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Project Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 01-Feb-2024 | Report No: PIDIA00347

BASIC INFORMATION

A. Basic Project Data

Project Beneficiary(ies)	Region	Operation ID	Operation Name
Afghanistan	SOUTH ASIA	P504220	Empowering Microfinance and Enterprises for Resilience and Growth
Financing Instrument	**Estimated Appraisal Date**	**Estimated Approval Date**	**Practice Area (Lead)**
Investment Project Financing (IPF)	30-Jan-2024	19-Mar-2024	Finance, Competitiveness and Innovation
Borrower(s)	**Implementing Agency**		
Agha Khan Foundation - US	Afghanistan Credit Guarantee Fund		

Proposed Development Objective(s)

The Project Development Objective (PDO) is to support the demand for and supply of finance for micro and small enterprises; focusing on women's financial inclusion.

Components

Reviving Micro-Finance Providers (MFPs)
Building a Pipeline of Bankable Micro and Small Enterprises

PROJECT FINANCING DATA (US$, Millions)

Maximizing Finance for Development

Is this an MFD-Enabling Project (MFD-EP)? No

Is this project Private Capital Enabling (PCE)? Yes

SUMMARY

Total Operation Cost	**16.00**
Total Financing	**16.00**
Financing Gap	**0.00**

DETAILS

Non-World Bank Group Financing

Trust Funds	16.00
Afghanistan Reconstruction Trust Fund	16.00

Environmental And Social Risk Classification

Moderate

Decision

The review did authorize the team to appraise and negotiate

Other Decision (as needed)

B. Introduction and Context

Country Context

1. **In response to the events of August 15, 2021, in Afghanistan, the World Bank (WB), ARTF donors, the Global Financing Facility for Women, Children and Adolescents (GFF), and international partners have found pragmatic ways to provide support for essential basic services to the Afghan people.** On March 1, 2022, the WB Board approved Approach Paper 2.0, which aims to protect the vulnerable, help preserve human capital and key economic and social institutions, reduce the need for future humanitarian assistance, and improve gender outcomes. A key element of this support is Recipient-Executed (RE) grants to United Nations (UN) agencies and international non-governmental organizations (INGOs). To ensure the principles of equitable access for women and women's participation in project activities, Entry Criteria for Access (ECA) have been included for each project1. The World Bank has led a coordinated aid response, pooling donor resources, and supporting critical service delivery. The nationwide at-scale design allowed projects to respond quickly to crises like the Herat earthquakes and the increased repatriation of Afghan returnees.

2. **The international aid response helped maintain core services for the Afghan people and mitigated the humanitarian crisis but will be difficult to sustain in the context of expected aid declines, restrictive Interim Taliban Administration (ITA) policy positions and a depressed economy.** Development gains made over the last two decades are eroding. Employment opportunities and incomes remain inadequate. One in two Afghans is poor and about two-thirds of households cannotafford food and other basic non-food items, forcing many adults to engage in low-productivity activities to generate income. Currently, an estimated 15.3 million people are acutely food-insecure while more than six million Afghans are on the brink of starvation.

[1] Entry Criteria for Access (ECA) provides a platform by which ARTF donors, implementing agencies and the World Bank can assess whether the situation on the ground continues to provide the required conditions under which activities can be implemented.

Sectoral and Institutional Context

3. **Afghanistan's private sector continues to face challenges.** Before August 2021, the Afghan private sector consisted of over 700,000 businesses, with 90 percent being micro, small, and medium enterprises (MSMEs), and 80 percent operating informally. Among the estimated 57,000 women-owned businesses, only around 2,500 were formally registered, representing 4 percent of women-led businesses. Informality and limited financial literacy disproportionately affect women-led businesses, which hinders their bankability. According to the World Bank's ~~2023~~ Private Sector Rapid Survey (PSRS), businesses in Afghanistan are facing a drop in demand, leading to operational challenges: surveyed firms reported operating below capacity due to weakened demand. The significant decline in overall demand since August 2021 has had notable effects on the Afghan labor market. This includes increased participation of women and youth in the workforce. However, due to limited labor demand and additional constraints imposed by the ITA, most of the increase in female economic activity has been confined to their homes. The surveyed women-led businesses were disproportionately impacted by the economic and financial constraints.

4. **The formal financial sector in Afghanistan is small and largely underdeveloped, and the sector has shrunk further since the events of August 2021.** The formal financial sector in Afghanistan consists of twelve banks and is facing challenges related to solvency risks, shrinking assets, and the inability to perform core banking functions. Liquidity constraints have also greatly impacted the domestic payments systems and Afghan banks have experienced a significant decline in profitability, with a 51 percent decrease in total revenues from 2021 to 2022. Financial inclusion (FI) is a persistent issue, with nine out of ten Afghan adults being financially excluded due to trust issues and geographical barriers. The gender gap in FI is a substantial barrier for women's economic empowerment, with only 5 percent of Afghan women owning a financial transaction account compared to 10 percent of men. Moreover, FI for women is decreasing, with a decline from 7 percent in 2017 to 5 percent in 2021 (as per FINDEX data). Limited trust in the formal banking sector, low financial literacy, and the distance to the nearest financial institution are the main barriers to women's access to finance (A2F). Financial intermediation remains extremely low, with a credit to gross domestic product (GDP) ratio of 3.1 percent in 2021 (down to 1.9 percent in 2023). As a result, households in Afghanistan heavily rely on the microfinance sector (MF) for financial services, which also faces challenges due to economic contraction and the mandatory transition to Islamic finance.[2].

5. **Microfinance (MF) has always had more borrowers than conventional banks in Afghanistan.** The formal MF sector comprises of three MF institutions (MFIs), namely, OXUS, Mutahid and the First MF Bank (FMFB). The FMFB is the only microfinance provider (MFP) with a commercial banking license. Therefore, it is allowed to collect deposits. The sector operates in 14 provinces in Afghanistan (across 82 districts). In July 2021, the sector had 120,998 active borrowers (compared to 58,000 borrowers from banks) and a gross loan outstanding portfolio of Afghani (AFN) 8.2 billion (~US$ 115 million). The Microfinance Investment Support Facility for Afghanistan (MISFA) is the apex wholesale financing organization for the microfinance sector and a de facto supervisor because the MFI sector has not been regulated by the Da Afghanistan Bank (DAB). The DAB has recently issued new regulations for microfinance (in early 2023), but these are not yet implemented and are under discussion with the industry. The Community and Enterprise Development Authority (CAEDO) has recently been established as an offshoot of the MISFA and independent NGOs to promote A2F, support

[2] Islamic finance is a way to manage money in keeping with the moral principles of Islam. It covers things such as saving, investing, and borrowing to buy a home. Islamic financial services are described as 'Islamic finance' or '*Shari'ah*-compliant'.

livelihoods and develop domestic payment channels through shared agents' networks in Afghanistan[3].

6. **MFP's lending in Afghanistan operates at two levels**: micro-loans, with an average size of US$1000, primarily serving rural areas, and small and medium enterprise (SME) loans, with a maximum size of US$20,000, targeting urban areas. MFPs are responsible for loans up to AFN 2 million (~US$28,000) based on regulatory guidelines. In early 2020, 20 percent of MFPs' outstanding loan portfolio was in SME finance, with an average loan size of US$19,000. This contrasts with the banking sector, where SME lending accounted for only 16 percent of total lending. Therefore, MFPs in Afghanistan have expanded their services beyond traditional microcredit. However, it is important to note that credit supply for micro and small firms is also limited in Afghanistan due to demand-side constraints, including high levels of informality and limited financial literacy.

7. **The MF sector has always had a significant share of female borrowers (averaging 40 percent across the MFPs).** The sector is also a significant source of credit in the Afghan economy. For instance, in 2020, loans from the MFPs accounted for 17 percent of the total outstanding stock of formal credit. However, like the conventional banking sector, the MF space has also been hit hard by the massive economic contraction since late 2021. Borrowers were unable to service their loans due to a collapse in incomes which sent the asset quality of the MFPs into a freefall. Concurrently, due to the mandatory transition to Islamic Finance, the MFPs were not able to collect interest on even those loans that were being serviced. This has greatly eroded the capital position of the MFPs. For the sector to start to rebuild its business model in the new economic reality of Afghanistan, the balance sheets of the MFPs must be cleaned up. At present, of the AFN 3.3 billion (US$ 45 million) gross loans outstanding for the MFPs, 79 percent represents loans that originated before August 2021. Almost 90 percent of these loans have been past due for more than 180 days (that is, they are technically non-performing loans). However, the balance sheets of the MFPs do not accurately reflect this reality.

8. **Despite solvency challenges, the MFPs have resumed lending.** The DAB approved one Islamic product in September 2022, namely the *Murabaha*[4]. This is the only formal *Shariah*-compliant lending instrument currently available in Afghanistan. The uptake of new Murabaha loans by women in Afghanistan is influenced by changes in the labor market. Around 80 percent of the loans approved for women are for home-based services, handicrafts, and manufacturing. However, MFPs have become more cautious in lending to women due to increased risk aversion. Although they still offer Murabaha loans to women, the average loan size has significantly decreased, with women receiving loans that are half the size of those given to male borrowers. Out of the AFN 2 billion (US$26 million) outstanding Islamic portfolio, only 24 percent is attributed to women borrowers. Women borrowers have a different credit risk profile, which can affect their A2F in the long term.

9. **The proposed project aims to promote sustainable and equitable economic development by facilitating capital flow to productive activities.** Despite challenging economic conditions, there are signs of gradual stabilization, including improved security, reduced corruption, and decreased reliance on foreign aid. This presents an opportunity to restart economic growth. By creating jobs, delivering essential goods and services,

[3] The CAEDO is an independent offshoot of the MISFA. It aims to support livelihoods and promote access to finance. Additionally, the CAEDO has been mandated to work with MFPs and other stakeholders to develop a shared third-party agent network for greater outreach, as well as to promote greater transparency in domestic payments. This is a timely development, as the lingering issues in the banking sector and its payment systems have resulted in a shift to informal payment channels (including a heavy reliance on hawala systems).

[4] The *Murabaha* is a contract of sale between the MFP and its client for the procurement of goods at a price, plus an agreed profit margin for the MFP. The contract involves the purchase of goods by the MFP, which then sells them to the client at an agreed mark-up price. Repayment is usually in installments.

supporting reconstruction, and empowering women economically, the project can mitigate fragility and promote economic growth.

C. Proposed Development Objective(s)

Development Objective(s) (From PAD)

The Project Development Objective (PDO) is to support the demand for and supply of finance for micro and small enterprises; focusing on women's financial inclusion.

Key Results

10. The PDO outcome indicators include the following:

    a) Number of MFPs with non-negative capital.
    b) Number of loans to micro and small enterprises, including the percentage of such loans made to women or women-owned enterprises.
    c) Number of enterprises made credit-ready through business training and mentorship, including the percentage of which are women or women-owned.

D. Project Description

11. **All project activities are designed with a particular focus on promoting women's financial inclusion.** The project activities will commence in parallel by working through the implementing partners to leverage complementarities and synergies across components and existing programs where possible. The project components follow:

12. ***Component 1: Reviving MFPs (US$10 million)***: **The first component will strengthen the supply of finance to micro and small enterprises in Afghanistan by supporting the MFPs on two fronts.** Firstly, performance-based Capital Support Grants (CSGs) will be provided to the 3 MFPs currently operating in Afghanistan. These are designed to clean the balance sheets of the MFPs with a legacy of Non-Performing Loans (NPLs), more specifically, NPLs that originated before August 2021[5]. This will put the MFPs on the path to stability and sustainability. Secondly, to deepen the sector and to enhance its outreach, Technical Assistance (TA) to the MFPs and CAEDO will target the deployment of *Shariah*-compliant products, promote digitization, support operational capacity building, and so on. This component will be implemented by the Afghanistan Credit Guarantee Company (ACGF) and will also support the expenses that ACGF will incur on managing and overseeing its implementation.

13. ***Component 2: Building a Pipeline of Bankable Micro and Small Enterprises (US$6 million):*** This component will support the demand for credit among micro and small enterprises[6] (including women-led enterprises or those which create jobs for women) by developing a pipeline of bankable enterprises and connecting them to the

[5] This will likely involve write-offs of NPLs and/or financial restructuring. Credit enforcement (going after the debtor in a bid to recover) unlikely to work in the current context.

formal financial system (especially the MFPs under Component 1). This component will include: (i) business development services to firms; and (ii) the establishment of a credit viability fund. It will be implemented by the Aga Khan Foundation (AKF) United States through its Afghanistan office of AKF[7] in collaboration with the AKF's teams of Accelerate Prosperity (AP) and the Aga Khan Cultural Services (AKCS). This component will also support the costs that the AKF incurs to manage and oversee Component 2, including technical support, training, monitoring, and reporting.

14. **The project's primary beneficiaries will be the MFPs and their borrowers (both existing and future), as well as micro and small enterprises — with a particular emphasis on women-owned businesses**. A geographical focus will be on 15 provinces in Afghanistan (including Badakhshan, Baghlan, Balkh, Bamyan, Daikundi, Faryab, Herat, Jowsjan, Kabul, Kunduz, Kandahar, Parwan, Samangan, and Sar-e-pol).

Legal Operational Policies	Triggered?
Projects on International Waterways OP 7.50	No
Projects in Disputed Area OP 7.60	No

Summary of Screening of Environmental and Social Risks and Impacts

E. Implementation

Institutional and Implementation Arrangements

15. **The Aga Khan Foundation USA (AKF-US) will implement the project.** AKF has been working in Afghanistan since 1996 and has committed over US$1 billion in development assistance AKF-USA will be the Grant Recipient and sign the Grant Agreement with the Bank. They will also engage AKF Afghanistan and the ACGF as implementation partners through Subsidiary Agreements (SAs). ACGF, established in 2004, aims to enhance access to finance for Afghan MSMEs by providing credit guarantees and TA. They have previously implemented projects like SAFI and PAISA in Afghanistan.

16. **The ACGF will implement Component 1 and the AKF-Afghanistan will implement Component 2.** AKF-USA will establish a Project Implementation Unit (PIU) in Afghanistan, staffed with individuals who meet the Bank's qualifications. The PIU will have two main responsibilities: overall project coordination for both components and project implementation, including reporting consolidation, environmental and social safeguards, and project management. The ACGF and AKF-Afghanistan will utilize their existing institutional arrangements with MFPs and private sector enterprises to deliver the activities. The PIU will ensure timely implementation of project activities in accordance with the Bank's rules and policies.

[7] Aga Khan Development Network (AKDN)

17. **The project has an 15-month implementation period, and it will be implemented under a POM.**

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APPROVAL

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