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Report No: T7702-AF

TECHNICAL ANNEX

FOR A

PROPOSED GRANT

IN THE AMOUNT OF SDR 19.2 MILLION
(US$30.0 MILLION EQUIVALENT)

TO THE

ISLAMIC REPUBLIC OF AFGHANISTAN

FOR AN

EXPANDING MICROFINANCE OUTREACH AND IMPROVING SUSTAINABILITY PROJECT

28 November 2007

Finance & Private Sector Unit
South Asia Region

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CURRENCY EQUIVALENTS

(Exchange Rate is Kabul based open market buying rate Effective 1 October 2007

Currency Unit = Afghani (AFN)
= US$1.0 = 49.9 Afghani

GOVERNMENT FISCAL YEAR
March 21 – March 20

ABBREVIATIONS AND ACRONYMS

Af	Afghani (national currency)
ARTF	Afghanistan Reconstruction Trust Fund
CDC	Community Development Council
CIDA	Canadian International Development Agency
DCA	Dutch Committee for Afghanistan
DFID	UK Department for International Development
EC	European Commission
GoA	Government of Afghanistan (Islamic Republic of Afghanistan)
IDA	International Development Association
IFC	International Finance Cooperation
MFP	Microfinance Service Provider
MISFA	Microfinance Investment Support Facility for Afghanistan
MRRD	Ministry of Rural Rehabilitation and Development
NGO	Non Government Organization
NSP	National Solidarity Program
SDU	Special Disbursement Unit
SME	Small or Medium Enterprise
SOE	Statement of Expenses
USAID	United States Agency for International Development

Vice President:	Praful C. Patel
Country Director:	Alastair J. Mckechnie
Country Manager	Mariam J. Sherman
Sector Manager:	Simon C. Bell
Task Team Leader:	Stephen F. Rasmussen

AFGHANISTAN
Expanding Microfinance Outreach and Improving Sustainability

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ISLAMIC REPUBLIC OF AFGHANISTAN
EXPANDING MICROFINANCE OUTREACH AND SUSTAINABILITY PROJECT
GRANT AND PROJECT SUMMARY

Recipient:	Islamic Republic of Afghanistan
Implementing Agency:	Microfinance Investment and Support Facility for Afghanistan
Amount:	SDR 19,200,000 (US$ 30 million equivalent) on standard IDA Grant terms
Terms:	Grant
Objectives and Description:	The objective of the project is to achieve operational sustainability for most microfinance service providers and help them scale up outreach of financial services to meet the needs and demands of many poor Afghans, especially women. • Increased sustainability of microfinance service providers that have begun the process of diversifying their funding sources to include commercial sources in addition to funds provided by Government of Afghanistan and donors. • Microfinance service providers are registered as Afghan companies and operating under relevant Afghan laws and supervision. • Scaled up outreach to many more poor people in most provinces.
Project Benefits:	The benefit of the project will be the creation of a sustainable, growing Afghan microfinance program that serves millions of poor Afghans and contributes to establishing an inclusive financial sector in Afghanistan.
Project Risks:	Security remains a concern, especially for organizations working in villages throughout Afghanistan. Political and public support for microfinance service provision needs to continue. Microfinance service provider organizations need to continue their strong performance to date.
Project Appraisal Document:	In line with OP 8.00 there is no Project Appraisal Document for this Project. Instead, a Technical Annex is submitted with this document as required by Operational Policy 8.00.
Disbursement:	The Grant is expected to be disbursed fully by December 31, 2010

Thematic Code:	Finance and Private Sector
Sector Code:	Finance and Private Sector Development
Project ID No.:	P104301

Technical Annex 1: Country, Sector and Program Background

AFGHANISTAN: Expanding Microfinance Outreach and Improving Sustainability

Country and Financial Sector Context

Afghanistan is beginning to recover from more than 25 years of conflict. Despite a difficult security environment and persistent expenditure pressures, it has sustained its growth momentum. In 2005/06 the GDP growth rate was 14 percent. During 2001/02 to 2005/06, per capita income increased from US$ 123 to US$ 300 and is projected to rise steadily to about US$ 482 in 2010.

As economic reform and rebuilding efforts have gathered steam, there has been some revival in the financial sector as well. One of the more important steps Da Afghanistan Bank took to revamp the fragile financial system of the country was to frame a Banking Law that was approved in 2004. More recently, Da Afghanistan Bank's has taken initiatives to pave the way for the emergence of a short-term yield curve for the first time. Interest rates are market determined and so far commercial bank lending rates to small and medium enterprises and the trade segment are relatively high due to the banks' caution in taking credit risks given the market environment and legal framework.

The banking sector comprises 15 commercial banks including three state owned banks, seven private sector banks and five foreign banks. However, the progress of the banking sector has been understandably limited and bank operations are still mostly confined to the main urban centers with a limited distribution network of about 100 branches at the end of 2006. The table below shows the status of the commercial banking sector. In addition, there is one functioning leasing company and one state owned insurance company.

Afghanistan Banking Sector
31st December 2006
(Afghanis in billions; % of total banking system)

	Branches	Assets	Liabilities	Deposits	Loan Book
State owned banks	40+	11.9	3.9	9.7	5.9
Bank-e-Milli		(39%)	(18%)	(50%)	(73%)
Export Promotion Bank					
Pashtany Tejarati Bank					
Afghan commercial banks	51	11.3	9.8	6.8	1.9
Afghanistan International Bank		(37%)	(46%)	(34%)	(23%)
Ariane Bank					
Azizi Bank					
BRAC Afghanistan Bank					
Development Bank of Afghanistan					
Kabul Bank					
First MicroFinanceBank					

	Branches	Assets	Liabilities	Deposits	Loan Book
Foreign commercial banks Bank Alfalah Habib Bank National Bank of Pakistan Punjab National Bank Standard Chartered Bank	7	7.5 (24%)	7.5 (36%)	7.5 (16%)	0.3 (4%)

But the provision of financial services is still dominated by the informal sector, most visibly the *hawala* dealers, some of which have opted to be licensed by Da Afghanistan Bank under a special money payments provider law.

Microfinance is only one small part of the financial sector. This project addresses the development of the microfinance part of the overall financial sector, the part that specifically focuses on serving the needs of the poor. But efforts are being made to revive and strengthen all parts of the financial sector. While microfinance has emerged quickly in a largely informal economic context, its future health and growth will be at least partly dependent on the increasing strength and growing maturity of the financial sector as a whole.

Program Background

By the beginning of 2002 there was a large unmet demand for formal financial services, especially for poor people and microenterprises. Since the banking system had collapsed during the war and there were no functioning credit cooperatives or NGO microfinance institutions, the entire country relied on the ubiquitous informal financial systems. In 2003, the Government of Afghanistan, in collaboration with donors, decided to actively promote the development of microfinance services, or the development of a financial sector that would provide access to poor people. Commercial banks had not yet been established and it was clear that even after beginning operations it would take a long time before they would be in a position to serve the vast majority of people.

Taking account of the evidence for the link between improved access to finance and poverty reduction, in 2003 the Government of Afghanistan established a project under the Ministry of Rural Rehabilitation and Development called the Microfinance Investment Support Facility for Afghanistan, or MISFA, as the vehicle through which Government of Afghanistan and donors could channel funds to build up the lower end of the financial sector. MISFA was intended to (i) coordinate donor funding so that conflicting priorities endemic in post conflict situations did not end up duplicating efforts and distorting markets; (ii) help start-up microfinance institutions scale up rapidly and eventually become sustainable; and (iii) build systems for transparent reporting and instill a culture of accountability. Scaling up microfinance outreach has been included as an important development strategy under the Afghanistan National Development Strategy and is consistent with the Interim Strategy Note for Afghanistan. Since 2003 the World Bank has provided funding to MISFA through the Afghanistan Reconstruction Trust Fund and has been closely involved in the development of the microfinance sector.

Significant progress has been made over the past three to four years. By the middle of 2007 the sector had the following characteristics:

- 15 functioning MFPs; 13 NGOs, 1 bank, 1 credit union promoter.
- Presence in 24 of 34 provinces.
- 360,000 active clients (70% women); US$85 million outstanding portfolio.
- US$220 million total (cumulative) disbursements to clients.
- US$ 220 average loan size.
- 5% portfolio at risk at 30 days.
- 3 operationally sustainable MFPs. Combined, all 15 MFPs cover 89% of their operational costs from income earned on their outstanding loan portfolios.

In the year from March 2006 to March 2007 (1385) the microfinance sector added 10,000 active clients per month and loan disbursements averaged $7 million per month.

While MISFA began in 2003 as a project, it was converted into a private non-shareholding company in March 2006 with the Ministry of Finance as the sole sponsor. This was done through a *peshnahad* adopted by the Afghanistan Investment Support Agency high council that includes eight ministers and the DAB Governor. The company has a board of directors made up of two Government of Afghanistan nominees, three international microfinance experts, and two directors from the Afghan private sector.

To date MISFA has received and disbursed, or committed to disburse, US$ 136 million, of which US$ 119 million has been provided through the Afghanistan Reconstruction Trust Fund. The World Bank managed Japan Social Development Fund initially provided US$ 5 million to begin the process, but all the remaining funds have been provided by bilateral donors, the three largest contributors being CIDA, DFID and USAID. The total market size is estimated to be 3 to 5 million clients and so far demand has far outstripped supply. Between March 2005 and March 2006 MISFA could have disbursed US$ 60 million to MFPs whereas only US$ 34 million was provided. Between March 2006 and March 2007 MISFA received about US$ 40 million to disburse against a budget of US$ 60 million. This has meant that growth in the sector has slowed down over the past two years. It is estimated that outreach could have been more than 450,000 active clients by the end of 2006 if adequate funding had been made available on time.

There is clearly considerable room to expand outreach and improve the lives of many more poor people throughout Afghanistan, while at the same time creating long term sustainable Afghan microfinance service providers that can begin to mobilize funds from the market. Bilateral funding contributions are essential but not sufficient to contribute what is needed to reach these goals. Local commercial sources of funding are still not available and the sector is not yet mature enough to attract international funding. An IDA project of US$ 30 million will also not be enough to take the sector as far as it needs to go, but it will make a crucial contribution at a "make or break" time for the sector, and it can go a long way towards taking the sector to a position of relative strength. Additional financing could be considered in future depending on the progress achieved through this project.

A recently completed external evaluation of the microfinance sector in Afghanistan notes that growth in client outreach is impressive and stands first compared to many conflict affected

countries such as Bosnia and Herzegovina, Mozambique, Uganda, Sierra Leone, Liberia, West Bank / Gaza, and Cambodia in their early stages of recovery. The approach that is being proposed of providing funding to a specialized apex institution is a well known model to the World Bank. The design of the MISFA mechanism was based to a large extent on the successful Local Initiatives Project in Bosnia that was World Bank funded. And at present in the South Asia Region, the World Bank supports large microfinance apex institutions in Bangladesh and Pakistan.

Project Purpose and Benefits

The objective of the project is to achieve operational sustainability for most microfinance service providers and help them scale up outreach of financial services to meet the needs and demands of many poor Afghans, especially women.

The primary target group for this project is the microfinance service provider organizations that MISFA supports: expanding their outreach, improving their sustainability, and building Afghan institutions. Improving access to financial services is one part of the overall larger strategy to reduce poverty in Afghanistan. The impact of a strong microfinance sector with significant outreach that provides a wide range of financial services will be to improve the livelihoods of poor households being served by the sector. The project will pay special attention to the needs of women and people living in areas with significant opium production, in particular addressing the requirements of the World Bank's gender and anti narcotics mainstreaming guidelines. As such, the project will also consider *impact* measurement at the household level, not just at the microfinance service provider level.

Lessons Learned from Other Projects

Lessons have been taken from other similar projects that have supported microfinance apex institutions in post conflict environments (Bosnia) as well as in other South Asian countries (Bangladesh and Pakistan) in addition to lessons from other development projects in Afghanistan. Three lessons have been particularly influential in the design of this project.

- *Setting clear objectives and instituting performance based funding.* It is important to have clear, focused objectives and the ability to monitor indicators to measure progress against those objectives right from the start. This sends a clear signal to microfinance service providers about what is expected in terms of partnership support and allows each MFP's performance to be monitored against agreed performance targets. Once this has been done, it is important that the project base ongoing funding decisions on MFP performance, regularly discussing progress regularly with each MFP.
- *Developing a market integration strategy.* There is an important role for a specialized apex in the early stages of sector development. From the beginning, though, there should be a clear strategy for developing sustainable microfinance service providers that can eventually function as part of the commercial financial sector. This strategy should include how microfinance service providers can gradually make a transition from dependence on subsidized funding to working with market based funding sources.

- *Building local institutions and capacity.* There are immediate gains and added value early on from using international experience, i.e. international implementing organizations, in this case microfinance service providers, to start work and provide benefits to many people quickly. It has been especially true that organizations with prior experience in Afghanistan or significant regional experience were able to scale up and be effective more quickly. At the same time, though, this approach requires that a transition strategy be in place from the beginning to create local organizations with a long-term perspective and commitment. While this is difficult to do when the pressures are intense to expand services as rapidly as possible, it pays off in the medium term as things progress to the next stage.

Project Alternatives Considered

The most obvious alternative to the microfinance sector development approach taken since 2003 under the ARTF microfinance project and furthered by this project would have been to allow for an organic, market based financial sector development process in which financial service provider organizations initiate and develop programs on their own, without donor and government subsidies. This process would have allowed for some microfinance service providers to emerge on their own, possibly supported to grow and expand later on through the entry of a specialized apex institution or development fund. This is similar to the process that has occurred in many other countries. The advantage is that institutions emerge on their own and an apex fund that enters later on can focus on expanding microfinance service providers with a good track record rather than take risks with start-ups. There are very few examples of countries where a microfinance apex has been established to begin sector development from nothing. A slower organic microfinance sector development process was discussed by Government of Afghanistan and donors in 2002. But this strategy was rejected in favor of the higher risk approach taken so far. This path was chosen in order to develop the sector and provide access to finance to as many poor families as possible as quickly as possible, in line with national development interests after years of conflict. The Expanding Microfinance Outreach and Improving Sustainability Project comes along at a time when microfinance service providers are already established and it is possible to move them towards sustainability and significant size.

Technical Annex 2: Major Related Projects Financed by the Bank and other Agencies

AFGHANISTAN: Expanding Microfinance Outreach and Improving Sustainability

Since August 2003 nine donors have provided funding for microfinance in Afghanistan through the MISFA mechanism. These include CIDA, DFID, SIDA, Denmark, NOVIB, CGAP, USAID, AusAid and Japan. Although two or three donors have provided very small amounts of funding for microfinance related activities outside of the MISFA mechanism, the amounts channeled through MISFA represent the great majority of donor funding for microfinance. The total amount of funding received by MISFA to date is $136 million. Of this total, $119 million has come through the World Bank Managed Afghanistan Reconstruction Trust Fund.

In late 2006 USAID initiated a new $80 million rural finance project called ARIES that is managed by the Academy for Education Development. $30 million will be routed through MISFA, $15 million for microfinance and $15 million for SME finance. Another $40 million will be provided to three international NGOs to expand microfinance outreach in priority rural provinces. Two of those NGOs are MISFA partners and MISFA coordinates closely with the ARIES project.

The microfinance project begun under the ARTF drew its design from the Local Initiative Project begun in 1996 under the rebuilding process in Bosnia. The South Asia region presently has two other active projects that support microfinance expansion through an apex institution. Microfinance II in Bangladesh supports the work of PKSF and PPAF II in Pakistan supports the work of PPAF.

- Second Poverty Alleviation Microfinance Project - Bangladesh (P059143)
  This project provides funding to a microfinance apex institution, PKSF, that on-lends to MFPs. With additional financing the total project value is $166 million. It became effective 03/05/2001 and will close on 06/30/2007. The project has a satisfactory rating.
- Second Poverty Alleviation Fund Project – Pakistan (P082977)
  One of the major components of this project provides funding to PPAF that has a microfinance apex component that on on-lends to MFPs. With additional financing the total project value is $606 million. It became effective 04/15/2004 and will close on 07/31/2008. The project has a satisfactory rating.

Related projects in Afghanistan that are supported by the World Bank include the National Solidarity Program and the Livestock and Horticulture Development Program. Both of these projects focus on rural areas and poorer people and many of the implementing organizations have separate microfinance programs that work in tandem with their NSP and agriculture development efforts.

Emergency National Solidarity Project II (Project P102288, Credit/Grant IDA H2610): The objective of this project is to reach out to most communities in Afghanistan to lay the foundations for strengthening of community level governance and to support community-managed subprojects comprising reconstruction and development that improve access of rural communities to social and productive infrastructure and services". The Government of Afghanistan envisions the roll-out of the program across the entire country in the next three years at a total cost of US$525 million. This amount is expected to be financed through IDA ($120

million approved in December 2007), ARTF, JSDF and bilateral resources. The NSP program often reaches communities before the microfinance program and helps pave the way for microfinance expansion. The fact that the implementing ministry, Ministry for Rural Rehabilitation and Development, has a seat on the MISFA Board helps support coordination. Although there has been discussion in the past of CDCs being direct providers of financial services, this has proven to be impractical. CDCs are not designed for this purpose, though a self-help group model along the lines of what India has could be possible. An SHG model could possibly emerge out of the CDCs but would require modifications to the current CDC approach as well as considerable capacity building.

Horticulture and Livestock Productivity Project HLP (ID # P098256, Grant #. H2260): The project aims to stimulate marketable output of perennial horticulture and livestock in focus areas by (i) improving the incentives framework for private investments and (ii) strengthening institutional capacity in agriculture. IDA funding of $20 million was approved for this project in May 2006. This project will help create opportunities to expand microfinance outreach to farmers and the microfinance project can help provide some of the credit needs of farmers that will be necessary to the success of the horticulture and livestock productivity project. The Ministry of Agriculture has an observer seat on the MISFA Board.

Technical Annex 3: Results Framework and Monitoring

AFGHANISTAN: Expanding Microfinance Outreach and Improving Sustainability

Results Framework

PDO	Project Outcome Indicators	Use of Project Outcome Information
The objective of the project is to achieve operational sustainability for most microfinance service providers and help them scale up outreach of financial services to meet the needs and demands of many poor Afghans, especially women.	1. Increased sustainability of microfinance service providers that have begun the process of diversifying their funding sources to include commercial sources in addition to funds provided by Government of Afghanistan and donors (85% of the loan portfolio outstanding accounted for by MFPs with operational self sufficiency ratio, OSS>100%). 2. Microfinance service providers are registered as Afghan companies and operating under relevant Afghan laws and supervision. (100%of MFPs registered as separate legal entities [to provide microfinance services] under Afghan law – as corporations, companies, banks, or any other recognized legal form for financial service providers at the end of the project). 3. Scaled up outreach to many more poor people in most provinces. (Number of active clients of MFPs increased to 625,000; 65% of active clients who are women; growth of outstanding loan portfolio to more than 250% of the baseline portfolio; services being provided in more than 30 provinces by the end of the project).	Baseline data based on specific indicators will be established as will end of project targets. Regular reporting of these indicators will allow for progress to be measured and adjustments to be made to the project so that outcomes are achieved, or the reasons for not achieving outcomes are known and lessons can be learned.
Intermediate Outcomes	**Intermediate Outcome Indicators**	**Use of Intermediate Outcome Monitoring**
Operationally sustainable microfinance service providers increasingly capable of sourcing funds (commercial debt, international funds, savings) from the market.	1.. Number / %of MFPs with an OSS (operational self sufficiency ratio) of more than 100% that do not require any more grant subsidies for operational deficits. 2. Number / % of MFPs with PAR 30 (portfolio at risk greater than 30 days) of less than 5%.	All of these indicators will be collected and reported twice a year from the first year of the project. A review of progress will be made twice a year to allow for an assessment of progress and for any necessary adjustments to be made to in project strategy.

	3. Amount of funds on the balance sheets of MFPs from sources other than MISFA and their own equity. 4. Number / % of MFPs with a capital adequacy ratio above 12%.	
Microfinance service providers are Afghan corporations / organizations with Afghans on their boards and in top management positions.	1. Number / % of MFPs with Afghan board members / directors in addition to international experts and owner representatives. 2. % of middle and top management positions held by Afghans.	
Outreach of financial service provision to poor people by microfinance service providers has doubled (number of active clients) and reached most provinces.	1. Number of active clients doubled within three years. 2. Number of provinces in which MFPs are providing services.	

The primary target group for this project is the microfinance service providers that are MISFA supports. The targets for MFP and sector performance shown in this annex are only for the 15 MFPs that already have contracts with MISFA. It is possible that some new MFPs might be added as partners during this project. If so, targets for their performance will be set independently after discussion between MISFA and the World Bank.

The important secondary target group is poor people who are being served by the microfinance service providers. Within that group the project will especially pay attention to women and to people living in areas with significant opium production, in particular meeting the requirements of the World Bank's gender and anti narcotics mainstreaming guidelines. As such, the project will begin to address the need for *impact* measurement at the household level, not just at the MFP level.

Case studies will be carried out on a periodic basis to monitor what the loans to women are invested in, how they affect the economic situation at the household level and what is the impact on the female borrower's position in the family in terms of influence (decision making) and in terms of expanding economic activities/income and mobility. MFPs will use this information to identify project constraints and shortcomings and be able to adjust interventions and consolidate the positive impact especially on the female clientele through facilitating linkages to suitable skills development opportunities and other relevant inputs.

MISFA provides loan funds to microfinance service providers that in turn retail small loans to poor households in rural Afghanistan. By doing so it contributes to "strengthening and diversifying legal rural livelihoods" (National Priority Two of the Afghan National Drug Control Strategy 2006). The microfinance sector is active in 23 of the 34 provinces of Afghanistan and this is expected to increase to almost all provinces by the end of this project.

In early 2005 MISFA began a special alternative livelihoods program that was designed to contribute to the overall Government of Afghanistan effort to encourage small farmers to transition from poppy cultivation to a licit economy. Under this program MFPs were supported to reach out to small farmers in Nangarhar, Laghman, Kunar and Badakshan. The table below shows the progress of this special window up to March 2007.

Active Clients	Active borrowers	Cumulative number of loans disbursed	Cumulative amount of loans disbursed	Loans outstanding
12,715	11,765	22,114	$6,682,141	$2,749,401

Outreach in the above areas is expected to further increase with the additional US$9 million to be disbursed under the USAID/ARIES project that targets households mainly in the poppy growing areas.

In addition, a pilot project was conducted in Badakshan to provide loans to poor people who were in debt to opium traders. These loans allowed them to repay their debt as well as acquire an asset from which to begin to earn their livelihood.

MISFA commissioned a study for which the report is about to be published that uses qualitative interviews with borrowers and MFP staff to determine the impact of 'alternative livelihood' loans to help poppy growing farmers make a transition into licit economic activities. The study assesses the effectiveness of different strategies by MFPs to adapt their products and services to be more suitable to farmers looking to move away from growing poppy. Preliminary results indicate that microfinance is able to make a more effective contribution to this end when it is one part of an overall development program, one that not only includes things like development of agriculture production and developing markets, but also improved health and education services. MISFA has encouraged MFPs to link up with other development programs that offer these services in the same areas where loans are being made available.

MISFA proposes to hire outside consultants to conduct research on lending methodologies that will be more suitable to the cash flows of agricultural households. This will enable MISFA partners to improve targeting of micro loans to "class 2 (not dependent)" and "class 3 (highly dependent)" farmers (World Bank Anti-Narcotics Guidelines Table 1).

MISFA monitoring and evaluation data reports on the number of clients who have received loans under the alternative livelihoods program.

MISFA is presently conducting a national level baseline study that has four objectives:

1. Establish a baseline socio-economic and credit status of clients with the aim to evaluate and assess the effectiveness of microfinance at a later date.
2. Assess the initial impact of the microfinance program since the sector began to be established in 2003.
3. Examine clients who have dropped out of microfinance programs to establish reasons for client dropout.

4. Identify socio-economic indicators that can be used by MFPs to monitor improvements at the household level on a regular basis.

This baseline study includes a sample of 1015 households selected from all over the country. The data will be analyzed under several broad categories: male and female clients, urban and rural clients, old and new (recent) clients, clients and non-clients, dropouts, and regional trends and comparisons. Collection of household data will be undertaken at the end of the project period to measure progress and consider impact. Results will be published after the conclusion of the project.

Summary of how monitoring will be carried out:

- MISFA already has a system in place to collect, calculate and report all the indicators in the results framework. Reports will be prepared every six months and submitted to the World Bank.
- MISFA's six monthly reports will also include a short narrative section that reports progress on the alternative livelihoods work.
- Gender mainstreaming concerns will be addressed through case study based reports carried out at least twice during the course of the project – once in the first year and once in the third year.
- Based on the household baseline study being carried, MISFA will work with the MFPs to design and introduce a social performance monitoring system. Depending on how quickly progress can be made to design a system, reporting could begin during the second year of the project.
- At the end of the third year of the project MISFA will collect household data for a follow up study to the baseline study to consider and report on impact at the household level. Results will be published after the conclusion of the project.

Arrangements for Results Monitoring

		Target Values					Data Collection and Reporting		
Project Outcome Indicators	**Baseline Dec 2006**	**YR1 Dec 2007**	**YR2 Dec 2008**	**YR3 Dec 2009**	**YR4 Dec 2010**	**YR5 Dec 2011**	**Frequency and Reports**	**Data Collection Instruments**	**Responsibility for Data Collection**
1. Percent of loan portfolio outstanding that is accounted for by MFPs with OSS>100%.	51%	60%	70%	85%			Six monthly	MISFA's standard data collection system from MFPs. Confirmed by audited annual MFP accounts.	MISFA
2. Number / %of MFPs registered as separate legal entities under Afghan law – as corporations, companies, banks, or any other recognized legal form for financial service providers.	0 / 0%	10 / 67%	15 / 100%	**15 / 100%**			Six monthly	MISFA's standard data collection system from MFPs. Confirmed by audited annual MFP accounts.	MISFA
3. Number of active clients of MFPs.	300,000	375,000	500,000	625,,000			Six monthly	MISFA's standard data collection system from MFPs. Confirmed by	MISFA

								audited annual MFP accounts.	
4. % of active clients who are women.	70%	68%	65%	**65%**			Six monthly	MISFA's standard data collection system from MFPs. Confirmed by audited annual MFP accounts.	MISFA
5. Increase in amount and percentage of loan portfolio outstanding relative to base year	$65 M	$90 M / 138%	$130 M / 200%	**$175 M / 270%**			Six monthly	MISFA's standard data collection system from MFPs. Confirmed by audited annual MFP accounts.	MISFA
Intermediate Outcome Indicators									
1. Number / %of MFPs with an OSS (operational self sufficiency ratio) of more than 100% that do not require any more grant subsidies for operational deficits.	3 / 20%	4 / 30%	7 / 50%	10 / 67%			Six monthly	MISFA's standard data collection system from MFPs. Confirmed by audited annual MFP accounts.	MISFA
2. Number / % of MFPs with PAR 30 (portfolio at risk of greater than 30 days) of less than 5%.	13 / 85%	13 / 85%	13 / 85%	13 / 85%			Six monthly	MISFA's standard data collection system from MFPs. Confirmed by audited annual MFP accounts.	MISFA
3. Amount of funds on the balance sheets of MFPs from sources other than MISFA.	$ 14 M	$20 M	$30 M	$40mil			Six monthly	MISFA's standard data collection system from MFPs. Confirmed by audited annual MFP accounts.	MISFA
4. Number / % of MFPs with a capital adequacy ratio above 12%.	5 / 33%	10 / 67%	13 / 85%	13 / 85%			Six monthly	MISFA's standard data collection system from MFPs. Confirmed by audited annual MFP accounts.	MISFA
5. Number / % of MFPs with Afghan board members / directors in addition to international experts and owner representatives.	0 / 0%	10 / 67%	15 / 100%	**15 / 100%**			Six monthly	MISFA's standard data collection system from MFPs. Confirmed by audited annual MFP accounts.	MISFA
6. % of middle and top management positions held by Afghans.	50%	60%	75%	**85%**			Six monthly	MISFA's standard data collection system from MFPs. Confirmed by audited annual MFP accounts.	MISFA
7. Number of provinces in which MFPs are providing services.	21	24	28	**32**			Six monthly	MISFA's standard data collection system from MFPs. Confirmed by audited annual MFP accounts.	MISFA

Technical Annex 4: Detailed Project Description

AFGHANISTAN: Expanding Microfinance Outreach and Improving Sustainability

Project Component

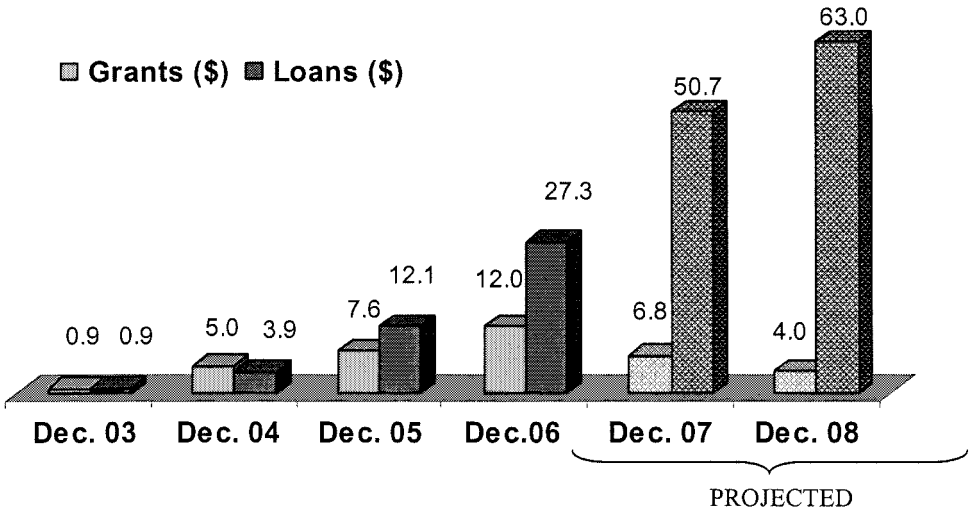
This project only has one component: all $30 million will be loaned by MISFA to the microfinance service provider organizations.

The IDA grant funds (US$ 30 million) provided to Ministry of Finance will be made available for use by MISFA through a subsidiary agreement between Ministry of Finance and MISFA. The funds will be provided to MISFA in local currency, to be repaid beginning five years after disbursement and entirely repaid in ten to eleven years. MISFA will pay an annual administrative fee to the Ministry of Finance equal to 1% of the outstanding amount in that year. In turn, MISFA will provide loans to microfinance service providers under already established criteria and based on business plans that have been negotiated with and approved by MISFA. Differently structured loans from MISFA to microfinance service providers can be financed, including debt products such as subordinate debt and quasi equity where needed. Microfinance service providers would in turn use the funds for on-lending to their microfinance clients, the majority of whom are women.

MISFA will provide loan funds to MFPs based on their track record to date and business plans they present for expansion. MISFA will structure terms that will allow it to service its repayment obligations to the MoF. Subsidized terms from MISFA to the MFPs support MFP capital formation and contribute to their long term sustainability and growth. At this early stage of development of the sector and in the absence of a more mature financial sector, this is akin to providing risk capital through well targeted interventions.

MISFA's role in supporting the creation of a microfinance sector has helped avoid more typical government interventions of "directed credit" found in some other countries. Further, the MFPs supported by MISFA have freedom in client selection just as MISFA is at liberty to screen MFPs before supporting them. Nonetheless, MISFA does provide donor grants for funding MFP start-up operational costs and capacity building programs and charges fees for providing loan funds to MFPs that under normal circumstances might be considered as below market rates. However, there is a clear economic rationale and an upfront phasing out strategy for such subsidies. With the current macro economic and ground level situation in Afghanistan, it is the financial support through grant and concessional administrative fees that helped facilitate and attract MFPs to set up shop in Afghanistan. Secondly, viewed in the country context, subsidies needed to contribute to the country's reconstruction and poverty reduction efforts and are well targeted. Thirdly, grants are capped since MFPs are expected to achieve operational sustainability within five years of beginning their operations, after which no more grants to subsidize operation deficits are expected to be provided. As the graph below shows, grant funding is declining over time while loan funding is growing rapidly. Lastly, the current financing strategy does not create any market distortions because no other player is currently financing microfinance.

MISFA – Disbursement to MFPs
(US$ millions)



Related Funding for Sector Capacity Building

The success of this project is dependent on the microfinance sector and MISFA continuing to receive funding from other donors, as it has in the past, to provide for MFP capacity building needs. These capacity building needs are met through grants from MISFA to the MFPs that decline over time and will eventually be phased out when MFPs can cover all their own costs through their own revenue streams. The IDA grant will supplement those other capacity building funds, not replace them. The Afghanistan budget for 1386 includes US$ 33 million in grant funding to be provided for use by MISFA through the ARTF. It is expected that donor funds will continue to contribute to diminishing capacity building needs in future years.

Recently, USAID funded ARIES, a US$ 80 million rural finance project being managed by the Academy for Education Development. Under this project, MISFA signed an agreement to implement some aspects of the project for a total of US$ 30 million. This project will provide US$ 9 million for MISFA's existing microfinance program, all of which is expected to be disbursed before the end of 2007. Another US$ 15 million is for a new SME financing window for which MISFA has established a separate SME department. This window largely works with banks to develop and scale up their small business lending portfolios. The remaining US$ 6 million will go as grants to apex institutions set up to oversee the credit unions and financial cooperatives that the project will establish through another implementation mechanism.

Other MISFA Roles

While the project will directly focus on strengthening microfinance service providers and expanding their outreach to underserved people, it will also indirectly contribute to the development of the meso and macro levels of the sector. These aspects of the project will be funded by other donor funding, just as with capacity building funds.

At the **meso level**, audit firms based in Afghanistan will be trained to audit microfinance operations and provide appropriate disclosures on audited financial statements, thus improving the transparency of the sector. In addition, MISFA will be the conduit for reporting MFP performance data to the international Microfinance Information eXchange (MIX) as well as to Da Afghanistan Bank, Ministry of Finance, donors and others.

A second meso level contribution will be to strengthen the nascent Afghanistan Microfinance Association that includes all the MFPs. This association was set up two years ago but has yet to become an effective organization. A stronger AMA can become an effective way to influence national policy on financial inclusion, help set industry standards, and generally be a voice for the sector.

There has already been discussion about establishing a credit reference bureau. The IFC and some donors are interested to support such an initiative. MISFA is engaged in this discussion and would try to ensure that microfinance is included when a credit bureau is established.

At the **macro level**, MISFA is engaged in discussing and setting national level policies related to microfinance and to promoting an effective and inclusive financial sector. One aspect of this involves appropriate regulation for microfinance. MISFA worked closely with Da Afghanistan Bank to establish the "deposit taking MFI regulations" under the Banking Law. These regulations were adopted in 2006 and allow for organizations that are not prudentially regulated to take deposits from their members if this is part of their loan product (i.e. integral to their credit methodology), something that is often called 'compulsory savings'. If MFPs want to mobilize voluntary savings from members, they need to be licensed by DAB and prudentially regulated, but with lower capital requirements and simpler reporting requirements than for banks. MFPs that wish to operate beyond that level and mobilize deposits from anyone must obtain a commercial bank license.

MISFA has also recently opened an **SME finance** window that works with banks to encourage and help them 'downscale' and offer credit to small businesses. This window provides technical assistance to banks as well as loan guarantees or lines of credit. By April 2007 two banks had signed agreements with MISFA. Under this window the minimum loan size is US$ 3000, while most loans are likely to be in the range of US$ 5000 to US$ 20,000.

MISFA plans to collaborate with a new initiative to use **technology** to try to improve access to finance. The largest mobile telephone operator, Roshan, recently began a pilot trial of a mobile telephone payments technology (M-pesa) developed by Vodafone and successfully introduced in Kenya. If the pilot is successful, Roshan could link up with any number of MFPs and banks to offer this service, as well as extend financial services through its airtime dealer network. Afghanistan already has about 2 million mobile telephone users, far greater outreach than the total number of bank accounts, which is still negligible, and growth in the sector is accelerating.

Future Funding Requirements and Sources

The objective of this project is to support MFPs to become sustainable such that they can continue to grow without requiring subsidies to fund operational deficits. But this does not mean that no Government of Afghanistan or donor funding will be required in future. In fact, just to reach the outcomes envisaged under this project, it is estimated that at least US$ 60 million more in bilateral donor funding contributions will be required before the end of 2009.

Sustainable MFPs that do not require more grant subsidies for basic operational costs only create the basis of a healthy microfinance sector with the potential to access market funding. But as MFPs grow and become financially stronger, they will have an even greater appetite and much improved capacity to grow and expand their outreach and portfolios even more. This growth will require very large amounts of funding, though this funding need not necessarily be subsidized and some of it could possibly come from commercial sources and savings mobilization. For the foreseeable future, though, it is expected that much of the funding required to support growth will still need to come from the accumulated capital of the MFPs and MISFA as well as further additions of capital from Government of Afghanistan and donor sources, even if these funds are provided to MISFA and the MFPs on market terms. For example, it is estimated that the total MFP balance sheet funding that will be required to reach the projected 625,000 clients by the end of the third year of this project will be in the range of US$ 200 million, a level that could possibly be achieved with MFP capital, some limited savings mobilization and MISFA contributions. But at that point the possibility would have been created for the sector to expand over the subsequent three to five years to reach 2 million or more clients, for which an additional estimated US$ 600 million would be needed to be added to MFP balance sheets. MFPs could afford market terms for some, if not most, of this additional amount, but it is doubtful that all of this will be made available from commercial sources and savings mobilization. As such, more donor funding is likely to be needed if sector growth is to be sustained.

The creation of sustainable MFPs with strong balance sheets and healthy cash flows does not necessarily mean that MFPs will be able to access commercial sources of funding from the market. That will take a more developed financial sector in Afghanistan with an appetite to enter the credit market and provide funding to MFPs. It took 30 years of microfinance development in Bangladesh before the first significant commercial deal between banks and an MFP came about in 2006, and it took twenty years for the same thing to happen in Pakistan in 2007. Part of the reason for this long gestation period has been donor and government funds sometimes undermining market mechanisms as well as lack of financially strong MFPs in some instances. But a major constraint has also been lack of interest on the part of commercial players. This project can support MISFA to influence the first two factors in the right direction, but it will have little influence over commercial financial entities. This will require that the overall financial sector in Afghanistan develop much more, in the process also becoming more willing to fund microfinance.

MISFA itself is already a sustainable Afghan Company. It is established as a Company under Afghanistan's 1955 Commercial Code and has a functioning Board of directors and management structure. It generates income from charging fees for the funds it lends to MFPs and in 2007 it is

expected to generate a surplus of income over expenditure. This project will further strengthen MISFA as an institution.

Risks

So far most people in Afghanistan have accepted the benefits and value of the growing microfinance sector. But questions are raised in various forums about issues that are inherent to microfinance. The most important of these is that the service charges levied by MFPs are sometimes higher than commercial banks might charge their clients. This is necessary to cover the higher costs associated with providing services to poor people that are not served by banks and often live in more remote areas. It will be important that the MFPs are transparent about their fees and treat their clients with respect. As MFPs grow and become more financially sound, they should also become more efficient and be able to pass on some of the benefits of lower transaction costs to clients. Some MFPs are already moving in this direction but MISFA will need to monitor this closely and make sure that costs and charges to clients do not exceed industry norms. Besides issues related to service fees, the need for lending approaches that conform to Islamic principles is important in the Afghan context. MFPs have already designed and introduced products to fit this need. Under this project, MISFA is committed to strengthening its public awareness efforts to help build better understanding of these and other microfinance sector development issues.

Until 2006 the level of conflict in the country was generally manageable and did not slow down or stop the development of microfinance outreach. But in early 2007 things began to change and as many as 20 MFP branch offices in at least 5 provinces were forced to close for varying periods of time during the past year. At the same time, robberies of MFP branches and attacks on staff in the field increased. The deteriorating security situation has slowed the rate of microfinance sector growth in the second half of 2007. At the same time, the overall loan portfolio at risk increased as a worsening security situation made it more difficult to collect back loans. If these trends continue, it could become difficult for the microfinance sector to expand to all provinces and continue to grow its outreach as it has over the past four years. One means to try to mitigate the effects of increasing levels of insecurity will be to help MFPs become sustainable as quickly as possible in regions that remain more secure, while waiting to expand, or expanding more cautiously, in regions where significant and growing conflict or insecurity exists. It also helps that MFPs are increasingly less dependent on expatriate staff and therefore better able to maintain their programs under more difficult conditions.

So far the microfinance service provider organizations have generally performed well. But as they grow, spread out geographically, and diversify their product offerings, good management will become an even greater challenge. In this process, it is entirely possible that some organizations will not be able to keep up and will close their operations. While this is a natural part of market growth, this means that it is even more important for MFPs to upgrade their systems and invest more to build the capacity of their staff. Under this project, MISFA is committed not only to supporting MFP capacity building but also to increasing its monitoring of MFP operations so that problems can be addressed early on. MISFA's ability to judge and manage risk will need to grow with the sector.

Technical Annex 5: Estimated Project Costs

AFGHANISTAN: Expanding Microfinance Outreach and Improving Sustainability

Summary of costs to be funded by the project

Project Cost By Component and/or Activity	Local US $million	Foreign US $million	Total US $million
Component 1: on-lending to MFPs		30	30
Total Project Costs		30	30
Total Financing Required		30	30

Technical Annex 6: Implementation Arrangements

AFGHANISTAN: Expanding Microfinance Outreach and Improving Sustainability

The project will be routed through the Government of Afghanistan that will make the IDA grant funds available for use by Microfinance Investment Support Facility for Afghanistan, a company established under the 1955 Commercial Code of Afghanistan and registered with the Afghanistan Investment Support Agency. MISFA will be the implementing agency that will on-lend project funds to MFPs, thereby helping to scale up microfinance outreach. MISFA is a non-distributive / non-shareholding company. The Ministry of Finance is the sole member of the Company, but it is a board managed company where the power to make decisions about assets rests with the board. The purpose of the Company is to support the development of an inclusive financial sector through support (loans and capacity building grants) to microfinance and small business finance service providers.

MISFA began in 2003 as a project under the Ministry of Rural Rehabilitation and Development. The principle source of funding was from donors making contributions through the Afghanistan Reconstruction Trust Fund. MRRD established a Steering Committee for this project chaired by a Deputy Minister and including three donor representatives in addition to project managers. Although MISFA was only a project under MRRD until March 2006, separate MISFA specific external audits were conducted beginning in 2004. To date these audits have been conducted by KPMG and the results have been satisfactory.

With a view to ensuring institutional stability and proper governance, the Government of Afghanistan formed a separate legal corporate entity "MISFA Ltd" through an asset transfer agreement executed in June 2006. The entire assets and liabilities of the government project (MISFA) were transferred to MISFA Ltd., the transfer taking retrospective effect from 1st April 2006. MISFA Ltd was registered as a non-distributive, non-shareholding Afghan company with its sole sponsor being the Ministry of Finance. The Company had equity of US$ 25.314 million on 31st March 2006.

Under the Articles of Association of the Company, the Board has the power to amend the articles and make all decisions concerning the assets and the management of the Company. Should MISFA Ltd cease to exist for any reason, a decision that rests with the Board, all outstanding loans to MFPs that are provided from funds that MISFA does not have to repay (loans provided out of its own equity) will be forgiven (granted to the MFPs) so that the purposes for which the Company received the funds can be carried on. Loans provided to MFPs from funds borrowed by MISFA, such as the loans under this project, will have to be repaid at that time to MISFA so that it can repay its obligations. Once MISFA has settled its obligations, remaining assets will be given to Da Afghanistan Bank.

Governance

The MISFA Board has seven members who are appointed for one year terms and can be appointed for subsequent terms as well. The Ministry of Finance and the Ministry of Rural Rehabilitation and Development each nominate one Board member. The donors that provide funding to MISFA together nominate three international microfinance experts, not donor staff, to

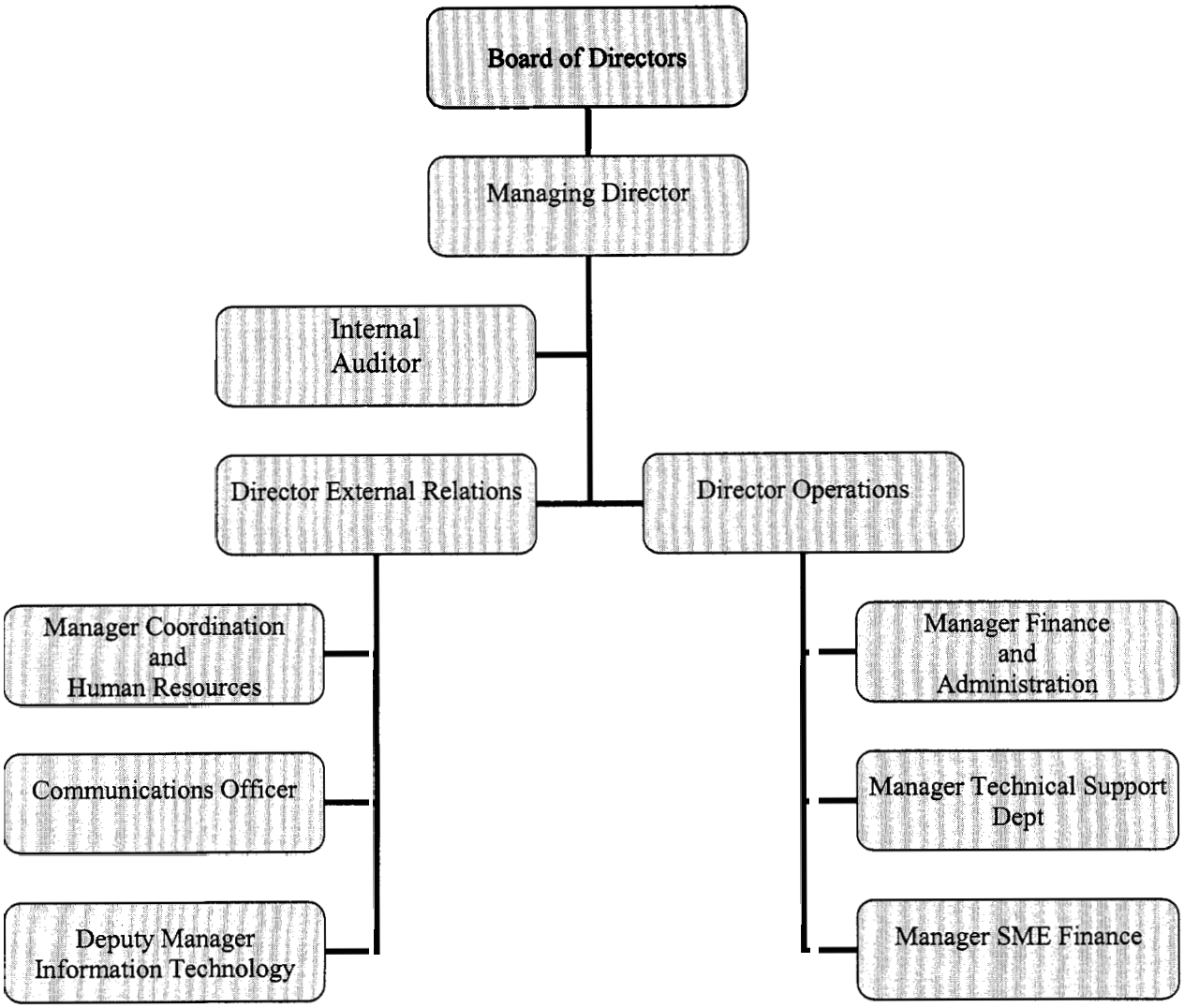
serve on the Board. Together these five Board members approve two more members selected from the private not-for-profit or for profit sectors in Afghanistan. The Board appoints the Managing Director, approves the annual work plan and budget, delegates authorities to the management, approves policies and procedures, approves the annual accounts, and makes all investment decisions based on management recommendations. The Board meets twice a year in Kabul and has other meetings by telephone as necessary. At present the Board members are:

- Ehsan Zia (Chairman) – Minister, MRRD
- Wahidullah Shahrani – Deputy Minister, Ministry of Finance
- Sima Samar – Chairperson, Afghanistan Independent Human Rights Commission
- Hameedullah Farooqi – Chairman, Afghanistan International Chamber of Commerce
- Martin Greeley – Senior Fellow, Institute of Development Studies, University of Sussex, UK
- Roshaneh Zafar – Founder and President, Kashf Foundation, Pakistan
- Mary Coyle – Director, Coady International Institute and Vice President St. Francis Xavier University, Canada

The Board composition and the organization structure, systems and procedures indicate that MISFA's overall governance framework is satisfactory. It would be necessary in the future to strengthen governance by constituting a board level Audit Committee to oversee the functioning of the Internal Audit Department, periodically review and vet the accounting policies followed by the Company, and scrutinize the annual financial statements prior to submission to the Board for approval. The Board has less than one year of active experience and Board processes are still being strengthened and improved. Leadership succession planning, both at the senior management level and within the Board itself, will be critical to ensure sustained growth of MISFA and for building up the microfinance sector in the medium-term.

Management structure and staffing

MISFA Organization Chart



Major Responsibilities

- Human Resource management
- Donor relations/fund raising
- Government relations/coordination
- External communications

Major Responsibilities

- Financial management
- Invest in and monitoring of MFPs
- Invest in and monitoring of banks doing SME financing
- Research, studies, impact assessment

As might be expected with a new venture that is growing rapidly while at the same time having to adjust from a project managed by an international firm under contract to an Afghan company with a medium term vision, MISFA has adjusted its organization structure several times and it is expected that future adjustments will be made as well. The most recent addition to the structure was the SME department that primarily works with commercial banks. This department is being established for MISFA by ShoreBank International, a consulting firm with extensive SME and microfinance experience.

MISFA has been conservative about expanding its staffing. It has relied on the combination of a few international experts and Afghan staff with no microfinance experience before joining MISFA, so there has been significant investment into developing staff. The Managing Director is a banker with significant microfinance experience and the Technical Advisor previously worked for a microfinance rating agency. The other managers are staff who have learned about microfinance after joining MISFA and have been promoted into these positions based on their good performance and future potential.

In March 2007 a complete review of MISFA's financial and administrative management structure, systems and capabilities was conducted. This review made several recommendations that MISFA has implemented or is in the process of implementing.

- All MISFA operating policies were consolidated in one document and updated. This revised Operations Manual takes account of recommendations made by the World Bank at the time of pre-appraisal and was approved by the MISFA Board at its April 18th 2007 meeting.
- Positions for a deputy manager finance and an internal auditor have been approved by MISFA board and recruitment is underway. The internal audit function will also examine and report on the use of funds at the MFP level.

The MISFA Board also recently approved the addition of three staff to the technical services department primarily to allow for more active portfolio audits at the field level. This will allow for random examination of loans from approval to their use by clients to help verify the data that is being provided to MISFA by the MFPs.

Decisions about investments in MFPs will be based on MISFA's Operations Manual. The manual specifies selection criteria for new MFPs, performance monitoring systems and criteria, and contract formats and obligations. The established criteria follow sound commercial practices of appraisal, risk diversification and performance obligations. Each investment contract requires negotiation and detailing by management. It is then recommended to the Board where it is reviewed by an investment committee before being recommended for Board approval.

Funding will flow through several different levels

- *World Bank to Government of Afghanistan.* IDA grant to Government of Afghanistan (Ministry of Finance).
- *Government of Afghanistan to MISFA.* Minimum ten year loan in Afghanis with a minimum five year grace period. A 1% annual administrative service charge will be paid by MISFA to the MoF. The exact terms of this loan will be determined by the Subsidiary Loan Agreement between MISFA and the MoF.

- *MISFA to MFPs.* MISFA will on-lend to MFPs on terms that might be adjusted from time to time and might also be different in future for organizations with different risk profiles. At present, MISFA has the same terms for all organizations: ten year afghani denominated loan with a five year grace period and a charge of 5% per year. MISFA is able to cover its costs with the spread it earns. Because of the need to repay MoF, MISFA might need to adjust terms with MFPs to be slightly less than ten years with a slightly less than five year grace period.
- *MFPs to clients.* Analysis shows that MFPs are charging interest rates by which they can become financially sustainable (i.e. rates are positive in real terms) and that contribute to the profitability and increasing capital base of the MFP (i.e. provide adequate margins for profitability). On average, MFPs yields on portfolio are in the range of 35% and projections show that they can become operationally sustainable (three already have) within five years from start-up with this level of yield. This compares to the 25% yields that commonly prevail in the much more developed microfinance markets in Bangladesh and India. A higher rate in Afghanistan, though, is justified in an environment where costs of delivering services are higher and where MFPs have only recently established their operations. In fact, there would be concern at this stage of development if MFPs were charging lower rates and thereby passing on subsidies to clients. Another comparison is to Pakistan where average MFP yields are 18% and sustainability is a long way off (63% operational sustainability for the entire sector in 2005, the lowest in South Asia) and many MFPs pass on subsidies to clients instead of using them to build up and strengthen their own institutions.

IFC has invested in two banks in Afghanistan, the First MicroFinanceBank that began operations in 2004 and is also supported by MISFA and the BRAC Afghanistan Bank that began operations in October 2006. While FMBA has so far focused on urban microfinance and is now developing an SME portfolio, BRAC Afghanistan Bank will begin with a small business portfolio and expand into offering commercial banking services. Both the parent organizations of these banks also own NGO MFPs in Afghanistan that are supported by MISFA and are the two leading MFPs in the country.

Technical Annex 7: Financial Management and Disbursement Arrangements

AFGHANISTAN: Expanding Microfinance Outreach and Improving Sustainability

Country Issues

The World Bank has gained substantial experience and understanding of the financial management environment in Afghanistan through the large number of projects under implementation over the past four years. The Public Administration Capacity Building Project is the primary instrument to continue and enhance the fiduciary measures put in place during the past years to help ensure transparency and accountability for the funding provided by the Bank and other donors.

A PFM performance rating system using 28 high-level indicators that was developed by the Public Expenditure and Financial Accountability multi-agency partnership program was applied in Afghanistan in June 2005. PEFA is comprised of the World Bank, IMF, EC, and several other agencies. The system is structured around six core dimensions of PFM performance: (i) budget credibility; (ii) comprehensiveness and transparency; (iii) policy based budgeting; (iv) predictability and control in budget execution; (v) accounting, recording, and reporting; and (vi) external scrutiny and audit. Afghanistan's ratings against the PFM performance indicators portray a public sector where financial resources are by and large being used for their intended purposes. This has been accomplished with very high levels of support from international firms, and this assistance will continue to be needed over the medium term if these ratings are to be maintained. There is also much room for improvement.

Despite the gains made in reconstruction since the end of 2001, the challenges facing Afghanistan remain immense. The policy framework benchmarks have not yet been fully costed, so various priorities are funded through the annual budgeting process. The rising costs of the security sector constitute the major constraint on attainment of fiscal sustainability. With regard to executive oversight, the national assembly will play an increasingly active role. In spite of considerable efforts to reform its core functions, the public sector remains quite weak outside of Kabul. Lack of qualified staff in the civil service after 30 years of war and conflicts is a binding constraint. Delays in reforming the pay structure and grading of civil servants have severely crippled the public administration of the country. Domestic revenues lag behind expenditures by a factor of ten to one. Large-scale corruption could emerge to undermine the government's efforts to enhance aid flows through national accounts. Capacities to track expenditures and monitor expenditure outcomes have improved, but they need rapid and substantial strengthening if progress toward the attainment of national development targets is to be monitored. Currently, 75% of external revenues bypass government appropriation systems.

The World Bank is financing a Financial Management Advisor to assist the Ministry of Finance, an Audit Advisor to assist the Control and Audit Office, and a Procurement Advisor to assist in Procurement-related activities. Also an Internal Audit function is being developed within the Ministry of Finance with World Bank financing. USAID, and earlier the Indian Aid Assistance Program, is financing a team of consultants and advisors to assist the Da Afghanistan Bank in local as well as foreign currency operations. The activities carried out under the existing Public Administration projects have helped the Government of Afghanistan to ensure that appropriate

fiduciary standards are maintained for public expenditures, including those supported by the Bank and the donor community.

Progress has been slower than expected in shifting from operations support provided by the three Advisors to capacity development and knowledge transfer to the civil servants. Given that situation, it is expected that the Advisors will continue to be required for the medium term. Challenges still remain in attaining the agreed upon fiduciary standards and then enhancing them. And to make matters more complex, the regulatory environment in Afghanistan has advanced significantly in the past three years. Unfortunately, even mastery of basic skills in the early environment does not fully qualify the civil servants to work effectively in the new emerging environment.

The Project

The table below identifies the key risks that the project may face and indicates how these risks are to be addressed. The overall FM risk rating is high but the residual risk rating after application of the mitigating measures is substantial.

Risk	***Risk Rating***	*Risk Mitigation Measures*	*Residual Risk*	*Condition of negotiations, Board or Effectiveness (Y/N)*
Inherent Risk				
Country Inherent Risk	M	Source - PFM study	M	N
Project Financial Management Risk	H	Minimize use of Designated Account, maximize direct payments to Financial Institutions	S	N
Perceived Corruption	H	Government commitment, internal controls and new internal audit will help to reduce the high level of perceived corruption	S	N
Overall Inherent Risk	H		S	
Control Risk				
1. Weak Implementing Entity	S	New status of the implementing entity, MISFA, as a limited liability non-profit company, an independent apex organization with a Board of Directors that performs oversight function. Presence of experienced and qualified personnel occupying the position of the Managing Director and managers of key departments including the	M	N

		Finance and Administration Department. Strengthening of the Finance & Admin Department with the recruitment of additional Deputy Finance Manager.		
2. Funds Flow	S	Payments will be made to financial institutions from the Designated Account (DA) by SDU-MoF or payments in form of advances will be made to MISFA from where financial institutions would be paid. In addition to payments out of DA funds, the implementing entity can also request the SDU to make (i) direct payments from the Credit Account to financial institutions and (ii) special commitments for contracts covered by letters of credit. These payments would only be made by SDU after due processes and proper authorization from the implementing entity.	M	N
3. Budgeting	S	The Manager, Finance & Admin will be responsible for coordination of the annual budget preparation process, the budget would be approved by the Board of Directors before submission for Government of Afghanistan approval.	M	N
4. Accounting Policies and Procedures	S	Will follow international standards. Project accounting procedures and details of the FM arrangements are already documented in the implementing entity – MISFA's Financial & Administrative Policies and Procedures Manual.	M	N
5. Internal Audit	H	Newly-created internal audit department at MoF and internal audit unit at MISFA will review project internal control systems	S	N
6. External Audit	H	Project's financial statements	S	N

		will be audited by CAO with support from Audit Advisor, while the entity financial statements will be audited by MISFA appointed auditors.		
7. Reporting and Monitoring	H	Strengthening the SDU is a priority under the new FM Advisor contract, to provide information that will comply with agreed format of financial reports.	S	N
Overall Control Risk	H		S	
Detection Risk	S	Adequate accounting, recording, and oversight will be provided in project procedures. Accounting, recording and oversight by SDU–MOF of all advances/M-16 supported by Financial Management Advisor. Additionally, reliance will be placed on existing internal controls within MISFA.	M	N
Risk rating: H=high risk; S=substantial risk; M=modest risk; L-low risk				

Strengths

The Government of Afghanistan provides assurance to the Bank and other donors that the measures in place to ensure appropriate utilization of funds will not be circumvented. Government of Afghanistan support for PACBP will be strengthened to enhance financial management in treasury operations, public procurement, internal audit in the public sector, and external audit by the Auditor General. A specific strength of the project is that this is a follow-up project, thus the agency involved in the implementation has experience in implementing Bank projects and following Bank procedures.

Weaknesses and Action Plan

The main weakness in this project, as in many others in Afghanistan, is the ability to attract suitably qualified and experienced staff, especially for financial management. The Deputy Manager Finance that MISFA will recruit and the establishment of internal audit unit, together with intensive training programs included in this project, is expected to strengthen fiduciary management.

Implementing Entity

MISFA will be the implementing entity for this project. MISFA is a limited liability non-profit company with a functioning Board of Directors. The Board of Directors performs the oversight function while the Managing Director and Managers of various departments are responsible for the day-to-day management of the company.

The project will utilize the same financial management arrangements as the ARTF microfinance project. MISFA's financial management system will be strengthened in the course of implementation with the engagement of a Deputy Finance Manager and an internal audit unit. The Manager Finance & Administration will take responsibility for financial management activities of the project, which will include processing of funds transfers to financial institutions, consultants and suppliers. This will include preparation of M-16 forms (payment orders), maintenance of relevant accounting records, preparation of required monthly, quarterly and annual reports, liaison with the SDU to ensure that the designated account is replenished when due, and responsibility to respond to project audits.

Budgeting

The Manager Finance & Administration will be responsible for coordination of the annual work plan and budget preparation process in accordance with the procedures documented in the company's Financial & Administrative Policies and Procedures manual. This would then be submitted to the Board of Directors for approval. MISFA shall also coordinate regular budget reviews to ensure adequate budget discipline and control. It will work with the Ministry of Finance to ensure that project expenditures for each fiscal year are captured in the government development budget of that fiscal year. MISFA will work with the Ministry of Finance to endeavor to obtain approvals from the presidential office and the parliament and attach them to B27 and PCS forms at the time of requesting yearly allotments for contracts under the project to avoid delays in payment processing.

Funds Flow

The standard funds flow mechanism in Afghanistan will be followed in this project. Project funds will be deposited in the designated account (DA) to be opened and maintained at the Da Afghanistan Bank. In keeping with current practices for other projects in Afghanistan, the DA will be operated by the MoF-SDU. Requests for payments from the DA will be made to the SDU by MISFA when needed.

In addition to payments out of DA funds, MISFA can also request the SDU to make direct payments from the grant account to financial institutions and make special commitments for contracts covered by letters of credit, though this is unlikely to occur under this project. These payments will follow World Bank procedures. Project payments will be made to either MFPs or to MISFA through normal bank transfers via Da Afghanistan Bank, local commercial banks or overseas banks.

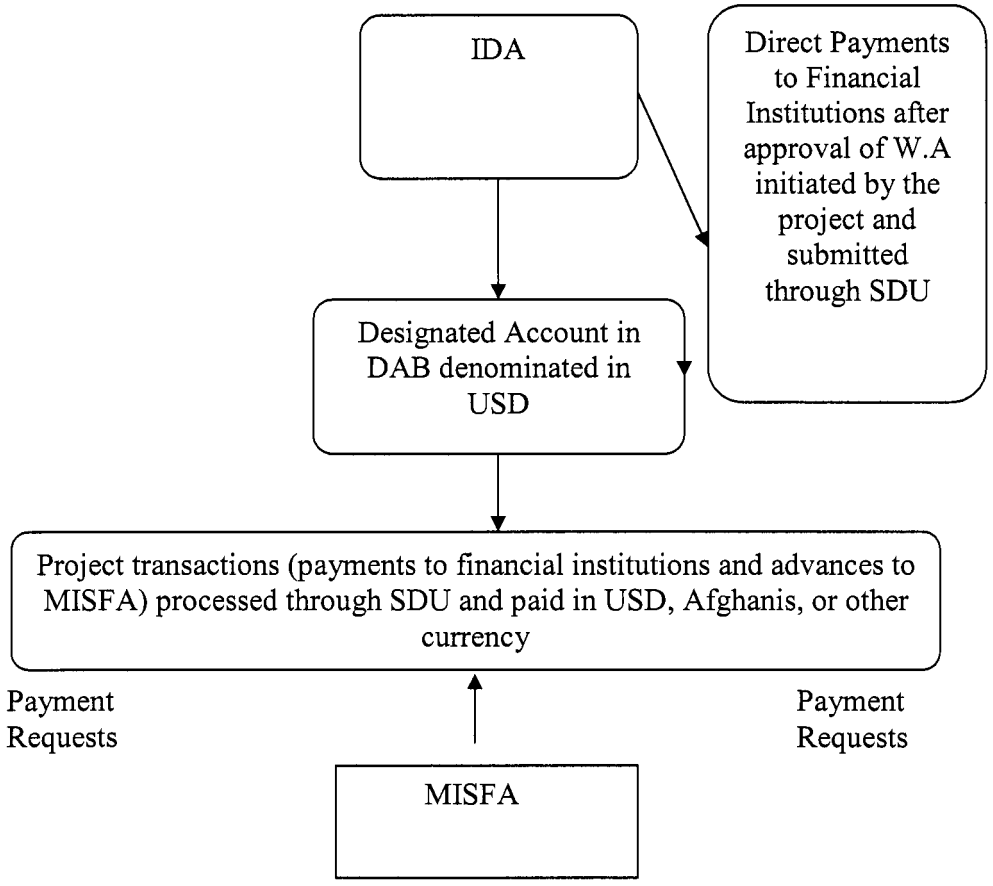
It has been agreed between MISFA and the MoF for funds to be transferred in the form of advances from the DA to MISFA's bank account, from where payments would be made to

MFPs. MISFA would be required to submit SOEs for the acquittal of an agreed percentage of a previous advance before approval and payment of the next advance by the MoF-SDU.

Retroactive financing

A provision has been made to reimburse the Government of Afghanistan for payments it makes, up to a maximum of US$ 10 million for eligible project expenditures made after April 1st 2007 and up to the signing of the Financing Agreement, in accordance with the Bank's procurement guidelines.

Fund Flow Chart



Legal requirements for authorized signature

Ministry of Finance has authorization to disburse funds from the Grant. Specimen signatures of authorized signatories in MoF are already on file with IDA.

Accounting

The SDU will maintain a proper accounting system of all expenditures incurred along with supporting documents to enable IDA to verify these expenditures. The Finance and Administration staff of MISFA will: (i) supervise preparation of supporting documents for expenditures; (ii) prepare payment orders (Form M16); (iii) obtain approval for M-16s by the Managing Director; and (iv) submit them to the Treasury Department in MoF for verification and payment. Whilst original copies of required supporting documents are attached to the form M16, the project is required to make and keep photocopies of these documents for records retention purposes. The FM Advisor in the MoF/SDU will use the government's computerized accounting system, AFMIS, for reporting, generating relevant financial statements, and exercising controls.

The Finance and Administration staff of MISFA will maintain essential project transaction records using Quick books and Excel spreadsheets and generate required monthly, quarterly, and annual reports.

The existing MISFA Financial & Administrative Policies and Procedures manual is considered adequate. However, in accordance with the procedure described in the manual for making revisions, it should be updated for this project to include: (i) roles and responsibilities for all FM staff; (ii) documentation and approval procedures for payments and release of funds to each implementing entity involved in the project; (iii) project reporting requirements; and (iv) quality assurance measures to help ensure that adequate internal controls and procedures are in place and are being followed.

MISFA's Financial & Administrative Policies and Procedures manual covers all activities and funding sources of the Company. MISFA should ensure that for this project it establishes project financial management in accordance with standard government policies and procedures including use of the Government of Afghanistan Chart of Accounts to record project expenditures. The use of these procedures will enable adequate recording and reporting of project expenditures. Overall project accounts will be maintained centrally in MoF-SDU, which will be ultimately responsible for recording of all project expenditures and receipts in the government's accounting system. Reconciliation of project expenditure records with MoF records will be carried out monthly by MISFA.

Internal Control & Internal Auditing

Project specific internal control procedures for requests and approval of funds are adequately described in the Financial & Administrative Policies and Procedures manual. This includes segregation of duties, documentation reviews, physical asset control, and cash handling and management. Annual project financial statements will be prepared by the MoF-SDU. Project financial management systems will be subject to review by the newly established internal audit directorate of the MoF according to programs to be determined by the Director of Internal Audit using a risk-based approach. The internal auditor to be engaged by MISFA will undertake similar tasks.

External Audit

Project accounts will be audited by the Auditor General, with the support of the Audit Advisor, with terms of reference satisfactory to the World Bank. The audit of project accounts will include an assessment of the adequacy of the accounting and internal control systems, ability to maintain adequate documentation for transactions, and eligibility of incurred expenditures for IDA financing. The audited annual project financial statements will be submitted within six months of the close of fiscal year. All agencies involved in implementation and maintaining records of expenditures would need to retain these in accordance with the IDA records retention policy.

The following audit reports will be monitored each year in the Audit Reports Compliance System (ARCS):

Responsible Agency	Audit	Auditors	Date
MISFA	SOE, Project Accounts and Designated Account	Auditor General	Sep 22
MISFA	Entity financial statements	Auditors appointed by MISFA Board in accordance with its legal obligations. At present the auditors are KPMG.	Sept 22

MISFA's audited financial statements along with the audit opinion will be submitted to the World Bank within 6 months of the end of each fiscal year.

There are key issues in the CAO audit results of the year ended March 20, 1384 (2006) for the ARTF microfinance project. The Ministry of Rural Rehabilitation & Development responded to these issues and submitted an action plan. The World Bank is satisfied with the responses and action plan submitted towards resolving the key issues.

Financial Reporting

Monthly, quarterly or annual financial statements and project reports, as appropriate, will be used for project monitoring and supervision. These reports will be produced based on records kept by MISFA with due reconciliation to expenditure statements from MoF-SDU (as recorded in AFMIS) and bank statements from Da Afghanistan Bank. Project reports will show sources and uses of funds by project component as well as expenditures consolidated and compared to governmental budget heads of accounts. MISFA will forward the relevant details to MoF-SDU with a copy to the Bank within 45 days of the end of each quarter. The Government of Afghanistan and World Bank have agreed on a pro forma report format for all Bank projects. This format is already being used for the current ARTF microfinance project. The annual project accounts will form part of the consolidated Government of Afghanistan accounts for all development projects.

Disbursement Arrangements

Disbursement procedures will follow the World Bank procedures described in the *World Bank Disbursement Guidelines and the Disbursement Handbook for World Bank Clients (May 2006).*

Table 1 shows the allocation of IDA proceeds in a single, simplified expenditure category which will facilitate preparation of withdrawal applications and record-keeping. Project funds will be disbursed over 36 months. The closing date of the project will include a final disbursement deadline four months after the closing date. During this additional four month grace period, project related expenditures incurred prior to the closing date are eligible for disbursement.

Table 1: IDA Financing by Category of Expenditure (US$ million)

Expenditure Category	**Amount of the Grant Allocations**	**Financing Percentage**
(1) Payments to financial institutions	$30 million	100 %
Total	**$30 million**	-

Summary Reports. All reimbursements will be made on the basis of summary reports in the form of Statements of Expenditure. These will be used for all payments to financial institutions. Records (copies of loan agreements and other evidentiary documentation supporting the amount requested) are required for direct payments.

Designated Account. A single designated account will be opened at Da Afghanistan Bank in US dollars for a maximum amount of US$ 10 million, representing 6 months of estimated expenditures. The MoF-SDU will manage both payments from and new advances to this account. Cash advances may be issued from the designated account to be held and managed by MISFA. MISFA's internal controls, cash handling accounting, and preparation of Statements of Expenses (SOEs) have been assessed as satisfactory. New cash advances will only be made when all other prior cash advances have been justified through submission of SOEs to the MoF-SDU.

Direct Payments. Third-party direct payments will be permitted for amounts exceeding 25 percent of the advance in the Designated Account. All such payments require prescribed supporting documentation.

Preparation of Withdrawal Applications. The SDU will review withdrawal applications for quality and conformity to treasury procedures and then obtain the authorized signatures. Selected MISFA finance staff will be registered as users of the World Bank web-based Client Connection system and play an active role in managing the flow of disbursements.

Financial Management Covenants

- MoF shall submit audited financial statements for the project within six months of the end of each fiscal year. The Project's audit report will cover the financial statements, the

designated account, and SOEs, in accordance with terms of reference agreed with the World Bank.

- MISFA shall submit audited financial statements for its operations within six months of the end of each fiscal year.
- Un-audited project interim financial reports will be submitted by MISFA on a quarterly basis to the World Bank and a copy to MoF-SDU within 45 days after the end of each quarter.

Supervision Plan

During project implementation, the Bank will supervise the project's financial management arrangements. Supervision will be carried out on a regular basis and will be comprehensive. The supervision team will:

- Review the project's semi-annual un-audited interim financial reports as well as the project's annual audited financial statements and auditor's management letter.
- Review the project's financial management and disbursement arrangements (including a review of a sample of SOEs, movements on the designated account and bank reconciliations) to ensure compliance with the Bank's minimum requirements.
- Review agency performance in managing project funds to ensure that it is timely, accurate, and accountable. Particular supervision emphasis will be placed on asset management and supplies.
- Review annual audit reports received by MISFA from benefiting financial institutions as well as MISFA's internal audit reports and Technical Support Department reports on monitoring of benefiting financial institutions.
- Review of financial management risk rating and compliance with all covenants.

Conclusion

The FM arrangements including the systems, processes, procedures, and staffing are adequate to support this project subject to implementation of the items listed in the action plan.

Technical Annex 8: Procurement Arrangements

AFGHANISTAN: Expanding Microfinance Outreach and Improving Sustainability

Country Context

The Bank has gained substantial experience and understanding of the procurement environment in Afghanistan through its involvement in the interim procurement arrangements put in place through the Emergency Public Administration Project as well as by working with the Afghanistan Reconstruction and Development Services that is responsible for procurement administration. As part of a broader review of Afghanistan's Public Finance Management system, the World Bank recently carried out an assessment of the procurement environment in the country based on performance indicators developed by a group of institutions led by the World Bank and the Organization for Economic Cooperation and Development's Development Assistance Committee.

The first key issue identified through the procurement assessment was the need for a champion in government to drive reform, deepen capacity, ensure integrity in the operation of procurement systems, and promote sound procurement practices by ministries.

A new Procurement Law was adopted in November 2005 which radically transformed the legal and regulatory framework for procurement administration in Afghanistan. While it provides a modern legal system for procurement, effective implementation of the law may encounter difficulties in the current weak institutional structure and capacity of the Government of Afghanistan. A Procurement Policy Unit (PPU) has now been established under the Ministry of Finance to ensure the implementation of the Procurement Law through the creation of secondary legislation, standard bidding documents, provision of advice, and creation of the necessary information systems for advertising and data collection. The Afghanistan Procurement Procedures have been effective from April 12, 2007. Procedures for Procurement Appeal and Review have been developed by the Ministry of Finance PPU. Members have been appointed and the system has been functional since April 2007.

In the absence of adequate capacity to manage procurement activities effectively, some interim arrangements have been put in place to improve the procurement management of the country. A central procurement facilitation service, ARDS has been established under the supervision of Ministry of Economy. The World Bank and the Government of Afghanistan have agreed on a program for country wide procurement reform and capacity building, leading to a transition from centralized to decentralized procurement services. The World Bank funded Public Administration Capacity Building Project is the primary instrument for implementing the program to strengthen capacity of line ministries to manage public procurement in an effective, transparent and accountable manner. However, the implementation of the procurement capacity building strategy has not yet made significant progress due to lack of coordination and delays in decision making within government. The radical changes to the procurement management environment expected from the new Procurement Law would require the urgent implementation of a comprehensive human resources and capacity development program. Implementation of the procurement reform component of the PACBP should be considered with due priority to ensure

that fiduciary standards are further enhanced and that capacity is developed in government to maintain these standards.

The Project

The proposed project will be implemented by MISFA on behalf of the Government of Afghanistan. The Ministry of Finance will lend the proceeds of the IDA Grant to MISFA on the basis of a subsidiary agreement signed by both parties. MISFA will then loan funds to qualified MFPs to carry out activities described below. The funds provided to the MFPs will be used by them for making loans to microfinance clients of whom majority will be women. The procurement actions under the proposed grant for (i) goods / works and non-consulting services shall be in accordance with paragraph 3.12 (Procurement in Loans to Financial Intermediaries) of the Bank's Procurement Guidelines, and for (ii) consulting services shall be in accordance with paragraph 3.14 (Commercial Practices) of the Bank Guidelines for Selection of Consultants.

Under the Credit Component of this project (US$ 30 million), MISFA will make loans to MFPs that will in turn use these funds to make loans to individuals in the communities. These individuals will use these credits for micro level businesses such as grocery shops, tailoring shops, carpet business, purchasing of fertilizer and animals, etc. The average size of loan will be around US$ 250 and the maximum amount would be in the range of US$ 1500. The MFP loan recovery rate at present averages 96 % (i.e. less than 4% portfolio at risk at 30 days), which indicates that repayments are prompt and proper collection mechanisms are in place.

To the extent possible, MISFA shall ensure that the MFPs use the Grant proceeds (loans) for the intended purposes. The operational procedures followed by MFPs are documented in their operational manuals. The manuals elaborate the credit/loan approval system and internal audit procedures. MISFA has also established an internal control system by which staff visit the MFPs and beneficiaries periodically, and external audits of MFPs are conducted by independent auditors to ensure that grant proceeds are used for the intended purposes. These procedures mitigate risks of misuse of funds.

MISFA is currently financed by an ongoing project under the ARTF and by some other donors operating outside the ARTF process. At present 15 MFPs are receiving funding from MISFA. The procedure for selection of MFPs is described in the Operations Manual approved by the MISFA Board in April 2007. . In addition the Operations Manual also describes the MISFA mission, guiding principals, terms and conditions of grants/loans to MFPs, etc. MISFA has agreed to publish some of the above information in the public domain, especially the MFP assessment and selection criteria, the documents required for this and the internal approval procedure.

Technical Annex 9: Economic and Financial Analysis

AFGHANISTAN: Expanding Microfinance Outreach and Improving Sustainability

Economic Analysis

Significant economic benefit is expected to be derived from the project. The project will help improve the outreach of microfinance services. The sector's loan portfolio outstanding to microfinance clients is expected to grow by more than 250% between 2007 and 2009, with more than 600,000 active borrowers expected by the end of 2009. The project will also contribute to fostering sustainable MFPs and moving the microfinance sector along so that it begins to access commercial funding and mobilize savings. It will also support the creation of Afghan companies (MFPs) that are largely managed and governed by Afghans and instill credit repayment discipline both at the MFP as well as apex level. The Bank's funding will also encourage 'crowding in' of other capital into the microfinance sector, thereby having a leverage effect.

Global experience demonstrates that a strong, growing microfinance sector is a prerequisite to achieving the desired household level impact. The creation of a strong growing microfinance sector will contribute to poverty alleviation and increases in the incomes of poor people, create economic opportunities for poor people in rural and urban areas, contribute to gender equity by increasing the economic involvement of women and enhancing their role in society, facilitate improved access to financial services to poor people throughout the country, create employment opportunities, and contribute to the government's counter narcotics strategy.

Further, by increasing the provision of loans to micro-clients across Afghanistan, the project will provide opportunities to urban and rural poor to invest in and manage microenterprises and earn additional income. MISFA' loans help microfinance clients undertake investments for microenterprise activities such as livestock rearing, petty trade of numerous items, weaving/handicrafts/tailoring, agro-processing, rural and urban transport, etc. Microfinance loans also provide a substitution effect, whereby more expensive credit from non-family informal sources, which is what the poor most often have access to now, is replaced by the much cheaper and more easily accessible microfinance loans.

An analysis of the returns from such activities, as determined through a household level study[1] to quantify the returns at the household level from providing micro loans, shows positive results. Based on an analysis of 27 microcredit investments it was found that all 27 families included in the study have generated surplus income (receipts minus payments) during the year. The contribution of microcredit to the family income was found to be significant. On average it contributed 67% additional income per year in the form of family labor and profit. Also, the

[1] A poor household may have more than one source of income including the microcredit investment. The incremental impact on household income of microcredit was calculated by developing an income / expenditure profile of the household for a period of one year. All cash inflows and outflows of the household were accounted for one year, including the inflow due to microcredit borrowing. In computing the net profit from the activity an expense component has been estimated for family labor depending on the amount of time employed by the family members and the usual labor rate in the area. Inflows to the family have been divided into six main categories: (a) income of the family from sources other than microcredit investment, (b) gifts received by the family, (c) additional borrowing from sources other than the MFP, (d) contribution from the other income generating activities related to family labor, (d) borrowing from the MFP, (f) net profit from the income generating activity related to the loan, and (g) remittances from outside the household. The outflows have been categorized into (a) household consumption expenses, (b) capital expenditure, and (c) loan repayment.

proportion of contribution from microcredit to total family income is significant, between 17% and 97%. The rate of return for loans varied between 100% and more than 500%, levels that are not unusual in the case of such family managed micro-investments.

Financial Analysis

MISFA

A financial analysis of MISFA shows that it has sound financial ratios and is performing well. This performance can be expected given that MISFA has a five percent financial margin, virtually no liabilities and excellent asset quality (see also tables below on balance sheet and income statement analysis). MISFA's capital ratio is nearly 100%, return on assets even without including grant income is strong, and there are currently no bad assets. With growing operations, even when the cost of funds increases as a result of IDA borrowings the overall financials for MISFA are expected to remain strong with larger volumes leading to economies of scale setting in (see below). MISFA's loan portfolio is expected to more than triple over the project period.

MISFA's Projected Financial Statements

(US$ million)

	Actual	Projections		
	December-06	**December-07**	**December-08**	**December-09**
Balance Sheet				
Assets				
Loans to MFIs	44.0	70.0	100.0	135.0
Cash	1.0	1.5	2.5	3.0
Other assets	0.1	0.1	0.2	0.2
Total Assets	**45.1**	**71.6**	**102.7**	**138.2**
Liability		10.0	20.0	30.0
Equity –Grants	44.4	59.6	78.3	100.2
Retained Earnings	0.7	2.0	4.4	8.0
Total Equity & Liability	**45.1**	**71.6**	**102.7**	**138.2**
Income Statement				
Income				
Grant Income	25.5	20.0	12.0	6.0
Interest Income	1.6	2.9	4.3	5.9
Expenses				
MISFA Operating expenses	1.3	1.6	1.9	2.2
Grants to MFIs	25.5	20.0	12.0	6.0
Profit (Loss)	0.3	1.3	2.4	3.6

MISFA – Financial Performance And Ratios

	March 04	March 05	March 06	December 06
Net Profit/Fund Balances (ROE)	100.0%	78.7%	65.0%	56.6%
Earnings Ratio				
Net Profit/Average Assets (ROA)	80.4%	124.0%	92.0%	77.4%
Capital Ratio				
Fund Balances/Total Assets	80.4%	99.4%	99.3%	99.9%
Profitability Ratios (% of Avg. Assets)				
Interest income	0.7%	1.8%	2.7%	NA
Non-interest income	NA	NA	NA	NA
Overhead expense	29.9%	36.6%	12.4%	4.1%
Risk				
Growth rate – Assets		542.3%	18351.6%	100.0%
Growth rate – Fund Balances		370.4%	147.1%	117.6%
Liquidity Ratio				
Total Net Loans/Total Assets	42.2%	69.8%	37.4%	78.2%
Interest-bearing Assets ($ m)	1.21	7.63	10.11	45.76
Average Interest-bearing Assets ($ m)	1.21	4.43	8.87	27.94
Interest Income/Interest-bearing Assets	1.7%	2.5%	7.2%	0.0%
Spread ($ m)	0.02	0.20	0.73	NA

In terms of **profitability**, MISFA has done well so far. However, in the coming years MISFA may be required to pay interest on its borrowings from IDA or other sources and also meet increased operational expenses, possibly reducing its operating profit to some extent. As a substantial portion of its assets would continue to be funded by the grants already received, the entire interest income from loans funded by interest free grants and the net interest income from the balance loan portfolio would still be sufficient to meet the increased operating costs and provisioning requirements. MISFA is therefore a financially viable entity.

The tables below show financial information for MISFA.

(US$ millions)

	March 04*		March 05*		March 06*		December 06**	
Fixed assets	0.033	1.1%	0.086	0.8%	0.092	0.3%	0.074	0.1%
Current assets								
Cash & Bank	0.347	12.1%	0.531	4.9%	0.670	2.5%	1.115	1.9%
MFP (Loans)	1.213	42.2%	7.633	69.8%	24.977	92.3%	44.083	75.3%
MFP (Others)	1.211	42.1%	2.609	23.9%	0.488	1.8%	13.242	22.6%
Other Assets	0.071	2.5%	0.075	0.7%	0.823	3.1%	0.024	0.1%
Total	**2.876**	**100%**	**10934**	**100%**	**27.050**	**100%**	**58.538**	**100%**

** Audited* *** Provisional*

Liabilities And Equity

(US$ millions)

	March 04*		March 05*		March 06*		December 06**	
Grants(Capital)	1.214		1.233		7.847		25.315	
Additions	-		6.419		17.345		19.105	
Sub-Total	*1.214*	*42.2%*	*7.652*	*70.0%*	*25.192*	*93.1%*	*44.420*	*75.9%*
Surplus/Deficit	0.019	0.7%	0.195	1.8%	0.123	0.5%	12.505	21.3%
Total	*1.233*	*42.9%*	*7.847*	*71.8%*	*25.315*	*93.6%*	*56.925*	*97.2%*
Deferred Liab.	1.078	37.5%	3.025	27.7%	1.555	5.7%	1.554	2.7%
Current Liab.	0.565	19.6%	0.062	0.5%	0.180	0.7%	0.059	0.1%
Total	**2.876**	**100%**	**10.934**	**100%**	**27.050**	**100%**	**58.538**	**100%**

* *Audited* ** *Provisional*

Income Statement Analysis

(US$ millions)

	March 04*		March 05*		March 06*		December 06**
Income							
Interest	0.021	2.4%	0.195	2.4%	0.726	6.7%	NA
Grants	0.861	97.6%	8.091	97.6%	10.147	93.3%	13.528
Total	*0.882*	*100%*	*8.286*	*100%*	*10.873*	*100%*	*13.528*
Expenses							
Opg. Exp	0.861	97.7%	2.527	30.5%	2.355	21.7%	0.398
Non-Opg Exp	-		5.564	67.1%	8.395	77.2%	0.590
Others	0.001	-	-		-		0.035
Total	*0.862*	*97.7%*	*8.091*	*97.6%*	*10.750*	*98.9%*	*1.023*
Surplus	0.020	2.3%	0.195	2.4%	0.123	1.1%	12.505

* *Audited* *NA – Not available* ** Provisional

In terms of capital adequacy, the accumulated retained earnings of US$ 22.81 million,[4] the key component of MISFA's capital, on March 31, 2006 would be adequate to support an asset book of about US$ 285 million, applying a capital adequacy norm of 8% as is currently prescribed by DAB for commercial banks. The projected aggregate loan portfolio of MISFA on March 31, 2009 is only US$ 157 million. Hence, MISFA should meet the capital adequacy norm quite comfortably in the medium term. Its strong capital base bodes well for MISFA in the future and provides more than sufficient cushion for future growth and expansion on a sustainable basis.

MISFA's asset quality is good. While amortization of its loans to MFPs has not yet started, so there is no direct way to estimate what the repayment performance might turn out to be, the underlying MFP loan portfolios financed with MISFA funds is sound. The current repayment rate is above 95%. With more and more MFPs steadily heading towards full operational

[4] Accumulated retained earnings are estimated after subtracting a 5% loan loss reserve (US$ 2.5 million).

sustainability (see below), servicing the interest on MISFA loans and adhering to repayment commitment in respect of MISFA loans within say, five to eight years from date of disbursement, would not be difficult for the MFPs.

In terms of risk management, MISFA has on its roll a competent and young management team consisting of qualified professionals with good appraisal capacity. However, as stated elsewhere, there is an imperative need for MISFA to strengthen its Technical Support and Finance functions to cope with increased volumes, loan monitoring and complexity of work in the days to come consequent to growth in business and outreach. MISFA will also have to ensure that significant MFP entities like BRAC-A and ARMP adopt robust risk management practices. This, however, is not an easy task either for MISFA or the MFPs in the context of the serious limitations the country faces in availability of skilled human resources.

So far there is no interest rate or currency risk given that MISFA has been funded through grants. With the IDA project, MISFA would be borrowing from the Government of Afghanistan in Afghanis at a pre-defined and fixed interest rate, and would be lending to its partner MFPs in Afghanis in structured terms that reflect an appropriate level of pricing and tenor while enabling MFPs to service the debt based on projected cash flows (see the section below on MFP performance for more information). No risks are seen with regard to either interest rate or currency fluctuations.

MISFA's role as an industry facilitator and an apex financier has been of crucial importance. Given the current state of the financial sector in the country and the very low penetration of bank branches in provinces and consequent low access to banking facilities for deposits and loans, funding sources for MFPs other than MISFA remain limited. However, once more MFPs stabilize their operations and their role and financial viability gets independently assessed in financial circles, commercial banks and private players might begin to extend funding support to MFPs. In the medium term, well managed and credit rated MFPs should be able to begin to attract some private equity and long term debt, both from the domestic market and from abroad. Already MISFA has played an active role in negotiating what is expected to be a borrowing relationship between a commercial bank and one of the leading MFPs. It is expected that once this initial agreement is made and a first loan extended from a bank to an MFP, it would pave the way for more such lending from fully commercial sources over the medium term. Overall, MISFA has gone beyond what many other similar apexes have done to incorporate elements of a transition strategy to commercial funding terms over time. From the first year of operations, it has taken initiatives to facilitate crowding in more commercial capital and an explicit and clear structuring all its financing based on an appraisal of business plans and clearly defined performance criteria.

Taking into account the composition of MISFA's Board of Directors, the caliber of the line management, MISFA's organizational structure and its systems and procedures, the overall governance and management framework of MISFA is satisfactory. MISFA's Board consists of seven members. Though MoF is the sole sponsor of the Company, the Board controls the Company and it has a well diversified membership. There are two members representing Government of Afghanistan (one each from MoF and MRRD), and two non-government independent individuals, but nominated by the respective Ministries). The non-government

nominees' induction in the Board however requires the approval of the Board. Development partners are entitled to choose three nominees. These representatives must have extensive experience in the micro finance sector, either in Afghanistan or in other countries that have micro-finance programs. The Board elects the Chairman of the Board annually. He presides over meetings of the Board. While constitution of an Audit Committee of the Board and further streamlining the Board procedures etc. will strengthen its governance, these are steps that MISFA plans to initiate soon.

MISFA has adopted international accounting standards for compiling its financial statements. Its loan policies and operational procedures are of acceptable standards, though adopting Loan loss Provisioning Policy and Loan Write off Policy (both of which would have relevance particularly if future NPLs were to arise) is suggested.

Microfinance Service Providers

A review of MISFA's partner MFPs shows positive results. Given country conditions, the geographical reach of the MFPs is impressive, and more than 70% of the loan beneficiaries are women. Of the 13 MFPs supported by MISFA through grants and loans up to the end of 2006, 12 are NGOs and one supports the establishment of credit unions. The overall performance of the sector has been good.

Microfinance Sector – Performance Overview
December 31, 2006

No. of Active Clients	300,501
No. of Active Women Clients	209,940
No. of Active Borrowers	257,450
No. of Returnees	11,316
Gross Loan outstanding	US$ 68 million
Avg. Loan outstanding per borrower	US$ 264
Current Repayment Rate	95%
Client Savings Outstanding	US$ 26 million
No. of Provinces	21
No of Districts	150
No. of Branches (Urban 67, Rural 83)	230
No. of MISFA's MFP Partners	13
MISFA's Loan to MFPs -outstanding	US$ 44 million
MISFA's Grant to MFPs outstanding	US$ 13 million

Sector	Exposure % to Total outstanding loans
Trade & Services	51%
Livestock (small & large animals)	21%
Agriculture	13%
Handicrafts & Manufacturing	13%

As part of project preparation, a detailed financial review of four MFPs was undertaken. With a clear emphasis on sustainability, of the four sample MFPs appraised, one of them, namely, ARMP has already achieved operational self sufficiency and the other three hold bright prospects

of emerging as viable operationally self-sufficient financial entities in the next two to three years. This performance is quite impressive given the country conditions and the nascent stage of the microfinance sector. Loan asset quality is acceptable with a repayment record of 95%. Hence all four MFPs appraised are "acceptable credit risks" for MISFA (see tables below). However, all MFPs face the following challenges: (i) availability of local talents to build their institutional capacity to support their growth plan and (ii) high security cost impacting their operational cost. If security situation deteriorates it will not only move up further their already high operational cost, but also slow down their operations, adversely impacting their operational viability. MFPs' non-viability in turn can adversely affect MISFA's future operations and viability.

MFP Balance Sheet Analysis (December 31, 2006)
(US $ millions)

	ARMP		BRAC-A		PARWAZ		WWI	
Cash & Equivalents	4.21	20%	5.84	22%	0.225	27%	0.403	24 %
Net Loans	16.30	78%	18.14	69%	0.572	69%	1.183	72%
Other Debtors	0.08		0.39	1%	0.016	2%	0.006	
Net Fixed Assets	0.30	2%	0.69	3%	0.020	2%	0.058	4%
Non –current Assets			1.42*	5%				
Total	**20.89**	**100%**	**26.48**	**100%**	**0.833**	**100%**	**1.650**	**100%**
MISFA Loans	10.26	49%	12.32	47%	0.517	62%	1.313	80%
Savings Deposits			5.34	20%				
Other Current Liab	3.10	15%	6.51	24%	0.086	10%	0.177	11%
Equity	7.53	36%	2.31	9%	0.230	28%	0.160	9%
Total	**20.89**	**100%**	**26.48**	**100%**	**0.833**	**100%**	**1.650**	**100%**

MFP Income Statement Analysis (December 31, 2006)
(US $ millions

	ARMP		BRAC-A		PARWAZ		WWI	
Interest Income	2.397		1.794		0.100		0.177	
Borrowing cost								
MISFA Loan	0.309		0.549		0.015		0.041	
Savings Deposit			0.087					
Total	0.309		0.636		0.015		0.041	
Operating Income	**2.088**		**1.158**		**0.085**		**0.136**	
Operating Expenses:								
Manpower cost	0.996	58%	1.626	65%	0.149	64%	0.166	40%
Other Overheads	0.618	36%	0.818	32%	0.085	36%	0.252	60%
Depreciation	0.106	6%	0.062	3%				
Total Operating Exp	**1.720**	**100%**	**2.506**	**100%**	**0.234**	**100%**	**0.418**	**100%**
Op Profit/(Loss) Before Provision	0.368		(1.34)		(0.149)		(0.282)	
Loan Loss Provision	0.386		0.301		0.004		0.006	
Op Profit/Loss after Provision	(0.018)		(1.64)		(0.153)		(0.288)	
Non-opg. Income(grants)	0.293		2.000		0.266		0.162	
Net Profit/Loss	**0.275**		**0.351**		**0.113**		**(0.126)**	

Projected financial performance of the reviewed MFPs is strong (see tables below) and all four reviewed MFPs are projected to be sustainable and quite profitable by 2009 – overall they represent an acceptable credit risk for MISFA.

Credit Quality
Estimates March 07*

	ARMP	BRAC-A	PARWAZ	WWI
Portfolio at Risk >30 days	0.60%	1.6%	1.10%	0.0%
Loan Loss Reserve Rate	1.35%	2.54%	1.08%	1.02%
Risk Coverage Ratio	223%	191%	478%	3158%

**Based on 9 months provisional data (actual) for Apr -Dec 06*

Profitability And Sustainability
April 06- March 07 Estimates*

Revenue

	ARMP	BRAC-A	PARWAZ	WWI
Return on Assets (RoA)	3.05%	-3.91%	-12.04%	-6.57%
Return on Equity (RoE)	9.05%	-66.03%	-80.24%	326.4%
Operational Self Sufficiency	123.0%	85.35%	50.24%	73.33%

MFP Expense Ratios

	ARMP	BRAC-A	PARWAZ	WWI
Total Expense	13.25%	26.68%	24.19%	24.65%
Financial Expense	3.56%	6.66%	2.34%	3.42%
LLP Expense	1.79%	2.59%	0.57%	0.69%
Operating Expenses	9.69%	20.02%	21.85%	21.23%

Based on 9 months provisional data (actual) for Apr -Dec 06

MFP Productivity Ratios

	ARMP	BRAC-A	PARWAZ	WWI
Operating Expense/GLP	12.36%	23.61%	32.74%	28.30%
Cost per Borrower	76.69	32.65	35.88	42.67

Based on 9 months provisional data (actual) for Apr -Dec 06

MFP Projected Performance to December 2009
(US$ million)

	ARMP	BRAC-A	PARWAZ	WWI
Outreach				
No. of Active Borrowers	56,000	314,229	23,000	25,735
Gross Loan Portfolio	44.80	60.00	3.00	5.25
Average Loan balance per Borrower	800	191	130	204
Financial Structure				
Capital / Asset Ratio	28.16%	16.84%	6.83%	6.82%
Financial Performance				
Financial Revenue ratio	21.31%	27.31%	33.66%	32.36%
Profit Margin	39.98%	47.78%	16.09%	27.22%
Return on Assets (ROA)	8.52%	13.05%	5.42%	8.81%
Return on Equity (ROE)	30.91%	102.35%	90.63%	189.43%
Operational Self-Sufficiency (OSS)	166.60%	191.50%	119.18%	137.40%
Productivity/Efficiency				
Head Count	663	2,860	180	175
Borrowers per Staff Member	84	110	128	147
Portfolio per staff, US$	67,572	20,979	16,667	30,000
Cost per Borrower US$	50.89	17.67	29.06	34.95
Operating Expense Ratio	6.06%	8.10%	21.37%	16.80%
Portfolio Quality				
Portfolio at Risk > 30 Days	0.3%	0.3%	0.0%	0.0%
Loan Loss Reserve Ratio	2.16%	2.32%	2.02%	2.01%

Overall, the financial analysis shows that MISFA's current operations as a financial intermediary are viable: (i) it has adequate profitability; (ii) it meets the prudential requirements of capital adequacy; (iii) it has acceptable credit quality; (iv) it has the institutional capacity and systems to manage the current business, and with due organizational strengthening and skill development can efficiently manage future business growth; and (v) it has partner MFPs that are acceptable credit risks and increasingly better performing institutions. MISFA's future projected performance is also strong and it is thus a good conduit for on-lending IDA funds to MFPs.

Technical Annex 10: Communication Strategy

AFGHANISTAN: Expanding Microfinance Outreach and Improving Sustainability

The mandate of this project and MISFA's mandate is to build a microfinance sector in Afghanistan that provides flexible, convenient and affordable financial services for poor Afghans on sustainable basis across the country.

Though MISFA started with direct support to NGO-led microfinance service providers, its goal is to work with a whole range of financial service delivery channels including regulated MFPs, commercial banks, cooperatives, insurance companies serving different segments of the low-income market.

In this context, the objectives of the communication strategy are:

- To create wider public awareness and acceptance of microfinance as an effective mechanism of delivering financial services to the poor.
- To increase awareness and support for MISFA and its partner MFPs within government at national and provincial levels.
- To increase interest and support for MISFA and the microfinance sector within international donors, development finance institutions and international social investment funds.
- To improve communication and information sharing between MISFA and partner MFPs.

Priorities and Approach

The highest priority in MISFA's communication activities will be to provide information about and greater visibility to needs within Afghanistan, followed by the growing demand from international donors and investors.

Highlight microfinance success stories. MISFA will provide news and information about microfinance to the media and encourage journalists to cover issues related to microfinance. In addition, partner MFPs will be encouraged to write and distribute articles and information beyond the usual reports they already produce.

Counter negative sentiments. MISFA will develop materials that explain issues that are not well understood or could become controversial. For example, interest charged on loans, why women are the majority of microfinance clients, etc.

V*isibility and transparency.* In order to ensure a high level of visibility and transparency and to promote a better understanding of microfinance among the public, regular country specific communication activities will be undertaken. Efforts will be made to focus on changing needs and strategies in Afghanistan.

MISFA's Communications Unit

MISFA will strengthen its communications unit to have the capacity to produce press releases, articles, reports, issues papers, poster sand brochures as well as maintain a useful website. This unit will have the main responsibility to develop and disseminate the communication tools to different stakeholders. IN addition to producing materials, the unit will maintain good relations with the media and will provide training and awareness building for microfinance service providers. The unit will be headed by a Communications Specialist who will have previous work experience in print/media, strong communication and writing skills with a degree in communications/journalism. The Communications Specialist may be an Afghan or expatriate. In addition, the department will also have a Communications Officer who will be an Afghan, with strong communication/writing skills and the ability to network with local media persons.

Target Groups

The target groups for MISFA's Communication activities are presented in the below table:

Target Groups	Key Messages/Issues	Example means of communication/Tools
Government Institutions and Authorities in Afghanistan	• Client success stories/impact of microfinance • Geographical outreach of MFPs • Growth in access to credit by poor households • Sustainability of MFPs – why MFPs charge higher interest?	• Newsletter • Website • Monthly sector update including geographical outreach of MFPs
Donors in Afghanistan	• Client success stories/ impact of microfinance • Growth in access to credit by poor households • Empowerment of women • Funding needs of the sector	• Quarterly donor report • Website • Newsletter • Monthly sector update, including a brief fact-sheet on Afghan microfinance sector
The general public	• Why microfinance? • Client success stories/impact of microfinance • Islamic compliance of microloans • Sustainability of MFPs –	• Newsletter • Website • Press releases in local print media (Hewad, Anis, Kabul Times) • Radio/TV interviews with MFPs and their clients

Target Groups	Key Messages/Issues	Example means of communication/Tools
	why MFPs charge interest? • Geographic distribution of clients and portfolio	• Video films on microfinance
Media in Donor Countries	• Client success stories/ impact of microfinance • Growth in Access to credit by poor households • Impact of microfinance on the lives of the poor • Empowerment of women • Success stories • Microfinance in the South? - regional distribution of resources	• Website • Newsletter • Video films of microfinance clients • International Press briefings/visit by journalists
MISFA and MFP employees in Afghanistan	• Different Loan products to the employees • Afghanistan Statistics • Event taking place in Microfinance • News, Afghanistan Statistics, MFP profiles, Information on MF. • Success stories	• Access to more information on sector by any kind of publication distribution.

Tools

Website. All the publications are placed on the website, including the latest updated information, details of any jobs being advertised, Newsletters, Posters, success stories, background information about MISFA, and press releases. The website address is www.misfa.org.af.

Press releases. Press releases in English, Dari and Pashto will be distributed to MISFA's partners, government institutions in Afghanistan as well as donors, Afghan media, and ACBAR (for dissemination to INGOs and NGOs).

Newsletter (English and Dari). MISFA publishes a bi-monthly Newsletter that includes a brief profile of microfinance partners, special event or news, an MFP case study, microfinance sector statistics, and other useful information. The newsletter is widely circulated through email and hard copies are being distributed as well.

Responding to the requests from the media. MISFA will respond positively to requests from the media for interviews or articles.

Brochure and posters. The MISFA brochure will be updated occasionally and posters that advertise microfinance activities will also be developed and disseminated. and

Partner MFP communication materials. MISFA will collect publicity/communications materials (newsletters, videos, photographs, etc.) from partner MFPs and distribute them more widely.

Afghan media and information channels. MISFA already has a good connection with will expand this to include a wide variety of other media channels throughout Afghanistan.

Technical Annex 11: Safeguard Policy Issues

AFGHANISTAN: Expanding Microfinance Outreach and Improving Sustainability

Introduction

Scaling up microfinance outreach has been included as an important development strategy under the Afghanistan National Development Strategy and is consistent with the Interim Strategy Note for Afghanistan. Since 2003 the World Bank has provided funding to MISFA through the Afghanistan Reconstruction Trust Fund and has been closely involved in the development of MISFA.

The IDA grant funds (US$ 30 million) provided to Government of Afghanistan will be passed on to MISFA through a subsidiary agreement between Government of Afghanistan and MISFA. The funds would be in the form of a long term loan to MISFA that MISFA would in turn loan to microfinance service providers under already established criteria and based on business plans that have been negotiated with and approved by MISFA. Differently structured loans from MISFA to MFPs can be financed including debt products such as subordinate debt and quasi equity where needed. MFPs would in turn use the funds for on-lending to their microfinance clients, the majority of whom are women.

The objective of the project are to achieve a measure of commercial sustainability of Afghan microfinance service providers that have scaled up the outreach of financial services to help meet the needs and demands of many poor Afghans, especially women. Increased sustainability of microfinance service providers that have managed some level of diversification away from only donor and government funds should be achieved. A shift away from international MFPs to Afghan MFPs operating under Afghan laws and supervision is gained. Scaled up outreach is gained to many more poor people.

The EA Framework is prepared in accordance with World Bank EA OP4.01 and pertinent to the Afghan laws and regulations. The purpose of the EA Framework is to ensure that all activities that the micro loan supports are environmentally sound and are in compliance with requirements of pertinent Afghan laws and regulations as well as World Bank environmental policies, bearing in mind the characteristics of micro loans that support household level economies. By definition, micro loans require very short turn around time and transaction costs must be kept very low. As such 'subprojects' are limited to those that have no or little environmental impacts and therefore need no formal EA.

MISFA will assume overall responsibility for compliance with pertinent Afghan laws and regulations on environmental protection and with the requirements of the World Bank. For this purpose, MISFA will take necessary steps to encourage environmental due diligence during project implementation. Commitment to ensuring environmental soundness should be included in the cooperation agreement between MISFA and the MFPs. In order to do this MISFA will include in its contracts with MFPs requirements related to environmental procedures that will be

agreed between MISFA and the World Bank. The following basic environmental requirements form the core of this framework:

- MFPs will conduct its activities with due regard to environmental factors and the principles of environmentally sound and sustainable development.
- MFP operations will comply with the World Bank's FI Environmental Exclusion List.
- Operations supported by MFP funds shall comply with the applicable health, safety and environmental regulations and standards.
- MFPs will provide periodic environmental reports to MISFA.

In consideration of the fact that the environmental issues involved in the project are generally clear and insignificant, the environmental management of the project is relatively simple and a totally separate environmental management system is not necessary. An environmental management system which is embedded in the project management system and makes full use of existing project management resources will be established.

MISFA will appoint one member of its Technical Services Department as an Environmental Focal Person to be responsible for the implementation of the agreed EA framework. At the MFP level, a person will also be designated to be responsible for environmental protection. MISFA will ensure that the MFPs have access to professional EA advice in case there is a need for this. Environmental laws and regulations in Afghanistan are evolving and are not yet adequate. All the same, the National Environmental Protection Agency (NEPA) has developed a few laws and regulations to ensure environmental soundness of the rehabilitation and development activities and projects in the country. Expertise can be sought from this source if necessary.

MISFA will take necessary steps to ensure that MFPs put in place environmentally sound policies and procedures to enable credit officers and other staff to adhere to the pertinent Afghan laws and regulations governing environmental screening, assessment and reporting in the process of credit appraisal and administration. The main tool to be used by MFPs is a 'subprojects' exclusion list that will be developed to guide credit officers in their loan decisions. A suggested environmental screening procedure is contained in this annex.

Afghan Laws and Regulations

The current Afghan laws and regulations on environmental protection mainly deal with construction projects and manufacturing industries. The supplementary local regulations also cover services and trade, with direct applicability to subprojects targeted by the MSE finance project.

Article 14 of the Environmental Assessment Law (Article 14) relates to larger projects, not those financed by micro loans. The 'subprojects' under this microfinance project will have only minor environmental impacts.

World Bank Policies

The World Bank operations policy (OP 4.01) requires that " For a financial intermediary (FI) operation, the Bank requires that each FI screen proposed subprojects and ensure that sub borrowers carry out appropriate EA for each subproject." The Bank policies also require that "In appraising a proposed FI operation, the Bank reviews the adequacy of country environmental requirements relevant to the project and the proposed EA arrangements for subprojects." This requirement was not designed for microfinance projects with hundreds of thousands of micro loans at the household economy level. So it has been applied more generally to other microfinance apex projects such as PKSF in Bangladesh and PPAF in Pakistan. These projects follow similar procedures to those described above.

Process for Implementation of Environment Safeguards

It is recognized that incorporating environment issues as a mainstream part of the core business of microfinance service providers is a process that can begin early on in the project but will take time. MFPs are not yet sophisticated organizations with the capacity to be able to understand all the implications of this. In addition, it will take time and considerable effort to institutionalize environment principles and practices. While it is clear that MFPs share World Bank values about the importance of environmental concerns, they will need to develop ways to express these values as a part of their mainstream business model that is focused on sustainability, efficiency and lowering costs to poor clients.

Staffing: MISFA will appoint one person (50% time or full time determined by need) in the Technical Services Department to be the focal person for environment and safety issues. MFPs will designate one of their existing staff persons to be their focal person. This will be done in the first year by larger MFPs with the small MFPs doing it as they develop the capacity to do this.

Terms of reference: Terms of reference for the focal points will be written. These will focus on the need for clear strategies, training and awareness building, systems for the use of negative lists, and reporting.

Reporting: A system for reporting at the MFP and MISFA level will be developed.

In order to begin to introduce this system, at the beginning of the first year of the project MISFA will engage the services of a consultant. This consultant should be a microfinance expert with good knowledge of environment issues in microfinance programs. In order to help guide the consultant, the World Bank team will share examples of mainstreaming environment concerns in other microfinance projects, especially those where addressing environment issues is a core part of the business plan of microfinance service providers and makes a positive contribution to their business. The consultant will:

- Write terms of reference for the focal points in collaboration with MISFA and the MFPs.
- Define training and awareness building activities to be undertaken.
- Develop a reporting system that is both useful to and feasible for all concerned.

- Finalize the negative lists after reviewing microfinance activities in the field, considering what has been done in other World Bank funded projects, and reviewing the applicability of Afghan laws. Also, develop systems for the introduction and use of the negative lists.

The World Bank supervision team will review progress during the first full supervision mission for this project.

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

Ineligible Activity Lists

1. Involves the significant conversion or degradation of critical natural habitats. Including, but not limited to, any activity within:

- Ab-i-Estada Waterfowl Sanctuary;
- Ajar Valley (Proposed) Wildlife Reserve;
- Dashte-Nawar Waterfowl Sanctuary;
- Pamir-Buzurg (Proposed) Wildlife Sanctuary;
- Bande Amir National Park;
- Kole Hashmat Khan (Proposed) Waterfowl Sanctuary.

2. Will significantly damage non-replicable cultural property, including but not limited to any activities that affect the following sites:

- monuments of Herat (including the Friday Mosque, ceramic tile workshop, Musallah complex, Fifth Minaret, Gawhar Shah mausoleum, mausoleum of Ali Sher Navaii, and the Shah Zadehah mausoleum complex);
- monuments of Bamiyan Valley (including Fuladi, Kakrak, Shar-I Ghulghular and Shahr-i Zuhak);
- archaeological site of Ai Khanum;
- site and monuments of Ghazni;
- minaret of Jam;
- mosque of Haji Piyada/Nu Gunbad, Balkh province;
- stupa and monastry of Guldarra;
- site and monuments of Lashkar-i Bazar, Bost;
- Archaeological site of Surkh Kotal.

3. Requires:

- political campaign materials or donations in any form;
- weapons including (but not limited to), mines, guns and ammunition;
- chainsaws;
- pesticides, herbicides and other chemicals;
- investments detrimental to the environment;
- motorized extraction of groundwater;2
- involuntary land acquisition under any conditions;
- any activity on land that is considered dangerous due to security hazards or the presence of unexploded mines or bombs;
- any activity on land or affecting land that has disputed ownership, tenure or user rights.3
- any activity that will support drug crop production or processing of such crops.

4. In addition to the above general list, the following negative list is added from the IFC exclusion list:

- Production or trade in any product or activity deemed illegal under host country laws or regulations or international conventions and agreements.
- Production or trade in alcoholic beverages.
- Gambling, casinos and equivalent enterprises.
- Trade in wildlife or wildlife products regulated under CITES.
- Production or trade in radioactive materials.
- Production or trade in or use of unbonded asbestos fibers
- Purchase of logging equipment for use in cutting forest.
- Production or trade in pharmaceuticals subject to international phase outs or bans.
- Production or trade in pesticides/herbicides subject to international phase outs or bans.
- Fishing in the marine environment using electric shocks and explosive materials.
- Production or activities involving harmful or exploitative forms of forced labor/harmful child labor.
- Commercial logging operations for use in primary tropical moist forest.
- Production or trade in products containing PCBs.
- Production or trade in ozone depleting substances subject to international phase out.
- Production or trade in wood or other forestry products from unmanaged forests.
- Production, trade, storage, or transport of significant volumes of hazardous chemicals, or commercial scale usage of hazardous chemicals.
- Production or trade in any product or activity deemed illegal under host country laws or regulations or international conventions and agreements.
- Production or trade in alcoholic beverages (excluding beer and wine).
- Gambling, casinos and equivalent enterprises.
- Production or trade in or use of unbonded asbestos fibers.

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[2] Indiscriminate installation of irrigation wells using motorized extraction of ground water have in some areas contributed to lower the ground water table, and constitute a threat to the traditional sustainable irrigation by *karez*. Until water resource assessments of a particular catchment area or basin has been undertaken and has established that irrigation is feasible, investments in motorized irrigation wells is not permitted.

[3] Thus, investments involving an expansion of the command area of an irrigation system can only take place with agreement from the owners (or users in case of tribal common land) of the land brought under new irrigation.

- Production or trade in products containing PCBs

Social Issues

The microfinance project is not expected to have any negative social impact - on the contrary, it is expected to generate considerable positive social impact through provision of loans to the poorer section of the population and especially to women (the great majority of borrowers), who otherwise have extremely limited access to credit.

Social Safeguards. The project is not expected to trigger any of the WB safeguards policies. Involuntary land acquisition and any activity on land or affecting land which has disputed ownership, tenure or user rights are deemed ineligible. Permissible land transactions will be based on willing buyer - willing seller principle only.

A negative list also excludes any activity which will damage non-replicable cultural property, and in case of chance finds the procedures to be followed are defined in the Law on the Preservation of Afghanistan's Historical and Cultural Heritages (Official Gazette no. 828, 1383/02/31), specifying the authorities and responsibilities of cultural heritage agencies if sites or materials are discovered in the course of project implementation. This law establishes that all moveable and immovable historical and cultural artifacts are state property.

MISFA is a national level program and thus does not exclude any region/ethnic group - although security concerns may temporarily prevent project activities in certain districts. MFPs do not target beneficiaries on the basis of ethnic/religious etc. characteristics, but equity in impact across various social categories will have to be monitored during project implementation.

Gender Mainstreaming. The majority of MFP clients are women and the project will monitor what the loans are invested in, how they affect the households' economic situation as well as the impact on the (female) borrower's position in the family in terms of influence (decision making), expanding economic activities/income and mobility. Hereby the MFPs will identify project constraints and shortcomings and be able to adjust interventions and consolidate the positive impact especially on the female clientele through facilitating linkages to suitable skills development opportunities, and other relevant inputs. In particular, links should be forged with other WB funded projects such as the National Emergency Rural Access Project, the Horticulture and Livestock Project and NSP which have project activities/components targeting women and where significant synergy can be promoted.

Technical Annex 12: Project Preparation and Supervision

AFGHANISTAN: Expanding Microfinance Outreach and Improving Sustainability

	Planned	Actual
PCN review	12/14/2006	12/14/2006
Initial PID to PIC	01/05/2007	01/15/2007
Initial ISDS to PIC	01/05/2007	01/15/2007
Appraisal	07/23/2007	07/23/2007
Negotiations	11/05/2007	11/05/2007
Board/RVP approval	01/08/2008	01/08/2008
Planned date of effectiveness	01/15/2008	01/15/2008
Planned date of mid-term review	05/15/2009	
Planned closing date	07/30/2010	

Key institutions responsible for preparation of the project:

Microfinance Investment Support Facility for Afghanistan (MISFA) and the Ministry of Finance.

Bank staff and consultants who worked on the project included:

Stephen Rasmussen	Task Team Leader	SASPF
M. Reazul Islam	Senior Private Sector Development Specialist & Country Officer, IFC	SASPF/IFC
Nazir Ahmad	ET Consultant	SASPF
Sheila Braka-Musiime	Counsel	LEGMS
Deepal Fernando	Senior Procurement Specialist	SARPS
Asha Narayan	Financial Management Analyst	SARFM
Mohammad Arif Rasuli	Environmental Specialist	SASES
Asta Olesen	Senior Social Development Specialist	SASES
Maria Majorie Espiritu	Program Assistant	SASPF
Rahimullah Wardak	Procurement Analyst	SARPS
David Freese	Senior Finance Officer	LOAGS
Kenneth Okpara	Senior Financial Management Specialist	SARFM
Martin Serrano	Counsel	LEGMS
Nargis Yousaf	Financial Management Analyst	SARFM
Rubina G. Quamber	Team Assistant	SASPF
Niraj Verma	Financial Specialist	SASPF
Parwana Nasiri	Team Assistant	SASPF/IFC
Bikki Randhawa	Sr. Financial Specialist	CSMFP
Syed Mesbahuddin Hashemi	Sr. Private Sector Development Specialist	CGAP
Momina Aijazuddin	Sr. Investment Officer	IFC
Jennifer Isern	Lead Microfinance Specialist	CGAP
K.R. Ramamoorthy	Consultant	

Technical Annex 13: Documents in the Project File

AFGHANISTAN: Expanding Microfinance Outreach and Improving Sustainability

A. Bank Staff Assessments

World Bank: Project Identification Mission, December 10, 2006
World Bank: Project Pre-Appraisal Mission, February 19, 2007

B. Other

MISFA Memorandum of Association, July 10, 2003
MISFA Article of Association, July 10, 2003
MISFA Midterm Review, October 18, 2006
MISFA Appraisal of Intermediaries, February 2007
MISFA Operations Manual, May 2007

Technical Annex 14: Statement of Loans and Credits

AFGHANISTAN: Expanding Microfinance Outreach and Improving Sustainability

			Original Amount in US$ Millions						Difference between expected and actual disbursements	
Project ID	FY	Purpose	IBRD	IDA	SF	GEF	Cancel.	Undisb.	Orig.	Frm. Rev'd
P102288	2007	NSP II	0.00	0.00	0.00	0.00	0.00	123.18	0.00	0.00
P098256	2006	AF: Hort. & Livestock Project	0.00	0.00	0.00	0.00	0.00	18.99	-2.00	0.00
P098118	2006	Afghanistan: Natural Resources Devt	0.00	0.00	0.00	0.00	0.00	28.54	-0.65	0.00
P087860	2006	Urban Water Sector	0.00	0.00	0.00	0.00	0.00	41.97	0.00	0.00
P089040	2005	Strengthening Higher Education Program	0.00	0.00	0.00	0.00	0.00	37.06	-0.42	0.00
P088719	2005	AF Investment Guarantee Facility	0.00	5.00	0.00	0.00	0.00	3.91	1.97	0.00
P084736	2005	Public Admin Capacity Building Project	0.00	0.00	0.00	0.00	0.00	17.09	9.81	0.00
P083964	2005	Education Quality Improvement Program	0.00	0.00	0.00	0.00	0.00	30.31	-0.84	0.00
P083919	2005	Kabul Urban Reconstruction Project	0.00	25.00	0.00	0.00	0.00	24.63	8.89	0.00
P084329	2004	Emergency National Solidarity Project	0.00	0.00	0.00	0.00	0.00	5.59	-70.11	0.00
P083908	2004	Emergency Power Rehabilitation Project	0.00	105.00	0.00	0.00	0.00	113.98	46.84	0.00
P083906	2004	Emergency Customs and Trade Facilitation	0.00	31.00	0.00	0.00	0.00	9.53	3.36	0.00
P083720	2004	AF: Emergency Communications Development	0.00	22.00	0.00	0.00	0.00	6.77	3.51	0.00
P078936	2004	AF: Emer Irrig Rehab	0.00	40.00	0.00	0.00	0.00	20.16	18.64	1.80
P082472	2003	Natn'l Emergency Emp. Prog for Rural	0.00	20.40	0.00	0.00	0.00	2.54	0.12	0.00
P078324	2003	Afghanistan Health Sector Emergency Reha	0.00	0.00	0.00	0.00	0.00	36.61	0.00	-6.52
P078284	2003	Emergency Transport Rehabilitation	0.00	108.00	0.00	0.00	0.00	24.56	-29.48	0.00
		Total:	0.00	356.40	0.00	0.00	0.00	545.42	- 10.36	- 4.72

AFGHANISTAN
STATEMENT OF IFC's
Held and Disbursed Portfolio
In Millions of US Dollars

		Committed				Disbursed			
		IFC				IFC			
FY Approval	Company	Loan	Equity	Quasi	Partic.	Loan	Equity	Quasi	Partic.
2006	Areeba Afg. LTD	40.00	5.00	0.00	0.00	0.00	0.00	0.00	0.00
2003	FMBA	0.00	0.85	0.00	0.00	0.00	0.85	0.00	0.00
2006	FMBA	3.50	0.00	0.00	0.00	0.00	0.00	0.00	0.00
2004	TPS (A)	0.00	0.00	7.00	0.00	0.00	0.00	7.00	0.00
	Total portfolio:	43.50	5.85	7.00	0.00	0.00	0.85	7.00	0.00

		Approvals Pending Commitment			
FY Approval	Company	Loan	Equity	Quasi	Partic.
	Total pending commitment:	0.00	0.00	0.00	0.00

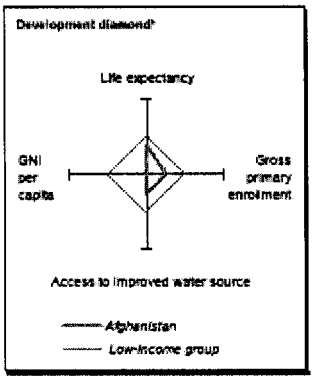
Technical Annex 15: Country at a Glance

AFGHANISTAN: Expanding Microfinance Outreach and Improving Sustainability

Afghanistan at a glance

1/5/07

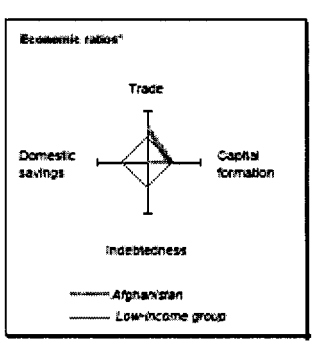
POVERTY and SOCIAL	Afghanistan	South Asia	Low-income
2005			
Population, mid-year *(millions)*	..	1,470	2,353
GNI per capita *(Atlas method, US$)*	..	634	580
GNI *(Atlas method, US$ billions)*	7.0	1,005	1,364
Average annual growth, 1999-05			
Population *(%)*	..	1.7	1.9
Labor force *(%)*	2.3	2.1	2.3
Most recent estimate (latest year available, 1999-05)			
Poverty *(% of population below national poverty line)*	..	..	..
Urban population *(% of total population)*	24	29	31
Life expectancy at birth *(years)*	45	63	59
Infant mortality *(per 1,000 live births)*	165	66	80
Child malnutrition *(% of children under 5)*	..	45	39
Access to an improved water source *(% of population)*	40	84	75
Literacy *(% of population age 15+)*	29	60	62
Gross primary enrollment *(% of school-age population)*			
Male	54	110	104
Female	..	116	110
	..	105	99



KEY ECONOMIC RATIOS and LONG-TERM TRENDS

	1985	1995	2004	2005
GDP *(US$ billions)*	..	..	6.0	7.3
Gross capital formation/GDP	..	..	31.1	25.0
Exports of goods and services/GDP	..	..	11.5	12.4
Gross domestic savings/GDP	..	..	-13.1	-18.2
Gross national savings/GDP	..	..	-13.1	-18.2
Current account balance/GDP	..	..	1.4	-1.0
Interest payments/GDP	..	..	..	..
Total debt/GDP	..	..	..	..
Total debt service/exports	5.7	..	..	..
Present value of debt/GDP	..	..	..	..
Present value of debt/exports	..	..	..	..

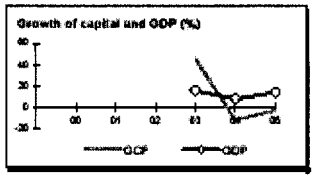
	1985-95	1995-05	2004	2005	2005-09
(average annual growth)					
GDP	..	..	8.0	14.0	..
GDP per capita	..	..	..	..	..
Exports of goods and services	..	..	-2.8	31.4	..

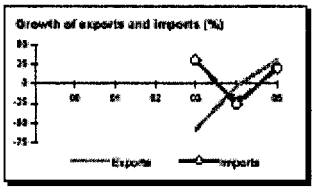


STRUCTURE of the ECONOMY

	1985	1995	2004	2005
(% of GDP)				
Agriculture	..	..	37.2	36.1
Industry	..	..	24.4	24.5
Manufacturing	..	..	15.8	14.9
Services	..	..	38.3	39.4
Household final consumption expenditure	..	..	104.0	109.6
General gov't final consumption expenditure	..	..	9.1	8.6
Imports of goods and services	..	..	55.7	55.7

	1985-95	1995-05	2004	2005
(average annual growth)				
Agriculture	..	..	-17.1	11.3
Industry	..	..	32.4	16.4
Manufacturing	..	..	21.5	10.0
Services	..	..	34.6	14.3
Household final consumption expenditure	..	..	-5.0	20.3
General gov't final consumption expenditure	..	..	-7.7	14.0
Gross capital formation	..	..	-11.9	-2.7
Imports of goods and services	..	..	-25.7	20.9



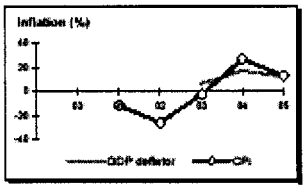


Note: 2005 data are preliminary estimates.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

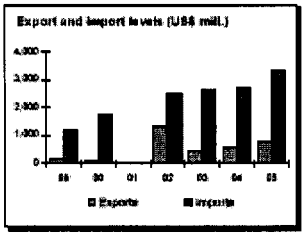
PRICES and GOVERNMENT FINANCE

	1985	1995	2004	2005
Domestic prices				
(% change)				
Consumer prices	..	..	26.7	12.7
Implicit GDP deflator	..	..	17.0	11.9
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	..	9.5	9.9
Current budget balance	..	..	0.1	1.1
Overall surplus/deficit	..	..	-0.7	0.1



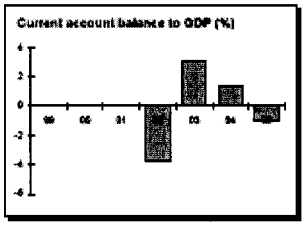
TRADE

	1985	1995	2004	2005
(US$ millions)				
Total exports (fob)	..	..	592	755
Fresh fruits	..	..	..	..
Dried fruits	..	..	..	..
Manufactures	..	..	..	..
Total imports (cif)	..	..	2,713	3,280
Food	..	..	..	..
Fuel and energy	..	..	..	..
Capital goods	..	..	..	..
Export price index (2000=100)	..	..	..	..
Import price index (2000=100)	..	..	..	..
Terms of trade (2000=100)	..	..	..	..



BALANCE of PAYMENTS

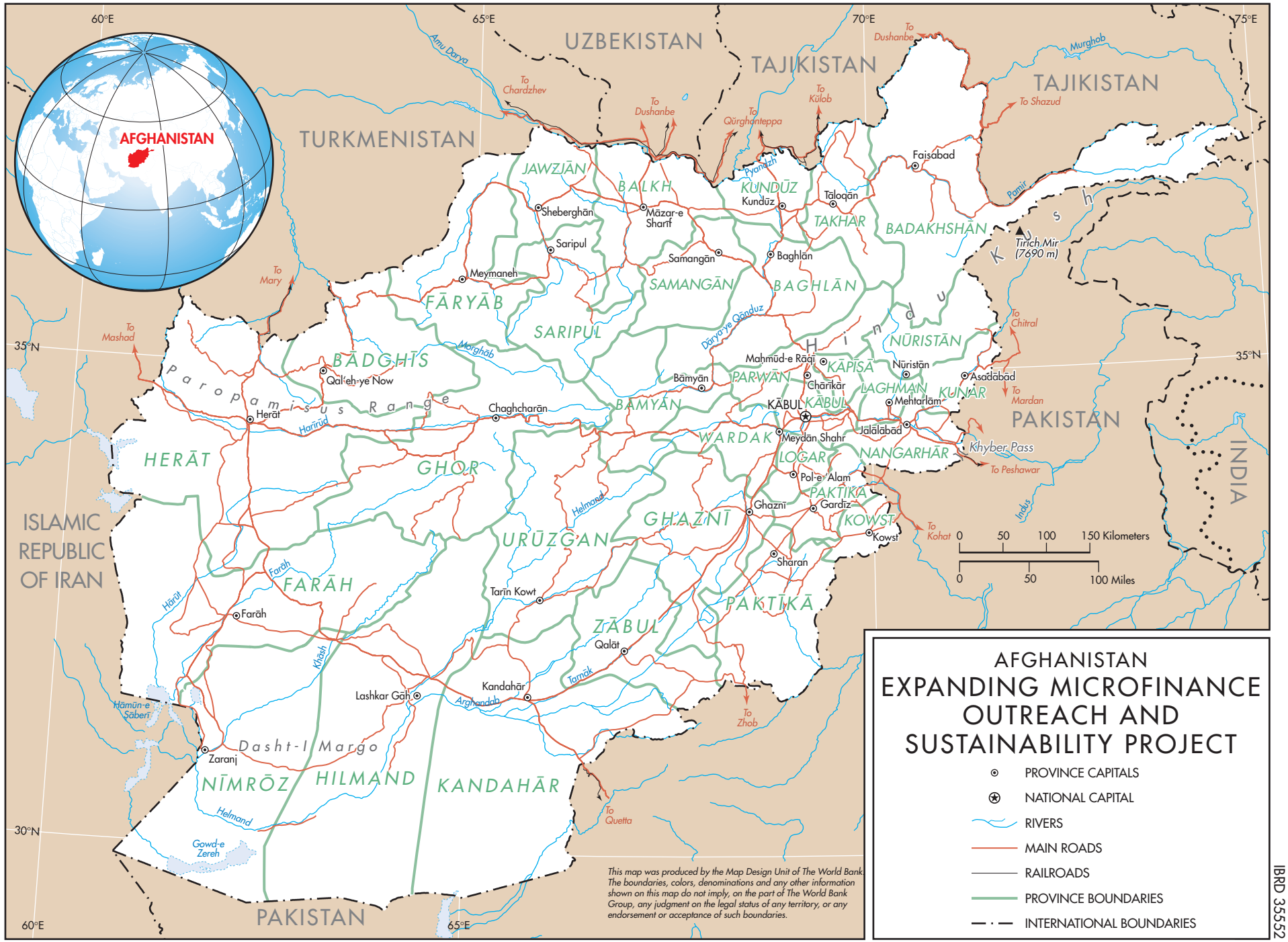
	1985	1995	2004	2005
(US$ millions)				
Exports of goods and services	668	..	1,720	1,705
Imports of goods and services	1,076	..	4,432	4,849
Resource balance	-408	..	-2,712	-3,144
Net income	21	..	8	27
Net current transfers	..	..	2,787	3,048
Current account balance	..	..	83	-70
Financing items (net)	..	..	381	448
Changes in net reserves	-26	..	-464	-378
Memo:				
Reserves including gold *(US$ millions)*	611	..	1,293	1,662
Conversion rate *(DEC, local/US$)*	50.6	..	47.8	49.7



EXTERNAL DEBT and RESOURCE FLOWS

	1985	1995	2004	2005
(US$ millions)				
Total debt outstanding and disbursed	2,274	5,619	..	..
IBRD	0	0	..	..
IDA	0	0	..	..
Total debt service	47	89	..	..
IBRD	0	0	..	..
IDA	0	0	..	..
Composition of net resource flows				
Official grants	..	..	..	..
Official creditors	210	0	..	..
Private creditors	0	0	..	..
Foreign direct investment (net inflows)	..	..	..	..
Portfolio equity (net inflows)	..	..	..	..
World Bank program				
Commitments	0	0	..	..
Disbursements	0	0	..	..
Principal repayments	0	0	..	..
Net flows	0	0	..	..
Interest payments	0	0	..	..
Net transfers	0	0	..	..

The World Bank Group: This table was prepared by country unit staff; figures may differ from other World Bank published data. 4/5/07


AFGHANISTAN
AFGHANISTAN
EXPANDING MICROFINANCE OUTREACH AND SUSTAINABILITY PROJECT
PROVINCE CAPITALS
NATIONAL CAPITAL
RIVERS
MAIN ROADS
RAILROADS
PROVINCE BOUNDARIES
INTERNATIONAL BOUNDARIES
UZBEKISTAN
TURKMENISTAN
TAJIKISTAN
ISLAMIC REPUBLIC OF IRAN
PAKISTAN
INDIA
JAWZJĀN
BALKH
KUNDŪZ
TAKHAR
BADAKHSHĀN
FĀRYĀB
SAMANGĀN
BAGHLĀN
SARIPUL
BĀDGHĪS
HERĀT
GHOR
BĀMYĀN
PARWĀN
KĀPISĀ
NŪRISTĀN
LAGHMĀN
KUNAR
KĀBUL
WARDAK
LOGAR
NANGARHĀR
GHAZNĪ
URŪZGĀN
PAKTIKA
KOWST
FARĀH
ZĀBUL
PAKTĪKĀ
NĪMRŌZ
HILMAND
KANDAHĀR
Paropamisus Range
Hindu Kush
Dasht-I Margo
Amu Darya
Murghob
Panir
Harīrūd
Morghāb
Helmand
Farāh
Hārūt
Khāsh
Tarnak
Arghandab
Indus
Khyber Pass
Gowd-e Zereh
Hāmūn-e Saberi
Dar'yā-ye Qūnduz
Pyanj
Tirich Mir (7690 m)
Sheberghān
Māzar-e Sharīf
Kundūz
Tāloqān
Faisabad
Saripul
Samangān
Baghlān
Meymaneh
Qal'eh-ye Now
Herāt
Chaghcharān
Bāmyān
Mahmūd-e Rāqī
Chārīkār
Nūristān
Asadābād
Mehtarlām
KĀBUL
Jalālābād
Meydān Shahr
Pol-e Alam
Ghaznī
Gardīz
Kowst
Sharan
Tarīn Kowt
Farāh
Qalāt
Lashkar Gāh
Kandahār
Zaranj
To Dushanbe
To Chardzhev
To Dushanbe
To Qürghanteppa
To Külob
To Shazud
To Mary
To Mashad
To Chitral
To Mardan
To Peshawar
To Kohat
To Zhob
To Quetta
60°E
65°E
70°E
75°E
35°N
30°N
0 50 100 150 Kilometers
0 50 100 Miles
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JUNE 2007
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