takes three percent of the value of the contract (loan amount) to execute the collateral registration and another three percent to release the property from registration, i.e. a total of six percent. However, property transfer as collateral in the name of the bank takes about six percent of the property value, and thereby another 6 percent to transfer it back to the owner. Therefore, a total of 12 percent is needed for transfer and re-transfer to the owner – a very high cost for the borrower. Third, because of weak human resource capacity in the financial sector, it is very difficult to hire qualified banking experts.

Management also expressed that capacity building of both the commercial bank staff and the staff of DAB would be essential, and could be done by establishing a banking training institute. Furthermore, the enactment of a Secured Transaction Law, Mortgage Laws and the Negotiable Instruments Law would help improve the lending situation. Once this legislation is in place, the banks could widen their proposal evaluation to include more customers for extension of loans.

Bank Millie: “Struggling with lack of qualified staff”

Case Study 9: Bank Millie

The Bank Millie was one of the three licensed state-owned commercial banks (SCBs) which were re-licensed in 2003. It is the largest SCB, followed by Bank Pashtany and the Export Promotion Bank. Although Millie has much higher capital than any other commercial bank, the quality of the lending portfolio is very weak with about 53 percent of the loan portfolio being non-performing. Non-performance of the SCBs initiated restructuring of these banks. The Cabinet has decided to have two SCBs: the Bank Millie remaining as an independent bank; and the Export Promotion Bank merging with Pashtany Bank.

Bank Millie was the first bank to be created in Afghanistan and was established with a 72 percent share of the private sector and 28 percent of the Government in 1933. It was operating as the central bank of Afghanistan until 1939, when Da Afghanistan Bank was established and took over the responsibility. Based on a Presidential decree in 1976, the bank became a government entity. The Ministry of Finance currently holds the majority of shares (96.6 percent). Bank Millie has 21 branches, out of which nine branches are operating in different parts of Kabul city, and 10 branches are operating in the provinces. Recently the bank restarted lending and so far has approximately 3,600 small and medium borrowers. It has a capital of US\$ 140 million including real estate assets. Total loans made are US\$ 19.6 million.

Bank Millie’s management has voiced that efforts to restructure the bank have been constrained by several factors, particularly the lack of skilled labor with strong financial experience and knowledge at all levels of banking operations. The restructuring of a bank inevitably entails replacement of unqualified staff by capable new staff. However, Bank Millie is finding this to be very difficult for various reasons. First, the specific salary ceiling for each position is too low to attract qualified staff from the region or even within Afghanistan. Second, the stakeholders require that Bank Millie hire only Afghans in key positions in order to build local capacity in the banking sector. Given that Afghanistan has few experienced bank professionals, the key positions are usually filled by less competent employees who can incur additional costs without improving operational efficiency in the bank. Third, Bank Millie is short of professional banking experts from outside who could carry out the restructuring process. Currently only one adviser from BearingPoint is supporting the bank operation. Although the Government promised to

send one more expert, this is still not enough to undertake a successful restructuring process. Finally, Bank Millie is overstaffed with unqualified employees. The bank now has 545 employees, although 67 of these were given a golden handshake. Out of 280 employees recently tested for basic banking competence, only 125 passed. There is little understanding of the components of profit and loss, cash/funds flows, financial intermediation, 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 due to war and internal strife. Hardly a single employee has been exposed to modern accounting and organisational systems or technology.

III. ANALYSIS

The banks in Afghanistan are mostly risk averse and not willing to extend loans to a new borrower, even to the reputable investors without secured collaterals. According to the World Bank's recent investment climate survey (2006), only three out of 335 firms in five major cities in Afghanistan (Kabul, Kandahar, Mazar-e-Sharif, Jalalabad and Herat) reported having bank credit for new investment. On average, nearly 94 percent of new investment by firms was funded by either internal funds or money from family and friends. Even some of the large investors in Kabul did not access bank financing as they found it very difficult to obtain such financing. It will be a challenge for the financial institutions to bring these types of investors into the banking network. Inclusion of them in banking services would certainly strengthen the economic growth of the country.

Access to finance is extremely limited for almost all SMEs in Afghanistan. This is severely constraining the overall growth of small businesses in the country and reducing the prospect of employment generation and expansion of individual small business. Although there is strong demand for credit from SMEs, the financial institutions are not responding to it. Limited access to finance, particularly for working capital, is a severe problem for SMEs. Discussions with AISA registered entrepreneurs have found that due to the shortage of working capital, some SMEs pay higher prices for raw materials which they buy in the local market with deferred payment conditions. The prices they pay are 20 to 25 percent higher than what they would pay if they were importing these materials either from Pakistan or India.

Since private commercial banks (PCBs) have been comfortable lending extensively for trading activities with secured cash collaterals, they are reluctant to venture widening their lending base to loans for industries. Lending for industries, in particular SMEs, was virtually absent in the case of PCBs. Financial systems or commercial banking does not see the small businesses as a potential market source for sustainable investment and commercial banking, thus losing the potential earnings from these credit relationships. On the contrary, Microfinance Institutions (MFIs) have taken advantage of this situation to expand their business to SMEs with great success in the absence of competition from commercial banks.

The World Bank's investment climate survey (2006) stated that 51 percent of firms considered access to finance a major problem for investment and business operations in Afghanistan. An ongoing World Bank survey of 50 enterprises, registered under the Afghanistan Investment Support Agency (AISA), shows that institutional financing in terms of working capital or investment capital could have a positive impact on business competitiveness, resulting in business expansion, increased employment and improved profitability.

More recently, the banking sector has grown significantly. Fourteen banks in operation have successfully been able to mobilise funds in terms of deposits from the informal sector of the economy, which previously avoided banking services. Although mobilisation of deposits has been growing, there has been little improvement on the lending side. Overall, lending to the manufacturing or service sector, except for the increase in trade financing, has been less significant due to the absence of CIB, the higher cost of registration and the weak capacity of banking human resources.

Commercial bankers have stated that the legal framework is not strong enough and that the court system is too weak to enforce contracts. The enactment of three new financial laws initiated by DAB would help improve this situation. However, the enforcement issue will remain and this will require setting up special commercial courts, recruiting and training of judges and also facilitating infrastructural facilities.

SCBs have been plagued by problems such as weak corporate governance and management structures, unskilled labour, outdated technological capacity, and serious liquidity and solvency problems. The first financial assessment of the banks conducted in January 2003 concluded that all the banks were in dire financial condition. Restructuring of three licensed SCBs is underway, and the Cabinet has recently approved a strategy paper on the

restructuring of Bank Millie to meet the IMF's benchmark for the financial sector. A similar restructuring paper for the Pashtany Bank will be placed in the Cabinet in June 2007 to meet the benchmark. Although the restructuring effort of these banks is in progress, the extent and intensity of the process needs to be evaluated properly to examine its impact on improving the operational and financial performance of these banks.

IV. RECOMMENDATIONS

Improving access to financial services

Lack of access to adequate financing on reasonable terms is partly caused by the risk averseness of the conservative banking systems in Afghanistan which have neither the necessary credit information on small borrowers to price risks accurately, nor the instruments to transfer such risks. In this context, the goal of improving access to finance will over the longer-term be met by building efficient financial markets and institutions and the necessary infrastructure underpinning these markets.

However, in the period of transition to an efficient banking system, targeted approaches to help jump-start financing are needed. Such approaches would include innovative risk-sharing methods, such as credit guarantee instruments designed to share banks' risks in lending; providing housing loans to low-income groups; and developing leasing markets which could meet the financial needs of small businesses as an alternative to traditional formal banking finance.

Setting up a banking training institution

The capacity building of the commercial banks has become important in order to provide efficient and transparent banking services. Establishment of a Banking Training Institute (BTI) will improve the skills of the employees of commercial banks, financial institutions and the central bank. While some individual banks are developing their own programmes, these are not adequate to meet the national need. The BTI can directly contribute to: (i) upgrading the skills and knowledge of credit officers, managers and administrators; (ii) developing banking systems with qualified professionals; and (iii) conducting research and promoting discussions on the financial sector policy issues to help national development.

Establishing a Credit Information Bureau

Establishment of a Credit Information Bureau (CIB) in Afghanistan could help the banking and financial institutions to maintain high quality loan portfolios of the customers. Commercial banks and financial institutions strongly support the establishment of a CIB for gathering, processing and storing information on the payment behaviour of businesses and consumers to help with risk assessments of the borrowers. The CIB needs to be linked to the central bank, since DAB has natural advantages to collect such information from the commercial and other financial institutions.

V. QUESTIONS FOR DISCUSSION

1. Even some of the large investors in Kabul did not access bank financing as they found it very difficult to obtain. What are the main reasons for this?
2. Why does commercial banking not see the small businesses as a potential market source for sustainable investment and commercial banking, while some MFIs, i.e. BRAC SEP, see them as excellent business opportunities?
3. What are the success factors for BRAC SEP to be able to expand SME loans?
4. In the case of Bank Millie, what would be more important, "building local capacity in the banking sector" or "revitalising the bank by allowing the bank to hire qualified international banking experts" or both?
5. How serious is the lack of capacity in banking human resources, and what are efficient ways to develop the capacity?
6. How could a CIB help financial institutions assess the credit risk of borrowers, and how urgent is it to establish a CIB in Afghanistan?
7. Why is the cost of collateral registration so high and what are the ways to bring down the cost for efficient financial transactions?

This case study was prepared based on a series of interviews with stakeholders in the financial services sector operating in Afghanistan.

