Project Information Document/ Integrated Safeguards Data Sheet (PID/ISDS)

Concept Stage | Date Prepared/Updated: 11-Nov-2016 | Report No: PIDISDSC19788

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Parent Project ID (if any)	Project Name
Afghanistan	P161348		Modernizing Afghan State Owned Banks (P161348)
Region	**Estimated Appraisal Date**	**Estimated Board Date**	**Practice Area (Lead)**
SOUTH ASIA	Apr 17, 2017	Jun 08, 2017	Finance & Markets
Lending Instrument	**Borrower(s)**	**Implementing Agency**	
Investment Project Financing	MINISTRY OF FINANCE	Ministry of Finance	

Proposed Development Objective(s)

The proposed project development objective is to contribute to the modernization, transparency and efficiency of Afghan state-owned banks.

Financing (in USD Million)

Financing Source	Amount
IDA Grant	40.00
Total Project Cost	**40.00**

Environmental Assessment Category	Concept Review Decision
C-Not Required	Track I-The review did authorize the preparation to continue

Other Decision (as needed)

B. Introduction and Context

Country Context

1. **Afghanistan has made substantial progress since the overthrow of the Taliban regime in late 2001.** In September 2014, the country had its first democratic and peaceful transition of power. The National Unity

Government has embarked on an ambitious reform agenda to revitalize the economy. Despite a solid stride towards growth and stability, the Bank's recent economic update report for the country indicates that the economy remains under significant pressure. Economic growth has slowed, falling to 1.3% and 0.8% respectively in 2014 and 2015, compared to an average 9.4% over 2003-2012. Fiscal pressures have been well managed: the government undertook reforms that increased revenues from 8.4 percent in 2014 to 10.2 percent of GDP in 2015. The country remains highly dependent on aid, which helped finance around 60 percent of budget expenditure and the high trade deficit. Declining global food, fuel and other commodity prices combined with weakening domestic demand in 2015 has resulted in a fall in inflation into negative territory. Consumer price inflation dropped to -1.5 percent, down from 4.5 percent in 2014. Past gains ae being eroded. The poverty rate has increased from 36 percent in 2008 to 39 percent in 2014. Unemployment and underemployment have also increased from 25 percent in 2008 to 39 percent in 2014.

2. **The medium-term outlook points to slow post-transition recovery.** Real GDP growth is projected to increase modestly in 2016 and 2017 respectively, conditioned on improvements in the security environment and strong reform momentum, which could help restore confidence in the economy. Nevertheless, much higher growth rates are required to counter an estimated population growth of 2.5 percent and an estimated 400,000 entrants into the labor force every year. Good performance of the agriculture sector and declining food prices could mitigate the upward pressure on poverty that stems from the negative growth in per capita GDP in 2014 and 2015. Poverty is expected to persist higher than its pre-transition level due to the contraction in off-farm labor demand and security-related constraints in service delivery.

Table 1: Selected economic indicators

	2013	2014	2015	2016e	2017e	2018e	2019e
In Percent of GDP, unless otherwise indicated							
Nominal GDP (billion US$)	20.5	20	19.6	18.9	20	21.2	22.6
GDP per capita (US$)	643	632	620	607	604	608	627
Population (million)	30.7	31.6	32.5	33.4	34.2	34.9	35.7
Real GDP growth /1	3.7	1.3	0.8	0.5	1.8	3.0	3.6
CPI inflation (period average)	7.4	4.6	−1.5	6.0	5.0	5.0	5.0
Exports of goods (million US$) /2	3.56	3.92	3.40	3.63	3.85	4.19	4.69
Imports of goods (million US$) /3	45.1	43.6	40.1	42.2	41.3	40.4	41.2
Trade balance	−41.6	−39.6	−36.7	−38.7	−37.5	−36.2	−36.6
Current account balance	7.4	8	5.4	4.5	3.6	2.8	1.2
Gross foreign exchange reserves (million. US$)	7,447	7,360	6,864	7,500	7,600	7,700	7,800
External debt /4	6.7	6.5	6.3	6.6	6.6	6.3	6.1
Revenues to recurrent spending ratio (%)	55.2	43.8	51.9	49.7	47	46.4	46.4
Domestic revenues	9.7	8.7	10.2	10.9	11.6	12	12.3
Donor grants	14.4	15.7	15	18.1	19	18.9	18.9
Share of dollar deposits (%)	68.0	66.0	71.5	..	..	..	..
Credit to private sector, commercial banks	4.2	3.8	3.9	4.2	5.0	5.8	6.8

1/ National Accounts data exclude opium value added.
Sources: Central Statistics Organization, Central Bank, World Development Indicators, IMF staff estimates, and Bank staff projections.

Sectoral and Institutional Context

1. **In terms of structure within the financial sector, the banking sector dominates.** The banking sector is composed of 3 state-owned banks (SOBs), 9 private full-fledged banks (PBs) and 3 branches of foreign commercial banks (FBs). One bank focuses on microfinance. There are four insurance companies. In addition, there are 994 licensed money service providers (MSP) and 2,104 licensed FX dealers.

2. **Afghanistan has a modestly developed financial sector and intermediation leves are abysmally low.** While banking sector assets amounted to 22 percent of GDP (USD 4.1 billion), only 3.7 percent of GDP was intermediated as loans from banks to private sector in 2015. Total deposits represented 17.5 percent of GDP. Afghanistan lags behind its regional peers in terms of financial intermediation and outreach (tables 2-4) other fragile and conflict-affected situations (FCS). The financial underdevelopment has reflected on low financial inclusion with only 10% of adult Afghan population having accounts with formal financial institutions which is substantially low compared to 53% in India, 30% in Vietnam and is also considered lower than other FCV countries including Iraq where it read 11% and Mali that reads 13%.

Table 2: Indicators of Banking Activities for selected countries (2015)

Countries	M2/GDP	Bank Credit/GDP
India	79.2	52.7
Pakistan	53.5	15.4
Vietnam	137.6	111.9
SAR average	74.5	47.6
Bangladesh	64.5	43.9
FCS average	61.1	21.1
Afghanistan	**34.4**	**4.0**

Source: World Development Indicators

3. **The modestly developed banking sector was dealt a major shock with the collapse of Kabul Bank in September 2010.** While the sector has been marked by lingering concerns on governance, deteriorating asset quality and weak profitability, the offshoot of the Kabul Bank collapse was unprecedented. Indeed, public confidence, shattered by the fraud and collapse of Kabul Bank, has not fully recovered yet. Kabul Bank (now" New Kabul Bank") was Afghanistan's largest private bank established in 2004

4. **The Kabul Bank crisis amplifies the need to improve the health of the financial sector especially considering continuing stresses even while efforts to cater to legitimate needs of the economy and enhancing intermediation need to be gradually enhanced**. Non-performing loans have been steadily increasing over the past four years reaching 17.11 percent in end-June 2016, a record high since the Kabul Bank crisis. The banks have highly dollarized balance sheets. Around 69 percent of total loans and 66 percent of deposits are denominated in US dollars. Banking sector profitability is of concern, with the banking sector barely breaking even during 2015. Broad liquidity ratios reached 72 percent as of-end-June, well-above the required 15 percent. While the average capital adequacy ratio is above the minimum 12 percent requirement, there is wide variation between banks. The high liquidity and solvency ratios are actually misleading, but reflect the fact that banks do not play their intermediation role, especially state-owned banks (SOBs). The average system-wide loan-to-deposit ratio stood at only 19.2 percent and at 4.6 percent for the three SOBs as of December 2015.

Table 3: Banks in Afghanistan (US$ million, end-June 2016)

Category	Number of Banks	Number of branches	Assets	Assets Share	Loans	Loans Share	Deposits	Deposits Share
SOBs	3	131	1,063	27%	43	6%	935	27%
PBs	9	276	2,587	65%	623	92%	2,237	65%
FBs	3	7	350	9%	8	1%	276	8%
Total	15	414	4,000	100%	674	100%	3,450	100%

Source: SOBs – State owned banks; PCBs – Private banks; FBs – Foreign banks (branches)

Table 4: Key financial soundness indicators – Afghanistan banking sector (2012-16)

(in %)	2012	2013	2014	2015				2016
				Q1	Q2	Q3	Q4	Q2
Capital adequacy								
Regulatory Capital to Risk-weighted Assets	21.8	26.2	26.5	25.8	25.6	26.3	28.3	
Capital to Assets	7.6	11.6	11.9	12.0	12.2	12.9	13.5	10.1
Asset quality								
Non-performing Loans to Total Gross Loans	5.0	4.9	7.8	10.1	13.5	13.7	12.3	17.1
Non-performing Loans Net of Provisions to Capital	6.6	2.5	3.4	4.0	6.8	6.3	5.7	
Earnings and profitability								
Return on Assets	-0.4	0.6	0.9	-1.5	-1.0	-0.2	0.4	2.46
Return on Equity	-5.5	7.1	7.2	-12.9	-8.0	-2.0	3.5	
Liquidity								
Liquid Assets to Total Assets (Liquid Asset Ratio)	65.7	61.2	73.2	72.9	74.4	73.4	71.4	65.7
Liquid Assets to Short-term Liabilities	79.7	77.0	89.0	90.5	93.1	92.6	90.4	

5. **There are three state-owned banks (SOBs) − New Kabul Bank, Bank Mellie Afghan and Pashtany Bank −** which are fully owned by the Government of Afghanistan**.** Table 5 and Table 6 below provide data on SOB's financial and operational performance.

Table 5: Selected Indicators of SOBs performance (as of end-December 2015):

	New Kabul Bank (NKB)	Bank Mellie Afghan (BMA)	Pashtany Bank (Pashtany)	Sector-wide	SOBS as % of sector
Deposits (AF mln)	20,688	22,369	15,881	237,002	25%
Loans (AF mln)	-	2,741	8.4	45,409	6%
Total assets (AF mln)	29,607	30,520	17,044	270,689	29%
Branches	112	34	18	410	40%

**data as of-end June 2016*
Source: DAB; SOBs

6. **SOBs deliver banking services through a widespread network of branches across all provinces in Afghanistan.** NKB's network covers the whole country and is represented in all provinces with 112 branches. BMA has 34 branches one third of which are located in Kabul (the country's capital). Pashtany's network is limited to 18 branches, with two thirds located in the central area. In total, the three SOBs account for half of the sector's full service branches, and close to 40 percent of the total branch network. SOBs have a very limited automated Teller Machines (ATM) network however. Currently, only NKB owns 38 ATM machines in 17 locations (fifteen of which are not functional), or 20 percent of the total 185 ATMs available (see annex I; table 4).

7. **Several challenges are currently facing SOBs.** Strengthening governance structures and upgrading risk management practices; resolving the challenge of filling top positions with competent candidates; building capacity within the ministry of finance for oversight of SOBs and developing clear mandate and business plans to properly function as banks and mitigate high operational risk and inefficiencies. The widening skills and

technological gap between SOBs and other market players explain SOBs' inability to compete with private banks.

Relationship to CPF

8. **The proposed project is fully aligned with Government priorities and is consistent with the World Bank Group's strategy**. Providing a credible system for banking regulation and oversight is an identified priority of the GoIRA, in the 2017-21 Afghanistan National Peace and Development Framework (ANPDF). In particular, the ANPDF highlights state-owned banks as an area of focus to improve sustainability, increase efficiency and facilitate access to financial services. The Afghanistan Systematic Country Diagnostic (SCD, report No. 103421) also specifically finds that improving banking sector confidence, through enhanced accountability and stronger governance is an essential condition for stability and will be critical to boost job creation and growth. In addition, the SCD points to the need to exercise effective regulatory and prudential oversight of the overall financial sector, with a focus on enforcement, to help avoid serious financial crises.

9. **Building strong and credible institutions remain a key objective of the FY17-20 Country Partnership Framework (CPF), which was recently approved.** The proposed project directly contributes to pillar 2 of the CPF which aims to support inclusive growth through a more stable and efficient financial system. To date, the Afghan banking sector has been unable to play its role in in financing the country's growth, despite its high liquidity. For banks to assume this role, solid regulatory foundations and robust reform policies to safeguard financial stability are prerequisites that DAB is mandated to establish, along with the MoF for SOBs.

10. **The proposed project builds on the World Bank Group's lending and knowledge engagements** in support of laying the necessary foundations and building key blocks for a sound financial sector. The World Bank Group has been playing a leading role through lending as well as advisory services and analytical engagements. In particular, the proposed project, which provides support to MoF in its oversight of SOBs, complements well the ongoing Financial Sector Rapid Response Project, which provides technical assistance to enhance DAB's capacity in supervising the overall banking sector. The proposed project will also be informed by the ongoing review of risk management and corporate governance practices in the banking sector.

C. Proposed Development Objective(s)

The proposed project development objective is to contribute to the modernization, transparency and efficiency of Afghan state-owned banks.

Key Results (From PCN)

11. The project will supports Afghanistan's efforts in restoring financial stability and confidence in the sector. By the end of the project, the following key results are expected for all SOBs: (i) improved financial health; (ii) strengthened regulation and oversight by afghan authorities; (iii) reinforced governance and risk management; and (iv) more efficient operations through improved IT systems and better operational processes.

Expected results and indicators:

12. **The key proposed results indicators are as follows**:

a. **SOB Automation** – Full automation of transaction and business processes for all SOBs, including the interconnectivity of their branches.
Measured by: CBS and ERP implementation by number and percentage of branches

b. **SOB Governance --** full compliance with standards/guidelines related to (a) Risk Management, (b) Corporate Governance, (c) Credit Management and (c) Internal Audit;
Measured by: extent of compliance with standards set by DAB/MoF - substantially compliant/partially compliant/noncompliant

c. **SOB Efficiency and Outreach--** Cost efficiency and outreach of the banks is improved
Measured by: share of operating costs over revenues, number of accounts, and growth in deposits.

D. Concept Description

13. The proposed project will include the following four broad components: (i) supporting the corporate governance and oversight framework of SOBs, (ii) supporting the modernization of IT systems and business processes of SOBs; (iii) supporting Institutional development of MOF and SOBs; and (iv) support for Project Coordination, implementation and monitoring.

Component 1: Supporting corporate governance and oversight of SOBs (US$8-10 million)

14. The project proposes an all-encompassing approach to the improvement of all dimensions of corporate governance in the SOBs, including properly constituted boards, management, capital management, risk management, internal controls, compliance, internal audit, external audit, and transparency, disclosure and accountability. Overall, the project will support the establishment of firewalls between the different roles related to SOBs: regulator, supervisor and owner.

15. To this end, TA would be provided to the MoF for reforming Governance of SOBs through conducting in-depth assessment of the current structure, identifying gaps, and proposing an action plan with a clear organizational structure that is disconnected from the government bureaucracy and leans towards a well-defined corporatized structure. The project will thus finance the establishment of an oversight unit for SOBs at the MoF. Moreover, this component would also involve developing clear terms of references for various roles including general assemblies (GA), boards, committees and key positions. Technical assistance would also provide advice on the needed legal and regulatory reforms. In line with the government’s recent appointment of the same representatives at the GA of the three banks, the project would explore ways to harmonize risk management and corporate governance practices at these three banks. This could involve setting up a common board to enhance synergies and move towards the rationalization of the banks

16. The recourse to disbursement-linked indicators (DLIs) will be further explored during project preparation. Through results-based financing, the project would establish interim and end-project targets for improving SOB governance and the overall ownership function of the government, and provide strong disbursement incentives for the authorities to achieve tangible and measureable results against these targets.

Component 2: Supporting the modernization of IT systems and business processes of SOBs (US$22-25 million)

17. This component will aim to minimize the operational risks of the three banks and invest in the financial infrastructure and automation to boost their operational efficiency, increase transparency and support their role in scaling up the provision of financial services. This component will support the operationalization of strategies that will be developed under the first component.

18. Given the importance of modern information technology (ICT) for effective decision-making and financial services delivery, upgrading business processes and transaction processing is a prerequisite for SOBs to become effective and efficient competitors in the banking sector. The process may finance the expansion of points of services for these SOBs, to increase their outreach.

19. The project will seek to centralize common services and IT platforms to the extent possible. The project will anticipate possible co-operation arrangements with respect to branches, should the option of rationalizing SOBs be privileged in the future by the MoF.

Component 3: supporting Institutional development of MOF and SOBs (US$3-5 million)

20. Capacity challenges are a key contributing factor to the weak financial position and performance of SCBs. The project will thus finance efforts to build the capacity of staff within SOBs (GA, Boards, management and employees), as well as relevant MoF staff. Training plans wills be developed as appropriate, and joint training delivered to maximize economies of scale. In addition, the project will seek to achieve synergies with the FSRRP project and identify training that can be delivered by the Afghanistan Institute of Banking and Finance supported through the FSRRP.

Component 4: support for Project Coordination, implementation and monitoring (US$3 million)

21. This component will provide support for the monitoring and coordination of Project activities undertaken by various beneficiary institutions (SoBs and MoF). It will also help develop a strong monitoring and evaluation system to be used by the Project Implementation Unit (PIU) and other stakeholders to assess implementation progress.

SAFEGUARDS

A. Project location and salient physical characteristics relevant to the safeguard analysis (if known)

Most of the project activities will be implemented in the country capital Kabul and could also be extended to some provincial branches (possibly including but not limited to Balkh and Kandahar). However, the activities themselves will not have any direct environmental impacts and thus there is no need to trigger any safeguard policies. The project team will ensure the development of an effective GRM system to respond to any grievances. Since the project does not directly affect the population and focuses on the efficiency of state-owned banks, possible grievances would likely be limited to banks' staff and clients who are adversely affected by the project.

B. Borrower's Institutional Capacity for Safeguard Policies

The Borrower's Institutional Capacity for Safeguards Policies is limited as these organizations, e.g., MoF and the SOBs have not implemented WB funded projects requiring Environmental Assessment and Management. However, one could argue these activities could have some downstream impacts later on once these Banks give loans for projects which will have environmental impacts, assessment and management.

C. Environmental and Social Safeguards Specialists on the Team

Mohammad Arif Rasuli, Qais Agah

D. Policies that might apply

Safeguard Policies	Triggered?	Explanation (Optional)
Environmental Assessment OP/BP 4.01	No	
Natural Habitats OP/BP 4.04	No	
Forests OP/BP 4.36	No	
Pest Management OP 4.09	No	
Physical Cultural Resources OP/BP 4.11	No	
Indigenous Peoples OP/BP 4.10	No	
Involuntary Resettlement OP/BP 4.12	No	
Safety of Dams OP/BP 4.37	No	
Projects on International Waterways OP/BP 7.50	No	
Projects in Disputed Areas OP/BP 7.60	No	

E. Safeguard Preparation Plan

Tentative target date for preparing the Appraisal Stage PID/ISDS

Apr 17, 2017

Time frame for launching and completing the safeguard-related studies that may be needed. The specific studies and their timing should be specified in the Appraisal Stage PID/ISDS

n/a

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