Microfinance in Afghanistan:

General Background

- Population : 25.47 mn (2009)
- Main towns : Kabul (2.5 mn); Kandahar (0.45 mn); Herat (0.35 mn)
- Currency : Afghani (Af)
- Exchange rate: USD = 46 Af (as of August 2010 Kabul Market Price)
- Fiscal Year : 21st March - 20th March
- **Development Indicators:**
  - Population below poverty line (National): 42% (2007)
  - GNI per capital (Atlas method, USD): 370 (2008)
  - Literacy Rate (15-24 years): 23.5% (2005)
  - Mortality Rate (child<5 years): 257 per 1000 births (2008)
  - Life expectancy at birth: 44 years (2008)
  - HDI: 0.352, 181 rank in 182 countries (2009)

Historical Evolution

The microfinance sector in Afghanistan came into existence in 2003, when the Government of Afghanistan, together with the World Bank, the Consultative Group to Assist the Poor (CGAP), the Department for International Development (DFID), Sida, USAID, Novib and the Governments of Denmark and Canada established the Microfinance Investment Support Facility for Afghanistan (MISFA) - an apex institution to pool diverse donors funding mechanisms and to offer a streamlined flexible support to MFIs in Afghanistan. In 2006 MISFA was transformed into a company owned by the Ministry of Finance (MoF) and governed by an independent board of directors elected by donors.

Indicator	**2009-10**
Nominal GDP (USD bn)	14.5
Real GDP Growth (%)	22.5
Consumer Price Inflation (avg, %)	-8.3
Exchange rate (avg vs USD)	50.23
External Debt (year-end, USD bn)	n/a
External Debt (as a % of GDP)	10
FDI (USD mn)	185
FDI (as a % of GDP)	1.4

To date, these donors have provided more than USD 100 mn to MISFA and the World Bank has further committed USD 30 mn in June 2008 to improve the microfinance sector in the country. Overall the initiative has proven to be very successful. 15 MFIs have emerged to render the much needed financial services to the low income population, supported by MISFA funding and capacity building programs. It is important to note that most of these MFIs come from NGOs background.

Amongst the MFIs, the Bangladesh Rural Advancement Committee (BRAC) Afghanistan is the largest player in the market with 152,671 active microfinance borrowers which is 52% of total borrowers and 31% of Outstanding Loan Balance (OLB) as of May 2010.

The Afghanistan Microfinance Association (AMA) acts as a network of MFIs operating in Afghanistan. It aims at promoting a sustainable sector through capacity building of MFIs, advocacy, lobbying and awareness raising, to establish itself as a voice of the sector. Registered in 2007, AMA currently has 13 permanent members and 2 associate members.

MFIs have about 12 times more credit clients than all commercial banks combined; however, unlike banks, they do not have depositors. In clear contrast, banks have about 23 depositors for every borrower.

Types of MFIs

There is no comprehensive legal framework for the microfinance sector in the country and there are no prudential regulations for MFIs. Currently, while a majority of MFIs are incorporated as limited liability companies and registered under the Ministry of Commerce; other institutional forms are present as well.

The types of institutions active in the microfinance sector are:

- **Deposit taking Microfinance Institutions (DMFI):** Registered and regulated by the DAB under DMFI license. These can take two forms: Limited liability companies and Corporation/Companies. Both types are registered under the Afghan Investment Support Facility (AISA) and are not regulated except under normal company law according to the Commercial Code of 1955. To date no MFI has applied for this license

- **MFIs registered as general companies/corporations:** They do not take deposits and can take two forms: Limited liability companies or Corporation/Companies. Both forms are registered under the AISA and are not regulated except under the normal company law according to the Commercial Code of 1955. All MISFA partners are registered under these legal forms.

- **Credit Unions:** They are registered with AISA but are not regulated. There are currently 20 Islamic Investment Financial Cooperatives supported by World Council of Credit Unions (WOCCU) with funding from MISFA and others.

- **Commercial Banks:** Among commercial bank, there are currently two banks in the country that focus on microfinance clients. Both of them are MISFA partners and have received significant financial support from MISFA via loan facilities:

  - The First Microfinance Bank Afghanistan (FMFB-A) is promoted by the Aga Khan Development Network. FMFB-A was the first private commercial bank to be licensed and incorporated in Afghanistan in 2003. Since its inception, the Bank has grown rapidly and is now operating 13 branches in 7 provinces. The bank is currently the largest microfinance institution in Afghanistan in terms of outstanding portfolio size. The bank's microfinance portfolio was valued at USD 39.8 mn at the end of 2009. Of the total portfolio, 22% benefited rural clients. Women constitute 13% of the bank's client base. The bank also provides micro-savings, allowing individuals to open an account with as little as USD 1. The continued increase in deposit activity has brought the number of clients up to 37,342. The value of deposits climbed to USD 10.8 mn.

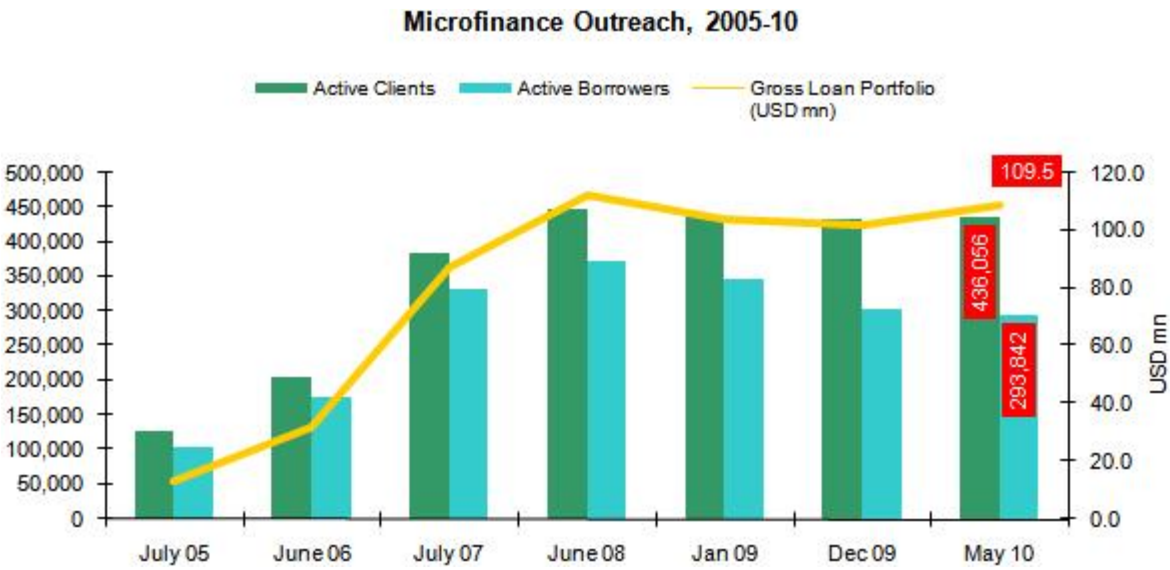
- BRAC Afghanistan Bank (BAB) is a commercial bank registered with the DAB offering financial services to small enterprises in Kabul and other major cities. BRAC Bank is incorporated in Afghanistan and is an international bank with institutional shareholdings by BRAC, the International Finance Corporation (IFC) Shore Cap International (based in Chicago, USA) and Triodos Bank of The Netherlands. It has one branch and three sub-branches in Kabul. During its operation, the Bank has disbursed more than USD 35 mn in loans to no fewer than 6,000 small and medium entrepreneurs.

It is important to note that all MFIs that are financed by MISFA have to register with AISA. The most common legal form for MFIs in Afghanistan is under the status of a Corporation. The role of MFIs outside the MISFA network is insignificant.

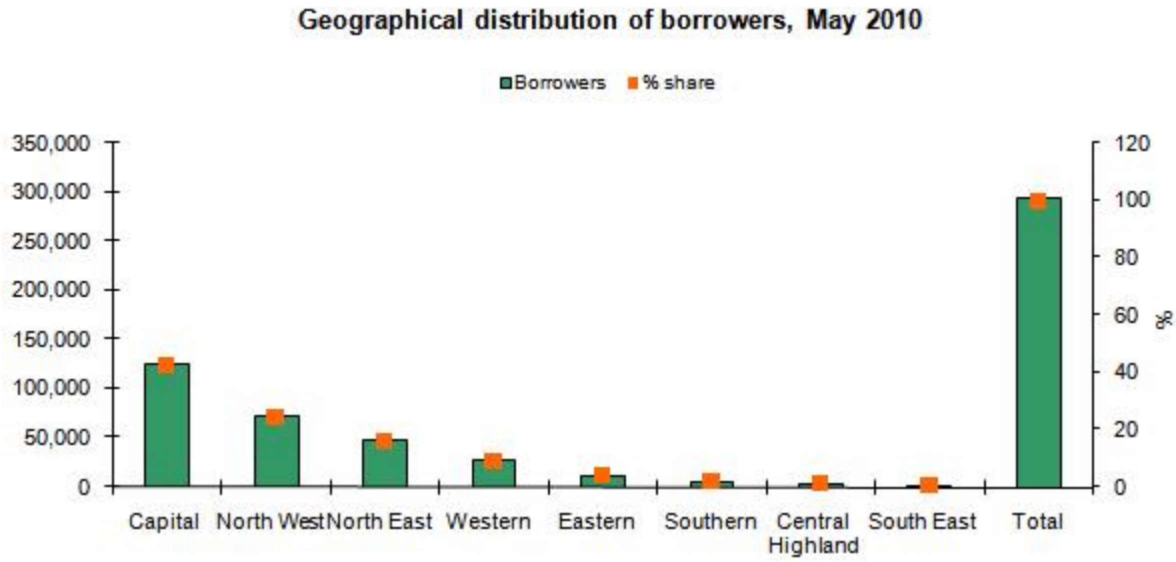
Major highlights of the sector

Outreach

Since its inception, the microfinance sector has made substantial growth in terms of active borrowers, loans disbursed, size of loans as well as provinces and districts covered.



According to a research study from the Institute of Development Studies, the growth of the sector has led to increased business activity, employment opportunity and assets as well as improved socio-economic status for women.

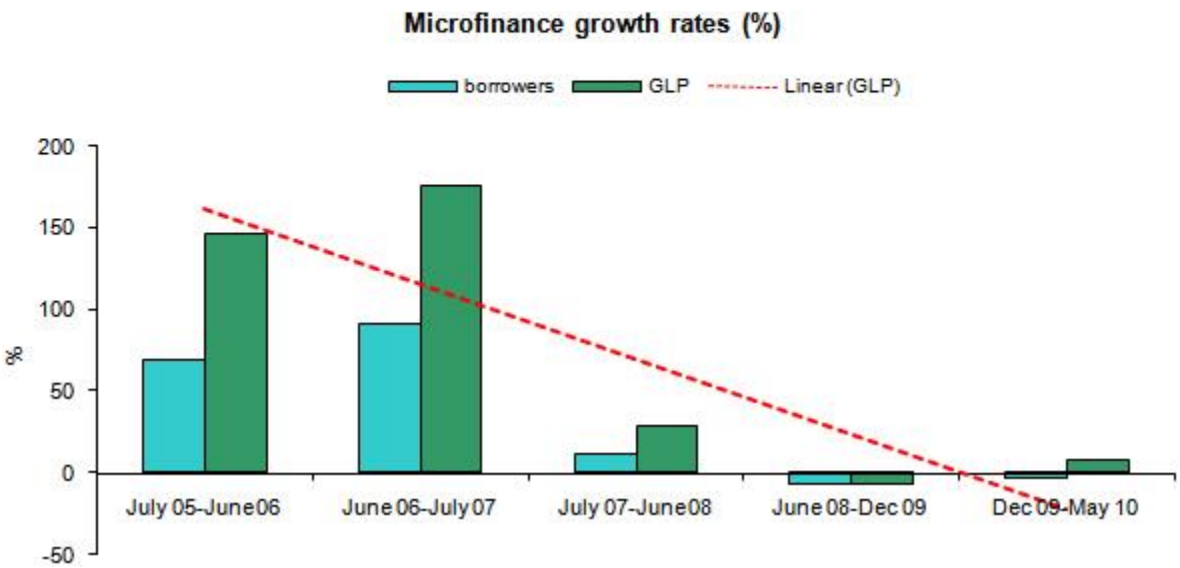


As of May 2010, 15 MFIs registered with MISFA operate in 109 districts of 26 provinces reaching 436,056 clients and 293,842 borrowers, and have Gross Loan Outstanding of Af 5,364 bn Af (USD 109.5 mn). Among the borrowers 43 % are women and 72 % are urban.

However, outreach is mainly concentrated in Kabul and surrounding areas where close to 43% of borrowers coming from these regions. So far the cumulative total loan disbursed by MISFA partners amounts to Af 35,159 mn (USD 717 mn).

Growth

The microfinance sector in Afghanistan grew at a very fast rate since its start as pilot in 2003-4 led by MISFA. Between 2006-08 the microfinance sector achieved considerable growth in terms of the number of MFIs, outreach and loan outstanding, but then dropped considerably in growth rates from 2007-08.



According to AREU study looking at problems of the sector, this trajectory clearly brings out the fundamental problems of the sector that seriously undermine the viability of MF in the medium to long term. The key reason for problems besetting the sector is a push towards scale and operational sustainability while ignoring important dimensions of putting in place sound internal systems and ensuring quality. This had far reaching implications on how MFIs approached clients and eventually led to systematic problems at the sectoral level that are reflected in the downward trend seen since 2008.

Products

Credit services are the main products for all the MFIs with variations in characteristics such as lending methodology, amount and purpose across the MFIs and provinces. According to a MISFA impact study, 89% of the loans were used for productive purposes. 53% of surveyed households used their loan to expand their business and 28% for start-ups. Generally interest rates on loan products offered by MFIs depending on terms and type of product/guarantee or lack thereof range from 1.4% - to 2% flat per month or 17% to 24% flat per annum. There has been some downward pressure on pricing, particularly in Kabul due to competition among the MFIs. In almost all cases loan repayment starts almost immediately and repayments are on a weekly, biweekly or monthly basis.

Voluntary savings are forbidden by law to MFIs that are not registered as DMFIs. Existing MFI therefore can only mobilize mandatory savings. Although savings products are offered by a few MFIs and made compulsory by others. Eight of the current 15 MFIs include some kind of savings product for members of the groups. None of the MFIs have offered an insurance product. Voluntary savings are forbidden by law as only mandatory savings can be mobilized, otherwise MFIs fall under DMFI regulation.

MISFA considers Islamic microfinance as a great opportunity and is paying close attention to its development. Currently 4 out of 15 MISFA partners offer Sharia compliant products and consider them as very promising not only for clients but also for community leaders and authorities.

Active banks in the microfinance space, i.e. FMB-A and BAB, are targeting micro and small business owners. Other services such as micro-leasing, micro-insurance and micro-remittance are not practiced in the country.

According to a recent study by Afghanistan Research and Evaluation Unit (AREU), on the microfinance sector in Afghanistan, the MFIs developed a simple and limited range of credit products that are easy for new loan officers to introduce. Such standardized product portfolio is easy for the MFI to monitor, but did not necessarily meet a clients desire for loan products fitting their specific livelihood activities. The mismatch with client interests could have been particularly the case in rural areas, where cash flows are irregular, returns low and risky and come after a significant maturity period. Therefore, product simplicity, while meeting the short term interests of MFIs, eventually backfired for not being more concerned with client needs.

Sustainability

In the beginning of 2009, the Operational Self-Sufficiency (OSS) figures for the sector stands only at 79%. It is suggested that MFIs in the country have achieved growth at the expense of profitability and sustainability. The MFIs incur high operational costs due to the security environment, small size of loans, poor infrastructure and high costs of top management, all contributing to limit their ability to achieve sustainability.

Another cause for concern for the sustainability of MFIs is the recent trend in rising Portfolio at Risk (PAR). Broadly, PAR>30 increased from 3% in September 2007 to 10% in October 2008. In January 2009 the PAR>30 is 11% for the sector as a whole. This has further deteriorated in recent months for many MFIs, however, the updated data for the sector as a whole is not available. Some explanations given for the increase in PAR are due to the lack of human resource capacity, deteriorating national security, lack of internal control and unconsolidated growth.

The high operating costs and unstable security situation continue to pose major challenges for MFI sustainability.

Meso level infrastructure

The meso-level infrastructure is still under developed and continues to rely on overseas consultants and agencies for TA, ratings etc. However, a noteworthy development is the transformation of the Afghanistan Microfinance Association (AMA) into a network of MFIs leading advocacy and technical service provision to MFIs. AMA has also developed manuals in local languages and provides training to MFIs in local languages. Presently AMA provides training in Financial Ratio Analysis, Accounting, Delinquency Management, Training of Trainers and Basics of Microfinance among others.

At a sectoral level, there are not many specialized TA providers, independent rating agencies or valuation agencies. MISFA has played an important role in building the sector and indeed conducts a variety of capacity assessments, ratings and portfolio audits among other things through independent consultants and agencies as well as by MISFA's Technical Support Department.

Competition

There is no study or data available to know competition within the sector. However, considering that sector is concentrated in Kabul and surrounding areas and other relatively secure regions, it is indeed quite probable that MFI are chasing same set of clients.

Risks

The key external risk is related to the increase in insecurity and general instability throughout the country, which this report will not dwell on. Besides this, a number of other factors pose risks to the microfinance sector. Among them are political risk stemming form negative religious sentiment, complete reliance of MFIs for financing and capacity building support on MISFA. As the support from MISFA has met their funding requirements, MFIs are giving less priority to external funding and therefore lack diversified funding sources and investment preparedness.

Internally, frauds among credit officers and staff in the guise of ghost clients have already damaged the sector. According to AREU study, rapid MFI expansion without concurrent investments in staff training or the establishment of monitoring and internal audit systems has led to fraud within the sector that often happens through the creation of so-called “ghost client”. Many MFIs have also been slow to computerize their operations at the branch office level which may lack the infrastructure to support it. The lack of oversight and management information systems, whether computerized or manual, coupled with rapid loan officer recruitment to meet scale targets but with little investment in training, set up an environment ripe for fraud.

These consequences combined with external factors such as a deteriorating security environment, drought, internal and regional migration, high food prices and devaluation of the Pakistan rupee put further stress on MFI business models and client's repayment capacity and as a result MFI repayment rates started to decline leading to declining rates of operational sustainability due to loan losses and fraud.

Regulations

The only microfinance specific regulation is applicable to DMFIs. Any MFI that mobilizes voluntary deposits is required to register and be regulated under the DMFI articles form published by the DAB. However, it is important to note that no MFI has applied for a DMFI licence to date.

The two commercial banks with a focus on microfinance come under the DAB regulation and supervision is as applicable to commercial banks.

In the absence of any specific regulatory authority for the MFIs, MISFA is taking the lead role in not only funding the MFIs, but also in guiding them in reporting, governance structure etc. MISFA monitors and reviews the performance of MFIs in a very proactive manner. MISFA regularly takes detailed reports from member MFIs on indicators such as number of clients, outstanding loan balance, rural and women ratio, geographical spread and staff among others and publishes them on its website. MISFA is also instrumental in enhancing transparency in the sector and encourages MFIs to report on the Microfinance Information Exchange (MIX) market.

Financing

The majority of MFIs currently depend on MISFA funding. Aiming at building the equity and fund base of MFIs, MISFA provides debt on soft terms to finance their portfolio and grants to cover operating expenses, purchase of fixed assets and expenditures for training and technical assistance. Since its inception and learning from other countries, MISFA's financing strategy has been clearly designed and oriented to gradually reduce the proportion of grants and substitute them by debt financing, while MFIs stabilize their financial positions and gain the ability to raise commercial funding from various other sources.

Over the last five years (2003-08) it has provided approximately USD 717 mn as loan funds to partner MFIs. The loans are priced at 5% for old partner MFIs. However, for new MFIs like ASA the interest rate is 8%. The minimum loan amount is USD 100,000, with term period of one year, with the option of roll-over to another term after written consent from MISFA management and based on satisfactory performance.

Tier II MFIs

MISFA or AMA does not have any classification of MFIs as Tier I or Tier II. However, looking at outreach figures of 15 MFIs registered with MISFA, except for BRAC and FINCA that together account for over 60% of outreach, the rest of the MFIs have a client outreach of between 5,000 to 10,000. Therefore, except for the two bigger MFIs, the rest can be classified as Tier II in the country context.

Market Gaps and Challenges

Despite the considerable growth of the sector, a 2006 study from the World Bank shows a large market potential for continuing expansion. Considering the economically active population living below the poverty line, only 5% of their financial service demand was covered by MFIs in the country and only 8% of the projected credit requirements were met by the MFIs.

Estimated Credit Demand in Afghanistan			
	Households	Households Demanding Credit	Credit Demand (USD mn)
Rural	3,300,000	1,386,000	970
Urban	985,000	492,500	345
Total	4,285,000	1,878,500	1,315
Source: Microfinance in Afghanistan, InM, 2009			

The present client outreach of 436,056 (May 2010, with 293,842 borrowers), is still only 8% of the approximately 2 mn households living under the poverty line in the country. This leaves a major scope for expansion. In addition it is concentrated in the central and north-western regions and urban areas, leaving the eastern region and specifically many parts of the southern regions and rural areas underserved leaving a great potential for increasing the outreach.

Estimated credit demand in Afghanistan is estimated to be much higher than current supply. Gaps also exists in availability to financial products and most MFIs offer more or less similar credit products.

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