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AFGHANISTAN CASE STUDY: REVITALIZING A FINANCIAL SECTOR AFTER SUSTAINED CONFLICT

AMAP KG ECONOMIC RECOVERY AMID CONFLICT CASE STUDIES

microREPORT # 116

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INTRODUCTION

As countries emerge from armed conflict, they are often faced with the challenge of rebuilding a financial sector destroyed by years of sustained violence. A functioning financial system is a crucial component of the reconstruction process as it is one of the most efficient development tools to revive an economy, create jobs and promote economic growth. In these countries, enterprises of all sizes, confronted with pervasive poverty and limited employment opportunities, have the potential to provide livelihoods and incomes for various segments of the population. Working at all levels through a variety of access to finance initiatives, donors and development organizations have tried to address targeted poverty alleviation while promoting the development and growth of micro, small and medium enterprises for broad-based economic growth and sustained economic development.

AMAP KG

USAID's Accelerated Microfinance Advancement Project (AMAP) Knowledge Generation (KG) research on Microfinance Amid Conflict[1] began in 2003 with a focus on identifying best practices among microfinance organizations in conflict countries. This was later expanded to amine particular populations impacted by war, specifically youth. The focus of research during the last two years of the project is the role of microfinance within broader economic recovery efforts after conflict. Economic recovery is a broad umbrella of activities that tries to capture the full gamut of programming that has an economic objective. This spans short-term and often relief-like activities such as grants or in-kind support for basic livelihoods to more long-term oriented activities such as establishing commercial banks or support to potentially competitive industries.

As part of this broader agenda on economic recovery, the AMAP KG conducted a series of workshops and discussions with practitioners and donors working in conflict affected contexts. Participants at the workshops agreed that there were undocumented examples from the field that could provide valuable lessons to the larger community. To learn more about these efforts, focusing specifically on linkages with financial services, AMAP KG issued a call for nominations for case studies. Two programs in Afghanistan--Child Fund Afghanistan Microfinance (CFA MF) and the Afghanistan Rural Finance Corporation (ARFC)--were selected for further investigation and are profiled here. These projects illustrate the effects of working at different levels of enterprise financing in post-conflict settings. CFA is an example of an MFI that was built on a community-based model but which transitioned into a sustainable financial institution, with strong community ties and a sustained

[1] See www.microlinks.org for more information on this research.

vision to serve marginalized groups. ARFC takes a very different approach to economic recovery, focusing on high growth SMEs which can create sustainable jobs. ARFC works with and uses linkages with a variety of non-financial programs to strengthen the SMEs with which it works and to increase the financial and social impact of the broader aid agenda.

First, this microREPORT provides background information on the country context for financial sector development in Afghanistan. It is followed by a case study of CFA MF, highlighting its transformation from a community-based model to a sustainable institution that serves disadvantaged groups. The second case study details ARFC's financing and support of small and medium enterprises as well as linkages to other USAID-funded programs. Each case study begins with a description of the project, followed by a summary of lessons learned.

BACKGROUND ON AFGHANISTAN

The fall of the Taliban in late 2001 ushered in an era of reconstruction and rehabilitation for Afghanistan. Afghanistan had been devastated by 25 years of warfare, which began with a bloody communist coup in 1978. Using the country as a pawn in the Cold War with the U.S., the Russians invaded Afghanistan one year later. Over one million Afghan civilians and combatants were killed during the occupation, and after Russian withdrawal in 1989, the country descended into ten years of civil war fueled by warlords, which further decimated the country. The Taliban, a term meaning "students" referring to the those attending religious schools, (madrasas) and adhering to the Wahhabi teachings promulgated by Saudi Arabia, seized Kabul in 1996 and instituted an oppressive regime, curtailing individual freedoms and perpetrating human rights violations. The American-led invasion of Afghanistan after the September 11th attacks finally ousted the Taliban in 2001.

The ethnic, tribal and religious makeup of the country is complex but the importance of these various factors has ebbed and flowed over the years. In its original nation-state status dating as far back as 1747, Afghanistan was predominantly a Pashtun country made up of various Pashto tribes. In the 19th century, as the new territorial borders were defined, the Pashtun were split between British India (now Pakistan) and Afghanistan. This territorial shift reduced the Pashto population of the country to approximately half of the population. Under the reign of Abdur Rahman Khan (1880–1901), non-compliant minorities such as the Hazara and the Nurastani groups were targeted and the Pashto ethnic group was forcibly moved throughout the country to limit and curtail regions of the country that had large minority pockets. The Pashto groups interspersed with other minorities were given privileges such as access to pastures in Hazara-dominated regions of the country, reinforcing the inequity among the various groups.

The ethnic make-up of Afghanistan is reflective of its geographic location, with all ethnic groups of its neighbors represented in the country. Ethnic groups include Pashtun, Tajik, Hazara, Uzbek, Aimak, and Turkmen. The map below provides a visual of where the various ethnic groups reside in the country. The majority of these groups are Sunni Muslim, with the Hazara the only Shi'ite group in the country. Given the complexity of Afghanistan's history and geo-political wars, readers are encouraged to reference other sources for a more thorough understanding of the country. One excellent account of the history of the conflict is provided by the International Crisis Group.[2]

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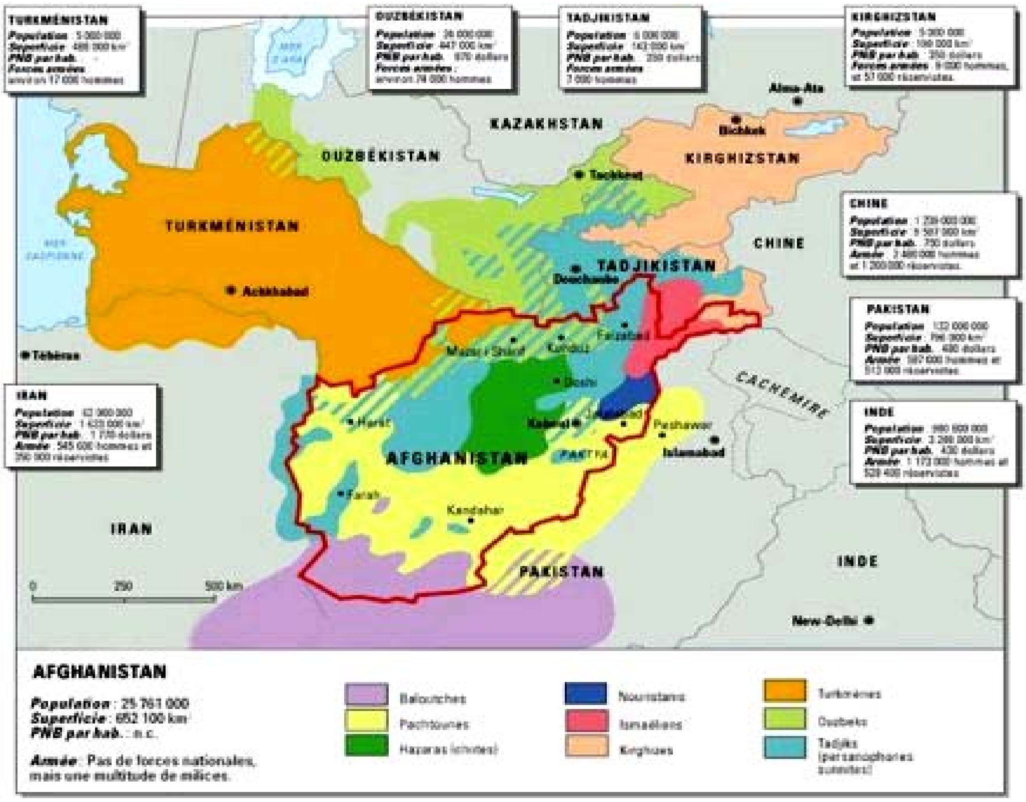
[2] http://www.crisisgroup.org/home/index.cfm?action=conflict_search&l=1&t=1&c_country=1



Source: Le Monde Diplomatique, January 2000

At the time of the American invasion, more than half of the population lived in dire poverty with little hopes of employment in an economy dominated by the opium trade and black market activities. The Taliban defeat prompted millions of Afghan refugees, the majority of them destitute, to return to their homeland, putting additional pressure on the nascent government and weak economy. The formal financial sector had collapsed, and Afghanistan's private sector was virtually nonexistent. There were no operational financial institutions, and all financial intermediation was conducted through the informal system of traditional moneylenders, *hawala*. As donors and development organizations arrived to support the revitalization of the Afghan economy, rebuilding the financial sector became a priority.

As part of this process, the World Bank and the Government of Afghanistan established the Microfinance Investment Support Facility for Afghanistan Ltd. (MISFA) in 2003. As an apex facility, MISFA coordinated donor funding and supported the growth of the microfinance industry by providing funds to Afghan microfinance institutions (MFIs) for loan capital, operational support, and technical assistance. As a result, in a few short years, Afghanistan developed a thriving microfinance sector with 15 MFIs working throughout the country in 23 provinces and providing financial services to over 410,000 clients. This represents a very healthy outreach figure for any nascent industry, let alone a post-conflict environment with as many complexities as Afghanistan. According to MISFA, 600,000 jobs have been created as a result of microfinance loans.[3]

At the same time, the formal banking sector in Afghanistan has grown rapidly with donor funds and private sector support, and there are currently 15 commercial banks in operation, including 12 private sector banks. Donors such as USAID and the International Finance Corporation (IFC) are supporting the expansion of lending to small and medium enterprises (SMEs) through the commercial banking sector. The USAID-funded Agriculture, Rural Investment and Enterprise Strengthening (ARIES) project is working through MISFA to set up SME lending windows in a number of banks. In addition, non-bank financial institutions such as the Afghanistan Renewal Fund, the Small Enterprise Assistance Fund, the Afghanistan Finance Company, and the ARFC are also serving the SME sector.

Afghanistan's financial sector has expanded significantly despite an increasingly difficult security environment, but challenges remain as the sector continues to grow. War-torn Afghanistan has significant populations of disadvantaged groups, including returnees, internally displaced persons (IDPs), and disabled persons. With extremely high demand from more traditional microfinance clients, female and male entrepreneurs, MFIs have little incentive to reach out to remote locations and disadvantaged groups, which are perceived as more costly to reach. In addition, access to credit continues to be a major obstacle to the growth of SMEs and larger enterprises. Formal lending to these enterprises remains limited; few financial institutions are providing loans, which meet only a small percentage of the total demand. Commercial banks remain averse to SME lending, and their national outreach is limited to major urban areas.

CFA MF: INSTITUTIONAL PROFILE

CFA MF was founded in partnership with Christian Children's Fund (CCF/CFA), an affiliate of the international humanitarian aid organization CCF, Inc. CFA MF was registered as an independent MFI on June 2, 2007. As of August 2007, CFA MF has disbursed a cumulative total of 29,374 loans amounting to $6,729,478. Its active portfolio is currently 14,192 loans with an outstanding portfolio of USD $2,126,812 and compulsory savings deposits of USD $159,759. CFA MF is operationally sustainable* and provides group loans to economically active poor businessmen and women. The current average loan size is $150.

* Operational self-sufficiency is defined as covering all operational and financial costs. Please refer to the CGAP Consensus Guidelines for a detailed explanation of microfinance terms and definitions.

[3] Interview with Amjad Arbab in December 2007.

PART I: REACHING OUT TO DISADVANTAGED AND VULNERABLE GROUPS

PROJECT DESCRIPTION

Conflict affected countries like Afghanistan often host large numbers of disadvantaged and vulnerable persons, including returnees, refugees, IDPs, ex-combatants, and the disabled. According to Amnesty International, the total number of refugees and IDPs from and in Afghanistan by the beginning of 2003 was over 3.5 million and 700,000 respectively. While non-governmental organizations (NGOs) often provide these groups with social and economic services through community development programs, making access to finance available to them can be more challenging.

Child Fund Afghanistan (CFA) began working in microfinance in September 2002 with seed money from Christian Children's Fund (CCF) and the United Nations High Commissioner for Refugees (UNHCR) to support carpet weavers in northwest Afghanistan. The majority of clients were returnees and IDPs from the UNHCR program. In 2003, the United Nations Assistance Mission in Afghanistan awarded a grant to CFA to work with three women's associations in Kunduz, Takhar, and Badakhshan. From 2003-2005, CFA worked to build the capacity of these women's associations to intermediate loans on its behalf.

EASING THE TRANSITION FOR RETURNEES

The Bibi family returned from Pakistan in 2005 after living as refugees for 18 years. After years of hardship in refugee camps, the family decided to return to Imam Sahib, where they have a small piece of land. Due to their extreme poverty and lack of family or community connections, the family struggled for survival after returning. The male family members took loans for carpet materials from suppliers or from moneylenders at very high interest rates. However, after receiving a loan from the CFA MF program, they were able to build a carpet-weaving business and now purchase materials directly at cost. The family includes disabled members who have benefited from the family's overall increased income due to the CFA MF loans. The family has worked with CFA MF for three years and plans to continue doing so, citing a strong, trusting relationship with their loan officer.

In 2005, CFA's microfinance program reassessed its approach of working with the women's associations, as its growth was limited, and it was unable to raise additional monies under this structure. After negotiating a loan with MISFA in 2005, CFA MF Ltd. became an independent organization working in coordination with Child Fund Afghanistan. CFA has three individuals on the board of CFA MF Ltd with three additional individuals from other organizations in Afghanistan. CFA acquired a loan from MISFA for $3.6 million for a 5-year term for on-lending in the north of the country. In order to reach both its financial and social objectives, CFA MF continued to work with vulnerable groups but also began reaching out to a broader client base and expanded its portfolio to ten districts in Kunduz, Takhar and Badakshan. It was clear to the organization that to achieve sustainability, greater outreach was required.

CFA MF is a distinct, for-profit, legal entity that is separate from Child Fund Afghanistan (CFA). This separation has allowed CFA MF to limit confusion in the community and with the populations that it serves. While CFA offers a variety of social service programs to vulnerable groups, CFA MF is marketed differently to the communities to ensure that there is a clear understanding that CFA MF is a business, as opposed to a social service agency.

One of CFA MF's main objectives continues to be "to improve the economic growth and well-being of families through sustainable access to financial services in support of income generating activities, especially targeted to women and at-risk groups like displaced persons, unemployed youth and returning former soldiers." CFA MF reaches these disadvantaged and vulnerable populations by working through the CFA Community Well-Being Committees (CWBCs) and leveraging trust in CFA communities. Each CWBC is comprised of 10-15 nity leaders from the village. The CWBC introduces CFA MF to the community and helps nate information about the microfinance program. In addition, the CWBC assists CFA MF to identify disadvantaged and vulnerable groups as well as actual residents within the community so that CFA MF does not give loans to IDPs or returnees who then relocate. The CWBCs also work with CFA MF to collect late payments by putting pressure on clients in arrears to repay loans.

CFA offers three group loan products, a Family Business Loan, a Winter Loan, and a Graduated Clients Loan--as well as Compulsory Savings. With its new model, CFA MF achieved operational self-sufficiency within three and half years, and its business plan calls for achievement of full financial self-sufficiency[4] within five years. As of April 2008, CFA MF had 22,808 clients of which 21,135 were active loan borrowers. Fifty-four percent of its clients are female. CFA MF has grown to be the largest of the smaller MFIs, and the fifth largest MFI in the country. It has achieved this while maintaining excellent portfolio quality. Portfolio at risk of more than 30 days comprises only 2% of the portfolio.[5]

CFA MF is well aware that its cost structure is higher than its competitors given the remote regions it covers and the focus on vulnerable populations. It is continually looking for ways to improve its efficiency in order to compensate for the higher cost structure related to adhering to its mission. It estimates that approximately 30 to 40% of its portfolio is focused on vulnerable clients which have average loans of less than $100. As a cost balancing strategy, CFA also focuses on urban areas where operational costs are lower and average loan sizes are higher, allowing it to reduce its average cost per loan.

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[4] This is defined as covering all operational and financial costs. Please refer to the CGAP Consensus Guidelines for a detailed explanation of microfinance terms and definitions.

[5] Portfolio at risk at 30 days is defined as the outstanding value of loans with arrears of 30 days or more. Please refer to the CGAP Consensus Guidelines for a detailed explanation of microfinance terms and definitions.

With its origins focusing on the displaced populations of northern Afghanistan, the communities where CFA operates are those with large numbers of IDPs or returnees. While ethnic conflict has been and continues to be a major issue in the Afghan landscape, ethnically based violence is less prevalent in the northern region of the country where the organization is based. The predominant ethnic groups are Tajiks, Uzbeks and Pashtuns. The security related incidence in the north have revolved around the international presence or Afghan institutions that reinforce this presence, with periodic attacks against the German base which is near Kunduz, or police installations. There have been several suicide bombings as well, all linked to the international military presence as opposed to ethnically based violence. This violence has had an impact on the organization, nonetheless, in that movement is often curtailed when and if attacks on convoys occur. This makes loan collection and processing difficult for the organization. In 2007, more than 10 clients were impacted by the violence in the region. To minimize the impact on the families of victims of this violence as well as to protect its portfolio, CFA MF introduced an insurance product which it manages internally. Each loan requires the purchase of insurance for 0.05% of the loan amount. The insurance pays out the balance of any outstanding loans that a client may have as well as the client's savings balance to the family.

GROWING A FAMILY BUSINESS

After returning from Tajikistan in 2004, the Mahgul family began a small home-based business tailoring chapans, a traditional coat worn over clothes during the winter months. The skill had been passed onto Qurban, the father from his grandfather, who had also tailored chapans. Women in the family worked with the men to produce chapans, but due to the high cost of borrowing to purchase raw materials, their profit remained limited to 20 Afs per chapan. Since receiving a CFA MF loan, they now make 80 Afs per chapan and are able to purchase the raw materials directly from the producers. In addition, other women in the neighborhood are now working with the family and production has increased. They are also expanding the business to produce other products such as bed covers, pillow covers, and wall hangings.

Unlike many MFIs which do not assess whether they reach vulnerable or poor groups, CFA MF tracks inclusion of vulnerable clients through its standard loan application form, which allows the program to set a baseline for all clients. Forty-two percent of CFA MF's clients are considered disadvantaged (defined as a refugee, IDP, widow, disabled, ex-combatant, or returnee). Of these groups, 11% are IDPs and 14% are returnees. Loan officers and management state that for the most part there is no difference in repayment rates between vulnerable and non-vulnerable clients. Information on vulnerability is currently only tracked at the application stage and is not entered into the electronic management information system. However, CFA MF plans to integrate data on disadvantaged and vulnerable groups into its new MIS system which will be adopted this year. In addition, it plans to conduct a social impact assessment in order to evaluate outreach and impact on vulnerable groups.

LESSONS LEARNED:

While many NGOs operating in post-conflict environments work with disadvantaged and vulnerable groups such as IDPs, returnees, the disabled, and former combatants, the majority of them do so through the provision of training and grant-making programs. Microfinance programs targeting these groups often find themselves to be unsustainable since it can be difficult to expand from such narrow market segments. However, CFA MF has been able to transition successfully from a typical

NGO model to a sustainable MFI. Through this transition, it continues to reach out to disadvantaged and vulnerable groups by leveraging the community contacts of the NGO, but at the same time, it is able to address its sustainability goals by reaching the broader population groups in the regions it operates. As a result, the CFA MF experience provides lessons to NGOs and MFIs seeking to serve disadvantaged and vulnerable groups in post-conflict settings while maintaining broader goals of institutional sustainability, growth, and outreach. CFA MF has been able to retain its vision to reach the vulnerable by retaining strong community linkages, but has at the same time commercialized is operations in order to reach its sustainability goals.

- **Reaching Vulnerable Populations**: Globally, MFIs that adhere to the double bottom line by meeting both social and financial targets directly target vulnerable and disadvantaged groups by utilizing specific eligibility criteria, or they use indirect methods such as product features and services tailored for a certain group. For example, by limiting loan sizes and requiring weekly payments, some MFIs are targeting poor individuals as those with other opportunities would not be interested or attracted to such requirements. Microfinance programs, however, which focus only on a narrow market segment are rarely financially and institutionally sustainable as the volume of lending would be too small to cover costs.[6] Qualification for access to financial services includes a client's ability to repay a loan and manage a business which may or may not coincide with their status as a disadvantaged or vulnerable group. While it is incorrect to assume that a disability lowers a client's ability to repay a loan, it is conversely incorrect to assume that vulnerability by itself should qualify a client for a loan. MFIs must apply the same discipline and selection criteria to all clients, regardless of special needs or conditions in order maintain the double bottom line. CFA has applied this lesson well in its operations and as such has been able to reach economically active vulnerable groups who are able to manage economic activities and repay their loans. Portfolio quality for its vulnerable clients is as strong as it is for its non-vulnerable clients demonstrating that the organization has been able to properly select its clients and is not indebting individuals who do not have the ability to repay.

- **Retaining its mission during a transition from a community-based approach to a sustainable MFI:** CFA MF began as a project within an NGO using humanitarian assistance funding to channel loans to vulnerable clients. This is a standard model in many conflict affected environments, but it is rare to find institutions evolving into sustainable entities without disregarding their original mission. Its initial small-scale activities allowed CFA to gain the

[6] For additional information on financial and institutions sustainability, please visit www.microfinancegateway.com for numerous articles and publications on microfinance. In brief, financial sustainability refers to covering all financial and operational costs and institutional sustainability refers to creating an institution with sound systems, governance, management, staff capacity, pricing and overall business model to sustain operations in the long-term.

trust of the communities with which it works and build a core team of dedicated and well-trained staff. As a result, CFA MF had the foundations on which it could build an independent financial services provider. As CFA MF developed and grew, it continued to rely upon the social ties CFA created in the communities as a source for identifying clients and expanding coverage. While CFA MF has begun working with more mainstream microfinance clients for its marketing and outreach, it is well known for its community-based roots and has been able to continue focusing on vulnerable clients and communities. Retaining the mission has been an important aspect of its evolution. The organization has been able to do this mainly by a governance structure that reinforces the mission as well as a focus on product development that is geared toward low-income groups. For example, at one stage the organization considered introducing a larger individual loan product which was considered one method to help it achieve sustainability faster. The board rejected this product, as it felt that larger loans will move the organization away from its core target market. One of the clear advantages that CFA MF has achieved by starting small and building its institution over time is that it is one of the few sustainable programs in Afghanistan today. It has also received the least amount of subsidy from MISFA. While MISFA and others in the microfinance community would highly praise this fact, CFA MF management has questioned whether a more institutional model, as opposed to a community model at its start up, would have allowed it to capture more of MISFA's subsidies in the longer-term allowing it to invest in systems and capacity building. By the same token, management acknowledges that over time the organization has benefited greatly from humanitarian funds that were channeled to Child Fund Afghanistan and which helped offset the costs of the microfinance component.

- **Building community respect and trust:** Through its many community-based activities, such as the Child Wellbeing Committees established by CFA, CFA MF has built trusting relationships with community members and clients, which is particularly important for vulnerable groups. CFA MF enters communities where CFA has been active and where community links are already strong. It introduces its financial operations through these Child Wellbeing Committees as well as through meetings with community elders. CFA MF is careful to differentiate its organization from the NGO in order to ensure that the community understands that it is a commercial entity and not a relief organization. This is achieved through a different organizational structure and legal status, name, staffing, office location and other basic features. CFA MF loan officers explain the aspects of the loan program in detail to the community members, and a Quality Assurance Officer follows up with clients to verify that they understand and agree to the loan repayment process. Clients in Kunduz and Imam Sahib cited their relationships with the CFA loan officers as the reason for their on-going cooperation with CFA. They criticized competitor loan officers as aggressive, inflexible, and corrupt in some instances.

- **Utilizing community connections to reach vulnerable clients:** CFA MF built on strong community connections through its relationship with the CFA's Child Wellbeing Committees, which introduce CFA MF to the community and assist them in outreach to disadvantaged and vulnerable individuals. Since the NGO is serving the very poor and working in rural and urban areas, CFA MF is able to penetrate communities which its competitors do not reach. CFA MF selects communities that include a high concentration of returnees, IDPs and other traditionally vulnerable clients. While ethnic violence is a problem in other parts of Afghanistan, it is not a major destabilizing factor for the areas in which CFA MF operates. It has focused its growth in a geographically concentrated area allowing it to reap financial benefits and efficiencies from the foundations it has already built. After achieving operational sustainability in these communities, it is now prepared to expand into other geographic areas, always using its sister organization and founder, CFA, as a link to building community ties. By providing smaller loans, CFA MF also serves the lower-end of the market compared to its competitors, and thus has deeper outreach into very poor communities.

PART II: AFGHANISTAN: LINKING SME GRANTS AND NON-FINANCIAL SERVICES WITH FINANCE

Building linkages across economic recovery programs in conflict countries is an important feature on which this case study series is focusing. The following case moves away from linkages at the micro-enterprise level to look at linkages between grant programs and credit programs as well as between financial services and non-financial services at the SME level. While some of the lessons for SMEs differ from the micro-enterprise level, they nonetheless provide useful insight on designing appropriate interventions that further the overall economic recovery agenda in conflict affected countries.

FINANCE AND KNOWLEDGE TOGETHER MAKE A DIFFERENCE

Bashir Refinery and Recycling, a Jalalabad-based business producing edible oil and soap from cotton seeds, is expanding into plastic recycling and rope production. The company presses cotton seed for edible oils and uses the residue to make soap. It is adding a plastic crushing line, with plastic sourced from Dubai and Kabul. Plastic is crushed and is used to produce rope. Currently all rope available in the market is imported from Iran and Pakistan, with no domestic production.

The firm received two grants from ASMED for its plastic recycling equipment. It has also received support from ASMED on its business plan and research on recycling, particularly competitors in Pakistan. The firm has 22 employees and its business plan calls for an expansion to 70 once the plastic recycling is fully operational. Demand is expected to be high based on market research.

The business will borrow from ARFC on Islamic terms. The owner has already invested over $200,000 in the business and is using his various properties worth over $2 million as collateral on the loan.

PROJECT DESCRIPTION

Afghan Rural Finance Company (ARFC) is a wholly-owned financial company established by ACDI/VOCA, a U.S.-based private voluntary organization (PVO). ARFC was capitalized with a grant from the USAID Agriculture, Rural Investment and Enterprise Strengthening (ARIES) Project. ARIES is a rural finance and enterprise development project managed by the Academy for Education Development and is a consortium of U.S. PVOs and contractors. MISFA, the local microfinance wholesaler, is also part of the consortium. ARIES began in September 2006 and scheduled to end in September 2009.

ARIES is designed to use finance as a catalyst for the promotion of rural jobs and enterprises. The project has assisted in the creation of numerous rural credit cooperatives and finance companies, expanded the branches for several microfinance organizations and created an SME lending window within MISFA. ARIES is structured to complement other USAID initiatives in Afghanistan which offer technical assistance to SMEs and other enterprises, most notably the Alternative Livelihoods Program (ALP) and the Afghanistan Small and Medium Enterprise Development (ASMED) project. Many of USAID supported programs, particularly the ALP, is focused on providing Afghan rural populations alternative economic opportunities that are not reliant on poppies. ARFC is one of the investment vehicles created under ARIES, a nimble structure that allows for quick response to SMEs and rural cooperatives' lending needs.

ARFC was established in February 2007 as a limited liability company headquartered in Kabul, Afghanistan. The board is comprised of ACDI/VOCA personnel and two Afghans, one from a local NGO and the other from the Ministry of Rural Rehabilitation and Development. A team of seven Afghans and three expatriates cover the entire country, building linkages and coordinating closely with other USAID-funded projects and organizations. ARFC does not maintain separate branch offices, although it has worked through an Afghan company, Southern Development, which originated and serviced loans on its behalf in the past. Most recently, ARFC has focused on originating loans internally utilizing its relationships with other USAID projects for leverage. In the past, ARFC based short-term personnel within the offices of other U.S. government-funded projects to improve coordination and help source SMEs as potential clients.

ARFC's loan portfolio was $15 million as of December 2007. The finance company is seeking additional capital from private investors. Its current commitments are $9.17 million, but demand is high and its management sees capital as the biggest obstacle to its continued growth. It maintains a word-of-mouth marketing strategy so as not to raise expectations of SMEs until it is able to secure additional capital.

ARFC lends to a variety of rural SMEs, tailoring its products to the needs of its clients. It offers either traditional or Islamic financing[7] options at effective rates of 10-12% annual interest.[8] Rates are structured based on risk and the collateral available. Loans can be a maximum value of 80% of a specific investment with the owner(s) offering the remaining value of the investment. In some instances, grants offered through other USAID or donor initiatives are accepted as the owner's contribution. In fact, ARFC often intermediates with other USAID projects on behalf of owners to negotiate a grant package to improve the financial viability of the enterprise and in turn increase returns on ARFC's investment.

As of May 31, 2008, ARFC has loans outstanding to 31 SMEs in all regions of the country covering Kabul, Nangahar, Parwan, Balkh, Herat, Kunduz, Faryab and Helmand. While security around the country varies considerably, ARFC does not believe that security has prevented its investments or that of Afghans starting SMEs. The risk-reward is currently very high in Afghanistan and firms understand this. To minimize their risks, many of the SMEs with which ARFC works have operations in either Pakistan or Dubai which can pick up production should security curtail production in Afghanistan.

Loans and financing structures set in place are tailored to the business needs of clients, allowing ARFC to be a unique financial services player in the Afghan market. Loans range from $4.3 million to a pomegranate juice factory in Kabul to $20,000 for a poultry business in Helmand. About 80% of all loans are sourced through other USAID projects, while others are sourced through word of mouth or through USAID directly.

In addition to its strong relationships with USAID-funded projects, ARFC has also branched out is cooperation to the banking sector and is negotiating with Afghanistan International Bank (AIB) and Standard Chartered to co-finance SMEs when opportunities arise. This would allow each partner to diversify the risk of their portfolios and would

CAPTURING A MARKET OPPORTUNITY

Al Riyaz Packaging, a newly created business in Jalalabad expected to begin operations in February 2008, will be the first packaging company in the eastern region. The company will produce wooden carts and cardboard boxes, with raw materials sourced from Pakistan, China and Iran.

Al Riyaz was founded by a former distributor of cartons who is relying on this network to generate contracts. Like other ARFC investments in the Jalalabad area, Al Riyaz has benefited from technical assistance provided by ALP and ASMED. ALP helped with developing the company's business plan, negotiating labor training, and providing a consultant on marketing. ALP also sent the owner to a trade show in Herat.

The company currently has 12 workers and will expand to 33 by the end of December 2007. Al Riyaz has borrowed $100,000 from ARFC with a four year term. The owner has contributed $116,000 of his own funds for the construction of the plant and purchasing of equipment. The company's first year sales are expected to be $655,000 increasing to over $1 million by its third year of operations.

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[7] Islamic finance is a system of financing that follows Shari'a, Islamic scripture. Islamic products must be sanctioned by appropriate religious institutions to be Shari'a compliant. Pure Islamic finance is essentially based on risk sharing principles. For more on Islamic finance, please see the forthcoming publication by CGAP at www.cgap.org on Islamic finance.

[8] Islamic loans offered by ARFC use a standard "mark-up" as opposed to a fixed interest rate. This is called the "Murabaha" loan.

further allow banks, which have higher regulatory requirements, to finance larger projects which may be above set limits.

Despite the heavy operational costs for security, expatriate packages and transport across the country, ARFC has achieved 55% operational self-sufficiency after only 12 months of operations. It is expected to cover all of its operational costs by September 2008. All profits generated from lending are reinvested into the capital base of the organization.

LESSONS LEARNED

There are more SMEs in Afghanistan today than at the end of the conflict in 2002, and the numbers continue to grow. Anecdotal evidence from the SMEs receiving financing from ARFC indicates that a large number of employment opportunities have been created by SMEs. This is particularly true in the eastern region of the country, an area where ARFC has been heavily engaged and where cooperation between ARFC and USAID's other initiatives, ALP and ASMED, is quite strong. ARFC estimates that over 40,000 jobs or income earning opportunities have been created through its investments.[9] Although at this stage it is difficult to measure the exact reason for the increase in the number of SMEs, many in the development community cite the availability of financing as a major catalyst[10] and development assistance projects such as ASMED and ALP providing non-financial services can all be cited as catalysts for enterprise creation and expansion. Without a controlled scientific study, it would be difficult to attribute greater economic activity to USAID projects, however, there is broad-based acknowledgement that there is clear progress in the number of enterprises operating in the country and a greater sense of opportunity. This case study is not intended as an evaluation of ARFC nor does it measure its overall financial and institutional effectiveness. However, there are some clear lessons that emerge which may be relevant in other post-conflict environments.

- **Institutional structure can influence speed and flexibility of delivery:** Originally, ACDI/VOCA intended to establish its more traditional structure--rural cooperatives which would be supported through an apex structure.[11] For a variety of reasons, this evolved into the creation of one finance company, ARFC, instead. Under this structure, activities could begin immediately. As an alternative to specialized financing vehicles with foreign ownership, some suggest the use of incentives for domestic banks to lend to SMEs. While this can work well, and to a certain extent has been working in Afghanistan, this alternative is less flexible and takes time to achieve, considering the low capacity of partner banks. The ARIES project addresses both the immediate needs of SMEs with ARFC and the longer-term political objectives of domestic ownership by encouraging local banks to lend to SMEs. The lesson here is that both models have relevance depending on the context at hand. In some instances, the political imperative is to inject resources into the market. In others, it may be to demonstrate investments in the capacity of local institutions. ARIES, as the umbrella project, has been large enough to do both. The structure is only one aspect of the formula, however, as ARFC has not been as quick to extend its outreach to other regions of the country, which have experienced less coordination and linkages with other USAID projects. Sources interviewed for this case identified personality conflicts or management that did not see value in coordination as the main reason why coordination has not been as extensive throughout the country.

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[9] ARFC report to USAID as of May 31, 2008.

[10] Note that while Afghanistan is considered more unstable today for many in the aid community, it is generally considered safer for Afghans. More than 5 million returns have occurred since 2002 mainly from Iran and Pakistan according to UNHCR.

[11] An apex is a body that serves as a wholesaler or technical assistance provider for institutions within its network. MISFA, for example, is an apex institution for MFIs in Afghanistan.

- **Grants and loans can work together if properly structured:** There has been a lot of discourse in the financial services community about the use of grants and loans, particularly in conflict affected countries. At the micro-level, most practitioners have advised against mixing these two instruments as it confuses clients and may be a disincentive to repay loans. The operating best practice principle, as noted above with CFA MF, is that social services or any form of subsidized programming should be distinctly separate from financial services. For ARFC, which focuses on SMEs, the principle continues to hold. All grants or subsidies are offered through other USAID projects such as ASMED and ALP and ARFC is distinctly separate from these projects. Firms are well aware that a loan must be repaid and the formality with which ARFC structures deals, from its collateral requirements to its frequent monitoring of its clients, confirms this understanding among clients. The combination of grants and loans is perceived as a benefit rather than a disincentive for repayment for ARFC as it strengthens the financial health of the firm and enhances its ability to repay the loan. Key informants interviewed for this case study indicated that when structured well and relatively small in scale as compared to the loan, grants serve as a catalyst for additional investments. Approximately 80% of ARFC's clients have received grants from another USAID project operational in the country. Repayment rates have been 100% since inception with 70% of clients prepaying ahead of the due date. Other countries, such as Georgia, have also benefited from coordinated grant and loan programs at the SME level.[12]

- **Project collaboration can help achieve goals:** One of the most unique aspects of ARFC's work is its linkages with USAID and other donor projects. Strong coordination is most highly evident in the eastern region of the country with two USAID funded projects – ALP-East and ASMED – projects managed by Development Alternatives Inc. These linkages have helped develop stronger SME partners, more bankable business plans, and less risky investments for ARFC. USAID has been a major driver behind the collaboration. This has been perceived as both positive, when the collaboration makes sense and is well designed, and negative, adding a level of burden to an already complex management structure. USAID requires that the various partners report on their collaboration in monthly reports. Collaboration is an elusive goal that many in the development community speak highly of, but rarely achieve. The formula for successful collaboration seems to include the right mix of personalities, an effective driver (in this case, the USAID Cognizant Technical Officer), a perceived shared interest, and perhaps a bit of luck.

- **Timing and sequencing matters:** Research for this case study took place in December 2007, a full five years after the cessation of hostilities. It is natural to ask if this relative success could have been possible immediately after the war or if the sheer passing of time had something to do with it. Afghanistan has received considerable USAID and other donor funding in the past five years. Some credit must be attributed to the precursor initiatives which have painstakingly worked with SMEs, creating a pipeline of firms with sufficient capacity to absorb financing for significant expansion. Precursor projects have most visibly assisted ARFC through the creation of SMEs as well as through the training of personnel which have been able to join ARFC and quickly take on high levels of responsibilities. Of note is the USAID precursor rural support program called Rebuilding Agriculture Markets Program (RAMP). Other financial institutions, such as the Afghanistan Investment Bank (AIB) or many of the others banks currently active in Afghanistan have been a good source of staff when ARFC began recruiting for Afghan loan officers.

- **There is room for multiple models to address different financial needs:** One of the recurring themes of discussion for USAID as well as others working in conflict countries is the issue of lending to SMEs or focusing on the vulnerable or those most impacted by war. Many argue that larger firms have greater impact on jobs creation and in turn the economic growth of a country. The belief is that benefits would trickle down to the poor as more investments are made in SMEs and larger firms. While there is no refuting the argument that SMEs can be significant actors in the economic revitalization process, there is also undeniable evidence that different models can reach different market segments and that each can serve a different need. While ARFC has been able to support the creation or sustainability of over 40,000 jobs through 31 loans to SMEs,

[12] FINAGRO in Georgia is an institution created by ACDI/VOCA which partnered with Mercy Corps, a non-profit organization which provided grants to SMEs. Grants represented 30% of an investment with loans from FINAGRO covering the remaining 70%.

microfinance providers supported by MISFA have reached nearly half a million borrowers throughout Afghanistan, sustaining as many livelihoods. Would clients of organizations such as CFA MF have benefited from SME lending through the trickledown effect? It is highly unlikely that they would have. The idea that one firm-level is priority over another is too narrow for the myriad needs of post-conflict environments.

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