



Progress Report on Tranche Release

Program Number: 37393
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Afghanistan: Private Sector and Financial Market Development Program

CURRENCY EQUIVALENTS

(as of 27 February 2009)

Currency Unit	–	afghani/s (AF)
AF1.00	=	\$0.02
\$1.00	=	AF52.39

ABBREVIATIONS

ADB	–	Asian Development Bank
ANDS	–	Afghanistan National Development Strategy
DAB	–	Da Afghanistan Bank
FY	–	fiscal year
IMF	–	International Monetary Fund
MOCI	–	Ministry of Commerce and Industries
MOF	–	Ministry of Finance
MOL	–	Ministry of Labor
MOU	–	memorandum of understanding
SOE	–	state-owned enterprise
SY	–	solar year
USAID	–	United States Agency for International Development

NOTES

- (i) The Afghan fiscal year (FY) coincides with the Afghan solar year (SY). The current FY, SY1387, runs from 21 March 2008 until 20 March 2009. FY before a calendar year denotes the year in which the fiscal year starts, e.g., FY2008 starts on 21 March 2008.
- (ii) In this report, "\$" refers to US dollars.

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I. INTRODUCTION

1. On 14 December 2006, the Asian Development Bank (ADB) approved a policy reform program grant to the Islamic Republic of Afghanistan for \$56 million for the Private Sector and Financial Market Development Program (Program), and a capacity building grant of \$4 million from the Asian Development Fund for the Supporting Private Sector and Financial Market Reforms Project (Project).¹ The objective of the Program is to promote the development of the private sector as the main engine of economic growth by (i) strengthening the enabling environment for private sector development through better legal and regulatory regimes, (ii) disengaging the Government from business through the liquidation of state-owned enterprises (SOEs), and (iii) improving the private sector's access to financial services. The capacity building grant also has an unallocated pool of funds to engage consultants to meet additional needs for advisory support as they emerge during program implementation. The grant agreements were signed on 14 March 2007 and declared effective on 18 June 2007. The 10 conditions for the first tranche of \$28 million were met and funds were disbursed on 28 June 2007.

2. This progress report provides an overview of key policy reforms undertaken by the Government and details of achievements that support compliance with the remaining conditions for the release of the second tranche of \$28 million.²

II. DEVELOPMENTS IN AFGHANISTAN AND PROGRAM IMPLICATIONS

A. Progress in Private Sector and Economic Reforms

3. The Government of Afghanistan is committed to structural reforms that promote sustainable economic growth and the welfare of the Afghan people. Since the fall of the Taliban regime, macroeconomic and socioeconomic progress has been made. Building on these achievements, the Government seeks to further transform the economy in a way that will allow the shift from reconstruction to sustainable development led by the private sector.

4. During the latter part of FY 2007, Afghanistan faced an increasingly difficult environment. The security situation continued to deteriorate, prices of imported fuel and foodstuffs increased substantially, and the harsh winter adversely affected livestock and private sector imports.³ Extreme violence has spread to parts of the country previously unaffected by the insurgency, with armed groups using targeted assassinations of government and military personnel; improvised explosive devices aimed at government staff, national and international military personnel, international and domestic development workers, contractors and consultants, as well as the civilian population; and kidnappings and beheadings. Insecurity (i) limits access to populations living in conflict areas, (ii) makes it difficult for the Government to extend public services, (iii) diverts development agency funding to security expenditures rather than to core development activities, (iv) increases project costs because of the need for expensive security measures, (v) limits interest from bidders in reconstruction contracts, (vi) hampers the ability to recruit international contractors and consultants (including expatriate Afghans), and (vii) erodes

¹ ADB. 2006. *Report and Recommendation of the President to the Board of Directors on Proposed Grants to the Islamic Republic of Afghanistan for the Private Sector and Financial Market Development Program*. Manila. The Project provides capacity building support to implementing agencies under the Program.

² The implementation period of the Program is 3 years. The Program will be completed by 31 December 2009 and closed on 30 June 2010.

³ International Monetary Fund (IMF). 2008. *Middle East and Central Asia Department Fourth Review*. Washington, D.C.

popular support for Government and international personnel. Thus, widespread and potentially deepening insecurity necessitates more attention to appropriate risk-mitigation measures. Despite the many constraints faced by Afghanistan, the authorities continued to implement reforms on several fronts, including under this Program. While the preparation of the Afghanistan National Development Strategy (ANDS) and the Paris Conference⁴ absorbed considerable time and resources, the authorities continued to focus their attention on the policy actions and structural reforms agreed upon under the Program.

5. The Government has improved budget processes. However, domestic revenue collection has continued to fall as a proportion of gross domestic product—from 7.5% in FY 2006 to 7.0% in FY 2007. The national currency, the afghani, has held relatively steady at AF50 per \$1 since 2005.⁵

6. The nascent finance sector does not yet play a significant role in promoting private sector development. The Government's medium-term reforms focus on creating an enabling environment for entrepreneurship and investment, reducing the state presence in areas where the private sector would be more efficient, and improving access to credit by private enterprise. Developing human capital in management and financial accounting is being pursued to support sustainable development of the private sector.

7. Private sector access and participation in transportation infrastructure has expanded. Many primary roads have been rehabilitated and repaired since 2002. In addition, nearly 1,500 kilometers (km) of the 4,900 km national (secondary) road network, and several thousand km of tertiary roads with gravel surfaces, have been improved. In contrast to the 1970s, when the state ran all ground shipping services with a fleet of almost 14,000 trucks, today this sector is completely private.

8. The Ministry of Commerce and Industries (MOCI) is responsible for developing national strategies, policies, and legislation directly related to private sector development, while the Ministry of Finance (MOF) is responsible for policies on state enterprise reform. However, most Afghan agencies perceive the impact on private sector development as a matter of physical infrastructure, such as power and road transport delivered by government agencies. Government appreciation of the essential elements of an enabling "institutional" environment needs to be developed. Sector reforms and capacity development are needed to support the Government in increasing its role as an impartial enabler, facilitator, and regulator; and less as an active controller of commerce and trade.

9. The Government recognizes the need for broad-based initiatives to streamline regulatory and tax policy, and to simplify administrative procedures, so that government reduces—rather than increases—the risks of entrepreneurship. Disincentives for businesses to join the formal private sector need to be reduced. The ANDS also highlights the need to reduce nonphysical barriers to regional economic cooperation.

10. ADB has contributed to the development of an enabling environment for private sector development through several investments, including the Afghanistan Investment Guarantee

⁴ During the Paris Conference, held on 12 June 2008, donors pledged about \$20 billion for the implementation of the ANDS. The horizon of donor pledges varied from 2 to 5 years; some donors are expected to make additional pledges in the year ahead.

⁵ The Economist Intelligence Unit. 2009. *Afghanistan Country Report*. Available: http://www.eiu.com/report_dl.asp?issue_id=1184089703&mode=pdf.

Facility,⁶ reforms under the Program, and other physical infrastructure projects. One transport sector loan in 2007 included an earmark for long-term maintenance by private sector contractors utilizing performance-based contracts.⁷ In addition, ADB's Private Sector Operations Department has provided \$138.1 million in private sector loans, equity investments, and loan guarantees to the banking and telecommunications sectors.⁸

B. Continuing Constraints to Private Sector Development

11. As in most countries, Afghanistan's private sector is substantially made up of small businesses. However, nearly 90% of Afghan businesses operate in the informal economy, because political insecurity, lack of certainty in the rule of law, and little protection from violations of private property rights discourage formal commerce. Informal firms typically remain small, and they lack investment in productive assets or access to technology that would permit economies of scale or a shift to higher value-added activities. Because of ongoing insecurity, direct foreign investment in Afghanistan has been small. Investment has been concentrated in a few sectors, such as telecommunications, banking, hotels, and diesel-fueled electric generators. Investment by expatriate Afghans has helped to stimulate some economic growth, mostly in the construction and service sectors, with limited investment in other value-added activities. Key constraints to development of a healthy private sector in Afghanistan are:⁹

- (i) **Insecurity.** Limited confidence that investments can be protected is a key constraint. Security considerations tend to dominate investor decision making. The Taliban have regrouped, rearmed, and increased their operations. The low-intensity conflict with the Taliban has evolved into a conventional guerrilla war.
- (ii) **High cost of doing business.** Security costs (as a ratio of sales) have not improved since 2005 when they were five to eight times higher than in neighboring countries.¹⁰
- (iii) **Poor infrastructure.** Afghanistan is landlocked with poorly maintained avenues to markets (poor roads and airport facilities), and inadequate electricity and water resources. These constraints are compounded by corruption and administrative obstacles.
- (iv) **Institutional weakness.** Recent conflict has weakened the informal and formal institutions that underpin commercial transactions and protect property rights in

⁶ ADB. 2004. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan and Guarantee for the Afghanistan Investment Guarantee Facility Project*. Manila.

⁷ ADB. 2007. *Report and Recommendation of the President to the Board of Directors on a Proposed Grant to the Islamic Republic of Afghanistan for the Road Network Development Investment Program*. Manila.

⁸ ADB. 2004. *Report and Recommendation of the President to the Board of Directors on a Proposed Equity Investment in Afghanistan International Bank*. Manila; ADB. 2004. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Telecom Development Company Afghanistan Limited for the Roshan Cellular Telecommunications Project*. Manila; ADB. 2006. *Report and Recommendation of the President to the Board of Directors on Proposed Loan and Political Risk Guarantee for the Roshan Phase II Expansion Project*. Manila.

⁹ Unemployment and insecurity caused by the insurgency are having a more immediate effect on the Afghan economy than the current global financial crisis. The financial crisis will likely have some impact on cross-border trade with neighbors such as India, Pakistan, and Iran, as well as in more distant markets in Europe and the United States. A protracted slowdown will reduce remittances, which will affect many of the poorest Afghan households that rely on income from family members working abroad. Anti-trade sentiments, if played out in barriers to trade, would have negative consequences for consumers, producers, and savers, as well as general economic conditions.

¹⁰ World Bank. 2005 and 2008. *The Investment Climate in Afghanistan*. Washington, D.C.

an open economy. There are also overlapping systems of justice, including *sharia* (Islamic law), *shura* (traditional law), and the formal government (constitutional law). People are reluctant to invest because of uncertainty that they will be able to enforce contracts and that property rights will be protected. Weak institutions and limited rule of law allows both petty and institutional corruption to flourish, undermining development and the credibility of the Government.

- (v) **Human development.** Dismal human development indicators—including poor education, poor health, low life expectancy, and gender inequality—undermine worker productivity and the potential for sustainable increases in competitiveness and private investment.
- (vi) **Limited information and technology flows.** Poor infrastructure, weak institutions, and illiteracy impede the flow of technology and information about economic opportunities, reducing opportunities for Afghan businesses to compete. A lack of credit records also constrains investment.

III. PROGRAM PERFORMANCE AND STATUS OF IMPLEMENTATION

A. Summary of Compliance with Policy Actions

12. Despite the constraints outlined in para. 11, the implementing agencies (MOF, MOCI, and Da Afghanistan Bank [DAB]) have made considerable efforts in policy, legal, and institutional reforms towards meeting the 12 conditions for the release of the second tranche. During the review mission in September 2008, substantial quantitative and qualitative evidence of compliance with second tranche conditions was confirmed and documented. As noted in Table 1, nine conditions have been fully complied with, while three conditions have been partly complied with. These three conditions involve two areas: the legal framework on audit and accounting, where substantial technical work has been completed, but more time and consensus-building efforts are needed before the laws can go to Parliament; and SOE liquidation, where the Government has taken substantive measures for liquidation and divestment of seven SOEs, against 20 SOEs as agreed upon under the Program.

13. The expected outcome, specific requirements, and a brief description of the rationale for ratings on each second tranche release conditions are presented in paras. 14-32. The status of the monitorable indicators is reported in the Appendix.

Table 1: Summary of Compliance With Second Tranche Achievement Targets

Achievement Targets	Status of Compliance (including outstanding actions)
Purpose: Strengthening the Enabling Environment for Private Sector Development	
1. The Government shall have approved and submitted to the Parliament a Commercial Arbitration Law to facilitate out-of-court settlement of business disputes, satisfactory to ADB.	Complied with.
2. MOCI, in coordination with the municipal governments, shall have streamlined the business registration process in the municipalities to facilitate market entry of private enterprises.	Complied with.
Purpose: Disengaging the Government from Business Activity through the Liquidation of State-Owned Enterprises	

Achievement Targets	Status of Compliance (including outstanding actions)
3. The Government shall have approved the liquidation or privatization through asset sales of 10 state-owned enterprises (excluding the state-owned enterprises to be divested under the Agriculture Sector Program approved on 4 May 2004 by ADB). ^a	Complied with.
4. MOF, through the liquidation committees, shall have issued liquidation/asset sales announcements for 20 state-owned enterprises, including calls for creditors and claimants.	Partly complied with. Waiver sought.
5. MOF, through the liquidation committees, shall have issued bidding invitation for the assets of 20 state-owned enterprises.	Partly complied with. Waiver sought.
6. MOF shall have allocated a budget for its State-owned Enterprises Department in line with the restructuring plan approved by the Independent Administrative Reform and Civil Service Commission.	Complied with.
7. MOF shall have allocated adequate budget for the social safety net program for redundant employees of divested state-owned enterprises for 2007 and 2008.	Complied with.
Purpose: Improving Private Sector's Access to Financial Services by : (1) strengthening the supervisory framework for financial institutions to (i) Improve Depositor Protection and Confidence in the Financial System, and (ii) Enable Provision of More Services to the Private Sector; and (2) Enhancing Disclosure Requirements to Improve the Private Sector's Access to Finance	
8. DAB shall have (i) drafted a standard memorandum of understanding to be signed by DAB and foreign banking sector supervisory agencies that includes clear and workable protocols for (a) ongoing supervision of cross-border establishments, (b) on-site examinations, (c) protection of confidentiality, and (d) the establishment of a system of regular and as needed meetings among supervisory authorities; and (ii) submitted this draft memorandum of understanding to its counterpart banking sector supervisory agencies.	Complied with.
9. DAB shall have drafted policies and procedures on conservatorship, receivership and forced liquidation of distressed banks.	Complied with.
10. DAB shall have drafted detailed regulations on credit risk, operational risk, and market risk management.	Complied with.
11. DAB shall have enhanced disclosure by publishing the financial statements of individual banks on its website.	Complied with.
Purpose: Enhancing Disclosure Requirements to Improve the Private Sector's Access to Finance	
12. The Government shall have approved and submitted to Parliament an Accounting Law and an Audit Law, satisfactory to ADB, which shall include, inter alia, a timetable for adopting International Financial Reporting Standards and International Standards on Auditing (ISA) for Public Interest Entities.	Partly complied with. Waiver sought.

^a ADB. 2004. *Report and Recommendation of the President on a Proposed Loan and Technical Assistance Grant to the Islamic Republic of Afghanistan for the Agriculture Sector Program*. Manila (Loan 2083-AFG).

ADB = Asian Development Bank; DAB = Da Afghanistan Bank; ISA = International Standards on Auditing; MOCI = Ministry of Commerce and Industries; MOF = Ministry of Finance.

Source: Attachment 2 to Schedule 2 of the Grant Agreement.

B. Progress on Second Tranche Policy Actions

1. Policy Objective—Improved Legal Framework for Business

14. The conditions under this policy objective will strengthen the legal and regulatory framework for commercial activities and financial transactions that are fundamental to private sector development. Incremental steps under this policy objective suggest an improving environment for business, as demonstrated by a general sense of more freedom of consumer choice, producer–investor exchange, and worker movement. However, the security and political situation undermines this trend.

Policy condition 1: The Government shall have approved and submitted to the Parliament a Commercial Arbitration Law to facilitate out-of-court settlement of business disputes, satisfactory to ADB.

15. The Commercial Arbitration Law was drafted and promulgated through a presidential decree under Article 79 of the Constitution. The law provides an adequate basis for alternative dispute resolution in an out-of-court procedure, although further capacity building efforts will be required to train arbitrators and to enable enforcement of arbitral decision through out-of-court means. This policy condition is rated "complied with."

Policy condition 2: MOCI, in coordination with the municipal governments, shall have streamlined the business registration process in the municipalities to facilitate market entry of private enterprises.

16. While constraints still need to be addressed at the municipal level to streamline the process,¹¹ the MOCI has reduced the number of licensing procedures from 38 to 5. In reaction, applications have risen from 15,000 to 70,000 since FY 2007.¹² MOCI also organized a workshop on registration and license reform to discuss various ideas and measures, and to get feedback from the private sector and local government.¹³ Support for these accomplishments included an informal survey and meetings with community leaders, supported by ADB technical assistance. Another indication of progress in 2008 was the first countrywide election for the directors of the Afghanistan Chamber of Commerce. The chamber has been a champion for small business development at the local level. In addition, following a review of all revenues collected by the Moustufiats (provincial offices of MOF), as well as all fees and charges identified by the business community as “nuisance” taxes, MOF has (i) instructed ministries,

¹¹ The Economist Intelligence Unit. 2009. *Afghanistan Country Report*. Afghanistan's rankings have improved slightly for starting a business, employing workers and paying taxes. It ranked 22nd for the ease of starting a business, an improvement from 25th in the World Bank Group, *Doing Business 2008* report. The category assesses factors such as the number of procedures to go through, the number of days required and cost involved in starting a business. The improvement for Afghanistan since last year was based on a reduction in cost from 84.6% of gross national income (GNI) per head to 59.5% of GNI per head. Afghanistan has successfully streamlined the procedure for registering a business since the establishment of the Afghanistan Investment Support Agency (AISA), as the body responsible for registering new businesses.

¹² While this is an indicator of compliance and initial success, it is too early to draw conclusions regarding the impact. MOCI noted that renewals are running at less than 5,000 per year, and an estimated 15% of the registered companies are not operational.

¹³ During the workshop on 27 May 2007 and in other settings, central officials indicated that the municipal business permit system is a difficult area for any part of the central Government to strongly influence. The view was expressed that even with laws passed by Government and MOCI mandates published, the enforcement at the municipal level is tenuous. MOCI is not a budgetary agency and the municipalities are under the jurisdiction of the Ministry of Interior. Municipalities expressed concern that current resource allocation leaves them with no central Government alternative source of revenues.

municipalities and other government agencies to stop collecting those revenues that it views as having no legal authority, and (ii) prepared a draft amendment to the Income Tax Law to incorporate only those fees and charges that were deemed taxes and had a proper legal basis. The Lower House of Parliament passed the draft law in March 2008. This policy condition is rated "complied with."

2. Policy Objective—Government Disengaged From Business Activities

17. The conditions under this policy objective will accelerate the liquidation of SOEs. Five tranche conditions are related to SOEs. Three of these five conditions have been fully complied with. Of these five conditions, three quantify the number of SOEs to reach certain sequential milestones in the privatization process. The SOE Department (under the MOF) is continuing with internal reforms. Capacity within the department is improving, although it remains weak. The SOE Department has benefited from capacity building under the Project.

18. When the Program was designed, the business environment appeared to be ready for significant progress in privatization. The Government and ADB expected SOE reforms to attract strategic foreign investors interested in the assets (primarily real estate) of the SOEs. Engaging strategic investors would attract more entrepreneurial and management talent, which would demonstrate an investment opportunity for others. However, the investment appetite of foreign investors turned out to be substantially less than envisaged under the Program. The poor security conditions have heightened risk premiums for any business activity in Afghanistan as the global investment environment deteriorates. In addition, ADB's and the Government's early assumptions guiding the conditionality related to procedural requirements of the SOE liquidation process now appear to have failed to capture the complexities and the time factors involved. This is reflected in the practical impediments that have led to partial compliance with two conditions (paras. 20 and 22) and institutional arrangements within the legislative and executive branches of the Government.

Policy condition 3: The Government shall have approved the liquidation or privatization through asset sales of 10 state-owned enterprises (excluding the state-owned enterprises to be divested under the Agriculture Sector Program approved on 4 May 2004 by ADB).

19. The Council of Ministers has approved 11 additional SOE liquidation plans, not including an agriculture sector SOE. This policy condition is rated "complied with."

Policy condition 4: MOF, through the liquidation committees, shall have issued liquidation/asset sales announcements for 20 state-owned enterprises, including calls for creditors and claimants.

20. Of the 20 required, seven SOE sales have been announced. While partial progress is noted, this policy condition is rated "not complied with," and a waiver of full compliance is sought. The rationale is provided in para. 21.

21. **Rationale for Waiver of Full Compliance of Policy Condition 4.** While 26 sales have been announced by the 20 liquidation committees,¹⁴ these announcements pertain to assets of

¹⁴ Each committee is constituted of independent persons who must be trained and informed of the complexities of their respective SOE. While this protocol was instituted to increase transparency and as a check on potential corruption, it has complicated the privatization process considerably.

only seven SOEs.¹⁵ Since SOEs are made up primarily of multiple parcels of real estate, the condition may have been more effective if the number of sales announcements had pertained to assets rather than SOEs. Further, the amount of time and effort involved in completing this policy condition was underestimated at the time of Program inception. This step in the process requires work in areas such as financial and title claims, surveys, and various other issues that have been contentious in Afghanistan. These elements require primary and secondary research, discovery, dissemination of findings, calls for claims, and time for public comment and legal action to protect rights that may be in contention. These rights involve municipalities as well as individuals.¹⁶ Given the emotional and political aspect of land in Afghanistan, these elements may have delayed the process when assets are beginning to be identified.¹⁷

Policy condition 5: MOF, through the liquidation committees, shall have issued bidding invitation for the assets of 20 state-owned enterprises.

22. Of the 20 required, bidding invitations have been issued for only five SOEs. The number of SOEs issuing bidding invitations is two fewer than in the previous step (condition 4) because two of the seven SOEs to announce sales involved movable assets (which do not require a bidding invitation). While partial progress is noted and recognized, this policy condition is rated "not complied with," and a waiver of full compliance is sought. The rationale is provided in para. 23.

23. **Rationale for Waiver of Full Compliance of Policy Condition 5.** Under the privatization procedures for SOEs in Afghanistan, bidding invitations cannot be issued (condition 5) without having completed sales announcements (condition 4). Since condition 5 is predicated on completion of condition 4, and the same 26 assets pertaining to seven SOEs in condition 4 are represented here, the rationale for seeking waiver of full compliance of condition 5 is the same as the one provided for condition 4 (para. 21).

Policy condition 6: MOF shall have allocated a budget for its State-owned Enterprises Department in line with the restructuring plan approved by the Independent Administrative Reform and Civil Service Commission.

24. MOF has allocated the equivalent of \$100,000 to recruit the needed additional staff on special salaries in line with a restructuring plan approved by the commission. These staff are not tied to the civil service grades. This policy condition is rated "complied with."

Policy condition 7: MOF shall have allocated adequate budget for the social safety net program for redundant employees of divested state-owned enterprises for 2007 and 2008.

25. Based on analytical surveys, the SOE Department of the MOF designed and implemented a social safety net program comprising lump sum payments and retraining for

¹⁵ As of 27 February 2009, these 26 sales announcements led to auctions resulting in sales totaling \$8.6 million. Source: United States Agency for International Development (USAID)–LTERA e-mail correspondence, 27 February 2009.

¹⁶ Resolving these issues highlights the challenge, as well as the value, that this step represents in overall development impact. These arduous steps with early SOEs are helping to establish precedent and procedures that will make later cases less cumbersome, thus establishing precedent in building the rule of law. ADB will remain engaged and well positioned to continue to support this fundamental long-term area of development.

¹⁷ More than 1,300 parcels of property throughout Afghanistan with an estimated value in excess of \$600 million are at stake. Source: Valuations by LTERA–USAID from 2005 to 2008.

employees displaced by the liquidation of SOEs. About 1,200 employees have received cash compensation totaling \$1.4 million, and 208 employees received retraining under the Program. The SOE Department is conducting a follow-up study to ascertain the effectiveness of the social safety net methodology and the business outcome of the liquidated SOEs with a view to making adjustments and recommendations to enhance the program's effectiveness. About \$2 million in additional funds have been budgeted for future needs. This policy condition is rated "complied with."

3. Policy Objective—Improved Financial Intermediation

26. The conditions under this policy objective will improve supervision and transparency of financial intermediaries. The Government recognizes that to enable the finance sector to provide better financial services to private enterprises, the banking system must be sound. The banking system must be adequately supervised and meet proper transparency and disclosure requirements. Greater confidence in the banking system will allow banks to mobilize domestic savings to meet the financing needs of private enterprises. The objectives of these policy actions appear likely to be achieved as the finance sector regulators and participants have demonstrated a keen interest in meeting the letter and the spirit of these conditions.

Policy condition 8: DAB shall have (i) drafted a standard memorandum of understanding to be signed by DAB and foreign banking sector supervisory agencies that includes clear and workable protocols for (a) ongoing supervision of cross-border establishments, (b) on-site examinations, (c) protection of confidentiality, and (d) the establishment of a system of regular and as needed meetings among supervisory authorities; and (ii) submitted this draft memorandum of understanding to its counterpart banking sector supervisory agencies.

27. DAB has completed work on cross-border supervision with India, Iran, Pakistan, and the United Arab Emirates. In addition, a uniform bank performance reporting and risk management system is in place. This policy condition is rated "complied with."

Policy condition 9: DAB shall have drafted policies and procedures on conservatorship, receivership and forced liquidation of distressed banks.

28. The DAB policies and procedures on conservatorship, receivership, and forced liquidations are embodied in the *Special Supervision Manual* that has been adopted by the DAB Supreme Council. While still in draft form, this manual has been used in training personnel of the special supervision section of DAB and tested in the supervision of at least one problem bank. This policy condition is rated "complied with."

Policy condition 10: DAB shall have drafted detailed regulations on credit risk, operational risk, and market risk management.

29. DAB has formulated an acceptable regulatory framework on credit, operational, and market risks. It has also established a Risk Management Department. This policy condition is rated "complied with."

Policy condition 11: DAB shall have enhanced disclosure by publishing the financial statements of individual banks on its website.

30. The banks under DAB supervision publish financial statements in the two highest circulation papers in the country and financial statements for banks are available through attached files or links in the DAB website. This policy condition is rated as "complied with."

Policy condition 12: The Government shall have approved and submitted to Parliament an Accounting Law and an Audit Law, satisfactory to ADB, which shall include, inter alia, a timetable for adopting International Financial Reporting Standards and International Standards on Auditing (ISA) for Public Interest Entities.

31. This condition will enhance disclosure requirements to improve private sector access to finance with better accounting and auditing standards. With ADB support, drafts of an Accounting Law and Audit Law have been completed. The laws have also been reviewed across the Government and endorsed by MOF. However, submission of the law to Parliament is pending consultation and agreement with development partners on certain conditions regarding enforcement and oversight. While substantial progress has been made, this policy condition is rated "not complied with," and a waiver of full compliance is sought. The Government has fulfilled its undertakings, and it has delayed submitting the laws to Parliament at the request of ADB and selected development partners. The rationale for a waiver of this condition is provided in para. 32.

32. **Rationale for Waiver of Full Compliance of Policy Condition 12.** While substantial technical work has been done and the two laws have been drafted and endorsed by the MOF,¹⁸ there are three compelling reasons for them to be withheld from the legislative process at this time: (i) the private sector is not yet able to comply and the public sector is not able to enforce these laws; (ii) the development partners have applauded the laws, but they do not agree on the placement of the oversight board (within the MOF or as self-regulated body in the private sector); and (iii) a World Bank study on this issue is due in the second quarter of 2009, and a steering committee is planned to resolve the issue of oversight so that the laws can move forward with a consensus (albeit with staggered implementation to allow public and private capacity to catch up).

C. Implementation of Capacity Building Grant

33. The objective of the capacity building grant under the Project is to assist the Government in implementing the Program. The grant also aims to develop and establish training programs in related areas to help sustain private sector and financial market development over the long term. ADB fielded regular review missions, including a Midterm Review Mission. In May of 2008, the Project was reassessed. Implementation arrangements were reviewed, consultant selection was completed, and the first consultant was fielded in June 2008.¹⁹ By September, all consultants were in country and supporting the MOF's efforts to implement the objectives and meet Program conditions. No consultant was fielded for banking reform as the terms of reference was largely covered by United States Agency for International Development (and supplemented by ADB

¹⁸ Letter of endorsement signed by Minister of Finance, 2 September 2008. Original in Mission files.

¹⁹ On 5 November 2007, a change in implementation arrangements was approved, reallocating \$2.5 million of capacity development grant for the engagement of the requested consultants.

staff inputs). ADB continues to support technical training for DAB to meet program-end objectives.

34. All ADB consultants attached to the Program were periodically assembled in Kabul to discuss progress and areas of potential collaboration related to themes within their respective expertise in private sector development and financial markets. ADB capacity building support has been a key ingredient of the Government's successful Program implementation.

IV. CONCLUSION

35. The Government has made considerable progress in implementing the reforms agreed under the Program, despite the fragile security environment and technical complexities inherent in public-private adjustment programs. The Government has also strongly pursued the capacity building initiatives under the capacity building grant.

36. While conditions outside the control of the Government and ADB have changed dramatically from what was envisaged, Program objectives remain intact and actions have been implemented to the extent practical and feasible. The Government and ADB remain committed to further progress, and will adapt to changing conditions and build on previous achievements.

V. THE PRESIDENT'S RECOMMENDATION

37. In view of the substantial progress made in the implementation of the Private Sector and Financial Market Development Program, as evidenced by the compliance with nine (9) tranche release conditions, and partial compliance with three (3) tranche release conditions, the President recommends that the Board approve, on a no-objection basis:

- (i) the waiver of full compliance with three (3) tranche release conditions, which have been only partially complied with, due to reasons set out above; and
- (ii) the release of the second tranche in the amount of \$28 million for the Private Sector and Financial Market Development Program.

SUMMARY OF STATUS: MONITORABLE INDICATORS

Of 15 monitorable actions, nine indicate compliance and six indicate ongoing progress.

Monitorable Indicators	Indication of Progress (including outstanding actions)
A. Strengthening the Enabling Environment for Private Sector Development	
1. Cabinet to adopt a Land Policy that outlines principles and policy directions for the formalization of land ownership.	A draft Law on Secured Transactions for Immovable Collateral (Mortgage Law) is being reviewed by Legislative and Research Dept. of Wolsei Jirga and is to be submitted to National Economic Commission with comments. In addition the USAID Land Titling and Economic Restructuring in Afghanistan (LTERA) Project, which includes the law as a result area, has been extended for 2 years. This monitorable action indicates compliance.
2. MOCI to monitor Kabul municipality authorities' compliance with the resolution abolishing price controls.	While the MOCI is ostensibly monitoring the situation, there is no political will for the municipality to abolish these price controls given the current spike in food and energy prices. While the liberalization of prices has economic merit, the political realities render this indicative condition less relevant than when the Program was approved. Given the partial monitoring and the current circumstances, this monitorable action indicates partial compliance.
B. Disengaging the Government from Business Activity through the Liquidation of State-Owned Enterprises	
3. MOF to appoint Liquidation Committees for 10 SOEs to implement liquidation/privatization via asset sales.	As per compliance with policy condition 3, this monitorable action indicates compliance.
4. MOF to (i) draft a restructuring plan, including staff requirements, for the SOE Department to assist in the divestiture of SOEs; and (ii) obtain the Independent Administrative Reform and Civil Service Commission's approval of the restructuring plan.	Restructuring plan has been approved by the commission. This monitorable action indicates compliance.
5. MOL to continue to implement the program on job counseling and retraining for redundant employees of SOEs under the National Skills Development Program.	Discussions with ADB consultant and SOE department indicate that MOL has not been active here. The SOE Department has initiated efforts to maintain job training, but this effort is not sufficient. This monitorable action indicates partial compliance.
C. Improving Private Sector's Access to Financial Services	
6. DAB to establish a uniform bank performance reporting system, including a database, to systematically assess bank performance.	According to DAB project consultants from BearingPoint, the uniform bank performance report is complete and a rating system is in place to assign a rating of each bank. This monitorable action indicates compliance.
7. DAB to establish a system for tracking its enforcement actions.	According to DAB project consultants from BearingPoint, the tracking system is in place. This monitorable condition indicates partial compliance.
8. DAB to issue regulations on the external audit of banks and the qualifications of bank auditors.	According to the DAB legal consultants from BearingPoint and the DAB website, DAB has issued

Monitorable Indicators	Indication of Progress (including outstanding actions)
DAB to issue regulations on the external audit of banks and the qualifications of bank auditors.	regulations. This monitorable action indicates compliance.
9. DAB to exercise remedial actions, if warranted, to enforce the submission of audited financial statements as required under the Law of Banking in Afghanistan (2003).	According to the DAB legal consultants from BearingPoint and a letter from the DAB governor, DAB has the legal ability to do so and has taken such action. This monitorable action indicates compliance.
10. DAB to design and conduct regular training programs in the areas of internal control, risk management, enforcement actions, and back-office operations.	A discussion with the governor of DAB was reaffirmed in detail by DAB project consultants from BearingPoint that DAB is conducting daily training in these subjects for a group of supervisors, Risk Department personnel, and employees of the commercial banks. This monitorable action indicates compliance.
11. DAB to start implementation of the regulation for <i>hawaladars</i> in Kabul and in major provincial capitals.	According to a BearingPoint consultant working on the project, in the spring of 2008, the DAB inaugurated the Non-banking Financial Supervision Unit, which had the immediate task of supervising the money service providers and foreign exchange dealers. The unit recently completed the first comprehensive inspection of 103 licensed money service providers in the Kabul market, which resulted in a dramatic increase in reporting from 40% to 70%. After the Kabul inspection, the unit traveled to Mazar-e-Sharif and Herat to inspect the two largest regional markets. This monitorable action indicates compliance.
12. DAB to start implementation of the regulations on depository microfinance institutions.	According to DAB advisors, the Non-banking Financial Supervision Unit has initiated contact with MISFA to determine the future plans for deposit taking in the microfinance sector. Currently, there is no deposit taking but there are plans to do so. The unit has recommended that MISFA and the DAB establish a quarterly reporting regime. This monitorable condition indicates compliance.
13. MOF to draft an Accounting Law. The Law should include, inter alia, a timetable for adopting International Financial Reporting Standards (IFRS) for public interest entities.	See policy condition 12. This monitorable action indicates partial compliance.
14. Cabinet to issue a decree establishing and defining the mandate and structure of an accounting and auditing board, under MOF and comprising representatives from MOF, DAB, MOCI, Control and Audit Office, and professional accountants from the private sector, to regulate the accounting and auditing profession.	The international community is not in agreement with placing Board inside the MOF. This monitorable action indicates partial compliance.
15. MOF to establish a unit, consisting of at least three persons, to act as the secretariat of the accounting and auditing board.	For reasons outlined in this table, this monitorable action indicates partial compliance.

ADB = Asian Development Bank; DAB = Da Afghanistan Bank; LTERA = Land Titling and Economic Restructuring in Afghanistan; MISFA = Microfinance Investment Support Facility for Afghanistan; MOCI = Ministry of Commerce and Industries; MOF = Ministry of Finance; MOL = Ministry of Labor; SOE = state-owned enterprise.

Source: Asian Development Bank.