

**RURAL FINANCE IN
AFGHANISTAN
AND
THE CHALLENGE OF THE
OPIUM ECONOMY**

**Report on a Two-day Workshop
Kabul, Afghanistan
December 13-14, 2004**

Mohammad Ehsan Zia

Deputy Minister, Ministry of Rural Rehabilitation & Development, Afghanistan

David Radcliffe

Development Adviser, British Embassy Drugs Team (Afghanistan)

Christopher Ward

Consultant, The World Bank

William Byrd

Adviser, The World Bank

Karri A. Goeldner

Consultant, Department for International Development (UK)

Renate Kloppinger-Todd

Rural Finance Adviser, The World Bank

Samuel Maimbo

Financial Sector Specialist, The World Bank

David Mansfield

Consultant, Department for International Development (UK)

Douglas Pearce

Team Leader, Financial Sector Team, Department for International Development

Stephen Rasmussen

Lead Social Development Specialist, The World Bank

Erick Zeballos

Rural Livelihoods Adviser, Department for International Development (Afghanistan)

July 2005

This report is dedicated with respect and gratitude to the memory of the late

Steven Blair MacQueen

1964-2005

**who served the cause of the Afghan people through his pioneering contribution
to the setting up of the Microfinance Investment Support Facility for
Afghanistan (MISFA)**

About the SASPR Working Paper Series

The purpose of the SASPR Working Paper Series is to provide a quick outlet for sharing more broadly research/analysis of issues related to development in South Asia. Although the primary source of such research/analysis is SASPR staff, other contributors are most welcome to use this outlet for rapid publication of their research that is relevant to South Asia's development. The papers are informal in nature and basically represent views/analysis of the concerned author(s). All papers submitted for publication are sent for an outside review to assure quality. I provide only a very light editorial touch. For enquiries about submission of papers for publication in the series or for copies of published papers, please contact Naomi Dass (telephone number 202-458-0335).

Sadiq Ahmed
Sector Director
South Asia Poverty Reduction and Economic Management
World Bank, Washington D.C.

LIST OF ACRONYMS

ADB	Asian Development Bank
AFR	Agricultural Finance Revisited
AKDN	Ag Khan Development Network
ALCU	Association of Lithuanian Credit Unions
ARC	Afghanistan Reconstruction Company
AREU	Afghanistan Research and Evaluation Unit
BDS	Business Development Services
BRAC	Bangladesh Rural Advancement Committee
CDC	Community Development Council
CDD	Community Driven Development
CECAM	Caisse d'Epargne et de Credit Agricole Mutuel
CGAP	Consultative Group to Assist the Poorest
CND	Counter Narcotics Directorate (now Ministry of Counter Narcotics)
CRALS	Creating & Restoring Alternative Livelihood Sources
DAB	Da Afghanistan Bank
DAI	Development Alternatives Inc.
DFCU	Development Finance Corporation of Uganda
DFID	Department for International Development (UK)
EU	European Union
FATF	Financial Action Task Force
FAO	Food and Agriculture Organization
FCO	Foreign and Commonwealth Office (UK)
FIU	Financial Intelligence Unit
FMFB-A	First National Microfinance Bank – Afghanistan
FSU	Former Soviet Union
GOA	Government of Afghanistan
GTZ	Gesellschaft fur Zusammenarbeit (German technical assistance agency)
IFC	International Financing Corporation
IFDC	International Fertilizer Development Corporation (an International Center for Soil Fertility & Agricultural Development)
ILO	International Labor Organization
ING	Dutch commercial bank
IMF	International Monetary Fund
KAFC	Kyrgyz Agriculture Finance Corporation
LCCU	Lithuanian Central Credit Union
MAAH	Ministry of Agriculture and Animal Husbandry
MFI	Micro-finance Institution
MISFA	Microfinance Investment Support Facility for Afghanistan
MRRD	Ministry of Rural Rehabilitation and Development
NBFI	Non-bank Financial Institution
NDCS	National Drug Control Strategy
NEEP	National Emergency Employment Programme
NGO	Non-governmental Organization
NLC	Network Leasing Corporation
NSP	National Solidarity Programme
ODA	Official Development Assistance
OTF	A US private consulting firm
PAL	Project on Alternative Livelihood Program
PEP-MENA	Private Enterprise Partnership for Middle East and North Africa
RAMP	Rebuilding Afghanistan's Agricultural Markets Programme
RSCC	Rural Savings and Credit Cooperatives
TA	Technical Assistance
RFP	Request for Proposals
UK	United Kingdom
UN	United Nations
UNDCP	United Nations International Drug Control Programme
UNODC	United Nations Office on Drugs and Crime
USAID	United States Agency for International Development
WB	The World Bank

Table of Contents

Introduction and Summary	1
Part I. The Workshop Report	4
Background: Combating Opium through Rural Finance	5
The Findings of the Workshop	10
What was Decided	16
Post-script to the Workshop: What has Happened Since	21
Part II. Workshop Papers	23
The Current Situation of Rural Finance in Afghanistan	23
<i>Steve Rasmussen (World Bank)</i>	
Roles and Opportunities for Rural Credit Initiatives in Afghanistan’s Opium Economy	29
<i>Karri Goeldner (DFID)</i>	
The Challenges of Regulating and Supervising the <i>Hawaladars</i> of Kabul	52
<i>Samuel Maimbo (World Bank)</i>	
Trends and Lessons from Global Experience	66
<i>Renate Kloeppinger-Todd (World Bank)</i>	
The Role of Opium as a Source of Informal Credit in Rural Afghanistan	75
<i>David Mansfield (DFID)</i>	
Annex	89
The Sessions of the Workshop	89

Boxes

Part I.

Box 1. The National Conference on Counter Narcotics (December 9/10, 2004).....	5
Box 2. A Range of Financial Products that can be Adapted to Clients’ Need.....	13

Workshop Paper No. 4

Box 1. KAFC of Kyrgyzstan.....	67
Box 2. Credit Unions in Lithuania – An Example of the Integrated Model.....	68
Box 3: Setting Up Financial Cooperatives in Russia.....	69
Box 4. Agricultural Bank of Mongolia.....	71
Box 5. Network Leasing Corporation Pakistan.....	72
Box 6. DFCU Leasing.....	72
Box 7. CECAM Madagascar.....	72

Workshop Paper No. 5

Box 1. Bonded Labor in Nad e Ali.....	79
Box 2. Jailed in Marja.....	82
Box 3. Threats from Khogiani.....	85

Table

Table 1. Commitments and Subsequent Actions.....	21
--	----

ACKNOWLEDGMENTS

The Workshop which served as the basis for this Working Paper was a joint effort by the Government of Afghanistan (in particular the Ministry of Rural Rehabilitation and Development), the Department for International Development of the UK, and the World Bank. The pro-active support of these institutions in making the Workshop a success is gratefully acknowledged. Particularly noteworthy was the engagement and leadership of H.E. Haneef Atmar, Minister of Rural Rehabilitation and Development. In addition to the authors of this paper, numerous individuals from these and other organizations contributed to the Workshop and provided inputs for the discussion. Anthony Fitzherbert (Alternative Livelihoods Advisor, MRRD) provided considerable guidance and support during the Workshop and facilitated numerous sessions. Shanthini Dawson (Advisor to the Minister, MRRD) was extensively involved in follow-up work to the Workshop. The paper has been processed by Juliet Teodosio.

It should be noted that all titles of persons listed in the paper refer to their titles at the time of the Workshop.

RURAL FINANCE IN AFGHANISTAN AND THE CHALLENGE OF THE OPIUM ECONOMY

Introduction and Summary

With the objective of developing rural finance and addressing the problem of opium debt, the Government of Afghanistan convened a two-day workshop on December 13-14, 2004 to discuss experience and put forward recommendations for enhancing the quality and outreach of the rural financial sector. The workshop, organized by the Ministry of Rural Rehabilitation and Development (MRRD) with support from the UK Department for International Development (DFID) and the World Bank, particularly focused on the challenges of the opium economy in relation to rural financial markets.

Opening the workshop, the Minister for Rural Rehabilitation and Development, H.E. Haneef Atmar, stated that “the issue of economic growth in rural areas is not just critical for poverty reduction, but also for the dignity of Afghans.” Minister Atmar stressed that the issue of narcotics could be disastrous for Afghanistan. He asked participants for their help in devising creative solutions.

Addressing many specialists in the field of rural finance from public agencies, non-governmental organizations (NGOs), commercial banks and international and bilateral development agencies, as well as representatives of farmers and agribusiness, Minister Atmar said that the poor in rural areas will remain marginalized unless the government comes up with concrete ideas and plans to offer real alternatives to opium debt.

During the opening session, the UK Ambassador to Afghanistan, Dr. Rosalind Marsden, said that “the UK is already working hard with the Afghan government and its international partners to help support the development of the Afghan economy and tackle the drugs problem, particularly to provide alternative livelihoods in poor, rural areas. The National Counter Narcotics Conference on December 9-10, 2004 called upon the international community to provide further assistance. Today's meeting, organized by MRRD with the assistance of the UK and World Bank, is looking at what more we can do to improve access to credit for farmers across Afghanistan and help break the opium debt cycle.”

The Country Manager for the World Bank in Afghanistan, Mr. Jean Mazurelle, said that “the government has launched a massive rural reconstruction effort which the World Bank and other donors are supporting. Rural finance is a key element in reviving the rural economy, and in supporting the robust and rapid economic growth essential for the country's development.”

Presenters from different organizations discussed current practices and challenges in rural finance and articulated options for promoting alternatives to Afghanistan's opium economy. The workshop emphasized the collective effort of the Government of Afghanistan and donors to strengthen ongoing national programs such as the

National Solidarity Program (NSP), Microfinance Investment Support Facility for Afghanistan (MISFA) and National Emergency Employment Program (NEEP).

The following steps forward were decided at the close of the workshop:

- The creation of a task-force, led by DFID and the World Bank to look at options for refinancing opium indebtedness. The task-force was also asked to look at ways to develop pilot programs and to scale up existing pilots.
- A study on supply chain financing, building on USAID's current Rebuilding Agriculture Markets Program (RAMP). DFID will complement the effort with a study on how to obtain preferential access to export markets for Afghan agricultural produce.
- Presentation of a plan by NSP, MISFA and NEEP to extend activities in the seven largest poppy producing provinces, to extend their coverage nationwide, and to develop linkages between their respective programs and rural finance at the field level.
- An options paper by the World Bank on ways to increase rural finance coverage.

Speaking at the conclusion of the workshop, Minister Atmar endorsed the recommendations and emphasized the need for prompt delivery of actions. Minister Atmar acknowledged the support from DFID and the World Bank in dealing with this important development issue.

Note: *This Workshop Report does not cover the most recent developments in rural finance, nor the 2004/05 eradication campaign and its implications.*

Part I. The Workshop Report

The Workshop

As part of its alternative livelihoods strategy, the Government of Afghanistan intends to “mainstream” counter narcotics objectives into its rural finance programs, with a particular focus on dealing with the opium and debt nexus, and a broader focus on financial capitalization of the rural economy nationwide. In preparation for this approach, the Ministry of Rural Rehabilitation and Development joined with DFID and the World Bank to hold a Rural Finance Workshop on December 13-14, 2004 in Kabul, Afghanistan. The workshop was intended to explore and address the issue of opium credit and indebtedness as well as the development of rural finance more generally and the role of national development programs in this regard. The objective was to identify what longer-term developments in rural finance are needed, what specific steps can be taken in the immediate future, and how synergies with other national development programs can be developed.

The Rural Finance Workshop was timely, as the Government was putting in place its alternative livelihoods program for 2005 as part of the wider drug control effort on which enormous national effort is now being focused. The Workshop was held immediately after President Karzai’s inauguration and after the National Conference on Counter Narcotics (December 9-10, 2004), at which the President announced that drug control was his first priority (see Box for an extract from the President’s speech). At the National Conference, Mr. Haneef Atmar, Minister of Rural Rehabilitation and Development, had argued that few benefit (“one Afghan in ten”) and many suffer from the opium economy, and that the country’s security is being surrendered for the benefit of the minority. The Minister had also described the undermining of the long-term sustainability of the rural economy, as tree crops are uprooted for short-term gain, and as the lion’s share of opium profits goes to landlords and downstream criminals, not to poor farmers, many of whom get locked into a debt and poverty cycle – “a new slavery”.

As a result of this extraordinary national focus on the drug control problem, the Rural Finance Workshop took place in a dynamic and pro-active context, in which participants and stakeholders expected not words but practical proposals and decisions.

This Workshop Report discusses first the background of the opium problem and its relation to rural finance. The Report then presents the findings of the Workshop and the decisions that were taken. A final section summarizes the actions that have been taken to follow up on the Workshop. The five formal papers presented at the Workshop are appended, and list the sessions of the Workshop and the participants attending.

Box 1. The National Conference on Counter Narcotics (December 9/10, 2004)

At the National Conference on Drugs on December 9-10, a united front of speakers (President Karzai, the Chief Justice of the Supreme Court, and the Ministers of Interior, Justice, Rural Rehabilitation, Education, Agriculture and Health) addressed all provincial governors, security chiefs, Loya Jirga members, donors, NGOs etc. President Karzai said:

“Poppy is like the Soviet occupation, Taliban, terrorism. If we do not fight it, it will devastate our land. It threatens our youth, it weakens our economy, it foments fundamentalism, it encourages foreign intervention. Poppy is like a cancer from within. I am ashamed of poppy in Afghanistan. The money goes abroad, only the shame remains within Afghanistan. What has caused the dignified people of Afghanistan to turn their pomegranate gardens into poppy fields? The causes are the Soviet invasion, foreign destruction of our economy, the loss of hope... We must not be parasites feeding off illegitimate sources. Please stop this disgrace! Are we inferior? If we are inferior, let us continue as parasites. We accept hunger and poverty, we do not accept dishonor. If we do not stop today, terrorism will return – this money goes to our enemies – it returns as bombs to Afghanistan. We will help ourselves – we stood against the Russians, we will stand against opium. The world will leave us if we are not decisive. Save our youth, our honor, our religion, our independence. Let us not trade our independence for poppy! We will destroy our poppy fields!”

Background: Combating Opium through Rural Finance

AFGHANISTAN’S OPIUM PROBLEM¹

The Afghan opium boom. In conditions of lawlessness and impoverishment, opium has become Afghanistan’s leading economic activity, accounting for one-third of total (opium-inclusive) GDP. Despite current attempts to stem it, the opium economy is expanding, driven by high prices and by rural poverty and debt, as well as by pressures from criminal networks. Production is now found in all of Afghanistan’s 34 provinces, and farmers harvested opium on a record area in the 2003/04 season.

Opium production. A large part of the Afghan population is benefiting from the production, processing and trafficking of opium. Overall, production may involve as much as 10 per cent of the total population. Some opium farmers are resource rich, but the majority are resource poor. Poppy cultivation is often required by sharecropping arrangements, so poor farmers involved in such arrangements have no choice but to cultivate poppy. Empirical evidence suggests that farmers’ motivations are part of complex and multi-faceted livelihoods strategies, and that there is a close connection between opium production and rural poverty.

Processing and trafficking. There is large interpenetration of the opium economy with local and central political interests, and large numbers of people gain from the profits, in a broad network of protection and pay-offs. Drug profits are clearly financing local warlords and much of the political elite, but also sustain the livelihoods of many quite poor people.

The political economy of the opium industry. The opium market more closely resembles a competitive market than a cartelized business. As a result there is likely to be a pattern of fragmented capture of the state apparatus at the local level and strong resistance to central

¹ The background information on Afghanistan’s opium problem is drawn from the report *Afghanistan’s Opium Drug Economy* by Christopher Ward and William Byrd, December 2004 (South Asia PREM Working Paper Series, Report No. SASPR-5, World Bank).

government control, making state-building extremely difficult. In the absence of law enforcement, an efficient and competitive drug industry will become increasingly embedded in local and regional power bases in many parts of the country. Opium has become increasingly “capitalized” in the rural economy and is distorting land and labor prices as well as urban real estate prices.

The macroeconomics of opium. World demand, particularly regional demand, is strong and the Afghan industry has the market structure, comparative advantage and factor availability to expand opium production considerably. Given the high margins, production is unlikely to diminish unless prices fall a long way. Production is also relatively “footloose”, and can migrate in the face of law enforcement. From an overall macro perspective, opium brings substantial benefits to Afghanistan, raising aggregate demand, boosting balance of payments and fiscal revenues, and acting as a coping mechanism for the poor.

FIGHTING OPIUM

Lessons from experience in fighting drugs. The size of the drug problem and Afghanistan’s limited resources suggest that counter-narcotics strategy should give priority to “interdiction”, that is to combating trafficking and processing as that is where the maximum harm is being caused. An interdiction-based strategy would also be likely to drive opium producer prices down at least in the short run, reducing the economic incentives for farmers to grow poppy. By contrast, a strategy that leads with “eradication” – destruction of the crop in farmers’ fields - would be likely, in the absence of alternatives, to pauperize the population and to create instability.

There is widespread agreement that programs are required to help rural people find alternative sources of livelihood. Some pilot “alternative livelihoods” programs are already producing valuable lessons, particularly that such programs have to be flexible and adapt to the specifics of household situations, that non-farm activities need a special focus, that a long-term approach is essential, and that building governance, responsible citizenship and the “social contract” also is very important. Law enforcement is also clearly needed and should be targeted to areas where programs have already palpably improved licit livelihoods. Production is indeed mobile and the problem is a national one. Fighting it cannot be done through small localized projects: the drug control effort has to be “mainstreamed” into the overall development effort.

Drug control is part of broader reconstruction and state building. Breaking the vicious circle of drugs, warlords, and insecurity, which is so inimical to Afghanistan’s state-building and reconstruction agenda, requires a multi-pronged approach. Drug control measures alone will not be effective. The response to the drug economy must occur within a broader strategic framework including state building, improving security and curbing warlords. In addition to drug control measures this framework includes (1) curbing warlords’ power; (2) building state capacity and resources; and (3) security sector reform and capacity-building. All of these efforts need to happen in a conducive environment for investment and economic growth, that will allow the drug economy and other forms of illegal activity to be eventually replaced by legitimate economic activities while ensuring that people’s licit incomes continue to grow during the process.

GOVERNMENT STRATEGY

Government strategy. The National Drug Control Strategy (NDCS), signed by President Karzai in 2003, targets a 70% reduction in opium production by 2008, and its elimination by 2013. The main mechanisms for implementation of the NDCS are an alternative livelihoods approach coupled with progressive enforcement of a cultivation ban, interdiction and prosecution of trafficking and processing, and forfeiture of drug-related assets.

The “alternative livelihoods” approach. Alternative livelihoods interventions combine short term rapid-impact interventions with a longer-term development approach. Recognizing that localized projects can achieve little impact, the Government has adopted “mainstreaming” as a central strategy, incorporating drug control objectives into nationwide development programs. The Government’s approach recognizes that many farmers are trapped in opium-related debt, and that investment and working capital is needed to start alternative activities to poppy cultivation. Rural finance thus occupies a central place in Government’s program. The Government’s alternative livelihoods strategy contains the following elements:

- A broad integrated approach to community and rural development, including the provision of community assets and services, and the development of local-level governance (including community institution building and the growth of responsible relations between communities and the government). Government programs under this heading include the **National Solidarity Program (NSP)**, which is helping set up elected Community Development Councils in communities across Afghanistan and providing block grants to finance local infrastructure projects within community development plans. Rural infrastructure, particularly roads, is being provided under the **National Emergency Employment Program (NEEP)**, which also provides short-term employment opportunities through labor-intensive cash-for-work contracts. Community health services and primary education programs are also reaching communities nationwide. The **National Area Based Development Program** provides small-scale infrastructure projects and capacity development support to the district *shuras* (councils) and Provincial Development Committees.
- A package of investments and services that offers alternative farming possibilities which address farmers’ real constraints and motivations defined in terms of income level, risk, and access to the means of production, including land and credit. A number of agricultural and irrigation development programs are underway, focused on rehabilitation of existing irrigation schemes and smaller works. Rural finance is being developed under a number of programs (see below), with a leading role in the development of rural microfinance being played by the **Microfinance Investment Support Facility for Afghanistan (MISFA)**.
- Development of the rural business environment and of downstream or off-farm businesses and jobs. For example, the USAID-supported **Rebuilding Afghanistan’s Agricultural Markets Program (RAMP)** is developing both external markets and internal processing, marketing and financing programs. The National Area Based Development Program will undertake feasibility studies to identify opportunities for economic regeneration.

The Government’s approach is to mainstream drug control objectives into these national programs, rather than setting up a multiplicity of special and local programs. There are, however, a number of small regional programs that are specifically targeting alternative livelihoods in the context of counter-narcotics. These include, among others, the INL-funded **Creating and Restoring Alternative Livelihood Sources (CRALS)**, operating in 10 districts in South Nangarhar, the Aga Khan Development Network (AKDN) program in Badakhshan, and the GTZ-financed

Project on Alternative Livelihoods Program (PAL), also operating in Nangarhar. Some of these programs are striving to take a more comprehensive approach within their respective areas of coverage.

RURAL FINANCE IN AFGHANISTAN

The rural finance market. Papers prepared for the Workshop (Rasmussen, Goeldner, Mansfield) document the credit environment in Afghanistan. There is an unmet demand for micro-credit exceeding one million households. Demand for credit appears to be rising at all levels, and this may be leading farmers into poppy cultivation as a reliable means of accessing credit.

Credit instruments. Traditional and informal credit predominates, as 80%-90% of Afghan economic activity occurs in the informal sector (Rasmussen; also see World Bank, *Afghanistan—State Building, Sustaining Growth, and Reducing Poverty*, 2005, Chapter 1). Traditional credit mechanisms include: (1) interest-free loans from family members (known as *karz-e-asaan*); (2) cash loans from shopkeepers and traders at interest rates in the range 80-100%; (3) *salaam*, an advance payment on a fixed amount of agricultural production (its use for opium credit is described below); (4) low-value commodities on credit, including consumption goods and agricultural inputs, at interest rates of up to 20% a month or 60% for six months and repayable usually after harvest; and (5) *anawat*, the short-selling of commodities for cash loans. (Mansfield, Rasmussen)

Sources of credit. Credit is typically obtained from a number of different sources, including family, shopkeepers, traders and landlords. Some farmers are able to access loans from all of these different sources, whereas others are more restricted, limited by their social networks or if they do not grow opium poppy (Mansfield). As a farmer's coping mechanisms are exhausted, he becomes a higher risk and finds credit harder to get, which often leads to the lender of last resort – the opium dealer (Goeldner). The traditional *hawaladar* provide a nationwide and international network for funds transfers (Maimbo).

Rural finance programs. In recent years a large number of rural finance initiatives have been launched in Afghanistan (Goeldner).² Most of these are operated by NGO micro-finance institutions (MFIs) offering some form of micro-credit. Mechanisms presently used in Afghanistan include:

- Group lending (12 programs), which works well with women's groups and can be set up quickly over a large area. Loans are typically very small (\$85 -\$600) and are repaid rapidly.
- Individual loans starting in the range of \$100 and going up as high (in exceptional circumstances) as \$6000 (offered by eight MFIs plus the banking system). These loans are highly sought after but scaling up is handicapped by problems of collateral and the difficulty of supervision.
- Integrated programs, combining credit with technical assistance (offered by nine organizations).

² The details of programs discussed reflect their status at the time of the conference, but some may have changed subsequently.

- Seed banks offering non-monetary credit (offered by four organizations).
- Willage banks and collective loans (offered by four organizations).

Innovative Mechanisms. Several organizations are developing new products for testing (Goeldner). These include: (a) land mortgage or re-mortgage, designed to free farmers of onerous traditional mortgage systems (one pilot program underway); (b) contract growing, primarily for wheat seed production (offered by five organizations) – this approach matches the structure of poppy financing, technical assistance and marketing, so it could be of future development potential; and (c) equipment leasing for agricultural production and processing equipment (one MFI is developing a pilot product, and AFC is introducing a regular leasing product).

MISFA. Micro-finance is the provision of banking and insurance services for low income people. The Microfinance Investment Support Facility for Afghanistan (MISFA) has been in existence since the middle of 2003 and has supported the emergence and initial development of the microfinance sector. MISFA provides technical assistance, grant financing for establishment costs, and loan funds for microcredit to its member institutions under negotiated contracts. The 12 microfinance institutions (MFIs) presently supported by MISFA so far have achieved significant progress in a short period, with more than 80,000 active clients in 17 provinces by December 2004. MFIs lend to groups (mainly women) and to small enterprises (mainly individual men). Loans usually comply with *shari'ah* principles. There has been a rapid diversification of microfinance services, driven by demand. Ninety per cent of borrowers are women, 25% of active loans are agricultural. Repayment rates are in the range 97%-99%. The target is to reach 600,000 clients by 2008 (Rasmussen).

RURAL FINANCE AND THE OPIUM DEBT PROBLEM

Rural finance is essential to combating opium. Rural finance is seen as a central element in Afghanistan's reconstruction of its rural sector, and also as a central element in the counter-narcotics strategy. A quarter-century of internal strife has left the country devastated, and the reconstruction of infrastructure, production and processing facilities and markets is essential. Rural finance is especially important in combating the opium economy, not only because recapitalization and investment are essential to the alternative livelihoods strategy, but also because of the need to offer substitutes for current mechanisms, which give opium farmers access to credit both for production and for household consumption and emergencies, and so are major drivers of opium production.

Opium credit is key to rural livelihoods for many. Despite the onerous terms of opium credit, many farmers, particularly the poor, have no alternative source of finance and can only access production credit if they enter into opium-denominated contracts with lenders. Opium debt overhang then keeps these farmers locked into the opium economy. In rural Afghanistan, credit is used by all wealth groups regardless of land tenure, the size of landholdings or the presence of opium poppy cultivation. While other forms of credit are available, seasonal loans are generally obtained from shopkeepers and traders in the form of an advance payment on the future opium poppy crop. Easy to access because opium is seen as less risky than other crops, these loans are typically used to satisfy basic needs, with the vast majority of loans being used to purchase food, clothes, and medical services, as well as agricultural inputs. In

opium growing areas, seasonal loans range from around US\$700 for those without land to US\$ 1500 among the land-wealthy.

A backlog of opium debt has built up. Opium production is a high-return business, but also high-risk. Two factors have led to accumulated opium debt. One is crop failure, caused by successive droughts, by disease and by failure to follow crop rotations. The second was the implementation of the Taliban ban on opium in 2000/01, which left many farmers caught in debt that could only be repaid from future opium production. Subsequent eradication campaigns have had similar effects albeit on a smaller scale.

Indebted farmers are locked into the opium economy. Accumulated debts of many are large by Afghan standards, with an average of around US\$ 700, but can be significantly higher in areas in which opium poppy cultivation is concentrated. Among the most marginal farmers, total debts can be the equivalent of three-quarters of annual cash income. Thus for the resource poor, cultivating opium poppy starts out as the best – or the only – means to gain access to credit, but ends up being the only way they can manage their debts without surrendering their assets.

Only external assistance or distress sales can help indebted farmers get out of the debt cycle. The principal form of opium credit is *salaam* (see above), a cash advance denominated in and repayable in opium. If the farmer cannot repay the opium – which can happen due to crop failure or eradication – the debt is converted back into cash at the (usually high) prevailing price of opium, and the farmer must liquidate other assets of that value in order to repay the debt. If the debt is not repaid, it is carried over to the next year with a continuing very high mark-up. As a result, large numbers of farmers have become locked into a debt cycle from which they can only escape by continuing opium production. For many of them, full repayment is unlikely without external assistance because of the level of accumulated debt, the need for new loans each year, the frequency of crop failure, and the threat of eradication, as well as the absence of alternative sources of income. In the absence of external assistance, many farmers are having to mortgage or sell land, sell off livestock, surrender their daughters (some as young as eight years old), or abscond to Pakistan.

The Findings of the Workshop

THE SITUATION OF RURAL FINANCE IN AFGHANISTAN

Two workshop presentations (Rasmussen, Goeldner) and the subsequent discussions confirmed the enormous demand for rural finance, and also highlighted the need for further rural financial market development as part of an accelerated rural development – and alternative livelihoods – strategy.

The market for rural finance. The traditional financial system is an organic system that responds to market supply and demand. Yet the traditional market is characterized by such deep flaws – particularly its low levels of financing, its very restrictive entry conditions, and its onerous terms and conditions – that it is unsuited to support rapid growth in the rural economy. The *hawaladar* service structure has potential for the future as an outreach of the banking system, but at present it is quite unregulated and has demonstrated no capacity for moving into development-oriented financing. The current banking law forbids *hawaladar* from lending. There is, in

general, a great need for legislation to enable and regulate these and other non-bank financial institutions in Afghanistan.

It is clear that the demand for credit is strong – but it has not been quantified or analyzed in any detail, and certainly varies for different socio-economic groups and in different parts of Afghanistan. Based on available information, there is demand for a wide range of working capital, consumption and investment lending, and also for savings and money transfer services.

Governance. A strong characteristic –and asset – of traditional rural finance is the very high level of individuals’ and households’ respect for financial contracts and for credit repayment in Afghanistan. Moreover, traditional social organizations such as the village *jirgas* or *shuras* provide strong support for respect of contracts. It is possible that this tradition can be translated into good credit discipline for new financial systems and products supported by communal solidarity. Certainly the current repayment rates under MISFA (97-99%) support this thesis. It is too early to know whether the social capital under construction through the NSP, with its elected Community Development Councils, could reinforce this communal and individual respect for contracts.

Rural finance development. Initiatives in microfinance with MISFA have successfully introduced new products, and microfinance is spreading rapidly. There are risks in accelerating further the already rapid expansion plans, but there is nonetheless scope to extend microfinance services to new areas of Afghanistan, to develop new products, and to deepen penetration of existing areas through links to community institutions.

The effort of the current NGO/MFI providers to push ahead and reach new frontiers of rural finance is clear. NGOs have played a key role in micro-finance development, and now financial institutions such as FMFB-A and BRAC Enterprise Bank (still to receive a license) are being set up. One emerging issue is that in the initial phase of rapid roll out, the financial market has moved ahead of the legal and regulatory framework.

Innovations and scope for development. In addition to the current broad effort and the particular focus on micro-finance products, other segments of the market for rural finance have potential. As part of the alternative livelihoods strategy, recapitalization of farms, agri-business and agro-industry is essential. Several initiatives are being started to address this market gap, including the FMFB-A and BRAC Enterprise Bank. At present, medium-term financing for investment is not readily available, but initiatives in leasing show potential for financing capital goods through that route. Experience with contract farming suggests that this approach also has significant potential. Finally, recent tests of products to refinance trader input credits for fertilizer have demonstrated the feasibility of the model.

Framework conditions. Discussions at the Workshop emphasized two key conditions for rural finance to be able to contribute significantly to the development of livelihoods and alternative livelihoods. First, participants emphasized that rural finance is one among many services needed for accelerated growth in rural areas, and that it is most effective when other services also are available – including technical and business development advice, input supply, market development, etc. Thus although rural financial development is pressing ahead apace, fully achieving

beneficial impacts requires strong parallel efforts on agricultural development, irrigation rehabilitation, farm to market roads, and development of downstream processing and marketing outlets. The second condition is security – financial services can only contribute to the development effort if security and minimum levels of governance prevail. Apart from considerations of physical safety of staff, rural finance depends on a close face-to-face relationship with clients as the basic “collateral” for lending, and only secure regular access on a long-term basis can allow this to develop.

OPIUM POPPY FINANCING AND DEBT

Nature of opium credit. Presentations (largely Mansfield, Goeldner) and subsequent discussions at the Workshop confirmed the prevalence of opium-based lending. Poppy farmers commonly take out seasonal loans denominated in opium, generally to satisfy basic needs, particularly over the winter. It was estimated that between half and two-thirds of farmers take out loans, and the total lending in any one season was estimated at between \$125m and \$200m. With arrears, it was estimated that total opium indebtedness is on the order of \$190-\$350 million. The unequal and risky nature of this lending is plain: the terms of the loan favor the creditor. The cash loan is typically equivalent to 50% of the cash value of opium on the date of issue, but repayment is based on the full value of opium when repayment becomes due.

The opium debt problem. Presentations (largely Mansfield) discussed the opium debt cycle. If opium yields are poor, or if crops are affected by a ban (as in 2000/01) or by eradication, borrowers are unable to harvest sufficient opium to repay their loans. Given few alternative options to obtain credit, some farmers are obliged to take out further opium-denominated loans, plunging them into a downward spiral of indebtedness. Such entrenched opium debt is particularly common in core poppy growing areas. An estimated 30-60% of poppy farmers are affected. Average indebtedness is estimated at \$700 per household, and based on very crude estimates total accumulated debt may be between \$65m and \$150m. Although opium-denominated loans are taken out by all wealth groups, poorer farmers are more likely to become deeply indebted. Among the most marginal farmers, total debts can be equivalent to three-quarters of annual cash income. Increases in opium prices can help those whose loans are denominated in cash but further penalize those whose debts are denominated in opium. Consequently, full repayment is unlikely without outside assistance, given the level of accumulated debt, the need for new loans each year, the frequency of crop failure and threat of eradication, as well as the absence of alternative sources of income. The failure to repay accumulated debts has become an increasing source of local tensions and conflicts.

Dealing with the debt problem. Based on the presentations, the Workshop discussed two options for addressing the opium debt problem: cancellation or refinancing. The consensus was that cancellation of debts is not enforceable, given both the traditional respect for such contracts and the likelihood of destabilization and violence that such an intervention could provoke. Cancellation of opium-related debts would risk undermining traditional credit markets and the strong “repayment culture” that currently exists in Afghanistan. Overall, cancellation would probably diminish rather than improve the availability of credit in rural areas.

The second alternative – opium debt refinancing (presentation by AKDN-ARMP, Suter and Sirrolla) -- is currently being tested on a very small scale in Badakhshan,

with farmers having average debts of \$300-500. Loans currently average \$200 and are repayable over a 15 month period. There are two lessons from this experience. First, refinancing needs to respect cultural and social norms and must be accompanied by investment in alternative skills or assets. Second, refinancing needs to be accompanied by interdiction against opium traders and creditors.

SOME OPTIONS AVAILABLE TO AFGHANISTAN BASED ON INTERNATIONAL EXPERIENCE

Range of products. Rural finance is a broad field with many different needs. The range of financial products that need to be matched to clients is correspondingly broad. The Workshop presentation (Kloppinger-Todd) reviewed different components in that range (see Box)

Box 2. A Range of Financial Products that can be Adapted to Clients' Need

- Creation or improvement of an income stream for the poorest (e.g. through partial grants for a productive asset or development of a skill)
- Microfinance to develop the smallest enterprises
- Microfinance (including savings and money transfers) for households to meet consumption, emergency, health and other needs
- Larger loans to scale up established micro enterprise
- Longer term financing, leasing, guarantees and risk management instruments for larger businesses

Source: Kloppinger-Todd

What type of instrument? Lessons from global experience. Globally, ideas about rural finance have evolved considerably in recent years, moving away from credit lines to broad ranges of financial services available to all rural dwellers, not only farmers. Use of market interest rates and developing the efficiency and financial viability of rural financial institutions have become prime objectives. Yet although these are vital objectives for Afghanistan as well, Afghanistan has very distinct problems associated with its large and dynamic opium economy. Therefore a financial systems approach has to be tempered by a wider search for alternative livelihoods for rural communities.

Countries of the former Soviet Union (FSU) offer an example of international experience under similar conditions to Afghanistan in their transition to a market economy. The FSU countries, like Afghanistan, experienced civil unrest, breakdown of the banking system, weak law enforcement or regulation, loss of external markets, poor infrastructure and little knowledge of what is needed to succeed in a market economy.

The FSU and other countries carried out a variety of approaches to the development of rural financial services:

- Creation of a new agricultural bank or non-bank financial institution (Latvia, Kyrgyzstan).
- Setting up cooperative financial institutions or credit unions (e.g. in Lithuania and Russia)
- Establishment of microfinance institutions that focus on rural areas (Kyrgyzstan and Georgia)
- Restructuring of a state-owned agricultural bank, (Mongolia)

- Leasing as a means of acquiring agricultural equipment (Pakistan, Uganda and Madagascar)

Kloppinger-Todd concluded that these approaches have been practical but have had mixed results. Evidently, the experience is instructive, but each model needs to be evaluated in the special Afghan context to assess its viability. The circumstances of Afghanistan may require the establishment of separate rural finance institutions to finance rural projects (agricultural and other), although diversified financial institutions with a broad product and client range are the best solution.

Another approach discussed was supply chain financing, which develops financing as part of an integrated package of input supply, advice and market outlet, thereby reducing costs and risks. The discussion underlined how closely this approach parallels what is offered under poppy contracts, which may indicate that it is a fruitful direction to pursue. An MAAH project, AIDTDP, financed by USAID/RAMP and executed by IFDC, is helping develop agri-input dealer linkages with financial institutions.

The roll of savings and grants. Savings-first approaches improve discipline, reduce risk and build up equity. Grants and savings have a large role to play at the lower end of the range set out in the Box above – stage 1 is suitable for part grant financing.³ From stage 2 onward, grants have to be used cautiously and intelligently to support the development of sustainable programs. In general, subsidies should not be provided on prices or interest rates, but public financing is acceptable for many other interventions such as capacity building, advisory services, pilot programs, market information, etc.

“Kick start” in post-conflict situations. Afghanistan is in a post-conflict situation, and moreover in many ways resembles some of the deteriorated economic and political structures that emerged after the break up of the Soviet Union. An important lesson can be drawn from this similarity, i.e. that where product chains and markets have been damaged (e.g. by conflict), exceptional measures may be needed to “kick start” recovery. These interventions might include some or all of the following: (i) using specialized institutions that facilitate development at weak links in the product chain (in finance, business development services, market access, etc.); (ii) “challenge funds” that provide matching grants for business development; and (iii) lines of credit (often associated with business development services) that provide investment finance where there is a lack of liquidity. One implication of the need for these interventions is that they all have high capacity building costs, and the Government and donors will have to provide significant levels of financing and substantial technical assistance.

Institutional development and capacity building. Although the Workshop accepted the logic of the need for a “kick start” approach, the goal of sustainability also has to be maintained. Development of rural finance needs to pay attention to capacity building and management as well as to simple disbursement of money, if sustainability is to be achieved. One particular concern discussed was the possible role of the CDCs under NSP. Evidently, community institutions can help facilitate financial market development – but making them agents for savings and loans creates unnecessary risk. Setting up separate financial services associations (e.g. credit unions) can reduce risk and costs and promote sustainability.

³ There is a matching grant activity being conducted by CFNA.

The legal and regulatory framework. Sustainable financial market development requires a conducive legal and regulatory framework, but this needs careful preparation as an inappropriate framework inhibits development. As noted earlier, the Workshop found that development of the legal and regulatory framework in Afghanistan has lagged behind the rapid development of micro-finance as well as other initiatives in rural finance.

What was Decided

AREAS FOR DEVELOPMENT AND WORKSHOP RECOMMENDATIONS

After the sessions devoted to presentations, break-out groups discussed specific sets of issues. Following reports back from the groups, a final session chaired by the Minister of Rural Rehabilitation and Development adopted a set of ten recommendations. In addition, at the Minister's request, a time-bound action plan was agreed. The following paragraphs describe the ten workshop recommendations. The action plan is summarized in the subsequent section.

1. Design and test mechanisms for possible refinancing of accumulated opium debt

Regarding the central topic of opium debt, the recommendation was to carry out financial modeling of the viability of restructuring of accumulated opium debt through refinancing and the adoption of a sustainable alternative income generation stream.

This should lead to the design of mechanisms for opium debt refinancing. These mechanisms should take into account inter alia: (i) eligibility criteria for the applications; (ii) loan repayment terms, which should allow a long enough period for the alternative livelihood activity to generate cash flows for repayment, but should not in principle include a subsidy on the interest rate; (iii) consideration of whether financing should be in cash or in-kind finance, or if both in what proportions; (iv) scope for associated grant financing for kick-starting of new alternative livelihoods activities; (v) mechanisms for re-acquisition of productive assets that may have been mortgaged or lost to opium creditors (e.g. land); (vi) collateral requirements for the new loans; (vii) incentives to former creditors to accept these arrangements; (viii) links to law enforcement, especially how to deal with interdiction in relation to creditors; (ix) links to business development and skills training; (x) monitoring requirements; and (xi) capacity of potential implementing partners.

Piloting of such innovative approaches will be essential. In a first step, consideration can be given to scaling up the existing Badakhshan pilot within the limits of near-term capacity constraints, and to design of new pilots for implementation in other core poppy producing provinces, taking account of the current Badakhshan experience and of the design work set out in the paragraph above.

It will be essential to coordinate this proposed opium debt refinancing with other programs (e.g. NSP, NEEP, MISFA, RAMP) to maximize development synergies, and to assess ways to attract new financial institutions to take up this challenge. Finally, a platform will be needed for lesson sharing, development of best practice and scaling up.

2. Understand the market in order to develop a range of products and programs adapted to each product/income stream and to each region:

For the next stage of rural finance development, it is essential to understand the market for services, both on the product supply side and on the demand side. Therefore, the Workshop recommended that product chain and regional financial market surveys and needs assessments be conducted where there are identifiable gaps in knowledge. As a fair amount of work on this has already been done but not consolidated, a priority is to synthesize and apply existing surveys and assessments, and to identify sub-sectors for further study and operational focus.

3. MISFA programs may spread nationwide, deepening their market by linking to existing community institutions and to trader networks, and continuing to adapt products to the needs of agriculture and off-farm enterprise

MISFA's extraordinarily rapid and successful start needs to be followed up by a clear strategy for consolidation and further expansion. It was clear at the Workshop that currently MISFA services are less represented in areas of intense poppy cultivation, and there is a strong logic for particular attention to expanding and extending MISFA in poppy areas, particularly in the seven largest opium producing provinces.

4. Explore links between social protection under NEEP and social capital/local governance development under NSP to the range of initiatives and products outlined above

There may be synergies which could be exploited by linking MISFA operationally with two national rural development programs that have broad coverage – NEEP in infrastructure and social protection and NSP in social capital and local governance development. Although there undoubtedly would be practical difficulties in pursuing this, the Workshop recommended that consideration be given to how NEEP/NSP can work within an integrated framework (at both CDC and district levels) to help move the poor from the social protection phase toward enhanced income streams; and then to how – for example – NSP CDCs may facilitate the entry of MFIs as well as savings and loan associations (and other financial and business development programs). Although this is a very ambitious approach, it could perhaps be started on a pilot basis in areas where the implementing partners for NSP and MISFA are the same entity. The Workshop also recommended an assessment of the capacity of NEEP and NSP to absorb more resources.

5. Expand supply chain financing as part of a program to stimulate market development (drawing on studies and pilot work done by RAMP and OTF)

Based on presentations and discussions of the multiple efficiencies to be obtained by working through a supply chain financing approach, the Workshop made a number of recommendations in this area:

- First, there is scope to develop contract farming approaches for certain activities (including through traders), and this should be investigated.
- Second, it should be possible to develop a sub-sector or product approach for high-potential supply chains, incorporating high-impact interventions at key points. Examples of this approach include the creation of a specialized institution to promote the effective functioning of the supply chain and related financial/non-financial services; establishment of a “challenge fund”; and setting up a market rate credit facility through a bank/MFI/specialized rural finance institution, linked to business development services. A challenge fund could, for example, provide grants to build the capacity of dealers and other market intermediaries in distribution, processing, marketing and financing, and so stimulate greater levels of private sector investment and activity.
- Third, consider how to factor in the infrastructure development needed for priority sub-sectors, such as roads and storage (including cold storage and associated electricity requirements).
- Fourth, there may be scope to convert non-sustainable market development programs into sustainable operations, e.g. by tendering seed provision currently conducted by NGOs to traders/suppliers, using technical assistance and matching grants to assist traders/suppliers to carry out these functions effectively.

- Fifth, review the potential for extension or other financing and technology transfer mechanisms linked to markets.

6. Develop approaches through the formal financial system

The Workshop discussed the possibilities of developing approaches through the formal financial system. The first recommendation was to explore the scope for outreach through the existing national banking system (building on work done by USAID and an earlier review of the financial sector conducted by the World Bank). This might include efforts to extend the outreach of the formal banking system to rural areas, for example using guarantees, technical assistance or branch subsidies. The Milli and Pashtuni Bank infrastructure, the proposed BRAC Enterprise Bank, and the First National Micro-finance Bank may offer opportunities.

A second approach recommended was to assist banks that already have functioning branches in Kabul to lend to upstream wholesalers/traders in Kabul.

A third recommendation was to develop business advisory services (embedded in supply chains) in association with the financial sector (building on existing initiatives with RAMP, PEP-MENA etc).

Guarantee funds to reduce risk in financing rural enterprises and “challenge funds” to attract local business and promote investment in improved capacity and services are other options to be explored. A financing facility for trader or wholesaler credit and other rural enterprises could be a possibility, perhaps through banks or through a specialized rural finance institution. One option discussed was to develop this facility through Rabo Bank and its Development Fund.

A final recommendation linked approaches through the formal financial system to the previous recommendations on financing supply chains: this was to consider contracting specialist entities to build embedded services to support agri-business service providers in priority supply chains (see Point 5 above).

7. Facilitate the growth of non-formal and semi-formal financial markets

Based on presentations on non-formal and semi-formal financial markets, the Workshop recommended considering programs to license and monitor *hawaladars* to provide credit, and to link them to the kind of re-finance mechanism or rural finance company recommended above (see Point 6). Technical assistance in system and product development could be provided. This approach could have special relevance in the case of opium debt, and consideration should be given on how to do this.

At the local level, the Workshop recommended exploration of ways in which community associations may provide savings and loan services, using Community Driven Development (CDD) and innovative microfinance approaches. It was considered that the Community Development Councils (CDCs) established as part of NSP would not be suited to this function.

8. Develop the capacity of financial institutions, facilitating partners and business development services at all levels

Given the newness of many interventions in rural finance and the massive institutional and capacity building challenge of developing a sustainable rural finance sector, the Workshop recommended developing capacity building programs. These could build on and work through MISFA, which already provides significant assistance to microfinance initiatives, and RAMP and other existing initiatives.

9. Firm up a conducive legal and regulatory framework that reduces risk and protects clients but allows flexibility in market development

Based on Workshop findings that development has moved ahead of the legal and regulatory framework, it was recommended that priority be given to developing and adopting legislation and a regulatory structure. A salient example is the pressing need for an enabling and regulatory framework for leasing.

10. Bring support to rural finance and other rural development within a coherent framework

Based on Workshop findings that different parts of the considerable rural finance and rural development effort in Afghanistan have been fragmented or isolated from the mainstream, a recommendation was made to develop policy commitments with partners that donor finance is to be channeled primarily through the National Development Programs. Given the pioneering rural development work done by such programs as USAID's RAMP and other alternative livelihoods programs, it was also recommended that a platform for sharing knowledge and findings should be consolidated, either through the Alternative Livelihoods Working Group or another forum.

IMMEDIATE ACTION PLAN

In response to the Government's request that the Workshop come out not just with broad findings and recommendations but also with an immediate action plan, the final session was largely devoted to agreeing on some practical next steps to be carried out in four key areas in early 2005. These "time-bound" steps are set out schematically below, together with institutional responsibilities. The final section of this Workshop Report documents progress on this action plan as of April 2005.

Topic One: Opium Indebtedness

- *Financial modeling of refinancing of opium-related debt:* this study will assess the viability and inform the design of refinancing instruments for opium-related debt to enable deeply indebted farmers to get out of debt and develop sustainable alternative income generation streams. *Institutional responsibilities: DFID and World Bank. Target for Delivery February 2005.*
- *Pilot projects:* this step will provide a design for scaling up the existing opium debt refinance pilot program and for design of new pilots for opium debt refinancing. *Institutional responsibilities: World Bank and DFID with MISFA. Funding to be identified. Target for start of action: March 2005.*
- *Policy on opium-related indebtedness:* Based on development/experience with pilots and further consultations, a draft policy on opium indebtedness would be prepared for consideration by the Government. The policy would be framed in the context of existing and evolving policies on: (i) counter-narcotics; (ii) agriculture; and (iii) rural development. The policy

may also include recommendations for changes in legislation. *Institutional responsibilities: DFID and World Bank. Regular meetings to be held with Government of Afghanistan during process (first in mid-late January 2005); Target for delivery: May/June 2005.*

Topic Two: Supply Chain

- Synthesis of knowledge: a process will be conducted to bring together existing sub-sector studies and experience on selected supply chains with potential for incentive financing to support alternative livelihoods (drawing on information from RAMP, FAO and other sources). *Institutional responsibilities: USAID/RAMP, in collaboration with DFID, World Bank and others. Target for delivery: end January 2005*
- Preferential access: a study will investigate opportunities for preferential access of Afghan products to markets. *Institutional responsibilities: DFID. Target for delivery, by end January 2005.*

Topic Three: Delivery Mechanisms

- Strategies for scaling up national programs: a process involving the managers of key national programs will develop a three-part strategy for scaling up: (1) a plan will be developed to roll out accelerated delivery of existing national programs and projects (MISFA, NEEP, NSP, RAMP) in seven priority opium-producing provinces (Nangarhar, Badakshan, Helmand, Kandahar, Farah, Uruzgan, and Ghor); (2) a plan will be developed to accelerate roll out and deepen coverage of national programs in the country as a whole; and (3) a review will be conducted of potential delivery institutions and mechanisms for expanded rural finance facilitated through national programs and projects. *Institutional responsibilities: World Bank and DFID with the national programs and RAMP. Target for delivery: January 2005.*

Topic Four: Informal Institutions and National Financial Institutions

- Options paper: a paper will be prepared assessing options for increasing rural finance coverage through informal institutions, and also through existing formal banking institutions including Milli Bank, Pashtany Tejarati Bank, and new Afghanistan-based banks. *Institutional responsibilities: World Bank. Target for delivery: end-January 2005.*

Post-script to the Workshop: What has Happened Since

Unusually for such an event, the Workshop resulted in the drafting of a specific Action Plan with commitments from a number of agencies. The Table below sets out those commitments and matches them with subsequent actions. Overall, the commitments have been largely met and changes on the ground are already underway.

Table 1. Commitments and Subsequent Actions

Development area	Action plan	What has happened
<i>Topic One: Opium Indebtedness</i>	Financial modeling of refinancing of opium-related debt.	The model has been developed and will be piloted in at least two provinces under the new MISFA “alternative livelihoods funding window” (see below).
	MISFA expansion to the largest poppy growing provinces: scaling up of existing pilot and design of new pilots for opium debt refinancing.	RFP for MFI expansion in opium areas and piloting of opium debt refinancing under a second window launched in February 2005. Eight responsive offers have been evaluated for \$20 million (although only one for debt refinancing). DFID additional financing of \$10 million for the AL funding window approved, and an additional \$22 m committed for the 3 year MISFA strategy.
	Policy on opium-related indebtedness.	Draft note sent to Government at end of January 2005, and offer of legal assistance in February.
<i>Topic Two: Supply Chain</i>	A process to synthesize existing knowledge will be carried out on selected supply chains with potential for incentive financing to support alternative livelihoods (drawing on information from RAMP, FAO and other sources).	Progress limited. Several value chain and cluster studies on going and pending to be systematized.
	Investigate opportunities for preferential access of Afghan products to markets.	Underway with DFID. Concept Paper to be developed and discussed with Government and donors by August 2005
<i>Topic Three: Delivery Mechanisms – scaling up national programs:</i>	A plan will be developed to roll out accelerated delivery of existing national programs and projects (MISFA, NEEP, NSP, RAMP) in seven priority provinces (Nangarhar, Badakhshan, Helmand, Kandahar, Farah, Uruzgan, and Ghor).	Plan delivered to MRRD in January 2005. MISFA: new MFI contracts and financing for seven provinces under negotiation (see above). NEEP: new financing for eleven priority provinces agreed (\$32 million from DFID). NSP: new financing for five priority provinces agreed (\$ 7.5 million from DFID), and contracts under negotiation for the five provinces. New USAID-funded Alternative Livelihoods Programs in Helmand/Kandahar, Nangahar and Badakhshan.
	A plan will be developed to accelerate roll-out and deepen coverage of national programs nationwide.	Plan delivered to MRRD in January 2005 (outlined above), which also covered accelerated roll out and deepening of coverage nationwide.
	A review of potential delivery institutions and mechanisms for expanded rural finance facilitated through national programs and projects.	An issues paper on rural finance has been prepared by World Bank. Mission to discuss and identify possible investment areas in May 2005.

<p><i>Topic Four: Informal Institutions and National Financial Institutions</i></p>	<p>Options paper: a paper will be prepared assessing options for increasing rural finance coverage through informal institutions, and also through existing formal banking institutions including Milli Bank, Pashtany Tejarati Bank, and new Afghanistan-based banks.</p>	<p>Issues paper prepared (as above)</p>
---	--	---

Part II. Workshop Papers

Workshop Paper No. 1

The Current Situation of Rural Finance in Afghanistan

Steve Rasmussen, Lead Social Development Specialist

The World Bank

Questions to be addressed

- i.* Most rural finance supply is presently through the informal system. What do we know about the largest informal provider system, the hawala system, and what could be done to bring it more into the mainstream of the formal sector?
- ii.* What are the current providers of rural finance? What services are being provided and how much outreach exists? What issues and challenges are being faced? What are the plans and prospects for scaling up? How are these efforts taking into account the need to be sustainable in future?
- iii.* What is known about demand for rural finance and generally how that demand, or parts of it, are currently being met?

Issues

RURAL FINANCE, AGRICULTURAL FINANCE AND MICROFINANCE

Rural finance refers to financial services offered and used in rural areas by people of all income levels. Agricultural finance is a sub-set of rural finance dedicated to financing agriculture-related activities including input supply, production, post harvest treatment, distribution, and wholesaling and marketing. Until recently microfinance was most often understood to be micro credit for tiny informal enterprises of micro entrepreneurs delivered through a credit methodology that employs short term, working capital loans provided without collateral requirements mainly by socially oriented NGOs. Today microfinance is understood to mean the provision of banking (savings, credit, payment transfers) and insurance services for low income people, especially the poor, and is provided by a wide range of regulated financial institutions as well as NGOs. As the scope of microfinance services widens, and the variety of types of service providers increases in parallel with the trend for increasing depth in the outreach of the traditional commercial financial sector, dominated by the banks, the line between microfinance and other parts of the financial sector becomes less distinct, and a financial system that serves all people begins to take shape. Pro-poor financial sector policy should promote both 'mainstream' financial development and institutions that focus on offering the poor direct access to financial services. It is important for policies to ensure that the entire financial sector functions well, thus contributing to economic growth and also to poverty reduction. This is particularly important in the context of a large opium economy dominated by informal financial systems.

THE INFORMAL SECTOR

The World Bank estimates that between 80% and 90% of the economic activity in Afghanistan occurs in the informal sector, and almost all credit and other financial transactions are still carried out in the informal sector. Four kinds of agricultural credit arrangements for small and poor farmers are prevalent in Afghanistan. *Anawat* involves short selling of commodities for cash loans, a system that is sometimes used by shopkeepers. Commodity credit is the delayed payment for commodities purchased from shopkeepers and traders. The third and most common form of credit is from family and kinship group sources. The fourth system is called *salaam* and is the credit system most widely used by opium traders. It involves the advance sale of produce at negotiated prices, often before planting season but also later on in the crop cycle. Microfinance products, and to a lesser extent bank credit products, often try to employ the advantages of informal credit systems while improving on them in one way or another. Microfinance institutions in Afghanistan use their knowledge of informal credit provision to design better products to meet local demand.

The largest informal sector financial service provision system in Afghanistan is the *hawala* system, and while it is not a major provider of agriculture credit to small farmers, the *hawala* system provides money services that play an important role in the economic life of the country and in the opium economy, more so in the absence of a developed formal sector. Da Afghanistan Bank has introduced legislation to supervise the *hawala* system and other providers of money services, though supervision will need to take a pragmatic approach, accounting for the importance of the informal sector and the significant amount of time it will take for the formal sector to make access available to most people.

FARMERS: CREDIT AND THE OPIUM ECONOMY

Opium traders use advances against the purchase of the opium crop to attract farmers, particularly small farmers who find it difficult to turn down advances at a time when they have little to live on. Availability of credit is one of the important coping strategies of rural households since it not only finances agriculture but also acts as an insurance facility and allows for consumption smoothing. It has been pointed out in some research about credit that access is the main constraint for most households, not the price of the credit. Indeed, informal credit systems like *salaam* cost much more than borrowing from microfinance institutions, for example. Despite the cost, recourse to advances paid by opium traders is advantageous to many rural households since it allows for the purchase of agricultural inputs, provides money to help cover major expense for things like illness or marriage, and even facilitates the repayment of old debts.

THE MICROFINANCE SECTOR

Years of conflict had left Afghanistan with a ruined economy by the end of 2001, with more than 90% of employment in the informal sector, no formal financial service providers, a weak legal environment, and high levels of indebtedness to informal financial service providers. Microfinance requires few preconditions to be able to work, one of those few being peace and stability, and it can be established more quickly than most other financial services in an economy that is largely unregulated, well before most reconstruction efforts and formal systems are in place. But it does require considerable investment in microfinance institutions to help them develop

good management systems and begin to scale up, and initially at least, NGOs will necessarily lead the way.

There are about 500 NGOs working in Afghanistan of which 20 to 25 are providing some kind of credit services, though half of those have tiny programs that are not designed to be sustainable. The Ministry of Rural Rehabilitation and Development established the Microfinance Investment Support Facility Afghanistan (MISFA) in 2003 to be a channel for funding and technical assistance to a microfinance sector that could adopt good practices, grow and become sustainable. During the pilot phase of MISFA that will end in March 2005 about \$25 million has been provided by donors to invest into developing the microfinance sector. By the end of 2004 MISFA will have 13 partner MFIs with more than 75,000 total active clients in more than 75 districts. MISFA is also working with the remaining NGOs with an interest in microfinance to help build their capacity to manage growing programs of good quality. In addition, one of the commercial banks, First MicroFinanceBank, has a microfinance loan portfolio.

The main loan product offered by MFIs is based on a solidarity group methodology with groups of four or five clients, primarily women, each one initially borrowing \$80-100 to be repaid in installments over a typical loan cycle of 4 to 12 months. Most MFIs allow good clients to graduate rapidly through subsequent loan cycles with increasing loan sizes. Some MFIs have also introduced another loan product that is for individually owned enterprises, primarily managed by men, with loan sizes between \$250 and \$2000 to be repaid in installments over a year or more. In all cases MFIs have designed loan products to comply with *shariah* requirements as understood locally. Most MFIs include some kind of savings product for members of the groups and some offer housing loans. Research is underway on products that could address some of the specific needs of Afghanistan including indebtedness due to opium, the large number of disabled people, and the *kuchis*. Such rapid diversification of microfinance services usually takes more time to develop, but is happening more rapidly in Afghanistan because of demand. This, though, presents management and sustainability challenges that might also reduce the pace of growth in outreach.

There has been better than expected demand for microfinance services, with demand still far outstripping supply, and more than 90% of borrowers are women. MFIs have generally been able to recruit women field staff but have sometimes struggled to develop and retain competent middle level management. They have initially had to rely on expatriate senior managers. Repayment rates have been good, exceeding 97% for most MFIs. Service charges are lower than what is charged by the informal system and are equivalent to 30% to 50% effective annual interest rates, very much in line with good microfinance practice elsewhere.

In 2004 MISFA received funding from USAID to support the development of agricultural lending programs by MFIs. Some MFIs were already engaged in such lending while others had to begin by developing appropriate products. Loans are provided for livestock and crops, including the purchase of inputs and the processing and trading of agriculture products. By late 2004 agriculture loans constituted about 25% of all active loans. In addition, most MFIs also provide some training and other forms of support for farmers. The challenges faced so far include a tradeoff between the volume of lending and tailoring products for specific needs, the need to fund and provide additional technical support for farmers, and the danger that in poppy growing areas 'fungible' money can be used to support poppy production almost as easily as help to substitute for it.

With the exception of the microfinance program of the First MicroFinanceBank, all the microfinance programs established so far are managed by NGOs. Going by experience elsewhere, some programs will continue to be managed by NGOs well into the future, but one MFI is already establishing credit unions and a few others have expressed an interest to

become regulated non-banking financial institutions, should that option become available. At the same time, more banks might become interested to develop microfinance programs. All such developments will require appropriate legal and supervision frameworks that have not been developed yet.

By the end of 2005 the number of active clients is expected to go above 200,000, and the sector now projects that it can reach 600,000 active clients by the beginning of 2008, spread out over much of the country, though not in areas of active conflict. At the same time, MFI projections show them moving from subsidized start-up programs to operational sustainability over 3 to 4 years, quite good performance if it can be achieved.

THE COMMERCIAL BANKING SECTOR

Seven commercial banks have established branches in Afghanistan since the latter half of 2003 after the banking ordinance was adopted by the cabinet. In addition, some of the state owned banks are being revived. None have branches outside Kabul yet and few are providing loans to local businesses, much less small businesses with any rural focus. Only two banks have definite plans to expand their branch networks widely in the country, including providing services in rural areas.

There are four international banks with one branch each in Kabul:

- Habib Bank from Pakistan.
- National Bank of Pakistan.
- Punjab National Bank.
- Standard Chartered Bank.

These banks are concentrating on international donor, NGO and international company business as well as the official business of their respective governments. They are not providing financing for local businesses or deposit services for the Afghan public, and while they might eventually open branches in other cities, it appears that they are satisfied for the time with their Kabul operations.

There are three Afghan banks, with a fourth about to be licensed:

First MicroFinanceBank is primarily owned by the Aga Khan Development Network with some IFC investment as well. It has one branch in Kabul and is about to open a second one. The business plan calls for opening 25 branches throughout the country over five years, though this is proving more challenging than they had originally thought. One concern about expansion into rural areas with a significant opium economy is the risk of not being able to conform with anti money laundering rules. The bank only became operational in May 2004, but beginning in early 2003, the Aga Khan Fund for Economic Development began a microfinance loan program in Kabul and Pul e Khumri. Their Kabul operation has already been absorbed into the bank and there are now 2200 active borrowers with an outstanding loan portfolio of about \$2 million. The Pul e Khumri operation has about 1000 clients with a portfolio of \$0.9 million that will be absorbed into the bank later on. FMFB-A's core business will continue to be microfinance, not larger commercial activities.

Kabul Bank is owned by Afghan business people based in the Gulf. It concentrates on commercial business.

Afghanistan International Bank began operations recently. It is primarily owned by Afghan American investors and also has investment from Asian Development Bank

(ADB). ING has the management and technical assistance contract. It plans to have 7 branches in Kabul and 7 in other places. AIB currently provides transfer services (and can transfer funds to the 32 Afghan cities served by the Da Afghanistan Bank [DAB] network), deposit services for commercial clients only (with special attention to money laundering procedures), foreign exchange services, and trade finance (letters of credit and post import and pre export lines of credit, with the aid of some guarantees). AIB also has a project with the USAID funded RAMP project. This project became operational two months ago and had five clients with loans between \$50,000 and \$100,000 by the middle of November 2004. This loan product is focused on agricultural enterprises and is partly funded by RAMP.

Aryan Bank is about to be licensed. It will be jointly owned by Milli Bank (one of the state owned Afghan Banks that is under the Ministry of Finance) and Sadarat Bank from Iran.

In addition, BRAC has a plan to establish the BRAC Enterprise Bank, a commercial bank that will focus on small business lending, including in rural areas. This plan is based on the model of the BRAC Bank in Bangladesh, a commercial bank established a few years ago that now has thousands of small business clients all over Bangladesh, with an average loan size of about \$9000.

STATE OWNED BANKS

Before the conflicts of the past two decades, six state owned banks were operating in Afghanistan in addition to Da Afghanistan Bank. None of these were operational at the end of 2001, though they still existed legally and had some assets. Da Afghanistan Bank has reestablished operations in Kabul and the provinces, but is not engaged in rural finance. The six banks have extensive branch networks and a lot of staff, though none has been operational for the past few years. Three have recently been re-licensed, with provisional licenses that keep them on a tight leash while it is determined if they can become operational again. These banks are Milli Bank under the Ministry of Finance, Pashtani Bank under the Ministry of Finance, and Export Promotion Bank under the Ministry of Labor and Social Affairs. While the extent of any remaining branch network that could become functional soon is still being determined, and while it is not yet known if they have the capability to become active soon, these banks are solvent and had enough equity to meet the requirement for a license. Even so, their future role is unclear.

The ministries that own the other three banks want to revive them, but it is reported that they are insolvent and would require an injection of capital. Or they could possibly be merged with one of the other banks, though the other banks do not want this. There is not yet a decision about the future of the Agriculture Development Bank under the Ministry of Agriculture, the Mortgage and Construction Bank, and the Industrial Development Bank.

Other Issues

The USAID funded RAMP project is working with the Afghanistan Reconstruction Company (ARC), Deloitte Touche Tohmatsu and Peoples Group to establish the Afghanistan Finance Company as a leasing company. DAB would like to see an NBFI law come into existence to regulate leasing companies and other financial institutions that do not take deposits from the public, something that some MFIs would also like to see happen.

As the only functioning bank in Afghanistan in 2002, and as the only one with operations in the provinces, DAB has been forced to get into the banking business. But the plan is to phase out this business and concentrate on regulation and supervision once other banks develop their operations to fill the gap.

Workshop Paper No. 2

Roles and Opportunities for Rural Credit Initiatives in Afghanistan's Opium Economy

Karri A. Goeldner, Consultant

Department for International Development, United Kingdom

INTRODUCTION

This paper examines the credit mechanisms currently available in the rural areas of Afghanistan, as well as others that could be introduced to provide a credit alternative to the financing available from poppy traders. The annex at the end outlines the organizations that are currently involved in finance activities (both credit and grant), providing a snapshot of the types of interventions currently taking place in Afghanistan, as well as their scope and geographical outreach.

The intention is that policy makers and donors will gain a better understanding of what is currently available and what is possible for future implementation. Hopefully, it will also stimulate thinking within the existing community of microfinance and other financial institution providers as to new products and methodologies that can be used to help rural borrowers move away from their dependence on opium, which currently provides the primary access to agriculture credit. Discussion is provided on the pros and cons of current and future credit interventions, as well as discussion on broad themes that will impact credit and alternative livelihood interventions generally.

It is assumed that the reader is familiar with the history of poppy cultivation in Afghanistan and documentation of the opium issues related to eradication, interdiction, and alternative livelihoods. This paper does not attempt to cover those complex issues in detail, but anticipates that the reader understands the framework for a discussion on rural credit issues and the role of credit in poppy cultivation.

THE CREDIT ENVIRONMENT

The overwhelming demand for credit in Afghanistan is well documented. MISFA's (Micro-finance Investment and Support Facility in Afghanistan) 2002 assessments estimated the demand for micro-credit at one million households, and that figure did not include demand for credits above a micro level. There are indicators now that the figures are much higher, and the demand for credit is strong at all levels.

This unmet demand is part of the reason that many farmers turn to cultivating poppy – as a means of accessing credit. It is not the only factor in farmers' decision-making process -- village leaders cite Islamic strictures, fear of eradication, fear of imprisonment, and the ban on cultivation as factors that have kept farmers from planting poppy⁴ -- however, improving rural credit will present cultivators with increased options for borrowing, thereby supporting their decision to move out of poppy cultivation.

⁴ "Farmers' Intentions Survey 2003/2004", UNODC, February 2004.

Over 57% of the reasons cited for farmers' choosing to grow poppy can be addressed directly or indirectly by various credit products. These reasons include: to get out of poverty (30%), to access credit (18%), to obtain luxury items (6.5%), to get out of debt (.6%), to cover wedding expenses (.4%), and to purchase agriculture inputs (.1%).⁵ Obviously, poverty reduction strategies should play a large role in alternative livelihood strategies, as growing poppy has become a survival strategy for many.

United National Office on Drugs and Crime (UNODC) found that 45% of farmers intended to take out a loan in 2004, and the average for these loans in 2003 was \$700⁶; and the need for loans has been consistent across socio-economic groups: a majority of landlords, owner-cultivators, and the landless all expressed that they had previously taken out loans.⁷ Farmers take out loans for fertilizer, food for the family, *ashr* (agriculture tax) payments, and contributions to local mullahs and merabs.⁸

However, most credits currently available in rural areas are at usury rates or are available only against a poppy crop. This has led to sky-rocketing debt levels after drought and eradication have caused many to lose their crops and have forced them to deplete their asset base in order to repay debts and meet household needs. Despite high debt levels, the strong respect for contracts laid out in Islam and desire for continued access to credit means that most microfinance institutions are experiencing 98% repayment rates or better. This is important because it indicates that there is still an appropriate environment for successful credit interventions.

As we begin to look at interventions in the credit sector, it is essential to think beyond the immediate political agenda. If credit responses are to be a part of the solution, they must remain in place for some time, so that farmers don't reverse their decision to grow licit crops when a credit source dries up. The World Bank has indicated that establishing a viable rural financial system should be seen as a medium-term goal, rather than a short-term goal.⁹ This is a prudent approach, one that leaves room both for immediate impact activities that can help jump-start a new livelihood, as well as long-term structures that can remain in place for decades.

TYPES OF PRODUCERS

In 2004, the greatest gains in area being cultivated came from those who had previously planted, rather than those who were new to the crop¹⁰. Credit is unlikely to be the motivator for a producer to stop planting poppy, but is essential once the decision is made. Therefore, this paper will place producers into three categories. While this is a simplification of a complex set of factors that determine the choice of individual farmers, this simplification will help facilitate the discussion regarding various types of credit mechanisms and the individuals they are likely to influence.

The first type of producer has a low-level of commitment to growing poppy: he may not have been growing it for long; he does not have high levels of accumulated debt; he may have a stable asset base, even if small; perhaps there is community support for not growing poppy. For him, growing poppy is truly a choice. Since northeastern

⁵ Ibid.

⁶ Afghanistan Opium Survey 2004, UNODC, November 2004.

⁷ UNDCP, "The Role of Opium as a Source of Informal Credit", Strategic Study #3, January 1999.

⁸ Afghanistan Opium Survey 2004, UNODC, November 2004.

⁹ "Afghanistan State Building, Sustaining Growth and Reducing Poverty: A Country Economic Report", World Bank, September 2004.

¹⁰ "Farmers' Intentions Survey 2003/2004", UNODC, February 2004.

Afghanistan shows the highest proportion of new opium producing villages, he may be located there¹¹.

The second type of producer has a high-level of commitment to growing poppy. He sees it as the only way to feed his family, he is heavily in debt, he may have liquidated most or all of his assets, it is likely that he has been growing poppy for many years, and he has disregarded any previous government warnings out of disbelief or necessity. Growing poppy has ceased to be a choice, and has become a survival strategy.

The final type of producer is permanently committed to growing poppy. This producer is likely to be unfazed by eradication and interdiction efforts, and will continue to produce poppy despite the religious and legal prohibitions on it. The motivation for production is profit-oriented.

The current microfinance activities in Afghanistan are likely to be able to meet the needs of producers in the first group. Because this group has little, or at least manageable amounts of debt, the added liquidity in the household budget provided by a microcredit loan allows this producer to better manage household funds, and move away from growing poppy. Issues to focus on for this group are outreach of microfinance organizations and increased variety of products provided by microfinance institutions. Efforts should be made to ensure that the loan sizes offered can meet the changing needs of this producer. The current initiatives to develop agriculture-specific products, micro-leasing, and mortgage products should be given additional support. Consumption or income smoothing loans should be considered, as should loans or savings instruments for emergencies.

The second group is the largest, and the most in need of credit activities that are area-specific, innovative, and long-term. This group has debt that far exceeds the ability to repay, and is caught in a cycle of debt or power structures that force them to continue producing poppy. They are the most likely to be made economically vulnerable by eradication efforts. Issues to focus on for this group are rebuilding the producer's asset base, increasing the number of income streams available for the producer, and restructuring their debt so that it becomes manageable. Looking at innovative types of financing and new program methodologies will be necessary for this group. Itinerant poppy harvesters are likely to fall into this group as they have the most to lose by the disappearance of this income source, and are also usually heavily indebted.¹²

The importance of the third group for financial institutions is that this group is most likely to abuse any credit systems that are made available to the wider community. Care must be taken to ensure that credit activities are not utilized directly or indirectly for the production of poppy. Monitoring systems are the primary issue to focus on with relation to this group.

OVERVIEW OF MECHANISMS

Microfinance Institutions (MFIs) represent the largest group of formal financial institutions in Afghanistan. The microfinance system was originally designed to

¹¹ "Farmers' Intentions Survey 2003/2004", UNODC, February 2004.

¹² "Looking for Peace on the Pastures: Rural Land Relations in Afghanistan", Liz Alden Wily, AREU, December 2004.

address the needs of the very poor, including borrowers with a lack of collateral and assets, and can flourish without the legal framework required by traditional banking. These elements make MFIs an important starting point for rural finance activities in Afghanistan. Group lending and individual loans are the most common forms of microcredit provided by MFIs. Each MFI determines individually whether the organization will offer group loans, individual loans, or both. This decision is based on the philosophy of the organization and the needs of the population being served by the institution.

a. Group Lending

The group lending methodology is being used (or is planned) by 12 financial institutions in Afghanistan. Group lending approaches involve the formation of a group with a fairly homogeneous need for credit (in terms of loan size and term), although the loan uses within a group are normally varied to decrease the risk of default for the group overall. In Afghanistan, group sizes vary from 4-20 members, who act as a guarantor for the loans of all members of the group. In the case that any member of the group cannot make a repayment, the other members of the group must repay on that person's behalf. This methodology works well in Afghanistan due to the high level of social cohesion.

Loans under this methodology tend to start small and have short repayment periods. The range in Afghanistan runs from \$85-\$600, increasing with each loan cycle. Groups with a good repayment history can continue taking loans of increasing size and duration; and several programs in Afghanistan allow borrowers to graduate from group lending to individual lending after a certain number of cycles.

One of the greatest advantages of this loan product is that peer pressure acts as the loan collateral. When one member is unable to repay, further lending to all members is normally stopped. Therefore, moral hazard is decreased by group members that are risk-averse and those who want to protect their individual borrowing capacity. Group lending also can help decrease administrative costs, as several loans are "managed" by the group leader.

This type of loan has been very successful with women's groups and can help diversify the income streams of the family. The average size of the first loan can easily cover the costs of seeds and fertilizer for 2 jeribs of land¹³, however care must be taken that there is diversification within the group, in order to mitigate risk. The greatest advantage of using this type of loan to respond to the credit needs of poppy cultivators is that MFIs using this methodology have, in a very short period, been able to set up operations in a large number of districts and provinces. However, the small size of the loan, especially in the initial stages, limits the investment and income creation opportunities. If this loan is seen primarily as a "women's loan" -- which it at times has been marketed as in Afghanistan -- then that may also limit its usefulness, as it will be the male members of the household who will determine if poppy is planted.

¹³ Although average landholding varies dramatically by region and district (see "Looking for Peace on the Pastures: Rural Land Relations in Afghanistan", Liz Alden Wily, AREU, December 2004.), 2-2.5 jeribs is frequently cited as an average landholding size for poor farmers, and this number is consistent with observation in the field.

b. Individual loans

Individual lending is defined as the provision of credit to individuals who are not members of a group that is jointly responsible for loan repayment¹⁴. This methodology is used (or is planned) by 8 MFIs in Afghanistan, as well as by all banks. It requires frequent and close contact with individual clients in order to provide products tailored to the specific needs and cash-flow of the business; therefore the loan officer to client ratio is much lower than it is for group lending¹⁵. In Afghanistan, individual loan sizes range from \$120 - \$6000, depending on the need of the client and the experience of the MFI in lending to that type of client. An analysis of cash flow and simple debt to income ratios are often used to determine the clients' ability to repay. Normally a client begins taking out smaller loans and as the client builds their credit history, asset base, and relationship with the lending institution they increase their access to larger loans.

The issue of collateral affects this type of loan most. The poor legal infrastructure and problems of land titling have restricted the ability of lending institutions to provide loans in large amounts. A trust relationship and strong repayment record will continue to be the primary "guarantees" for individual lending until mechanisms for contract enforcement and improved land title records are available in Afghanistan. The need for frequent and close contact with clients will be one of the major challenges for financial institutions trying to reach rural clients; both weak infrastructure and increased administration costs should be examined when designing individual lending programs for farmers, wholesalers, rural traders, and others in rural areas.

This is the type of credit is considered the most desirable by borrowers, and is most requested. The important issue for individual loans with regard to poppy is the structure of the loan. The size, term, and timing of the loan impact the usefulness of the loan to a farmer attempting to replace poppy with other crops. Some MFIs have adjusted their loans to provide grace periods or reduced payments in the early stages before an asset is productive, or during times when farmers are cut off from markets. The ability of a potential client to access the credit officer also has an impact. Offices can be located in market centers, or credit officers can visit borrowers in their homes to monitor the loan usage and collect repayments. However, the security of the area and the availability of transport directly impacts access issues.

Individual loans are the easiest to adapt to the needs of former poppy growers. However, financial institutions must always think in terms of their bottom line, and cannot afford to have too many specialized products as this will tend to decrease their efficiency.

c. Integrated Programs

Integrated programs use a combination of technical assistance, agriculture inputs, credit mechanisms, and community development activities to assist a specific population, usually to respond to a specific social need such as food security, agricultural development, or women's empowerment. Therefore, the credit products described in this section have generally developed out of a perceived need – not for

¹⁴ "Sustainable Banking with the Poor: Microfinance Handbook -- An Institutional and Financial Perspective", Joanna Ledgerwood, World Bank, 1999.

¹⁵ Ibid.

credit specifically – but as one piece of a development program. This makes them weak in some aspects (as credit responses), but useful as examples of interventions that may be able to be adapted and used as a response to the needs identified in Alternative Livelihoods analyses.

- *Integrated Micro credit and Grants.* Approximately nine organizations in Afghanistan are currently doing credit or grant finance activities that are designed as a complement to a non-financial activity. These financing activities may or may not follow best practices in lending, and sometimes blur the lines between grant and loan products. Often these programs were created because no MFI existed in the area of operations, or existing MFIs were unable or unwilling to meet the financing needs of the population targeted by the program.

While a sound argument can be made for these activities, it is especially important that organizations and donors designing integrated finance activities keep the following questions in mind:

- Is there a clear distinction between grants and loans, so that a dependency culture is not created?
- To the greatest degree possible, are best practices in lending used (even with grant programs) so that the appropriate credit culture can be created and moral hazard is reduced for future programming?
- Are sustainable financing structures being built and taught?
- If grants are the most appropriate response to programming, what can be done to help beneficiaries access credit for future financing needs?

The best situation would be to move away from a model where one organization attempts to meet all the needs of a set of beneficiaries towards a model where organizations are able to specialize in a set of activities that they can excel at, and there is close coordination between specializing agencies. In practice, this has been extremely difficult. However, donors and implementing organizations alike should continue to strive for the best utilization of time and resources and identify opportunities for partnering with agencies and organizations that can provide complementary programming.

This model does have the advantage of ensuring that the technical assistance and marketing needs of the borrower are also met -- making it more likely that borrowers will be able to enter new markets and create successful businesses. However, it is the least sustainable, as these activities have a high-cost that cannot normally be covered by the fees and interest collected by an MFI. In many cases, no fee is being charged for any services (credit provision, technical assistance, marketing) meaning that the activity will only function as long as donors or the government supports it. While this may be a useful model for initial or start up phases, it should not be implemented without putting in place in the early stages a transition plan to move to a more sustainable model.

- *Seed Banks.* For many, a Seed Bank is a mechanism by which plant genetic material can be stored for reasons related to bio-diversity or conservation. In Afghanistan, this term is used to describe a credit

mechanism that allows farmers to borrow seed and fertilizer before planting, and repay the value of these items either in cash, wheat seed, or wheat grain after the harvest.

This mechanism was initially used to introduce high quality wheat in rural areas in order to increase yield, and therefore improve food security. There are four organizations who have experience with this in Afghanistan; three of which are ongoing, and one that has recently completed the activity. The Seed Banks are considered successful both by borrowers and program managers, and have created the conditions for Village Banks to be developed out of the community mechanisms used to manage the Seed Bank activities.

The methodology is that a *shura* or specially created village organization is given (as a grant) a predetermined amount of wheat seed and fertilizer. This amount normally represents 25-75% of the seed requirements of the community. The shura determines on what terms and which families will receive the loan of seed and fertilizer. Some programs require only the seed to be repaid, others require the total value of the package to be repaid. Some ask for voluntary additional contributions after harvest, others have no additional cost for the borrower, or require only partial repayment (50%). In some of the very successful seed banks, *shuras* have chosen to liquidate excess seed in the bank in order to purchase community assets such as a tractor.

Since Afghanistan Research and Evaluation Unit (AREU) reports that a majority of households obtain less than 25% of their grain from their own production¹⁶, it would seem that there is an opportunity to expand this mechanism, although considerations about the effect of seed banks on the private sector should be considered.

One of the advantages of this system is that by providing a non-monetary credit, there is less opportunity for abuse – the credit is very likely to be used for its intended purpose. This type of credit is also *sharia*-compliant, making it attractive in conservative areas. Assuming the targeted communities need seed and fertilizer on credit, this is a useful method for testing the commitment and building the capacity of local structures to provide credit before cash is injected in the system. Mechanisms could be designed that start with the seed bank concept and assuming good management, transition it into a village bank.

It is an attractive option for rural areas that suffer from poor roads and limited cash liquidity. However, the operational cost of this activity is high at the initial stages, due to the transport of the wheat and fertilizer to the community; which is more likely to be borne by the implementing agency, rather than being passed on to the borrower. The required training and monitoring will also increase costs, especially in very rural program areas where it may be necessary to purchase motorbikes or hire horses for loan officers.

¹⁶ “Rethinking Rural Livelihoods in Afghanistan”, Jo Grace and Adam Paine, AREU, June 2004.

- *Village Banks and Collective Loans.* There are four organizations doing programs that follow or are planning to utilize the Village Banking methodology. Village Banks are community-managed savings and loan associations established to provide access to financial services in rural areas. Membership usually ranges from 15-20 members and the bank is financed by mobilization of members' savings in addition to seed capital, which all members agree to be liable for¹⁷.

A Village Bank will have a management committee that determines the loan procedures, amounts, and terms. Member's savings are usually tied to loan amounts and savings are used to finance new loans or collective income-generating activities. One organization is using the collective loan mechanism (although separate from their Village Bank activities) to assist communities in obtaining assets that benefit a number of families, such as a water pump. The key distinction of this lending product is that a community group determines who receives loans, under what conditions the loan are provided, and for what purpose the loans can be used.

This methodology would be useful for bring finance opportunities to very rural communities, as previously discussed under the seed bank section. However it is limited by the amount that can be mobilized in a community, and may not be as useful in areas that have a limited ability to save due to high debts or low asset base, unless additional outside funds are injected into the mechanism. If the community structure is not well trained or transparent, injection of outside funds can more easily lead to the mismanagement of those funds. A high level of training is essential to success, but can increase costs dramatically when rural areas are being accessed.

Village banks and collective loans are unlikely to help those producers that are highly committed. Nevertheless, they may be able to prevent farmers from beginning poppy cultivation, and may assist those producers with low-commitment to production, as the loans that are given are most likely to match the highest priorities of the community.

d. Innovative Mechanisms

Credit activities discussed under this section are those activities that have been considered or are being used by a very limited number of organizations.

- *Mortgage/refinancing products.* There is only one organization in Afghanistan currently providing a lending product that could be described as a mortgage or refinancing. This activity is in the pilot phase, has a very small number of loans, and is primarily in areas with a very low-commitment to poppy production. However, it can be used as one example of how a microfinance institution can address rural debt.

The methodology for this product works as follows: when land documents are being held by a third party due to unpaid debts, the finance institution pays the outstanding debt to the third party and holds the land documents until the debt is fully repaid, as well as giving the farmer a small amount of

¹⁷ "Microfinance Handbook: An Institutional and Financial Perspective", Joanna Ledgerwood, World Bank, 1999.

additional funds to start an alternative business. There are two primary advantages to this system. First, when land is being held as security on a debt, often the lender works the land instead of the borrower, meaning that the debtor loses his most productive asset. This type of refinancing would allow the land to again become a productive asset for the borrower, as well as allowing the farmer to have free choice in the crop that is planted on that land. The cost to the borrower for the mortgage would also become more transparent as finance institutions clearly lay out interest rates and fees, where as informal lenders are not transparent and often provide usury rates. MFIs and other financial institutions should be able to design this loan product and schedule repayments so that the debt is more manageable for the household, which can help rural families crawl out from stifling debt levels, rather than spiraling further into debt.

There is a moral hazard that borrowers will feel that there is no real threat of the MFI repossessing the land, and therefore they will chose not to repay. Options such as shura guarantees and character references can likely be used to mitigate these concerns. Like the long-term financing discussed below, this mechanism will likely have a long repayment horizon, and may require additional support to MFIs in order to cover administrative costs over a long time period and guard against risks.

It should be noted that initial studies indicate¹⁸ that the amount of land mortgaged is very small nationwide (less than 4%), however it is significantly higher in the provinces of Nangahar (12%) and Badakshan (18%), areas that will be focused on in upcoming alternative livelihoods programming. Studies do show that low landholding and poverty correlate,¹⁹ and that most of those who are selling land are poor, while those who are buying are rich.²⁰ Therefore, this type of credit product may help stem the flow of assets from the poor to the rich, and prevent farmers from going into poppy production for the purpose of paying off loans.

Homelessness is one of the factors most likely to lead to the poor staying poor; this lending product could address the need for financing to purchase homes, especially for returnees who have no home to return to. “Landlessness remains a singular separator of the truly poor from the rest of the community”^{21[18]} This information combined with the knowledge that 31.4% of farmers grow poppy to get out of debt, helps to highlight the fact that this type of product may need to be considered in more depth.

The next step in looking at this finance product would be an in-depth analysis of how this type of financing can be developed further. What terms and conditions would be required for borrowers be able to service their high levels of debt? (This is likely to vary by region.) What would be the best institution to provide these credits? What are the risk levels for uncollateralized loans used to pay off previous poppy debt? What is the social impact of paying off debts to opium traders and financiers?

¹⁸ “Rethinking Rural Livelihoods in Afghanistan”, Jo Grace and Adam Paine, AREU, June 2004.

¹⁹ “Looking for Peace on the Pastures: Rural Land Relations in Afghanistan”, Liz Alden Wily, AREU, December 2004.

²⁰ Ibid.

²¹ Ibid.

- *Contract growing.* Five organizations are currently engaged in contract growing. Four organizations use contract growing as a method for sourcing high quality wheat seed for other program activities, specifically Seed Banks and seed distribution. These organizations provide seeds and fertilizer, usually at a rate below market, and agree to purchase a specific amount of seed. The other organization has used contract growing as a method of introducing a new crop. This organization provided farmers with seeds and appropriate fertilizer during the pilot phase, as well as advance on payment, although not all took advantage of the cash advance option (20%-30%). Advances were 100% repaid after harvest. In the current programming, no advance is offered, because it was determined that a guaranteed price created enough incentive to get farmers to produce the required amount of product. Seeds and fertilizer are still provided to farmers.

This mechanism most closely matches the structure of poppy financing, and therefore may be the best way to help farmers highly committed to poppy production to change their crop. There are two significant, but not insurmountable challenges to utilizing this type of financing for converting farmers to licit crops.

- First, contract growing is utilized when there is a steady demand for a particular crop, and sale of either processed or unprocessed commodity can be assured. There has already been success in accessing specific markets, any activity would by necessity need to have the market in place in order for this type of financing to be useful and successful. It is likely that responding to needs in the local market (such as for edible oils) would be profitable more quickly than attempts to find contract buyers for export, although this option should not be ruled out. Additional work should be put into determining how appropriate technology and low level manufacturing can be introduced in rural areas to create a market for contract growers and introduce new income generation opportunities. Banks should also be provided with incentives, perhaps in the form of a guarantee, to assist processors in setting up factories that will create a demand for agricultural products.
- Second is the question of what type of organization or institution could implement this kind of financing in the Afghanistan context. Under normal circumstances it would be the processors or wholesalers who would provide contracts for contract growing. However it is clear that this will not happen immediately in Afghanistan. What can be done to jump start the private sector and assist local businessmen in accessing new markets and providing these kinds of services to growers? Would it be better to run it through a partnering/facilitating organization initially? Or do we trust that the private sector can do it with the right incentives? What would those incentives be?
- *Leasing.* Leasing is an interesting option that allows borrowers to obtain assets such as tractors and processing equipment without depleting their capital reserves. It also allows financial institutions to provide a larger credit to a borrower because the asset can be retrieved if payments are not made. The asset itself acts as the collateral. Lease-to-own schemes would

probably be the most appropriate for the purpose of providing productive assets and introducing new income-generating activities into rural areas, and these schemes have the advantage that most borrowers maintain the asset better when they know they will own it eventually. This kind of financing activity is sharia-compliant, known as *ijara wa iqtina'*, or lease-purchase.

Only one MFI in Afghanistan has plans to develop a micro-leasing product in 2005. However, this credit product is one that should be looked at more closely in conjunction with developing alternative livelihood activities. Leasing of appropriate assets, combined with technical assistance could be used to develop and create local markets for import substitution or used to strengthen and improve existing markets for perishable products. International Labor Organization (ILO) has developed a very good manual on setting up and managing a micro-leasing product²². One of the major disadvantages of this type of financing is the very high setup costs, as assets to be leased must be purchased outright by the financing organization. A leasing company for larger processing equipment is set to begin operations in February. Larger processing equipment should increase the demand for agricultural crops, ideally creating a stable alternative to poppy production.

High-commitment producers will require higher levels of inputs to entice them away from the well-developed opium market. Leasing provides one way of providing increased inputs to new markets, while mitigating risk for lenders. The misuse of assets, however, will be a risk for any assets that can also be used in poppy production (i.e. tractors), so monitoring will be an important element of leasing activities.

e. Informal and Indigenous mechanisms

The *salaam* credit, an advance on harvest, has been described in many documents as the primary method by which farmers receive credits that allow them to cultivate poppy, and occasionally other crops. Often it is the only access to credit for a farmer, and is critical for the purchase of agricultural inputs and meeting household needs during lean winter months²³. As this paper focuses on potential alternatives to that system, *salaam* will not be discussed in detail.

- *Traders and shopkeepers.* According to AREU, traders and shopkeepers are the most important source of credit after friends and family, especially for the poorest households.²⁴ This finding is consistent with other assessments and field visits that have found traders providing credits to anywhere from 5 to over 100 farmers, in amounts as high as 20,000 Afs to an individual farmer.²⁵ This loan can take the form of *anwat*, where goods are sold at a significant mark-up, and then immediately resold to the trader at a significantly reduced price, allowing households to obtain cash loans

²² "Leasing for Small and Micro Enterprises: A guide for designing and managing leasing schemes in developing countries", Linda Deelen, Maurico Dupleich, Louis Othieno, Oliver Wakelin, ILO, 2003.

²³ "Replacing Narco-Users with Micro Lenders: The Agricultural Finance Component of Opium Substitution Programs in Afghanistan", Bhuvana Anand, Fletcher School, Tufts University, May 2004.

²⁴ "Rethinking Rural Livelihoods in Afghanistan", Jo Grace and Adam Pain, AREU, June 2004.

²⁵ "Microfinance Market Analysis in Southern Afghanistan", Larry Hendricks and Altai Consulting, April 2004.

while bypassing Islamic strictures on interest²⁶. Perhaps more common are *murabaha* (cost plus markup) loans, which are commonly used to acquire food and agricultural inputs. Access to these loans is limited, as familiarity with the local shopkeeper is usually necessary to receive credit, meaning that families not living in market towns may have difficulty accessing credit²⁷, even if they can get to a location where it is available.

While it is very difficult to get information on the cost of borrowing from traders, indications from traders are that these costs represent a 10%-50% markup. Reports from borrowers indicate that these costs can be anywhere from 30%-100%, depending on whether the borrowing is for food items or for seeds and other agricultural inputs. This represents an opportunity for financial institutions, as they can provide credits at a much lower cost to the borrower – however loans need to be structured in a *sharia*-compliant manner, as this is an oft-cited reason for traders structuring the credits as they do.

Traders themselves have an almost unlimited need for credit, as the more cash in hand is available to them, the more commodities they can purchase in bulk, improving their costs and reducing transport costs. To give an example, one trader in Badakshan borrowed 50,000 Afs from an MFI. When the MFI's loan officer was asked why he would recommend such a large first time loan, the response was that the trader already had 150,000 Afs in cash. This credit simply topped up his existing resources.

Trade is seen as a profitable business with few risks, and therefore traders rarely have trouble accessing credit. On the contrary, trade financing was the first type of credit made available by banks in Kabul. Even relatively small rural traders seem to be able to access credit fairly easily, usually through long-standing trade relationships.

The question to consider is how traders can play a role in less usury forms of finance. Perhaps through technical assistance and/or incentive schemes, traders could be used to access new product markets (i.e. oilseeds, cotton) therefore creating a pull factor that could initiate contract growing for new crops. It is important that the private sector be used to the greatest extent possible, however in the current environment many traders remain risk-averse and are unlikely to initiate an expansion into new products and markets where they do not have long-standing trade relationships.

- *Hawala*. *Hawala* were originally developed to facilitate all aspects of long distance trade, emerging as a response to the need to have large amounts of bullion available to purchase goods as well as a repository for profits made at distant trading posts²⁸. The security of the system relies on highly personalized trust relationships; and often hawaladars do not know all of the links in the chain, as they are only familiar with the very closest link²⁹.

²⁶ "The Role of Opium as a Source of Informal Credit", UNDCP, Strategic Study #3, January 1999.

²⁷ "Human Security and Livelihoods of Rural Afghans 2002-2003", Feinstein International Famine Center, Tufts University, February 2004.

²⁸ "A Background Report on the Operation of Informal Value Systems (Hawala)", Roger Ballard, April 2003.

²⁹ "Informal Funds Transfer Systems: an analysis of Hawala", Dr. John Wilson and Dr. Roger Ballard, January 2003.

This proved true in field visits, as some hawaladars reported that transferring funds to various provincial capitals was not possible (even though users of the system had reported it was possible), and indications are that the most important role for hawalas is the transfer of funds outside of the country for trade or to protect financial assets.

While in many countries, hawalas are considered faster, more reliable, reaching more destinations, with lower costs than formal banking systems³⁰, in Afghanistan the reach of hawalas is surprisingly limited. For example, a trading town of approximately 11,000 people in Badakshan had no hawaladar, although it had about 40 shops. Several hawaladars confirmed that hawalas existed primarily “in big cities or where there is a lot of trade”. Therefore, even as a transfer mechanism, hawalas do not serve rural areas to the extent found in other countries.

The role of hawalas as a provider of credit is very limited in Afghanistan, compared to experiences in other countries³¹. While there are examples of hawaladar providing *mudaraba* (profit sharing) credits to local businesses in Faizabad, this seems to be more as a personal financial investment than as a regular part of hawala business operations. Indeed, some hawaladars reported that while lending was done in the past (short-term and at rates of 50-60% interest) this was no longer happening, and cited as the reason the recently passed laws forbidding hawalas from lending or taking deposits.

Some international organizations report using hawalas as a short term (1 month or less) credit source, with a fee of 2-3%. This is not perceived as a form of credit by hawaladars, but rather these “advances” are part of the service of transferring funds.

Because of legal limitations, somewhat limited outreach, and the recent concerns about this mechanism being used to launder funds, hawalas have an extremely limited role to play in increasing the outreach of rural credit in Afghanistan.

- *Cooperative financing.* In the past, the Ministry of Agriculture and Animal Husbandry’s Department of Cooperatives received funds from the Agriculture Development Bank to on-lend to cooperatives. Repayment was guaranteed by the Department of Cooperatives. The Department would then accept applications from cooperatives and lend to farmers on a 14:1 ratio of loan to their paid in share capital. This worked up until the communist government took over in the 1970’s³².

While it would not be wise to finance the Department of Cooperatives to restart this program, cooperative members frequently request that this mechanism be revitalized. At least three organizations have found the cooperatives a useful conduit for finance activities. As cooperatives also provide a good forum for technical assistance and marketing, this self-

³⁰ “Hawala and other Informal Payment Systems: An Economic Perspective”, Dr. John Wilson, May 2002.

³¹ “Replacing Narco-Users with Micro Lenders: The Agricultural Finance Component of Opium Substitution Programs in Afghanistan”, Bhuvana Anand, Fletcher School, Tufts University, May 2004, and the author’s experience in other countries.

³² “Conclusions Regarding the Role of Cooperatives in Afghanistan”, Annex to USAID’s Rural Finance Assessment, Part 1, Larry Hendricks, December 2003.

selected group could provide opportunities for lending through group lending or village bank-type systems. Because it is a mechanism that is familiar to many farmers, transition to this mechanism is likely to be understood and adopted quickly.

On the downside, the lack of formal business skills coupled with pervasive illiteracy create a major obstacle for cooperative activities. This deficiency makes medium and long-term business activities much more difficult, and subject to ad-hoc decision-making due to the dependence on the few leaders that are literate³³. Organizations using cooperatives to increase access to credit and other resources should take special care to provide capacity-building, extension services, and business development services at all levels of the organization.

f. Financing Mechanisms not currently in Afghanistan, but to be considered

- *Long-term financing.* Horticulture provides a tremendous export opportunity for Afghanistan.³⁴ And yet, while work is being done to handle issues related to phyto-sanitary certification, processing, marketing, and transport issues, there remains a gap in financing for horticulture activities because of the long horizon before the trees becomes productive.

While horticulture is far from being the only activity that would benefit from long-term financing, it is one that plays a direct role in alternative livelihoods. This is true not only because it provides an alternative crop to poppy, but also because once an area has been planted with fruit trees it is committed for 20-50 years. Unlike wheat and vegetables, the crop choice cannot be easily changed from season to season. It is a long-term investment, and one that many Afghans are eager to make.

While banks and MFIs do have a long-term perspective in regards to the operation of their financial institution, none have come up with a solution, even on a pilot basis to confront this issue. Reducing debt levels and increasing incomes in general will make more household funds available for this type of activity, however further discussion and exploration of incentives and guarantees that could be offered to financial institutions is necessary.

- *Consumption Loans.* The formal lending currently available is for the productive assets and working capital. There are no consumption loans, like those available from traders, available at reasonable lending rates. It is natural in the current lending environment that MFIs would be hesitant to give loans for consumption and income smoothing. Yet, borrowing for these purposes plays a major role in why credit is taken from narco-financiers and why debt levels are so high.

Loans for consumption and income smoothing are not always negative. Lack of access to credit can mean that productive assets are sold, making

³³ "Conclusions Regarding the Role of Cooperatives in Afghanistan", Annex to USAID's Rural Finance Assessment, Part 1, Larry Hendricks, December 2003.

³⁴ "Market Sector Assessment in Horticulture, Phase 1: Market Research - Identification of Business Opportunities", Altai Consulting, June 2004.

the household more vulnerable.³⁵ Therefore, further discussion is required on how existing institutions can begin to provide these types of loans, while protecting the portfolio of MFIs and complying with Islamic lending requirements.

- *Guarantee Mechanism.* The aim of a credit guarantee scheme is to reduce the net losses incurred by banks from defaulting small business borrowers, through the assumption of a share of the loss by the guarantee organization. Demand for credit will normally increase with the availability of a guarantee fund, if the extra cost paid for credit is less important than the availability of credit.³⁶ In Afghanistan, access to credit is a greater issue than the price of that credit, as evidenced by the usury rates currently charged.

Credit guarantee mechanisms are used in approximately 85 countries around the world; and are used in both developing and developed countries. The use of a credit guarantee mechanism is intended to shift the banker's risk-reward frontier so that loans to smaller scale borrowers, for longer terms, and/or with little or no collateral requirements can be included as one part of the bank's overall portfolio.

Benefits of this mechanism are³⁷:

- Serves to integrate the private sector with the borrowing community without providing direct funding for the loans
- Reduces perceived risk and therefore the sensitivity to lend and the reluctance to enter unknown markets
- Induces financial institutions to use their own capital for market-driven project financing
- Provides the lender with a stake in the success of businesses, by maintaining the capital risk for part of the requested loan amount
- Enhances economic growth for participating businesses by generating new lines of business for the institution and expanding operations

Several banks – international and local – have indicated that a guarantee mechanism would help stimulate their interest in lending to agro-businesses, both in the immediate and long-term. This would create non-farm wage labor, as well as creating an increased demand for agricultural products.

ISSUES TO CONSIDER

a. Income Streams

It is important to note that several studies^{38[35]} report on the prevalence of multiple income streams for rural Afghans. Nearly 50% of households surveyed reported five

³⁵ “Rethinking Rural Livelihoods in Afghanistan”, Jo Grace and Adam Pain, AREU, June 2004.

³⁶ “Credit Guarantee Schemes for Small Business Lending”, Bannock and Partners, 1997.

³⁷ “Guarantees for Rural Financing: A Guide to USAID’s New Mechanism”

or more different income streams; and for 54% of wealth groups non-farm labor was considered the most important source of income. The majority of wealth groups have between three and six income sources.³⁹ This is critical information for MFIs providing agriculture-related credits, because it gives confidence that loans, even in drought conditions may still be repaid through other income sources.

Organizations should develop methods for determining total household income from all sources. This will provide a clearer picture of a borrowers' ability to repay, in contrast to looking solely at additional income created from the items purchased with the loan. It will provide perspective on how households will handle lean months and the purchase of assets that will not become immediately productive such as young cows or horticulture cuttings. Having confidence that farmers will be able to repay these loans with other sources of income allows MFIs to loan funds for a wider range of activities. A better analysis of income streams also assists in the design of loan products, as grace periods or payment scheduling can be timed so that debt service does not put an unnecessary burden on the family.

Currently, opium income makes up on 62% of poppy farmers' total income. The rest is accounted for by income from cereals (14%), labor (11%), livestock (9%), other ag products (2%), and other sources (2%).⁴⁰ When looking at ways to shift farmers out of poppy production, it is important to consider increasing existing sources of income, especially those that can increase a farmer's access to credit -- for example the purchase of livestock can be both an investment and a working asset.

b. Shifting the bias towards trade

There is an overwhelming bias in certain areas to use microcredit activities to finance trade. While there is nothing inherently wrong with trade – it is well known that Afghanistan has a long history of trade – this bias underlines the need to introduce other options for income generation in rural areas. This will most likely be done through Technical Assistance (TA) and Business Development Services (BDS). The skills training being implemented by several NGOs, in combination with start-up grants should be explored further for its potential role in the development of alternative livelihoods. At this time, most of these programs take place in urban areas and target returnees. However, it is worth considering how to modify them to meet the needs of rural areas.

It is natural for a country moving out of the post-conflict phase, especially after such a long period of war, to be risk averse. Trade activities allow for a quick turnover of funds and short-term risk. Grants may be required to encourage individuals to enter into new income generation activities. Grant programs, however, should be structured in such a way that they do not harm the credit environment. Making grants available only for innovative activities, and linking them with existing credit providers for working capital or follow-on loans would help protect against a dependency mentality.

New skills training may be one way to meet the needs of itinerant laborers and households reliant on off-farm income to smooth income. AREU recommends using

³⁸ Tufts' "Human Security and Livelihoods of Rural Afghans 2002-2003" and AREU's "Rethinking Rural Livelihoods in Afghanistan", Adam Paine and J. Grace, July 2004

³⁹ "Rethinking Rural Livelihoods in Afghanistan", Jo Grace and Adam Pain, AREU, June 2004.

⁴⁰ "Farmers' Intentions Survey 2003/2004", UNODC, February 2004.

vocational training to develop and expand the existing skills of people living in rural areas, and creating new on and off farm opportunities⁴¹. This would also provide additional income streams, providing increased stability to rural households.

c. Capacity of existing institutions

In looking at the various credit innovations that could be supported and expanded, it is important to remember that most microcredit institutions have been operating for 18 months or less, and most banks have been open for less than a year. The ability to introduce new and innovative products is limited when financial institutions are only just discovering how well their pilot projects have worked over the last year. A staff that is fully conversant with standard operating procedures is important when looking at innovative solutions. Some organizations have recently chosen to completely re-work the initial design of their activities, and indicator that the Afghan financial market remains dynamic, but also risky. While there is a desire within the international community for responses that will have a quick impact, pushing financial institutions too far too fast could prove disastrous in the long run.

Therefore this will be the greatest challenge for donors who want to see immediate impacts in the credit sector. A full discussion is needed with MFIs and other organizations to determine their interest and ability to expand their products and geographic areas of operations. Quick expansion is likely to require a higher number of expatriate staff to train local staff in increasingly rural areas. However, the Afghan government may not be comfortable with additional donor funds being spent on expatriate salaries. A balance must be struck between putting sustainable programs with solid methodology in place, versus the political upset caused by resources going to non-Afghans.

Thankfully, there are very few examples of poor management of credit-related programs. But the point must be stressed that most credit systems in rural areas will use trust relationships as their primary guarantee. This trust goes both ways, and poor programming by ill-trained credit officers will create the opportunity for mis-use of the system, and eventually an erosion of the credit environment, which will further complicate the existing problems for credit provision in this country. The buy-in of shuras is essential to successful programs, and especially program monitoring, therefore all rural financial activities should begin with discussions with the shura to make all aspects of the program clear, discuss issues of Islamic lending, and gain their confidence and support.

Donors are likely to find MFIs extraordinarily cautious about further expansion, due to their experiences of growth over the last 18 months. Non-financial institutions attempting to jump into the gap must think carefully about their ability to provide credit using best practices, and donors should be vigilant about oversight and management of new institutions.

d. The need for savings mechanisms

Current regulations do not allow any institution other than a registered bank to hold deposits. The purpose of this regulation is, of course, to protect the savings of depositors. MFIs may hold deposits only if the amount of the savings is less than the amount of the loan given – then it is seen as a form of collateral. Hawala also

⁴¹ “Rethinking Rural Livelihoods in Afghanistan”, Jo Grace and Adam Pain, AREU, June 2004.

regularly hold large levels of savings for fairly long periods; this trend does not seem to be changing despite the new legal framework. However, as banks have a very limited outreach, for many rural households, opium acts as a savings mechanism, in addition to all its other roles.

The demand for legitimate savings instruments in rural areas is very high due to the need for a secure place to keep excess cash, the desire to smooth consumption patterns, the need to hedge against risk, and the desire to accumulate assets. Several MFIs encourage voluntary savings, while others are developing specific savings products. Regulation on this issue must be reviewed to ensure that the regulatory framework allows for savings mechanisms that are accessible to rural people.

e. Islamic Lending issues

The need for Islamic lending products in Afghanistan varies greatly from region to region. Many farmers, after years of lacking credit completely, being forced to pay usury rates to traders, or being forced to grow poppy in order to access credit are not as concerned about interest rates as they are about simply being able to access reasonable credits. In more conservative areas, Islamic lending principles are of great importance to borrowers and loan officers alike.

Sometimes education is enough to solve the problem. Islamic lending practices are founded on the belief that money itself should not be an earning asset. Once it is clearly explained that MFIs do not receive profits for their lending activities, but use these funds to pay staff salaries, office rent, and to provide additional loans, in some areas, this is enough to calm worries about lending practices.

However in other areas, organizations with credit programs must go to much greater lengths to satisfy the concerns of potential buyers. One organization has gone so far as to have a *fatwa* issued on their lending product that declares it *sharia*-compliant. However, that limits the ability of the organization to adjust the product according to the changing needs of the population that is being served.

Mudaraba (profit sharing) and *murabaha* (cost plus markup) are both practiced by indigenous credit providers and models exist for adapting them to the microcredit market.⁴² Anawat could also be adapted.

CONCLUSIONS AND NEXT STEPS

Access to a breadth of credit options is essential in a healthy economy, but especially important when attempting to encourage a change in behavior. The solutions presented above must be looked at as menu from which a variety of options should be chosen according to regional economics, access to markets, debt levels and asset base of potential borrowers, and capacity of the organizations available to implement the activity.

The greatest challenges to responding to demand for credit in rural areas will be access (conditional upon security) and the capacity of current providers to expand operations. MFIs are reaching the maximum of their response and outreach capacity at this time; they need time to solidify what has been learned over the last 18 months.

⁴² "An Application of Islamic Banking Principles to Microfinance", Rahul Dhumale and Amela Sapcanin, UNDP and World Bank.

Other (non-financial) implementing organizations may step into the gap, but extreme care needs to be taken that best practices are followed by these institutions, so that the credit market is not undermined by poor programming. New MFIs and financial institutions should be invited to enter into the lending market, however their operations should not be expected to expand quickly, as they will need to learn the culture and environment for lending.

After discussions with the Afghan government, donors may want to consider higher levels of expat staff within existing MFIs and implementing organizations. This may give implementing organizations the excess capacity for training, allowing them to expand geographically and pilot new products.

Within the limitations outlined above, the following are next steps for consideration:

- i. *Regional analysis of credit needs.* An analysis should be done at a regional level to determine which credit mechanisms are most attractive to low and high commitment poppy producers, as this will further inform financial institutions and donors of the most efficient way to match potential borrowers with credit interventions that will make an impact.
- ii. *Training and start-up grants.* Donors and implementers should begin looking at opportunities for training interventions that can introduce new skills and income generating activities to rural areas. These can be partnered with grant activities, as long as businesses are linked to financial institutions for working capital and future credit needs.
- iii. *Seed Banks to Village Banks.* Successful implementation of Seed Bank activities should be replicated in less accessible rural areas, and those Seed Banks that have been successful in managing their assets should be considered for transformation into Village Banks that can provide a wider range of services to the community.
- iv. *Debt and the potential for mortgages and re-financing products.* A deeper exploration of rural debt is needed, probably on a provincial basis, to determine if mortgage and re-financing products can be used to make current levels of debt more manageable and assist farmers in moving away from poppy production. Mechanisms for mitigating the risk to financial institutions must also be created.
- v. *Expand contract growing and processing.* Develop mechanisms for contract growing through business development services and incentives for traders. Assist traders in accessing new markets to create the draw for new agricultural products. Over the long-term, create processing opportunities, perhaps financed through the use of guarantees, that will use contract growing as a supply mechanism.
- vi. *Leasing.* Encourage more MFIs to consider leasing products, especially coupled with training on appropriate low-tech technology solutions for processing.

- vii. *Horticulture lending and consumption loans.* Donors should consider mechanisms, such as guarantees, that will provide incentives for financial institutions that provide these services.
- viii. *Savings mechanisms.* Donors and the Government of Afghanistan (GOA) should ensure that regulations regarding savings do not disadvantage rural savers. MFIs should be encouraged to develop savings products for their clients to build assets and protect against emergencies.

REFERENCES

- “Access to Labor: The Role of Opium in the Livelihood Strategies of Itinerant Harvesters Working in Helmand Province, Afghanistan”, Strategic Study #4, UNDCP, June 1999.
- “Afghan opium production predicted to reach new high”, Pierre-Arnaud Chouvy, Jane’s Intelligence Review, October 2004.
- “Afghanistan: The Opium Drug Economy”, Christopher Ward, World Bank, February, 2004.
- “Afghanistan Opium Survey 2004”, UNODC, November 2004.
- “Afghanistan Farmers’ Intention Survey 2003/2004”, UNODC, February 2004.
- “Afghanistan State Building, Sustaining Growth and reducing poverty: A country Economic Report”, World Bank, September 2004.
- “Agricultural Finance in the Market Chain”, Karri Goeldner, USAID, February 2004.
- “Alternative Development in Afghanistan: The Failure of Quid Pro Quo”, David Mansfield, August 2001.
- “An Application of Islamic Banking Principles to Microfinance”, Rahul Dhumale and Amela Sapcanin, UNDP and World Bank.
- “Badakhshan Province: Suggestions for an Area Development based Counter-narcotics strategy”, Aga Khan Foundation (Afghanistan), April 2004.
- “Credit Guarantee Schemes for Small Business Lending”, Bannock and Partners, 1997.
- “Conclusions Regarding the Role of Cooperatives in Afghanistan”, Annex to USAID’s Rural Finance Assessment, Part 1, Larry Hendricks, December 2003.
- “Drugs and the Financing of Terrorism”, Pierre-Arnaud Chouvy, 2004.
- “The Dynamics of the Farm gate Opium Trade and the Coping Strategies of Opium Traders”, UNDCP, Strategic Study #2, October 1998.
- “The Economic Superiority of Illicit Drug Production: Myth vs. Reality”, David Mansfield, August 2001.
- “Financial Services and Products to Improve Farmers’ Livelihoods in Badakhshan, Afghanistan”, Dr. Gideon E. Onumah and Barry Pound, October 2004.
- “Free Markets? Understanding and responding to markets in Afghanistan” Sarah Lister and Adam Paine, AREU, June 2004.
- “Guarantees for Rural Financing: A Guide to USAID’s New Mechanism”, USAID, 2002.
- “Hawala and other Informal Payment Systems: An Economic Perspective”, Dr. John Wilson, May 2002.
- “Human Security and Livelihoods of Rural Afghans 2002-2003”, Feinstein International Famine Center, Tufts University, February 2004.
- “Informal Funds Transfer Systems: an analysis of Hawala”, Dr. John Wilson and Dr. Roger Ballard, January 2003.
- “Leasing for Small and Micro Enterprises: A guide for designing and managing leasing schemes in developing countries”, Linda Deelen, Maurico Dupleich, Louis Othieno, Oliver Wakelin, ILO, 2003.

“Looking for Peace on the Pastures: Rural Land Relations in Afghanistan”, Liz Alden Wily, AREU, December 2004.

“Microfinance Institutions’ Response in Conflict Environments”, Marilyn S. Manalo, World Bank, Africa Region Working Paper Series No. 54, June 2003.

“Microfinance Market Analysis in Southern Afghanistan”, Larry Hendricks, MISFA, April 2004.

“Mission to Nangahar November 4-6, 2004”, Anthony Fitzherbert.

“Replacing Narco-Users with Micro Lenders: The Agricultural Finance Component of Opium Substitution Programs in Afghanistan”, Bhuvana Anand, Fletcher School, Tufts University, May 2004.

“Report from the International Counter Narcotics Conference on Afghanistan, February 8-9, 2004”, United Kingdom Government and UNODC.

“Rethinking Rural Livelihoods in Afghanistan”, Jo Grace and Adam Pain, AREU, June 2004.

“The Role of Opium as a Source of Informal Credit”, UNDCP, Strategic Study #3, January 1999.

“Rural Finance Assessment Part I: Agro-Processors and Agro-Cooperatives”, USAID/RAMP, December 2003.

“Rural Finance Assessment Part II: Management Operations Plan”, USAID/RAMP, March 2004.

“Sustainable Banking with the Poor: Microfinance Handbook – An Institutional and Financial Perspective”, Joanna Legerwood, World Bank, 1999.

“What is Driving Opium Poppy Cultivation? Decision Making Amongst Opium Poppy Cultivators in Afghanistan in the 2003/4 Growing Season”, A Report for the Drugs and International Crime Dept of the Foreign and Commonwealth Office, April 2004.

Workshop Paper No. 3

The Challenges of Regulating and Supervising the *Hawaladars* of Kabul

Samuel Maimbo, Financial Sector Specialist

The World Bank

INTRODUCTION

In September 2004, Da Afghanistan Bank, the country's central bank introduced legislation to regulate and supervise the activities of money service providers in Afghanistan. This regulation applies to all individuals and legal entities that provide money services in Afghanistan, whether or not the individuals and legal entities are domiciled in Afghanistan. For the purposes of the regulation, money services are defined to include safekeeping, money transmission, check cashing, and currency exchange. A licensed money service provider is entitled to engage in all of the activities of a foreign exchange dealer, but a licensed foreign exchange dealer may not engage in safekeeping, money transmission, or check cashing without upgrading its license to that of a money service provider⁴³.

Da Afghanistan Bank faces significant challenges in its efforts to regulate and supervise the informal financial *hawala* transactions of the *hawaladars* of Kabul under the recently introduced Money Exchange Dealers Regulations.⁴⁴ Reforming the formal financial sector in immediately after active conflict is difficult enough; undertaking to regulate the *informal* sector under such circumstances is doubly daunting.

Further compounding the problem, growing opium production in Afghanistan and an emerging nexus of drug-trafficking with terrorist and militant groups are exerting a very strong effect on the informal financial sector. Much needs to be done to ensure that the successful reforms undertaken to date are not undone.

Implementing the new regulations will be challenging for the central bank because of three specific challenges. First, the informal financial system has a long history of independence and self-regulation. Second, incentives for compliance are weakened by the weakness of the legal and judicial framework for the prosecution of financial crimes. And, third, the complexity of investigating money laundering and terrorist

⁴³ This regulation shall not apply to commercial banks licensed by DAB, their branches, and foreign bank branches permitted by DAB. Money services provided by these banking organizations are regulated and supervised as part of their overall operations, under the regulations issued pursuant to the Law of Banking in Afghanistan

⁴⁴ In Arabic, *hawala* simply means "transfer." For analytical purposes, the term is used to refer broadly to money transfer mechanisms that exist in the absence of, or in parallel to, formal banking channels. In some countries, commercial banks use the term *hawala* to refer to formal-sector money transfers. That definition is not used here. A *hawala* transaction, as defined here, encompasses financial transfers made by principals, or customers (Customer A, or CA, and Customer B, or CB) located in countries A and B, through *hawala* service providers in their respective countries. These providers (designated *hawaladars* HA and HB) operate outside the formal financial sector, regardless of the use or purpose of the transaction and the country of remittance or destination. Typically, HA receives funds from CA and asks HB to advance the amount to CB in the local-currency equivalent. In a prototype *hawala* transaction, an expatriate worker (CA) uses a *hawaladar* (HA) to arrange a remittance to his home country. CA makes payment in dollars or another convertible currency to HA, who contacts a *hawaladar* counterparty (HB) in the receiving country to arranges payment in local currency to the remitter's family or other beneficiary (CB) (El Qorchi et al, 2003).

financing—given the size of the drug economy and the emerging risk of a nexus of drug-trafficking with terrorist/militant groups.

This paper commences with a brief discussion of the rationale for regulating informal financial services, then proceeds to outline the special challenges the central bank faces in Afghanistan, and concludes with two modest recommendations – the need to continue strengthening the legal and judicial system, and the need to continue working in partnership with the association of *hawaladars*.

THE RATIONALE FOR REGULATION OF INFORMAL FINANCIAL SERVICES

In a conflict-afflicted country, conventional assumptions about financial risk and abuse do not necessarily apply, at least not everywhere or in every case. In an environment where increasing opium production and occasional terrorist acts have raised the incentives to conceal and obscure the origins and destinations of illicit financial transactions, it will not be possible to accumulate the breadth and depth of understanding of the informal financial sector similar to that which regulators have developed for formal commercial banks in stable developed economies. That being so, why bother to attempt regulation at all?

The financial sector, and banks in particular, are subject to heavier regulation than virtually any other industry. The reasons for this lie in the combination of several factors. First, banks are vulnerable to failure—and bank failures entail serious negative externalities. Second, there are significant problems of imperfect information between bank owners and depositors. Third, optimal regulation of the market – just enough regulation to minimize failure - is often difficult to achieve, forcing regulators to err on the side of caution with additional regulations. Although none of these factors is unique to banks, their combination is shared by few other industries.

By association, non-bank financial institutions, including informal financial institutions, attract similar regulatory interest and concern. The risk that non-bank financial institutions might create negative externalities for clients by engaging in unsafe and unsound financial practices compels regulators periodically to examine the need for action. Their interest is often spurred by an event such as a bank failure or financial fraud or, occasionally, by a broader economic or political event.

In the specific case of the *hawala* system, renewed regulatory interest was stimulated by press and law enforcement investigations into the September 11, 2001, terrorist attacks in New York and Washington, D.C. By pointing to a connection between informal remittance systems and terrorist financing, those investigations raised official concern about the susceptibility of informal remittance systems to abuse. Hitherto, most financial regulators had assumed that the amounts transferred through *hawala*-type remittance systems were small and did not pose significant systemic risks to the financial system.

October 10, 2001, the international Financial Action Task Force (FATF) against money laundering responded by issued eight special recommendations aimed at combating terrorist financing. Those recommendations supplemented its earlier 40 recommendations for fighting money laundering, which quickly became and have remained the world standard for preventing criminal abuse of financial systems.

Arguing that money- and value-transfer systems had shown themselves vulnerable to misuse for money laundering and terrorist financing, FATF urged in its sixth special

recommendation that all jurisdictions should contribute to the transparency of payment flows by imposing upon all types of money- and value-transfer systems consistent measures against money laundering and terrorist financing including either licensing or registration.

The recommendation called on countries to license or register formal and informal remittance business and subject them to all FATF recommendations that apply to banks and non-bank financial institutions. Said FATF:

“Each country should take measures to ensure that persons or legal entities, including agents, that provide a service for the transmission of money or value, including transmission through an informal money or value transfer system or network, should be licensed or registered and subject to all the FATF Recommendations that apply to banks and non-bank financial institutions. Each country should ensure that persons or legal entities that carry out this service illegally are subject to administrative, civil or criminal sanctions”.

Special Recommendation 6 is considered to be the minimum effective level that a money-transfer business should be required to fulfill to comply with international know-your-customer requirements.⁴⁵ It recommends that it is important for the credibility of the system that failure to produce an acceptable form of identification should lead to rejection of the client and refusal to conduct the transaction—and, under specific circumstances, to reporting the transaction to authorities.

In a subsequent interpretive note on special recommendation 6, FATF focused on three core points:

- Jurisdictions should ensure that money- and value-transmission services, including informal systems, are subject to all applicable FATF recommendations (in particular, 10–21 and 26–29).⁴⁶
- Jurisdictions should require licensing or registration of persons (natural or legal) who provide money- or value-transfer services through formal or informal systems.
- Jurisdictions should have the power to impose sanctions on money- and value-transfer services, including informal systems, that fail to obtain a license or register and that fail to comply with relevant FATF recommendations, including that pertaining to record keeping.⁴⁷

In Afghanistan, the call to regulate informal remittance systems came at a time, when development agencies were highly dependent on *hawaladars* for their financial transactions. No private financial institutions were operating in the country, and the remaining state banks were plagued by significant weaknesses—among them weak corporate governance and management structures, unskilled human resources,

⁴⁵ The recommendation states that the institution should be “identifying the customer and verifying that customer’s identity using reliable, independent source documents, data or information.” The documents commonly acknowledged and accepted for identification purposes are identity card, passport, driver’s license, and social security card.

⁴⁶ FATF recommends that jurisdictions should introduce transaction reporting in line with their current reporting requirements for financial institutions. Thus, jurisdictions may consider issuing to the money-transfer sector specific guidance as to what may constitute a suspicious transaction. Some currently used indicators of suspicious financial activity, such as those found in the FATF’s “Guidance for Financial Institutions in Detecting Terrorist Financing,” are likely to be relevant for money- and value-transfer activities. However, particular activities and indicators unique to this sector should be further developed.

⁴⁷ FATF’s recommendation 10 calls for financial institutions to maintain records for at least five years. FATF recommends that jurisdictions should consider setting some minimum requirements for the form in which those records should be kept.

outdated technological capacity and accounting systems, and grave problems of liquidity and solvency.

During the Taliban period, the country's formal banking system was not operational. The then six licensed state banks provided no commercial banking services, nor did they have the capacity to offer international or domestic remittance services. Short of physically moving cash around the country, *hawala* transactions were the only reliable, efficient, and safe means of transferring funds into Afghanistan and within its provinces.

In fact, the *hawaladars* of Kabul were the only active financial actors. They offered a diverse range of financial and non-financial services stratified into local, regional, and international markets. More than 300 registered *hawaladars* organized themselves into an impressive open market offering foreign-currency exchange, funds transfers, microfinance, trade finance, and deposit-taking activities. Non-financial activities included telephone and fax services, regional and international trade, and, more recently, internet services.

The *hawala system* was prized by foreign and local aid agencies for its efficiency⁴⁸. Transferring funds to Kabul from Peshawar, Dubai, and London took an average of 6 to 12 hours. Most transfers between Kabul and any of the regional centers were completed within 24 hours. Slightly more time was required for payments to more remote regions or villages where the money-exchange dealer did not have a local office or representative. The cost of transferring funds into and around Afghanistan was low, averaging 1 to 2 percent. The price depended on the volume of the transaction, the relationship between the client and the *hawala* dealer, the currency of exchange, the security environment in Kabul and at the destination for the funds, and the negotiating skills of the client. Nearly all nongovernmental organizations, aid donors, and development agencies used the *hawala* system to deliver humanitarian relief and developmental aid to Afghanistan and to move funds around the country. There was no limit to the volume of funds the *hawaladars* of Kabul could process, either individually or severally. Single transactions in excess of US\$500,000, especially between Peshawar and Kabul, were not uncommon. Smaller organizations regularly remitted US\$20,000–30,000 through the system to meet expenses.

The role of *hawaladars* in facilitating remittances is important. About 15% of the rural population receive remittances which represents about 20% of their expenditure on average (World Bank, 2004:19). During the past 25 years, more than 30% of the Afghan population has been externally or internally displaced (with over three million in Pakistan and 2.3 million in Iran). Remittances from Pakistan, Iran, North America, Europe and parts of Australasia remain a central element of Afghan households (World Bank, 2004:27).

At the same time, the use of the *hawala* system raised concern, particularly among the international financial institutions. The inaccessibility of the customer records of *hawaladars* and ambiguities in the settlement process made the system vulnerable to

⁴⁸ From 1980 to 1986 official development assistance to Afghanistan never exceeded US\$20 million a year. Between 1988 and 1998, Official Development Assistance (ODA) averaged a little more than US\$200 million a year, and during the years of the Taliban rule, external aid fell to a little more than US\$130 million a year. From 1992 to 2001, the United Nations provided a total of US\$ 160 million in aid. At the 2002 International Conference on Reconstruction Assistance for Afghanistan in Tokyo, the international community pledged more than US\$4.5 billion toward the US\$15 billion that international organizations estimated it would cost to develop the economy (Rondinelli, 2004:11-15).

abuse. There were no standard documentary requirements for conducting business in the market. Neither the central bank nor the *hawala* dealers' association required dealers to open their books for external inspection, nor do they require periodic financial reports. Standardized documentation and reporting were considered unnecessary because of the high level of trust upon which the informal system is founded. There were no standard requirements for keeping records of completed transactions and no regulatory requirement for customer identification. Consequently, *hawala* transactions were unlikely to leave audit trails for law enforcement agencies investigating money laundering, tax evasion, corruption, or other related activity.

In early 2002, when the Da Afghanistan Bank commenced financial sector reforms, it had four regulatory options regarding the informal sector (Maimbo, 2003). It could: adopt no regulatory or supervisory standard pertaining to the informal money-transfer sector; extend formal banking sector regulations to the money-exchange market and establish formal on- and off-site supervisory mechanisms; allow self-regulation and supervision among dealers; and, establish special regulatory and supervisory standards for the informal sector.

Each approach presented its own administrative and institutional challenges. The fundamental question facing the central bank was whether *hawaladars* posed systemic risks serious enough to require formal regulatory and supervisory regimes similar to those being developed for the banking sector. Or could the *hawaladars* be left alone without endangering the long-term stability of the financial sector and monetary policy?

In view of intense international efforts to combat money laundering and terrorist financing of terrorism, the first option had to be ruled out—it was not feasible to forgo regulatory standards altogether. Therefore, regulators began considering how *hawala* practices could be brought into closer compliance with international regulatory and supervisory standards.

Some of the key questions were:

- Could the registration process enforce at the time be strengthened?
- Could client information collected by *hawaladars* be standardized?
- Could *hawaladars* be induced to report suspicious activity to the central bank?
- Could *hawaladars* be made to keep appropriate records?
- Could an agreement be reached about external oversight and access to those records?

Nearly three years later, the same questions apply. But in the meantime, Afghanistan has made progress in reforming its financial system⁴⁹. Compared with conditions in December 2001—an outdated legal framework, no functioning commercial banks, a

⁴⁹ When reforming their financial sectors, conflict-afflicted countries face many challenges, among them damaged physical infrastructures, staff with outdated skills, and absent or outdated technology. Because properly functioning financial systems enhance economic development, reduce transaction costs in the economy, promote the efficient use of financial resources, and improve financial market liquidity, it is vital that those conditions be redressed. Experience from Bosnia-Herzegovina, Congo, and East Timor shows that the challenges are not insurmountable. Buildings can be rebuilt, staff retrained, and technology upgraded. Comprehensive, well-sequenced, and well-coordinated financial-sector reforms can restore basic services in the short-term, and the financial sector can return to long-term growth and vitality.

handful of NGOs competing with a vibrant informal financial sector—a basic formal financial system has emerged.

Now, the bank relicensing process of the state banks has been completed. Following the enactment of a new commercial banking law in September 2003, the central bank agreed to decide which banks would be allowed to submit applications for relicensing (by March 2004) and which would be relicensed (September 2004). A new central banking law now guarantees the autonomy of Da Afghanistan Bank. After the successful issuance of a new currency, a rudimentary monetary policy regime is emerging. A new banking supervision department has commenced on-site inspections of banks. The central bank's Swift connection is functional, and one-third of central bank branches are now connected electronically for domestic payments. Overall, the central bank's operational capacity has improved dramatically.

Banking services in Afghanistan, however, remain limited. The passage of the Central Banking Law and the Commercial Banking Laws in September 2003 and the entry of several commercial banks marks significant progress. But there is much to be done before financial services are restored to the level required for meaningful trade and investment activities. State financial institutions are largely non-functional. The new private banks have not yet started lending to industry, and it appears that at least some of them will not be inclined to do so in the near future (World Bank, 2004:57).

In light of the experience of other conflict-afflicted countries, Afghanistan's central bank has fared fairly well. However, though reforms in the formal financial sector have progressed at an impressive rate, much remains to be done in harnessing the positive aspects of the informal financial system while tempering the risks that it presents.

THE SPECIAL CHALLENGES OF REGULATING INFORMAL MONEY SERVICES IN AFGHANISTAN

To protect the progress made to date in the formal financial sector, the government must now rise to the challenges of implementing the recently introduced regulations and supervision requirements to a sector of the financial system with a long history of self-regulation; strengthening the legal and judicial framework for the prosecution of financial crimes; and building its capacity to investigate complex money laundering and terrorist financing transactions, a particularly serious task given the size and rate of growth of the drug economy and the emerging risk of a nexus of drug-trafficking and terrorist-militant groups.

The hawaladars' long history of self-regulation

The history of foreign exchange dealers in Kabul dates back to the era when the great overland trade routes between the Mediterranean and the Orient passed through Afghanistan (Nyrop and Seekins, 1986). From the 1930s, when the first banks were established, to present-day Afghanistan, *hawaladars* have played a central role in financial intermediation role with little or no regulatory oversight.

- Before 1930, all foreign-exchange transactions were handled by private dealers located primarily in Kabul and Qandahar. Even the Afghan government's foreign exchange was purchased from these dealers. Through Bank-i-Melli and later the central bank, the government tried to assert a monopoly of its own over foreign-exchange transactions between

1930 and 1960. Despite exchange-surrender regulations and occasional prohibitions of free-market dealings, the bazaars survived so successfully that Bank-i-Melli and the central bank had to keep their own dealers in the money bazaars

- The 1960s were a period of renaissance for the money bazaars, even as the formal banking system stagnated. The volume of business and the number of dealers grew; technological improvements, such as electronic calculators, appeared. Among the money traders specialization began to emerge.

By the 1970s dealers normally traded in either rupees or other convertible currencies. The money bazaars maintained close telecommunications links with correspondent banks around the world and handled foreign bank drafts as well as currency. By the 1970s they could provide nearly all the services of a commercial bank, making trade-finance loans, consumer loans (notably for weddings), working capital loans for farmers and entrepreneurs, housing loans, and loans for long-term industrial undertakings. Because of the bazaars' high interest rates, businessmen saw them as a last resort for credit. Because bank loans were largely unavailable outside Kabul, the prominence of the rural provincial bazaars continued to grow. Right up until 2002, the authorities continued to follow a policy of noninterference with operations in the money bazaars.

The market has had such a long history of operational and regulatory independence that external oversight is unlikely to be easily welcomed—especially if it is overly burdensome.

A WEAK LEGAL AND REGULATORY FRAMEWORK

To its credit, the central bank has not implemented regulations for the informal financial sector in haste. Rather, its new money-exchange regulations are the product of months of consultation, and discussion. As drafted, they provide detailed eligibility criteria for licensing, minimum prudential requirements, and requirements for compliance with anti-money laundering standards.

- *Licensing.* The proposed regulations specify that licensed *hawaladars* must maintain during the entire duration of their operations the minimum required capital and a standby letter of credit or other guarantee. They must employ at least two fit and proper persons to manage the business. If the business is a legal entity, some or all of whose owners possess a qualifying holding, those owners must be fit and proper persons or legal entities whose managers are fit and proper persons. The business plan of the licensed firm must specify a proper organizational structure with effective internal control mechanisms, an appropriate accounting system for recording transactions, and the financial means to attract and retain qualified staff. The firm must agree to apply the appropriate procedures for the prevention of money laundering and terrorist financing.⁵⁰ Once a

⁵⁰ The proposed prudential regulatory process is consistent with standard bank licensing procedures, which commence with the screening of license applicants to exclude those with inappropriate professional qualifications, banking experience, financial capacity, and ethical backgrounds. At a minimum, regulators generally assess three issues: the sufficiency of a bank's initial capital, the suitability of major shareholders and management, and the transparency of its corporate and organizational structure. In the case of foreign banks, the bank receives adequate supervision in its home country, and the home-country regulator approves the establishment of the branch.

license is granted, the money-service business is permitted to engage in any or all of the following activities: money transmission, safekeeping, and check cashing. It is not, however, permitted to accept deposits, make loans, exchange currency, or offer securities services as enumerated in Article 94 of the Banking Law.

- *Capital.* Under the proposed regulations, every money-service business is required to meet a graduated minimum capital requirement⁵¹ that is dependent on the volume of money transmitted during the year. The lowest requirement is AFN 1 million if the applicant has not previously provided money services in Afghanistan, or if the licensee and its authorized agents had a volume of money transmissions of less than AFN 50 million (or equivalent) for the previous 12 months. The highest requirement is AFN 5 million if the licensee and its authorized agents had a volume of money transmissions of AFN 200 million (or equivalent) or more over the previous 12 months.⁵²
- *Guarantees.* Every money-service business is required to maintain a standby letter of credit or guarantee for the sum of at least AFN 5 million from a licensed credit institution or other institution specified by the central bank. The security must cover up to five service units or authorized agents. For each additional unit or authorized agent it must be increased by AFN 500,000, up to a maximum of AFN 25 million. The security must be in a form satisfactory to the central bank and issued for the benefit of customers of the licensee. By enabling customers to seek compensation, the security is intended to secure the good performance of the licensee's obligations with respect to receipt, handling, transfer, and payment.
- *Anti-money laundering requirements.* In collaboration with the International Monetary Fund (IMF) and United Nations Office on Drugs and Crime (UNODC), Afghanistan's central bank has been working to improve the country's anti-money laundering regime.⁵³ The government has recently completed the process of legislating against money laundering and terrorist financing activities. The new law meets current international standards. The proposed legislation deals principally with the criminalization of money laundering and financing of terrorism, customer due diligence, establishment of a financial intelligence unit (FIU), international cooperation, extradition, confiscation of funds and properties connected to the crimes of money laundering and terrorist financing, and similar provisions.⁵⁴ When the legislation is adopted, every money-service

⁵¹ The rationale for a minimum capital requirement for *hawaladars*, may be questionable given that that equity might not be the most important concern for regulators of money-transfer operations. Instead, a minimum *liquidity* ratio might be a more prudent measure of financial soundness.

⁵² In choosing to define a minimum capital standard for money-service providers, regulators in Afghanistan have opened themselves up to the same issues that the banking sector has been contending with for years. How should capital be defined? What level of capital is adequate for money-service businesses to remain safe and sound? What criteria should be used to assess the adequacy of capital?

⁵³ For the purpose of compliance with UN Security Council Resolution 1373, the government has become a party to all relevant UN conventions and protocols relating to terrorist financing and laundering of funds and properties.

⁵⁴ Provisions from the following legislation were also used as the basis for Afghanistan's draft legislation. United Nations International Drug Control Program (UNDCP) Model Legislation on Laundering, Confiscation and International Cooperation in relation to Proceeds of Crime; the IMF Draft Model Financial Transactions Reporting Act; EU Directives 2001/97/EC of the European Parliament and the European Council dated December 4, 2001; the Law on Prevention of Money Laundering of Slovenia and the Belgian Royal Decree of June 11, 1993 on the composition, organization, operation and independence of Belgium's FIU.

business will be obliged to take measures for the prevention of money laundering⁵⁵.

To effectively implement the prudential, and anti-money laundering standards described above, the central bank will need to further strengthen its legal and judicial framework. Presently, if *hawala* dealers were to comply with the proposed suspicious-activity-reporting requirements, it is unlikely that successful prosecutions could be mounted in the Afghan legal system. The challenge of corroborating evidence provided by a *hawala* dealer that one of his clients was financing a terrorist activity or laundering the proceeds of opium would be significant. The prosecution would be faced with the task for building its case from anecdotal evidence. Furthermore, in order to ensure compliance by *hawala* dealers, the authorities would have to be able to sanction those who did not comply. At present, it is questionable that such sanctions could be enforced.

This problem is not unique to Afghanistan. Even in developed economies, anti-money laundering and counterterrorism programs are hampered by an inability to develop an endgame. Agents of law-enforcement agencies in developed economies often gather intelligence with little hope that they will be able to make a criminal case or otherwise disrupt the operation. In Afghanistan, the problems of preparing a firm case are compounded by a very weak judiciary. Years of conflict have resulted in extensive damage to buildings, office records, and essential equipment. Many lawyers and judges left the country, and the number of law students is low. Many judges lack adequate legal training. Significantly, there is little or no interaction among the judiciary, the police, and prosecutors.

The complexity of investigating

It remains difficult to document the degree to which *hawala* is used to launder money in Afghanistan. It is equally difficult to trace illegal money flows, to separate legal from illicit flows, and to establish the financial links to criminal activities. Law enforcement agencies are often unable to penetrate informal financial systems because of the close business or kinship ties of the participants. Additional constraints in Afghanistan include: poor monitoring of cross-border currency movements; no reporting requirements for large cash transactions; lack of uniform guidelines for identifying suspicious transactions; large parallel black-market economies, and ineffective information procedures and systems for sharing information with foreign law-enforcement authorities.

In addition to the legal constraints, law enforcement agencies face the considerable challenge of investigating financial crimes committed in a less than transparent sector. The legal and regulatory framework, particularly the reporting requirements, merely provides techniques for improving the basis of knowledge. Reports may not have evidentiary value and can be disappointingly weak if their limitations are not recognized.

⁵⁵ Some of those measures are: An appropriate customer-acceptance policy that identifies circumstances under which customers will be rejected; an appropriate customer-identification policy that includes identification of the beneficial owner of the transmitted funds when such owner may differ from the customer; continuous training of staff so that they are able to recognize transactions that might be related to money laundering; Instructions as to what action they should take in such circumstances; effective internal control and communication procedures; submission of reports to the FIU or another authority as required by the laws of Afghanistan; and, retention of records on transactions.

Financial reporting requirements are generally designed to help transform the raw material provided by financial institutions so that it can be assimilated in a manner similar to that of other information provided to regulators and law enforcement officers. To be effective, the recently established Financial Intelligence Unit (FIU) in DAB and law-enforcement authorities must be able to identify and define data that will be useful for investigative purposes; they also must be able to demonstrate to the sector how that data will in fact be used. Law enforcement and the financial sector need to have and understand typologies they can use in flagging data to be reported.

The data also needs to be *validated* to remove information that is unreliable (including reporting deliberately inserted to mislead). Detailed *analysis* should assemble fragmentary intelligence into coherent meaningful accounts. *Assessment* should then put intelligence into a sensible real-world context and identify how it can affect specific investigations and regulatory and law-enforcement policy. But there are limitations, some inherent and some practical, on the scope of information reported by *hawaladars*—as indeed by any financial institution. Those limitations must be recognized by the authorities responsible for receiving and using reported data.

The most important limitation on financial intelligence is its incompleteness. Much ingenuity and effort is spent by money launderers and terrorist financiers on making secret information difficult to acquire and hard to analyze. Although the financial intelligence process may overcome such barriers, it seldom yields the full story. In fact, when first acquired, the intelligence is often sporadic and patchy—even after analysis, substantial inferences often must be made, and then proved.

The way that financial intelligence is presented can contribute to misperceptions. The security procedures with which financial intelligence is necessarily handled can reinforce a mystique of omniscience and omnipotence that can discourage compliance. In fact, financial intelligence is not only incomplete, but also it can be incomplete in undetectable ways. There is always pressure, at the assessment stage if not before, to create an internally consistent and intellectually satisfying picture. When financial intelligence becomes the dominant, or even the only, source of law-enforcement information, it can become difficult for those responsible for the assessment process to establish a context and recognize that there may be gaps in that picture. Furthermore, to ensure full cooperation and compliance from the sector, law enforcement needs to be able to show that financial intelligence is in fact used in legitimate and valuable investigations. Without this verification, the credibility of reporting requirements can easily be lost.

These limitations are best offset by ensuring that the ultimate users of financial intelligence, decision makers at all levels, properly understand its strengths and limitations and have the opportunity to acquire experience in handling it. It is not easy to do this while preserving the security of sensitive sources and methods. But unless financial intelligence is properly handled, the effort made to gather it is wasted.

Unfortunately, in Afghanistan, two specific factors further threaten the legal process for investigating and prosecuting financial crimes: the size of the drug economy and the emerging risk of a nexus of drug-trafficking with terrorist and militant groups.

- *Size of the drug industry.* In 2003 the total area under opium poppy cultivation in Afghanistan increased by 8 percent—from 74,000 hectares

in 2002 to 80,000 hectares in 2003 (UN Office of Drugs and Crime 2004: 206). There has been a clear and accelerating extension of opium cultivation to previously unaffected and marginally affected areas. The number of provinces where opium poppy cultivation is reported has steadily increased from 18 of 32 provinces in 1999, to 23 in 2000, 24 in 2002, and a staggering 28 provinces in 2003. Potential opium production amounted to 3,600 tons in 2003, an increase of 6 percent compared to 3,400 tons the year before. The area under cultivation in 2003 ranks third in the country's recent history and the harvest the second highest recorded so far in Afghanistan. Even though the 2003 opium prices of US\$283 per kg represents a 19 percent decrease from last year's price of US\$350, the resulting revenue flows⁵⁶ from this level of opium output remain high, with significant implications for the financial sector, particularly the *hawaladars*. The pressure to launder funds is high—and will remain so for a significant while.

- *The emerging risk of a nexus of drug-trafficking with terrorist/militant groups.* The greatest threat to Afghanistan's economic development is the growing risk of a nexus of drug-trafficking and terrorist/militant groups—often referred to as narcoterrorism.⁵⁷ The presence of opium and terrorism in Afghanistan poses significant risks of abuse of the financial system—formal and informal—regardless of the legislation or regulations enacted. Historically terrorists have played a significant role in sustained conflicts in numerous countries—among them Bolivia, Colombia, and Peru (coca), Kosovo (primarily opium), Lebanon (opium), and Myanmar (opium).⁵⁸ The simultaneous presence of opium and terrorism imposes significant financial and ideological pressure on financial intermediaries to side with launderers and terrorist financiers, extending the criminalization of the economy.

Afghanistan's Council of Ulemas has stated that cultivation, processing, trafficking, and consumption of drugs must be prevented. "Even if it is not consumed by Muslims or if it is done out of poverty, [narcotics related activity] is illegal," stresses the statement, which was endorsed by the UN Office on Drugs and Crime. Despite it, however, the trade continues to grow. However, more remains to be done.

CONCLUSION AND RECOMMENDATIONS

The regulatory and supervisory challenges of the *hawala* system in Afghanistan are unique. In assessing the success of the country's central bank in regulating the *hawaladars*, it is imperative that analysts, the press and the public avoid the risks of "mirror imaging"—believing that experience with informal financial systems gained elsewhere is universal. In an environment where increasing opium production and terrorism have raised the incentives to conceal and obscure the origins and

⁵⁶ The aggregate value of the Afghan opium harvest (at farm-gate prices) declined to US\$1.02 billion in 2003 from US\$1.2 billion in 2002 (-15 percent). The 2003 harvest represents, on average, a potential income of about US\$3,900 per opium-growing family. The potential opium income per capita for 1.7 million growers averaged US\$594. In comparison, on the basis of a population estimated at 24 million and a GDP estimated at US\$4.4 billion, Afghanistan had a GDP per capita of about US\$184 in 2002.

⁵⁷ A subset of terrorism in which terrorist groups, or individuals participate directly or indirectly in the cultivation, manufacture, transportation, and distribution of controlled substances and the monies derived from these activities. Narcoterrorism may be characterized by the participation of groups or associated individuals taxing, providing security for, or otherwise aiding or abetting drug trafficking efforts to further or fund terrorist activities.

⁵⁸ Bannon and Collier 2003: 19.

destinations of illicit financial transactions, it is not possible to accumulate the breadth and depth of understanding about the informal financial sector that one might expect to gather in better circumstances or that we have about formal commercial banks in developed economies.

In a conflict-afflicted country, it is critical that observers and regulators alike appreciate that conventional assumptions about financial risk and abuse may not necessarily apply. The striking feature of Afghanistan's economic structure is the dominance of the informal sector – not only in agriculture and in the drug economy, but also in other sectors of the economy. It is inherently difficult to estimate the size of the informal economy, except in sectors where it is dominant like agriculture and drugs. The World Bank estimates that as much as 80%-90% of the economic activity in Afghanistan occurs in the informal sector (World Bank, 2004:5). The size of the informal economy represents a self-reinforcing equilibrium inherited from the past, involving failed governments; competing power bases; insecurity, lack of rule of law; and a very poor investment climate for formal activities. For this reason, more than any other, it is essential that the central bank sustain its pragmatic consultative approach to regulation.

In the long term, an effective strategy for isolating illicit funds being transferred through the *hawala* system is to encourage legal transfers to migrate to conventional financial instruments. The effectiveness of this strategy depends on the ability of formal financial instruments to compete with the *hawala* dealers with respect to exchange rates, speedy service, and coverage of areas that now lack banking services. The entry of new banks in Afghanistan is a first step toward such a transition. The rate at which banks open regional and provincial branches, offer services at attractive rates, and reach out to local customers will determine the long-term success of that first step.

While the informal sector is dynamic, a recent World Bank study concludes that it can not be the 'engine' for sustained long-term growth. The study rightly observes that international experience suggests that development beyond a certain point, is accompanied by a decrease in the share of the informal sector. Informality does not protect property rights and reduces the possibility of formalizing and enforcing contracts, weakens incentives to invest and opportunities for division of labor and trade (World Bank, 2004;8).

Despite improvements in policies and conventional financial institutions, *hawaladars* will continue to represent an important and often necessary element of Afghanistan's financial architecture. The market's simplicity, cost-effectiveness, and convenience will ensure its survival for many years to come. It is therefore advisable that the central focus of oversight policies should be regulation, rather than eradication. Cost-effectiveness and speed are virtues that cannot be regulated away. Only competitive market forces can replace the *hawaladars*.

Meanwhile, Afghanistan's central bank should, as it has already, continue working with the *hawaladars* of Kabul. Their association has an executive committee responsible for enforcing the tacit rules and business conduct of the market; code violations bring serious consequences.⁵⁹ The shaming and stigmatization associated with committee condemnation often curtail dealers' critical ability to collaborate with

⁵⁹ At periodic meetings the money exchangers select 10 individuals to serve as members of the executive committee.

other dealers to facilitate large transactions. Being limited to one's own funds in this business may force one out of the market. The committee is also responsible for the amicable settlement of disputes. It charges no fees for its services, and its appointed members are not salaried or otherwise compensated.

Partnering with the hawaladars is in line with the World Bank's recommendation that the government generate economic growth by harnessing the dynamism of the informal sector. Strategies for doing so include: (i) facilitating further growth of the informal sector, to the extent that it is legitimate – e.g. through microcredit; and (ii) gradually shifting informal activities to the formal sector (World Bank, 2004: xiii).

Coordinated efforts to strengthen legal and regulatory frameworks must also include engagement of the sector itself. This will help regulators to understand and implement measures that address vulnerabilities without inadvertently affecting dealers who work outside criminal circles. Outreach also will help to separate at least some legitimate dealers from those working in illicit finance. Any external oversight of the market will require the active collaboration of the *hawaladars'* association. Indeed, subcontracting some basic supervisory measures to the association in the interim may serve the central bank's objective of opening up the market to further transparency.

REFERENCES

- El Qorchi, Mohammed, Samuel Maimbo, and John Wilson. 2003. "Informal Funds Transfer Systems: An Analysis of the Informal Hawala System." IMF Occasional Paper 243, International Monetary Fund, Washington, D.C.
- Maimbo, Samuel, and Nikos Passas. 2004. "The Regulation and Supervision of Informal Remittance Systems." *Small Enterprise Development* 15(1).
- Maimbo, Samuel Munzele. 2003. "The Hawaladars of Kabul." Working Paper 13. World Bank, Washington, D.C.
- Nyrop, Richard F., and Donald M. Seekins. 1986. "Afghanistan Country Study." Foreign Area Studies, American University, Washington, D.C. Available at <http://www.gl.iit.edu/govdoc/afghanistan/>
- Passas, Nikos. 1999. "Globalization, Criminogenic Asymmetries and Economic Crimes." *European Journal of Law Reform* 1(4): 399–423.
- Winer J. M., and T. J. Roule. 2003. "Follow the Money: The Finance of Illicit Resource Extraction." In I. Bannon and P. Collier, eds., *Natural Resources and Violent Conflicts: Actions and Options* (170–71). Washington D.C.: World Bank.
- World Bank. 2004. "The Financial Sector in Afghanistan." South Asia Finance and Private Sector Unit, Washington, D.C.

Workshop Paper No. 4

Trends and Lessons from Global Experience

Renate Kloeppinger-Todd, Rural Finance Adviser
The World Bank

The topic of this paper relates to international experience in supporting access to financial services in rural areas. For many years, rural finance was defined as the provision of credit to special target groups, mainly farmers. International donors, including the World Bank, supported this approach through the provision of funds for international and domestic credit lines. By the early 1990s, it became apparent that many such credit lines had low recovery rates, were implemented by unsustainable institutions, and did not achieve the intended purpose of increasing rural livelihoods, except for those few farmers, often the more wealthy ones, who directly benefited from the limited funding and inefficient distribution structures.⁶⁰ By the beginning of the 1990s, donor agencies had shifted their approach away from agricultural credit towards a wider view of rural finance, characterized by a broad range of financial services, rather than credit only; provision of financial services to all rural dwellers, not just farmers; use of market interest rates; and the operational efficiency and financial viability of rural financial institutions.⁶¹

The following is based on this financial systems approach but is cognizant of the issue of lack of credit in rural areas and the very distinct problems of Afghanistan and its increasing opium economy. Access to financial services can only be one ingredient in providing alternative livelihood opportunities to poor rural farmers.

When looking for international experience under similar conditions to those of Afghanistan the most relevant appears to be from countries of the former Soviet Union or its allies in their transition to a market economy. Conditions in many of these countries were as follows:

- Civil unrest or war
- Absence of or complete breakdown of a functioning banking system
- Absence of or poor property rights, especially those related to land and its use as security for financing
- Little enforcement of laws and regulations
- Loss of most external markets

⁶⁰ Rural finance used to be defined as agricultural finance by donor agencies and governments for much of the period from the 1950s to the 1980s. Donor agencies provided resources for agricultural finance, often through subsidized credit lines for state-owned agricultural development banks. In the 1950s and 60s, projects tended to promote the adoption of productivity-increasing technologies and methods, often following a one-model-fits-all approach. The 1960s and 1970s also saw a trend in development thinking emphasizing industrial over agricultural development, resulting in increasing biases against, and deteriorating terms of trade of, the agricultural sector. Given deteriorating agricultural prices, subsidized finance was seen as the only means to induce farmers to adopt new technologies, FAO/GTZ, 1998. Agricultural Finance Revisited: Why? AFR Series No 1, Rome: FAO

⁶¹ The concurrent decline in agricultural credit programs has also led to a decline in available finance for agriculture. For example, World Bank lending for agriculture in the 1990s represents only one third of the volume of agricultural lending of the 1980s (FAO/GTZ, 1998. Agricultural Finance Revisited: Why? AFR Series No 1, Rome: FAO). This statement is corroborated by the Bank's 'Reaching the Rural Poor' strategy which states that "lending for agricultural activities declined dramatically from about 31% in 1979-81 to less than 10% in FY 00 and FY01." The largest declines occurred *inter alia* in the sector of agricultural credit, because of the shift away from commodity targeted credit. (World Bank, February 2003. Reaching the Rural Poor. Strategy and Business Plan: p15) However, rural finance lending started increasing in the mid 1990ies, after large declines in the 1980ies and early 1990ies. (ARD Internal Report: FY 2003 Agriculture and Rural Portfolio Review, Annex 3 Rural Finance, p.28)

- Poorly maintained infrastructure
- Little knowledge of a market economy, and the requirements and structures for success.

In these countries a variety of approaches to the provision of financial services in rural areas were piloted. At the time this was a wide-open field and little was to be learned from prior experience. In hindsight it turned out that no one solution was better or provided better results than another one. Local circumstances and conditions, more than any features of a particular approach, determined relative success or failure.

The examples outlined below, together with the success factors and lessons learnt provide an overview of different approaches that could be taken in Afghanistan, alone or in combinations, if conditions are favorable.

CREATION OF A NEW AGRICULTURAL BANK OR NON-BANK FINANCIAL INSTITUTION

Creating a new institution might be the approach of choice in a country where there are no financial institutions in rural areas that could be turned around, or the existing institutions are beyond turn-around aspirations. This has been the case in most countries of the former Soviet Union where, with few exceptions, the former state-owned agricultural banks were liquidated; leaving a void that has not been filled by private sector institutions as anticipated. The World Bank has been instrumental in establishing two agricultural finance institutions in this region, the Agricultural Development Bank of Latvia, which has been successfully privatized, and the still to be privatized Kyrgyz Agricultural Finance Corporation (KAFC), which is profiled in the box below.

Box 1. KAFC of Kyrgyzstan

The Kyrgyz Agricultural Finance Corporation (KAFC) was established in 1997 under the Bank-financed Rural Finance Project as a non-bank financial institution serving farmers and rural entrepreneurs. KAFC was designed to operate on a commercial basis – extending credit based on rigorous financial appraisal, taking full collateral, and fully covering its costs through its on-lending rates. The bank's loan recovery rate reached approximately 98% in 2004. KAFC offers individual collateralized loans and social-collateral-based group loans on a short- and medium term basis. KAFC supplies 90% of all agricultural and livestock lending in Kyrgyzstan, serving mainly small clients with an average loan size of US\$1400.00. KAFC has also started to lend to micro-credit organizations, and had financed 9 such organizations by 2003. KAFC has applied for a banking license in order to extend services to include deposit and payment facilities. The Bank assisted in establishing an enabling environment, providing funds for on-lending, obtaining donor support for technical assistance and early stage operating expenses, and ring-fencing the new institution from political influence.

Source: Broka, S., KAFC Data Sheet, WB Internal Note 2004

Setting up such an institutions requires significant funding for institution-building, in addition to refinancing. This can be achieved through a public private partnership with the government holding a minority stake and leaving management decisions to an independent professional team. Initially, it could also be a fully state-owned institution, ring-fenced from political influence by the use of the safeguards outlined below. Given that there are a good number of investment funds and networks that focus on financial institutions in developing countries, mostly for microfinance purposes, it should be possible to attract co-investors with a realistic business plan.

In addition to good banking principals and competent and independent management and advisory boards the institutions referenced above consistently made use of the following success factors:

Appropriate legislative framework and supervision:

- Clear separation of banking operations and decision-making from government influence and strong political will from all parties for an independent institution, including sanctions against political actors who attempt to use their influence to interfere;
- Consistent government policies concerning the development of a sustainable rural financial sector; e.g., no debt-forgiveness, interest rate subsidies or interest rate caps;
- Sufficient, no-strings-attached funding by government and/or donors for expert international technical assistance to build the institution's systems and products;
- Ability of the institution to charge full cost-recovery interest rates (net of time-bound subsidies for TA and initial operating expenses);
- Access to local currency funding through deposit mobilization or credit lines;
- Long-term approach that recognizes that progress might be slow and initially not spectacular.

SETTING UP COOPERATIVE FINANCIAL INSTITUTIONS OR SYSTEMS OF CREDIT UNIONS

Cooperative financial institutions range from formal cooperative banks to semi-formal financial cooperatives and credit unions. The main characteristics include ownership of the entity by members (or member cooperatives in the case of a federation or a bank), the provision of financial services to members, and governance by elected representatives of the owners/members. Members are usually people with a common bond, either geographic or occupational. Depending on the cooperative model being used, membership can be purchased for a token amount or requires significant involvement of the member, before a member becomes eligible to benefit from financial services.

There are two basic financial cooperative models that are in widespread use today. *The integrated model* consists of networks of primary financial cooperative banks with an apex institution owned by the member cooperative banks and providing services to them. There may also be parallel independent apex institutions responsible for supervision and auditing of the member banks. This model had its origins in Central Europe in the early 1800s, with the idea of encouraging poor people and small groups to pool their financial resources for mutual benefits.

Box 2. Credit Unions in Lithuania – An Example of the Integrated Model

The first credit union in Lithuania was founded in 1995, after a new law on credit unions was passed in the midst of the 1994-1996 banking crisis. In 1997, 11 credit unions formed the Association of Lithuanian Credit Unions (ALCU). The ALCU provides training, technical assistance, lobbying and financial services to its members. In order to separate financial from technical functions, an apex bank, the Lithuanian Central Credit Union (LCCU), was established in 2002. The LCCU provides financial services to credit unions, including the administration of a stabilization fund, a liquidity fund, and credit and deposit facilities. While the Central Bank retains supervision authority, the LCCU provides supplementary supervision services to its members. The sector has shown impressive growth since its establishment. Growth accelerated after a modification of the law in 2000 and the closing of rural branches of commercial banks.

Source: Lietuvos Centrine Kredito Unija: Short Introduction into Lithuanian Credit Union System

The atomized model, which is found in the USA, English-speaking Canada, Australia and many developing countries, consists of primary financial cooperatives that are sometimes organized into federations. Credit unions are an example of this model. Credit unions are based on a common bond, often occupational, and many times serve a primarily urban and middle-class clientele. Examples are teachers, government workers, but also farmers. Credit unions can be small village-based entities or larger, more professional organizations. Small primary cooperatives may be managed by members on a volunteer part-time basis, with low operating costs and close contact with their customers. Once an institution grows above a certain number of members, the social cohesion found in small cooperatives is not sufficient and needs to be reinforced through the installation of more professional management.⁶² While even small volunteer-managed cooperatives need to have a transparent structure, good accounting and sound criteria for decision-making, this is even more important when the cooperative grows and paid management takes on the functions previously performed by members. If a financial cooperative is not able to install strong systems, the result may be non-transparent decision-making, favoritism, and susceptibility to political influence, followed by high loan losses and eventual demise of the cooperative.

Box 3: Setting Up Financial Cooperatives in Russia

In Russia, the first Rural Savings and Credit Cooperatives (RSCC) were established in 1996, in the midst of the Russian banking crisis that led to the closure of many rural banks and branches. The sector operates as a three-tier structure with local credit cooperatives, regional and federal level federations, and apex institutions such as training institutes. The Central Bank is responsible for supervision. The RSCC are the main source of credit for the rural population, farming families and rural small businesses. Repayment rates are impressive with over 99%. International technical assistance is directed at all three levels, with emphasis on the development of an enabling regulatory framework and sector development at local and regional levels.

Source: Armbruster, P. G., 2004. Capacity Building, Modernization and Innovation Case Study: Russia. Paper presented at "Cooperative Financial Institutions and Access to Finance Workshop", World Bank March 2004.

Success factors for setting up sustainable financial cooperatives include the following, in addition to effective governance, committed management and strong financial systems:

- *Recognizing the important role of member savings in primary cooperatives.* Savings, as well as equity participation, provide members with a strong sense of ownership of the cooperative, which should motivate them to demand transparency and accountability from the governing body as well as management. External funding, whether it is from governments or donors, can diminish the incentives for good governance and management unless the savings focus can be maintained.
- *Affiliating with a federation of financial cooperatives.* This is critical for a primary cooperative that aims to provide a range of financial services to its members.
- *Defining the role of the federation.* A clear distinction between financial functions such as refinance, supervisory functions and support functions such as promotion and training is needed in order to avoid conflicts of interest.
- *Independent auditing of primary cooperatives and their federations.*

⁶² See Proceedings of the Conference on Cooperative Financial Institutions, 4th March 2004, The World Bank, Washington, DC.

- *Developing more effective regulatory and supervisory structures.*⁶³ In many countries, financial cooperatives are regulated and supervised by institutions such as Cooperative Ministries or Departments that typically lack specialized technical expertise to supervise financial institutions.
- *Eliminating the possibility of using cooperatives to promote political goals or to benefit powerful local individuals or companies.* Governments need to establish enforceable policies and procedures to prevent interference and influence peddling.

SETTING UP MICROFINANCE INSTITUTIONS THAT FOCUS ON RURAL AREAS

This was done successfully in Kyrgyzstan and Georgia, among other countries. Both of these countries suffered from civil unrest and many of the problems plaguing Afghanistan. Afghanistan already has a number of such institutions and lessons learnt are available in the country. Success factors for commercially oriented microfinance, urban and rural, based on international experience, include:

- Enabling policy environment, without subsidized credit or interest rate caps
- Appropriate regulatory framework⁶⁴
- Ownership structure that enables the institution to attract capital, mobilize deposits and obtain commercial refinance
- Transparent and accountable governance and management structure
- Focus on the “double bottom line” – financial services to low-income people and profitability
- Products and services that meet clients’ needs
- Methodology that enables products and services to be delivered efficiently
 - Portfolio diversification
 - Strong accounting and financial management systems
 - Strong management information systems
 - Skilled management and staff
 - Performance incentives

RESTRUCTURING OF STATE-OWNED AGRICULTURAL BANK

State-owned agricultural and rural development banks have the dual objectives of operating profitably and supporting the government in achieving social development goals (double bottom line⁶⁵). In the 1970s and 1980s, state banks were established in many countries, often with donor support, with high hopes of establishing permanent access to credit in underserved areas, especially for agriculture. Subsequently, in many cases, these institutions neglected, or were forced by governments to neglect, the first objective. This translated many times into decision-making by and for special interest groups, high transaction costs, high loan losses, and corruption. As a result, many of these institutions were closed or privatized in the late 1980s and early 1990s, with the expectation that the private sector would pick up the pieces.

However, in many cases, rural branch networks contracted following privatization, the private sector did not step in, and in some cases, financial institutions completely disappeared in rural

⁶³ Arzbach, M., 2004. Legal Framework, Regulation and Supervision. Presentation at the ‘Cooperative Financial Institutions and Access to Finance Workshop’, Washington DC, The World Bank, March 4, 2004

⁶⁴ See Christen, Lyman, Rosenberg, Microfinance Consensus Guidelines: Guiding Principles on Regulation and Supervision of Microfinance, CGAP, July 2003

⁶⁵ See footnote on double bottom line objectives for financial institutions. See also CGAP 2004. Financial Institutions with a Double Bottom Line: Implications for the Future of Microfinance. CGAP Occasional Papers No 8, July 2004. Washington DC: CGAP.

areas when state banks closed⁶⁶. Consequently, new thoughts have begun to emerge about the potential of such institutions for rural finance. While the shortcomings of state-owned banks are well known and have been extensively documented⁶⁷, the disadvantages of their disappearance have also now been recognized. As a result, quite a few Bank client countries are looking anew at setting up such institutions and are asking the Bank for guidance and support.

Restructuring a poorly managed state bank requires significant resources and political will from all stakeholders, and close cooperation and alignment of objectives. It is only recommended if all these are in place and if there is still an existing and functioning institution with a significant rural branch network. Should the state bank proposed for a turn-around be very weak, lack an existing branch network or if there is doubt about the political will and available resources, another approach to financial services in rural areas is preferable. The Agricultural Bank of Mongolia, described below, is one of the very few success stories.

Box 4. Agricultural Bank of Mongolia

After overcoming initial strong opposition from the multi-lateral financial institutions including the World Bank, the government of Mongolia obtained support from bi-lateral donors to turn-around the loss-making Agricultural Bank of Mongolia (AgBank, renamed Khan Bank in 2004)⁶⁸. Over a two year time period, the bank was restructured, based on sound banking principles, while keeping to its mission of providing financial services in rural areas. AgBank is one example of a privatized bank that recognized significant business opportunities in rural areas and took advantage of its competitive position as the only bank with an extensive branch network. AgBank was able to increase its rural penetration by following a well-thought out strategy of offering demand-driven products based on extensive market research and many other good practices. It decided to extend its already extensive network from 250 to 350 branches. A key success factor was an experienced hands-on international management team, free from loyalties to special interest groups in the country and backed by the government and generous donor support⁶⁹. Following privatization in early 2003, there was the general anticipation that the new private owners would re-focus the bank away from rural activities. This did not take place, as the new far-sighted owners are well aware of AgBank's strong position and earnings potential in rural Mongolia.

Source: IFC internal appraisal report, April 2003; Also DAI presentation and publication on AgBank and NMB, September 23, 2003, by Peter Morrow and Jay Dyer; also CGAP/ World Bank Information Note on Microfinance and Rural Finance No 2. Rural Financial Services through State Banks. January 2004.

Success factors are similar to those for creating a new specialized financial institution, especially the following:

Clear separation of banking operations and decision-making from government influence and strong political will from all parties for an independent institution, including sanctions against political actors who attempt to use their influence to interfere;

Sufficient, no-strings-attached funding by government and/or donors for expert international technical assistance to build the institution's systems and products.

LEASING

In many countries, lack of access to long-term financing for capital investments is one the

⁶⁶ Need to come up with several examples, most likely from Africa and Latin America

⁶⁷ See for example Adams, D. W.; von Pischke, J.D. (Eds), 1984. *Undermining Rural Development with Cheap Credit*. Boulder, CO: Westview Press.

⁶⁸ Deutsche Gesellschaft fuer Technische Zusammenarbeit GmbH, March 2002, Grashof Lutz, Country Case Study, Agricultural Bank of Mongolia, also IFC internal appraisal report of AgBank, 2003 (unpublished).

⁶⁹ See DAI presentation and publication on AgBank and NMB, September 23, 2003, by Peter Morrow and Jay Dyer; also CGAP/ World Bank Information Note on Microfinance and Rural Finance No 2. Rural Financial Services through State Banks. January 2004.

most pressing issues in rural areas.⁷⁰ Leasing has long been recognized as one solution, as it allows the circumvention of such financial market imperfections as lack of a collateral registry and collection enforcement mechanism, two of the major obstacles in equipment financing. Leasing is a financing tool where the provider (lessor) owns the equipment and permits the client (lessee) to use it in exchange for periodic payments (lease payments). Leases are also a means of eventually acquiring equipment (and not just its use), as ownership is generally transferred to the lessee at the end of the lease period, either automatically or at a token price.

Leasing is likely to be more accessible and affordable to rural enterprises than credit. Farmers and rural enterprises are particularly constrained by the lack of assets that can be used as collateral. Leasing overcomes this constraint, because no collateral needs to be registered. The lessor is the owner, not just the financier, and the equipment can quite easily be recovered from a lessee who is remiss in paying the lease obligations. Leases typically have lower down payments than loans, making them more accessible to lower income people. In a survey of ten leasing companies done by the Bank in 2003⁷¹, the surveyed companies indicated that they require down payments of 15% to 25% as compared to 30% to 40% required by banks in those countries for equipment financing. These advantages not only result in faster processing but lower overall transaction costs.

Below are three examples of rural leasing.

Box 5. Network Leasing Corporation Pakistan

Network Leasing Corporation (NLC) in Pakistan predominantly serves small and micro businesses. NLC innovated the leasing process by introducing post-dated checks as payment method and requiring clients to open bank accounts for this purpose. Payment pattern can vary according to the lessee's cash flow patterns and second-hand equipment can be leased. NLC includes a life insurance for the lessee in the contract in addition to covering the leased assets. NLC just launched a program to increase its business in rural areas in the North-Western Provinces of Pakistan with international assistance.

Source: Havers, M., 2003. Micro enterprise and Small Business Leasing – Lessons from Pakistan. Small Enterprise Development Journal, Vol. 10, No. 3

Box 6. DFCU Leasing

The Development Finance Corporation of Uganda (DFCU) has pioneered leasing activities in Uganda. DFCU also allows for leasing of second hand equipment and uses post-dates checks to ensure payments. DFCU uses in-house engineers to monitor proper maintenance of leased equipment. DFCU's main clientele are small and medium sized urban enterprises, but the company tries to reach more small and micro businesses by introducing a pilot scheme for beekeepers and mushroom growers in rural areas. DFCU has tried to increase its operations in rural areas by opening regional offices.

Source: Kisaame, J. 2004. Case Study of DFCU Leasing Company – Uganda. Paper presented at the conference: Paving the Way Forward for Rural Finance. Washington, DC 2004

Box 7. CECAM Madagascar

⁷⁰ See 'Agricultural Finance Revisited: Why' FAO/GTZ AFR Series No 1, Rome: FAO 1998. 'Financing Longer-Term Investments in Agriculture' is the title of the ongoing FAO/GTZ research project that publishes the AFR series. Details are available at www.FAO.org.

⁷¹ For a detailed analysis see the World Bank, Agricultural and Rural Development Discussion Paper 7, Leasing, An Underutilized Tool in Rural Finance, Ajai Nair, Renate Kloeppinger-Todd, Annabel Mulder, July 2004.

In Madagascar, the Caisse d'Epargne et de Credit Agricole Mutuel (CECAM), a cooperative for agricultural finance, has introduced hire-purchase schemes for farm implements, dairy cows, artisan's equipment and domestic equipment such as bicycles and sewing machines since 1992. Payment schedules are adapted to the crop cycle, and local member groups monitor the security of the hired items.

Source: Frasin, J.-H., 2004. CECAM: A Cooperative Agricultural Financial Institution Providing Credit Adapted to Farmers' Demands in Madagascar. Paper presented at the conference: Paving the Way Forward for Rural Finance. Washington, DC 2004

In general, less rather than more regulation is useful. There should be clear regulations that classify leasing companies as non-deposit-taking financial institutions that are not subject to the restrictions of banking laws, including reserve and liquidity requirements. A sufficiently enabling legal framework includes equally clear definitions in the areas of legal ownership of leased assets, repossession of leased assets in case of default, and liability in case of third-party losses. Leasing regulations are in general quite simple and uncontroversial, and thus offer a good opportunity for fast action by policy makers motivated to support rural development.

Desirable but not required features include a functioning market for second-hand equipment and affordable and accessible repair and maintenance facilities. Since special purpose leasing companies are not licensed to take deposits, they need to develop other reliable sources of refinancing, preferably in local currency. Credit lines from banks or international donors are quite often utilized and could present an opportunity for Bank intervention. Technical assistance and training to develop a skill mix among employees that includes technical knowledge about new equipment, assessment of used equipment and residual values, in addition to general credit skills, would also present a valuable contribution from international donors.

Potential World Bank interventions to support leasing should take advantage of IFC's experience in this area. In order to achieve maximum impact, interventions should be coordinated with IFC, and possibly complemented by an IFC investment. A possible model is IFC's PEP initiative, a multi-donor-funded and IFC-managed effort in countries of the former Soviet Union. PEP provided in-country support to introduce enabling legislation and direct technical support to leasing companies. In some cases, there was also an investment by IFC, but this was not PEP's focus. Based on its good experience with PEP in the countries of the former Soviet Union, IFC has decided to extend PEP to Africa and in late 2004 has established a PEP office in Johannesburg as a first step.

CONCLUSIONS

Each of the approaches outlined above offers advantages and disadvantages and should be evaluated in light of the specific Afghan circumstances to determine its viability. The guiding principals apply equally:

The creation of an enabling environment should go hand-in-hand with the work done on the institutional level.

Support in the form of technical assistance and capacity building and training is imperative and much more important than the provision of funds for refinancing.

The goal should be to create sustainable institutions that do not collapse after project end. The participation of private sector partners would support such an endeavor.

Product development should be based on client demand and ability to pay. There are different products that are in demand depending on a client's economic situation. The very poor would probably opt for savings products and micro loans to smooth income whereas small, medium and larger farmers in addition need appropriate loan and possibly insurance products.

Lack of access to financial services is only one of the factors limiting rural development. The establishment of farmers' association, availability of extension services and training, support in purchasing and marketing and the creation of appropriate physical rural infrastructure are all factors that should be addressed at the same time.

Workshop Paper No. 5

The Role of Opium as a Source of Informal Credit in Rural Afghanistan

David Mansfield, Consultant

Department for International Development, United Kingdom

Key Messages

- i. *Credit* is obtained by *all wealth groups* regardless of land tenure, the size of landholdings or the presence of opium poppy cultivation. However, there is a *higher incidence* of indebtedness amongst the *resource-poor*.
- ii. Whilst other forms of credit are available, *seasonal loans* are generally obtained from shopkeepers and *traders in the form of an advance payment on the future opium poppy crop*.
- iii. These loans are typically *used to satisfy basic needs*, with the vast majority of loans being used to purchase food, clothes, and medical services, as well as agricultural inputs.
- iv. In opium growing areas, seasonal loans *range from* around *US\$700* for those without land to *US\$1500* amongst the land wealthy.
- v. Crop failure is the major cause of accumulated debt with the implementation of the *Taliban ban* on opium in 2000/01 being the *single most important event in driving up household debt*.
- vi. *Accumulated debts* are large with an average of around *US\$700*, but *can be significantly higher* in areas in which opium poppy cultivation is concentrated.
- vii. A *ballpark figure* for the amount of *total debt* (seasonal plus accumulated) amongst opium poppy growers might fall *between US\$192 million and US\$350 million*.
- viii. Amongst the *most marginal*, total debts can be the equivalent of *three quarters of annual cash income* compared with only a third of the income of the land-rich.
- ix. Cultivating opium poppy not only provides farmers with *better access to credit* but also represents one of the *only methods of managing their debts*.
- x. Whilst *increased opium prices* can help with those whose debts are in cash, for those whose *debts are denominated in opium* (or their debt is converted at current opium prices) it *does not assist repayment*.
- xi. *Consequently*, full repayment is unlikely without external assistance given *the level of accumulated debt, the need for new loans each year, the*

frequency of crop failure and the threat of eradication, as well as the absence of alternative sources of income.

- xii. The failure to repay accumulated debts has become an increasing source of local conflict resulting in the sale of land, livestock **and** daughters as well as absconding to Pakistan.*

INTRODUCTION

There is a limited body of research on the role of opium as a source of informal credit. This discussion paper outlines the most salient points of the research thus far and raises some of the challenges that policy makers and development practitioners will need to overcome if opium poppy reductions are to be sustainable and not lead to the socio-economic differentiation and increasing levels of indebtedness that have contributed to the expansion of opium poppy cultivation in the first place.

TYPES OF CREDIT

There are a number of different ways that farmers in Afghanistan can obtain credit. Some of them, such as *salaam*, are very clearly opium related in that opium is actually given (or agreed to be given) in exchange for a loan. For others, the link is less explicit although for most opium poppy cultivation typically acts as an indicator of credit-worthiness in the eyes of the lender.

- The preferred option for many farmers is an *interest free loan* from family members known as *karz-e-asaan*. The popularity of this kind of loans is not just in that it is lower cost to the farmer but that repayment arrangements are more flexible. Marriage costs are typically financed through loans from family members, if of course an individual has relatives with sufficient resources.
- *Cash loans* are available from a variety of different sources including family and both shopkeepers and traders. Generally, the interest rate imposed on cash loans by shopkeepers and traders diminishes the larger the amount borrowed. For example, in Badakhshan a loan of the equivalent of US\$40 incurs 100% interest, whilst for a loan of the equivalent of US\$200 a rate of 80% interest is charged. Cash loans are more common in areas in which opium poppy cultivation has not become entrenched. Cash loans can also be given in opium. These loans are usually large and typically offer a more convenient and secure way of handling higher value loans (as well as a means of speculating during price fluctuations) than using cash. The exact amount of opium given is determined by the amount of cash required by the borrower and the current price of opium. For instance an individual that requires a loan of US\$300 would be given 2.5 kilograms of opium given a current price of US\$120 per kilogram. Although the loan is obtained in opium the borrower is committed to repaying the debt (and the interest accrued) in cash or its equivalent value in opium at the time of repayment. The debt cannot simply be repaid in-kind by returning the equivalent weight in opium plus interest due to the considerable fluctuations in the price of opium.
- The most common form of loans in opium poppy growing areas is the system known as *salaam*, an *advance payment on a fixed amount of agricultural production*. Whilst *salaam* sometimes provides advance payments on other agricultural products, such as wheat or black cumin, opium is the crop that is

avored by lenders. Although the majority of households that cultivate opium poppy in Afghanistan utilize the salaam system to some extent, the resource poor typically sell their entire crop prior to the harvest (some of them up to two years) in return for an advance payment.

Traditionally the price paid as an advance is half the current market price of opium on the day that the agreement is reached. To maximize the salaam payment the borrower will either delay the loan until later in the winter season when prices have traditionally reached their highest level or take a number of advances over the season, only selling as much opium as is required to meet any cash shortfall, and saving any further sales required until later in the season. The borrower is expected to submit the amount of opium that the advance has been provided promptly at harvest time. Whilst the lender can sometimes make losses, typically the salaam system facilitates 'distress sales', allowing traders to acquire opium at prices significantly less (often less than half) the harvest price. However, advance payments on opium do not dominate throughout Afghanistan, it is not as common in areas where opium poppy has not been concentrated for some years. For instance, in Badakhshan, opium was only the favored crop for salaam payments in the lower lying areas in the districts of Jurm and Baharak, and this had only occurred in since 2001. In the upper valleys, cash and commodity credit still dominate. Salaam payments on opium are even more uncommon in the province of Ghor where opium poppy cultivation is a more recent phenomenon.

Shopkeepers and traders will give low value *commodities on credit*, allowing farmers to delay the payment for goods until an agreed time, usually after the winter harvest. Goods purchased may include basic necessities such as wheat, sugar, tea and rice, as well as agricultural inputs. The mark-up on the market price for these goods will vary, depending on the item, the relationship between the lender and borrower, and the duration of the loan. A purchase of seven kilograms of wheat in Badakhshan, for instance, can incur interest rates of 20% after one month, 60% after six months and 100% after a year. Obtaining fertilizer on credit in Helmand and Nangarhar typically entailed a 40-60 per cent mark up on the market price. Given these premiums this kind of credit tends to be used by the resource-poor

- Anawat involves the short-selling of *commodities for cash loans*. Under this system, farmers pay usually twice the market price for commodities from shopkeepers and traders. These commodities are then sold back at market price with the difference being available to the farmer as a cash loan. Whilst more often than not they do not exchange hands, the commodities purchased and then resold under this arrangement are high value items such as opium, livestock and luxury items, such as a motorbike or even cars. Anawat is generally viewed unfavorably due to the punitive mark-up charged by the lender and that many considered it interest bearing and therefore forbidden under Islam.

SOURCES OF CREDIT

Credit is typically obtained from a number of different sources, including family, shopkeepers, traders and landlords. Some farmers are able to access loans from all these different sources. Others are more restricted limited by their social networks or the fact that they do not grow opium poppy.

- *Family members* are the preferred source for credit as they tend to offer interest free loans and are more flexible on the time period for repayment. However, typically it has been wealthier groups who have had better access to credit from family members whilst the poor have had to rely on traders and shopkeepers. More recent research in Nangarhar in 2004 (GTZ 2004) reports an increase in the proportion of loans obtained from family members by all socio-economic groups due to the increase in the amount of cash available due to the relatively high opium prices of the last two seasons.
- Typically *shopkeepers and traders* have been the main source of credit, usually in the form of advance payments on opium. However, whilst many recognize the financial benefits of purchasing opium prior to the harvest both in terms of increasing returns and securing supply, the salaam system is not seen to be without risk. In the late 1990s UNODC reported that traders typically limited their salaam payments to farmers that were considered 'credit-worthy'. This generally translated into farmers that were known to the trader, owned land in the area or who had record of providing quality opium in return for a salaam payment. Typically traders restricted their provision of advances to farmers within their district or neighboring districts and few traders were found to purchase more than 10% of the total amount of opium they traded through the salaam system, despite the potential to increase their returns

Box 1. Bonded Labor in Nad e Ali

A sharecropper of 70 years of age, reported that due to the drought he had left Washir district in southern Helmand in 1999. He had come to Nad e Ali with his family of ten members (with only one son of working age) to work as a sharecropper. Initially the respondent had worked in another village before moving to his current location. In both villages he had cultivated one to two jeribs of opium poppy. However, in the 2002/3 growing season his opium crop was eradicated and he had found himself unable to pay his outstanding debts to his landlord of approximately US\$1800. Without land, livestock, or a guarantor, the respondent reported that he was unable to obtain any further loans, not even an advance on his future opium crop. The landlord whose land he worked had agreed to give him further cash loans only on condition that he accept a reduced share of the final yield of the crops that he cultivated and that he did not work the land of anyone else. The respondent also had to agree that he would not work elsewhere until he had fully repaid his debts and that were he to die his family were responsible for repayment. The respondent agreed to these terms, including receiving only one sixth of the final opium crop (compared to the usual one third) as he felt he had no other option if he was to feed his family this coming season. At the time of interview in late 2003 the respondent complained that the landlord was becoming increasingly anxious about the sharecropper's movements and would not even allow him to leave the area for two nights in order to visit his

extended family. In the 2003/4 growing season the respondent claimed he was cultivating seven jeribs of opium poppy. He believed that if the crop was not destroyed he might be able to repay his outstanding debts. However, were the crop to be destroyed he claimed he would try and abscond, crossing the border into Pakistan

More recently in the 2002/03 and 2003/04 growing seasons, the threat of eradication and the anticipation of dramatic reductions in the harvest price of opium have prompted traders to restrict the availability of salaam payments. These restrictions not only manifested in a significant shortfall in the number of households obtaining salaam in provinces such as Helmand and Nangarhar but also in the amount of salaam paid being determined by the socio-economic position of the borrower. Given concerns over repayment a higher rate of salaam is made to those with assets that the lender could potentially seize if loans were defaulted on. Consequently, those with land would receive the traditional advance payment of 50% of the market price of opium that day, however, those individuals without land but with other assets (such as farm equipment, livestock etc) received only 30%-40% of the current price. It was reported that those with neither land nor other assets could not obtain any loans as traders perceived them as the most risk of eradication and the least able to repay their debts if eradication took place.

Whilst advances on the future opium crop are preferred shopkeepers and traders also provide credit in the form of cash and commodities. These loans are available from within the village either from the local shop (where there was one) or from passing traders but often at exploitative rates of interest. Generally these loans are relatively small and given in kind, however, repayment is expected in cash.

- *Landlords* have been found to provide loans to sharecroppers or tenant farmers mainly in the form of salaam. However, there is little evidence to suggest that the provision of credit is part of the land tenure arrangement given that a maximum of only one third of landlords have been found to provide credit and that the landless have been found to obtain their credit from a variety of different sources, in particular shopkeepers and traders.

REASONS FOR OBTAINING CREDIT

The research on credit in Afghanistan portrays a consistent picture in which a significant proportion of the rural population *rely on credit to meet their basic needs*. Research in Helmand in 2000 reported that two thirds of borrowing events were for social needs, such as food, clothing medical treatment and marriage whilst production needs such as fertilizer, seed, hired labor and capital investment accounted for the final third. More recent research in Nangarhar (GTZ 2004) suggests that loans were most commonly used to purchase basic commodities, such as food (32% of loans), clothes (20%) and investment in agricultural production (17%). Marriage (8%), the cost of hired labor (8%), medical expenditure and funeral costs (10%) were also cited. This work found that only three loans were for house construction and one to finance Haj. The timing of loans supports the findings in both Helmand and Nangarhar, suggesting that almost three

quarters of all loans are taken between September and March when extra cash is needed for agricultural investment prior to the winter planting season and for food during winter when household stocks have dwindled.

THE INCIDENCE AND SIZE OF SEASONAL LOANS

Seasonal loans are common. Typically, the research reports that between half and two thirds of those interviewed have obtained a seasonal loan over the twelve months prior to fieldwork. In areas where opium poppy cultivation has a longer history and cultivation is more concentrated the proportion of households obtaining a seasonal loan can be even higher. Recent fieldwork in Nangarhar province suggests that despite a change in the source of credit in 2004 the proportion of households obtaining seasonal loans remains relatively constant at 57%.

The research is consistent in showing that seasonal loans were *obtained by all wealth groups* regardless of land tenure, the size of landholdings or the presence of opium poppy cultivation. However, there is also evidence that that a *greater proportion* of the *resource-poor obtain seasonal debts* than wealthier members of the community. For instance, in research in Helmand reported that only 18% of the large landlords and 50% of landlords had obtained loans compared to 80% of the landless and 64% of those households that only worked on their own land. The results of UNODC's initial work on the role of opium as a source of informal credit in 1998 also supports these findings.

There is also broad agreement that *the wealthy take higher levels of debt* using credit to purchase basic commodities, as well as invest in some relatively expensive agricultural equipment and in non-agricultural enterprises. In 1998, UNODC reported seasonal debts of between US\$695 for the landless and US\$1668 for landlords. Whilst in Helmand (2000), levels of reported seasonal debt varied from US\$1782 for landlords to US\$695 for the landless. More recent work in Nangarhar (GTZ 2004) reports that whilst the average seasonal debt amongst those that took loans was US\$ 812, the land wealthy had obtained seasonal loans of US\$1461 which was almost three times the amount borrowed by those farmers with the smallest amount of cultivated land (US\$568).

Given UNODC's estimate that 364,000 households were involved in opium poppy cultivation across Afghanistan in the 2003/04 growing season (of which between 50% and 66% obtain seasonal loans) this would suggest that *the level of seasonal debt is between US\$127 million and US\$197 million.*

Seasonal debts have also been found to *be higher in areas in which opium poppy cultivation is concentrated.* For instance in 2002/03 the average seasonal loan in Helmand province was US\$774, in Nangarhar US\$665 and in Oruzgan \$648. Whilst in Badakhshan, the average advance payment received by respondents who had taken a loan on their 2002/3 opium crop was only US\$192

The research also shows a *greater proportion of the cash income of the resource poor being used to service debt.* For instance, in 1998, UNODC reported that seasonal debt alone represented 53% of the annual net income of those without land. In contrast the debts of those that employed

sharecroppers on their land was only 22% of their annual net income. recent work in nangarhar (gtz 2004) reports that despite obtaining lower seasonal loans those with more marginal landholdings would require the equivalent of 39% of their annual cash income to repay these debts compared to the land wealthy whose seasonal loans were the equivalent of 21% of total annual cash income

COPING WITH ACCUMULATED DEBT

In normal years seasonal loans are manageable. However, during times of family crisis (illness or death) or natural shocks, farmers find themselves unable to repay their loans. In the late 1990s the majority of households managed their debts relatively well. Whilst some farmers were found to have had to reschedule their debts due to poor opium yields in 1998, there were very few reports of farmers defaulting on their loans. In the few instances where a loan was defaulted on land was either sold or mortgaged to repay the debt. There were no reports of the indebted absconding or giving their daughters to traders as payment.

Since 2001 this changed has due to the widespread incidence of crop failure. In areas such as Badakhshan the *drought* was the main course of crop failure resulting in households incurring debts to meet both their shortfall in wheat production and cash income. In those areas ruled by the Taliban, *the implementation of the opium ban in 2001* was the main cause of accumulated debts. In this case, without an opium crop many farmers found themselves unable to repay the amount of opium on which they received an advance. To ensure that the advances were repaid, lenders converted the repayment due in-kind into cash payments. The conversion was based on the price of opium at harvest time 2001 (on average US\$500 per kilogram). The monetization of advances was the equivalent effect of charging interest at 1,000-1,500 per cent. This had a dramatic impact on debts that many farmers have still not recovered from despite the hike in opium prices over the last two years. Indeed, UNODC reported in 2004 that 61% of all accumulated debts dated back to 2000 and 2001.

Box 2. Jailed in Marja

A sharecropper in Marja district in Helmand reported that he had taken an advance payment of US\$,600 on the understanding that he would repay the lender ten kilograms of opium at harvest time in 2003. However, the sharecropper claimed that his crop was destroyed in the eradication campaign during the 2002/3 growing season campaign. In response his landlord took back the land blaming the sharecropper for failing to bribe the eradication team the US\$200 necessary for them to spare the crop. The sharecropper indicated he did not have sufficient money to pay the bribe and once his crop was destroyed he could not repay his outstanding debts. In the 2003/4 growing season the sharecropper obtained five jeribs of land from a different landlord, however, his creditor had him imprisoned in the district jail for twenty-three days for defaulting on his loans. It was reported that the sharecropper's mother and current landlord appealed to the district administrator for his release insisting that the women of the family would help him in the field so that he could repay his debts. The sharecropper was released but was ashamed. He stated that 'no wife or mother work on the land in this district but mine are working with me. My nine-year-old daughter and my two younger children are also working with me. They cannot go to school as they help me on the land – this is the curse of debt'. He was cultivating all five jeribs of land with opium poppy in the 2003/04 season.

The failure to repay the accumulated debts that resulted from the Taliban ban continues to be a source of local conflict. Creditors have adopted authoritarian tactics to ensure borrowers repay their debts. Stories of creditors taking the daughters of those that owe them money are not uncommon, The confiscation of domestic possessions, the compulsory purchase of land (at preferential rates), and creditors pursuing absconders across the border into Pakistan have all been used to recoup outstanding loans. The result has been *increasing socio-economic differentiation* as those with the financial resources to provide loans in the first place acquire the assets of the indebted for less than their market value.

Subsequently, in 2001/02 and 2002/03, *eradication was blamed for increasing levels of debt.* In the 2003/04 season disease and corresponding *low opium yield have been blamed for increasing levels of debt* in Nangarhar (GTZ 2004) and Laghman (Grace and Pain 2004). The sale of land and absconding to Peshawar has been a common response of those unable to manage their accumulated debts.

As with seasonal loans *all socio-economic groups experience accumulated debt.* Even opium traders have found themselves in debt due to the advance payments they received from other, larger, traders on future shipments of opium

Accumulated debt has also been found to be *higher in areas where opium poppy is concentrated.* In 2002/03 the year after than ban the average accumulated debt of those interviewed was US\$1835. However, average debts ranged from US\$428 in Badakhshan (where the ban on opium had not been implemented) to US\$3010 in Helmand. In 2004, UNODC reiterate this point reporting that accumulated debts in the southern region were on average US\$1059 compared to US\$351 in the North east of the country and US\$126 in the North West. Further research in 2004 reported average accumulated debts of US\$2373 in Helmand, US\$769 in Nangarhar, US\$337 in Badakhshan, and US\$127 in Ghor.

As of 2003/04, *average accumulated debts* ranged from *US\$600 to US\$700* per household with *between 30% and 60%* of those interviewed having outstanding loans. This would suggest that *the level of accumulated debt* could range from *US\$65 million to US\$153 million* based on the UNODC's estimate that 364,000 households were involved in opium poppy cultivation in the 2003/04 growing season.

And whilst the level of accumulated debt was found to *increase with socio-economic status*, the *resource poor are the least able to repay their accumulated debts* given their low levels of income.

STRATEGIES FOR REPAYMENT

Continued or even increased levels of opium poppy cultivation are consistently seen as the main *strategy for repaying accumulated debts.* Whilst other options include the sale

(or mortgage) of land, wage labor, daughters into marriage, and licit crops, opium poppy cultivation is typically cited by the majority of farmers interviewed.

The time period over which farmers anticipate repaying their debts suggests that opium poppy cultivation is *not actually a strategy of debt repayment but one of debt management*. Farmers typically report that they expect to their existing debts to be repaid over a one to four year period. However, given the level of accumulated debt, the incidence of new loans each year, the potential for crop failure and the current absence of income earning opportunities it is unlikely that these accumulated debts will be cleared without external assistance.

Box 3. Threats from Khogiani

In the 2000/1 growing season a landowner from Laghman received an advance payment of US\$400 on seven kilograms of opium from a trader in Khogiani. However, the Taliban ban meant that he could not repay this debt. In 2002 the lender from Khogiani asked his sons, who were serving with the security commander in Laghman, to reclaim his money (plus interest). They did so at gunpoint, demanding fourteen kilograms of opium or its equivalent in cash at the time (approximately US\$5600). The Laghmani was told that if he did not repay in full he would be killed, his house fired and his livestock slaughtered. As the Laghmani had only cultivated half a jerib of opium poppy in 2002/3 and already used it to repay other debts he did not have much opium with which to repay the Khogiani trader. After much consultation the jirga decided that the Laghmani would need to give the three and a half kilograms of opium he retained from his harvest and the US\$400 he had in cash to his the trader. The jirga also decided he would have to give two jeribs of his land in mortgage against his outstanding debt of US\$4000. The Khogiani trader intended to get his sons to work this land and cultivate all of it with opium poppy. The Laghmani claimed he had cultivated his remaining four jeribs of land with opium poppy this year so that he could repay his debts and regain ownership over the land he had mortgaged.

Even the *dramatic increase in the price of opium* that followed the Taliban ban and is often accompanied with eradication campaigns, does *not aid those with accumulated debts* as many of these households have unpaid advances on opium amongst their accumulated debt. Consequently, their debts are either denominated in opium (and 100% interest is added each year) or these debts are converted into cash at current opium prices. The *inflationary impact* high opium prices have on rents, bride payments and marriage costs may in fact lead to *increased levels of seasonal borrowing*. In contrast, for those without accumulated debts the increases in the price of opium since 2001 has been a windfall and led to an increase in conspicuous consumption. It has also provided them with the finances to provide further loans, not only acquiring opium from the indebted at prices significantly lower than harvest price, but their assets should they default on their repayments.

CONCLUSION

The *returns on opium differ considerably by socio-economic group*. Through *inequitable land tenure* arrangements such as sharecropping, those who own land receive between half to two thirds of the final opium crop produced, whilst those with *surplus financial assets* can typically purchase the opium crop for half the harvest price through the provision of salaam. By using these traditional systems *those that have* both land and capital (which tends to be the way in Afghanistan) can succeed in *absorbing the bulk of the profit* to be generated from opium poppy cultivation leaving those that do the lion's share of the work, *the resource-poor*, with *as little as a tenth of the net returns* of their wealthier neighbors.

The *level of debt* is a *key determinant* of the *actual returns* on opium poppy cultivation. Those households that are not using opium production as a means of servicing debt will benefit from the relatively high farm gate price that opium can currently obtain. However, for those that take seasonal loans or have accumulated debts, even relatively

high opium prices *do not* allow them to fully service their loans, particularly where a household is repaying in-kind in the form of raw opium.

The role opium poppy plays in increasing access to much needed credit, and subsequently in managing the debts that farmers incur, is certainly *furthering economic dependency on the crop*. Those with seasonal and accumulated debts currently see little option but to continue to cultivate opium poppy even though it *does not offer them a viable and sustainable strategy for debt repayment*. Were they to suddenly stop growing opium poppy they risk losing the long-term productive assets that ultimately offer them the means of pursuing a licit livelihood and give them a political stake in the community. As we have seen with the Taliban ban, it may also present those who are more engaged in the opium trade (through amongst other things their role in providing advance payments on the crop) with the opportunity to concentrate their economic and political power and establish the conditions for even further increases in opium poppy cultivation.

There is *no easy solution* to this problem. Whilst increased on farm and non-farm income opportunities, contract farming and new credit facilities (especially those at less exploitative rates) may reduce the need for opium related loans each year *accumulated debts will not disappear overnight*. Were eradication initiatives to be more indiscriminate and not target solely those with alternative licit livelihoods, *accumulated debts may increase even further*. Aside from asset accumulation by those providing the loans, the consequences of such an action might include a *dramatic increase in migration* as farmers who have sold their land to repay their debts search for non-farm income opportunities, or simply flee the intimidation and violence that can often accompany the failure to repay accumulated debts.

Clearly policy makers will need to consider some difficult options if they are to deliver *economic and political stability* as well as *sustainable reduction in opium poppy cultivation*. The issue of accumulated debt is indicative of just how entrenched and deeply problematic the opium issue is in rural Afghanistan and consequently how policy options need to be firmly supported by the evidence base. For instance, one policy option might include a one-off payment to clear accumulated debts regardless of the obvious logistical and presentational problems that this might entail. Another might include the enforcement of the current ban on opium denominated loans and arresting those members of the community that provide advance payments on opium on trafficking charges. A further option may include concessions (financial or development ‘gifts’) to those lenders who annul accumulated debts. However, many of these options from the ‘blue-sky-thinking’ school of policy development are contingent on the state having the authority and institutional capacity in rural areas with which to implement. Of course, were these conditions in place it is unlikely that widespread opium poppy cultivation would be such a problem in the first place.

Perhaps the more evidence based policy option, and certainly one supported by the success story in Thailand, would be to focus on *nation building* and not counter narcotics per se. This would require time. It would entail strengthening the authority and capacity of the state to deliver both in terms of improvements in security and governance, as well as the economic growth that will contribute to improvements in licit livelihoods. Immediate national coverage would not be an option: the more economically viable,

fertile, accessible and governable areas of the country would be a priority. Law enforcement would be targeted at those elements that seek to limit the writ of the state, including drug traders and traffickers. Eradication would be targeted where alternative livelihoods exist and there would be a greater acceptance of the need for a more gradual reduction in the amount of opium poppy cultivated by more marginal farmers so that they can not only meet their basic needs but also remain engaged in the process of nation building. To simply destroy their crop and drive up accumulated debt risks further weakening the social contract between state and communities and exacerbating socio-economic differentiation - the very conditions that have allowed opium poppy cultivation to flourish.

SOME KEY QUESTIONS

- What are the potential options for addressing the need for seasonal loans amongst opium poppy cultivators? How might these be implemented without creating perverse incentives amongst non-poppy growing households?
- What has been the impact of MISFA and other micro finance options thus far both on lives and livelihoods and the level of opium poppy cultivation?
- How might contract farming help alleviate the need for seasonal loans?
- How might these initiatives be best targeted at those amongst the resource poor who are heavily reliant on growing opium as their means of accessing seasonal loans and repaying old debts?
- What impact monitoring systems should be put in place to assess the shift from illicit to licit livelihoods, as well as identify how new sources of credit have facilitated this shift?
- How will traders react to a reduction in the demand for salaam and the subsequent shortfall in profit that they will incur? What can be done to counter this?
- Are there any 'blue sky thinking' on addressing accumulated debts that have some potential in today's Afghanistan? If not what are the conditions required to achieve results?

REFERENCES

Grace, J and A. Pain. Rethinking Rural Livelihoods in Afghanistan AREU Synthesis Paper Series, June 2004. AREU, Kabul.

GTZ. Diversity and Dilemma: Understanding Rural Livelihoods and Addressing the Causes of Opium Poppy Cultivation in Nangarhar and Laghman, Eastern Afghanistan. A PAL Internal Document No. 2. A Report for the Project for Alternative Livelihoods (PAL) in Eastern Afghanistan by David Mansfield (Forthcoming)

The Impact of the Taliban Prohibition on Opium Poppy Cultivation in Afghanistan, 25 May 2001'. Paper prepared for the Donors Mission to Afghanistan, 23 April – 4 May 2001.

Mansfield, David. The Economic Superiority of Illicit Drug Production: Myth and Reality - Opium Poppy Cultivation in Afghanistan'. Paper prepared for the International Conference on Alternative Development in drug control and cooperation, Flaring, January 7-12, 2002.

Mansfield, David. 'Coping Strategies, Accumulated Wealth and Shifting Markets: The Story of Opium Poppy Cultivation in Badakhshan 2000-2003' A Report for the Aghast Khan Development Network. January 2004.

Mansfield, David. 'What is Driving Opium Poppy Cultivation? Decision Making Amongst Opium Poppy Cultivators in Afghanistan in the 2003/4 Growing Season'. A Paper for the UNODC/ONDCP Second Technical Conference on Drug Control Research, 19 –21 July 2004.

Helmand Planning Group. The Helmand Initiative: Joint Strategy Development, Paper prepared for the United Nations Development Programme, Islamabad May 2000; UNODC Farmers Intentions Study 2004. UNODC Kabul, February 2004.

UNODC Strategic Study#3 The Role of Opium as a Source of Informal Credit. Preliminary Report, January 1999. UNODC Afghanistan Programme, Islamabad.

UNODC Strategic Study#2: The Dynamics of the Farm gate Opium Trade and the Coping Strategies of Opium Traders. Final Report. October 1998. UNODC Afghanistan Programme, Islamabad.

UNODC Strategic Study#9: Opium Poppy Cultivation in A Changing Policy Environment – Farmers' Intentions for the 2002/03 Growing Seasons. UNODC, Kabul.

UNODC Afghanistan: Farmers' Intentions Survey 2003/4. January 2004.

Annex

The Sessions of the Workshop⁷²

The overall workshop **objectives** were to: (1) review the current situation in Afghanistan's rural financial sector, actions that have been taken to provide rural finance, and options for scaling up; (2) learn about possibilities for further development of rural finance in the light of global experience; (3) assess the challenge of the opium economy with respect to rural financial markets – in particular the issue of opium-related indebtedness; and (4) develop practical ways forward.

Audience: Government (including CND), the formal financial sector, MISFA, NGOs involved in rural finance, key international and bilateral development agencies, representatives of farmers and of agribusiness.

This event was hosted by the Ministry of Rural Rehabilitation and Development (MRRD), the UK Department for International Development (DFID), and The World Bank (WB).

Opening session

Brief welcoming remarks by H.E. Dr. Rosalind Marsden, Ambassador of the United Kingdom, and by Mr. Jean Mazurelle, Country Manager for Afghanistan, The World Bank

Keynote introduction by H.E. Mr. Haneef Atmar, Minister of Rural Rehabilitation and Development

SESSION A. CURRENT SITUATION OF RURAL CREDIT SUPPLY AND DEMAND

Chair: Mr. Mohammad Ehsan Zia, Deputy Minister, MRRD

Facilitator: Anthony Fitzherbert (MRRD)

Discussant: Christopher Ward (WB)

Rapporteur: David Radcliffe (DFID)

Background documents: approach paper by Stephen Rasmussen (WB), preparatory study by Karri Goeldner (DFID consultant), paper on the *hawaladar* by Samuel Maimbo (WB)

Presentations:

- ***Rural finance in Afghanistan***: based on DFID preparatory study, supply and demand, lessons for rural financial markets in general and opium in particular. Presented by Karri Goeldner (DFID consultant)

⁷² It should be noted that all titles of persons listed in the paper refer to their titles at the time of the Workshop.

- ***Overview of the organized financial sector:*** including microfinance: outreach, issues, prospects etc. Presented by Stephen Rasmussen (WB with MISFA staff)
- ***Building on the informal financial system:*** bringing *hawala* and *salaam* into the mainstream. Presented by Samuel Maimbo (WB)

SESSION B. ADDRESSING RURAL FINANCE NEEDS: SOME CASE STUDIES

Chair: Mr. Mohammad Ehsan Zia, Deputy Minister, MRRD

Facilitator: Anthony Fitzherbert (MRRD)

Discussant: David Mansfield (DFID)

Rapporteur: Erick Zeballos (DFID)

Background document: paper on BRAC microfinance and small business finance programs.

Presentations:

- ***Scaling up microfinance and small business finance in rural areas:*** BRAC's experience in Bangladesh and Afghanistan. Presented by Amin ul Alah (BRAC)
- ***Rural finance and commercial banks:*** Presented by Olivier Messaert (FMFB-A)

SESSION C. INTERNATIONAL EXPERIENCE IN RURAL FINANCE RELEVANT TO AFGHANISTAN

Chair: Ms. Nargis Nehan, Director-General Treasury, Ministry of Finance

Facilitator: Anthony Fitzherbert (MRRD)

Discussant: Erick Zeballos (DFID)

Rapporteur: Shantini Dawson (MRRD)

Background document: paper on global experience by Renate Kloeppinger-Todd (WB)

Presentations:

- ***Trends and lessons from global experience with rural finance:*** Presented by Renate Kloeppinger-Todd (WB)
- ***Supply chain financing: scope for rural finance interventions:*** Presented by Douglas Pearce (DFID)

SESSION D. THE SPECIFIC FINANCING CHALLENGES OF THE OPIUM ECONOMY

Chair: Dr. M. Nabi Hussaini, Head of Alternative Livelihoods Section, CND

Facilitator: Anthony Fitzherbert (MRRD)

Discussant: William Byrd (World Bank)

Rapporteur: Christopher Ward (World Bank)

Background document: preparatory study by David Mansfield (DFID Consultant)

Presentations:

- ***Livelihoods and alternative livelihoods***: the livelihoods approach to rural poverty, growth, and poverty reduction, the role of finance in livelihoods strategies with specific application to the problem of the opium economy. Presented by David Radcliffe (DFID)
- ***The opium economy and rural finance***: presentation of preparatory study: characteristics of the opium economy and its financing, debt/land/credit nexus, entry points. Presented by David Mansfield (DFID)
- ***Opium specific finance products***: the opium debt problem in Badakhshan, opium debt buy back, mortgage relief, other possible instruments. Presented by Armando Sirolla and Henri Suter (ARMP-AKDN)

SESSION E. PRACTICAL WAYS FORWARD

Chair: H.E. Haneef Atmar, Minister, MRRD

Rapporteur: David Mansfield (DFID)

Introductory remarks, including strategic summary of main points emerging from workshop: John Gordon (DFID) and William Byrd (WB)

Discussion, with contributions from resource people and the floor

Summary, by Rapporteur

Closing synthesis on findings and concrete steps forward, by H.E. Mr. Haneef Atmar, Minister of Rural Rehabilitation and Development

List of Participants

2-Day Workshop Kabul, Afghanistan December 13-14, 2005			
No	Participants	Institution	Contact details
1	Jalaluddin	BRAC	jalaluddin_a2003@yahoo.com
2	Amin-ul-Alam		
3	Doris Buddenberg	UNODC	doris.buddenberg@unodc.org
4	Consuelo Casarotto		
5	Mohd Wali	MADERA	maderadp@yahoo.fr
6	Dr. Homayoun Wardak	Afghanaid	aacd@brain.net.pk
7	Mal Simmons		
8	Haneef Atmar	MRRD	haneef.atmar@mrrd.org
9	Mohammad Ehsan Zia		ehsan.zia@mrrd.org
10	Shanthini Dawson		
11	Anthony Fitzherbert		anthonyfitzherbert@hotmail.com
12	S. Macqueen	MISFA/ RAMP	steven_macqueen@misfa.org
13	Caroline Tsilikounas		tsilikounas@usa.net
14	Harish Chotani		harish_chotani@misfa.org
15	Fran Toomey		francestoomey@aol.com
16	Daniel Gies		daniel@gideon.hr
17	Shakir Ullah		
18	Rozikhan Zurmati		rozikhan_zurmati@misfa.org
19	Michael Bowers	Mercy Corps	mbowers@mercycorpsfield.org
20	Michele Breton		
21	Samuel Muzele Maimbo	World Bank	smaimbo@worldbank.org
22	Karina Manasseh		
23	William Byrd		wbyrd@worldbank.org
24	Christopher Ward		cward@worldbank.org
25	Jean Mazurelle		jmazurelle@worldbank.org
26	Steve Rasmussen		srasmussen@worldbank.org
27	Pooja Kumar		
28	Amer Durani		
29	Maha Ahmed		
30	Peter Middlebrook		pmiddlebrook@worldbank.org
31	Roya Karimy		rkarimy@worldbank.org
32	Deepak Ahluwalia		dahluwalia@worldbank.org
33	Renate Kloepfinger-Todd		rkloepfingertodd@worldbank.org
34	Jorgen Persson	Sweden Embassy	jorgen.persson@sida.se
35	David Mansfield	DFID	davidmfd@aol.com
36	Erick Zeballos		e-zeballos@DFID.gov.uk
37	Douglas Pearce		d-pearce@DFID.gov.uk
38	James Medhurst		j-mdhurst@DFID.gov.uk
39	John Gordon		j-gordon@DFID.gov.uk
40	Karri Geoldner		kgoeldner@aol.com
41	Heiko Faehnel	BMZ Kunduz (Germany)	bmz.dunduz@web.de
42	Armando Sirolla	AKDN	armando.sirolla@armp.akdn.afg.org
43	Henri Suter		
44	Swandip Sinha	ILO Microfinance (MISFA)	
45	Tamim Asey	CIDA Canadian Embassy	79304335
46	Dan Obenschain	IAM (MED Project Leader)	iam-med@yahoo.com / 070274579

List of Participants

2-Day Workshop Kabul, Afghanistan December 13-14, 2005			
No	Participants	Institution	Contact details
47	Edgar Comeros	WOCCU	ecomeros@woccu.org
48	Curtis Slover		csolver@woccu.org
49	Norbert Burger	German Agro Action (GAA)	norbert.burger@dwvh.org
50	Dr. Mirzazada		
51	John W. Haye	AIB	john.haye@aib.af
52	Ahmad Samet		
53	Sayed M Hashemi	CGAP	
54	Michael Alexander	EC	michael.alexander@cec.eu.int
55	Arnaud Cauchois		arnaud.cauchois@cec.eu.int
56	Lara Burger	Oxfam GB	
57	Helen Sand Andresen	Royal Norwegian Embassy	helen.sand.andresen@mfa.no
58	Johan Lorentz Wigand		
59	Allan Kelly	ADB	atkelly@adb.org
60	Grant Curtis		gcurtis@adb.org
61	David Larson	Hope International	davel@hopeinternational.net
62	Mirwais Yasini	CND	
63	Nabi Hussaini		
64	Fazli Khaliq		fazlikhaliq.niazi@cnd.gov.af/079410334
65	Shahpoor Amini		shahpoor@cnd.gov.af/070248286
66	William Reeve		reevew10@aol.com/ 070280085
67	Rudolphe Baudeau	Altai	rbaudeau@altaiconsulting.com
68	Richard Reed	Bearing point/DAB	79001660
69	Abdul Karim Haider	FMFB-A	karim.haidar@misfa.org
70	Olivier Massaert	FMFB-A	olivier_massaert@hotmail.com/ 79321001
71	A. Malik Ghafoury	KFW	kfwkabul@gmx.de/ 070274456
72	Dan Miller	USAID	
73	Rosalind Marsden	UK Embassy	
74	Chris Jones		chris.jones@fco.gov/ 070261130
75	David Radcliffe		david.radcliffe@fco.gov
76	Doug Wankel	US Embassy	70223146
77	Jerry Turnbull	IFDC	gtumbull@ifdc.org