Microfinance Landscape in Afghanistan and Islamic Financing Alternatives

Assessment Report and Strategic Recommendations

November 2023

Photo Credit: UNDP Afghanistan

The report was conducted as a collaboration between UNDP's Istanbul International Centre for Private Sector in Development (UNDP ICPSD) and UNDP Afghanistan Country Office.

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Acknowledgement

This report presents a comprehensive overview of the situation of Islamic finance and microfinance in Afghanistan. After doing a critical analysis of the situation, strategic policy recommendations are developed. The report is prepared by the United Nations Development Programme Istanbul International Center for Private Sector in Development (UNDP IICPSD) on behalf of the UNDP Afghanistan Country Office in 2022. It is the result of teamwork, dedication and cooperation. We would like to thank our researchers, writers, editors and interns for their devotion, commitment and high-quality work.

The research was carried out and authored and made successful through the constant and hard work of our consultants namely Prof. Dr. Mehmet Asutay, Dr. Mücahit Özdemir and Dr. Wail Aaminou and the complete report was developed by a team composed of Dr. Gülçin Salıngan, Fatma Çınar, Dr. Abdurrahman Yazıcı, Evrim Ayana Karslı, Shabana Zarsheed and Shoaib Mohammady. It also benefited momentously from the valuable inputs, constructive comments and observations of key stakeholders. The complete report was also enriched by data and inputs provided during workshops, meetings and interviews arranged with Afghanistan microfinance institutions (MFIs) and other stakeholders in and outside Afghanistan. The team members are recognized for their commitment and valuable efforts in writing, updating, editing and collating the report.

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Executive summary

Afghanistan has faced many challenges in the last forty years primarily driven by prolonged violent conflict that threatens human security and livelihood. Survival and war economies have been the dominant nature of Afghanistan's political economy since the Soviet occupation in 1979. Despite years of internationally concerted efforts since 2002 to transition Afghanistan away from this economic model, the country's fragility resurfaced with the recent regime change in 2021. As a capital-poor country with limited financial resources, Afghanistan's economy has been incentivised over the last twenty years with external finance through international aid, cash donations, and economic development projects. As a result, its economy slowly recovered between its post-war economy and micro development in the periphery until the regime change in August 2021. Initial steps in institutionalisation in various forms in the economy and society, including the institutionalisation of microfinance institutions (MFIs), were taking place to uplift people's lives by negating abject poverty. However, the ongoing war, violence, and regime change have prevented vital financial institutionalisation, which would implement structures for Afghanistan's continued socio-economic development. Hence, every change has somehow only ensured the continuation of similar conditions as part of Afghanistan's political economy. Nevertheless, the early indication is that a survival economy in the form of subsistence will remain for some time in the country as the change leads to the continuity of the present rather than shifting into a new paradigm of political and economic development.

Currently, with the deterioration of the business environment and halting of the microfinance sector, as well as adverse developments in the global political economy along with the visible drought in the country, food security and hence famine are becoming a real challenge for the ongoing survival economy. The 2021 regime change triggered the withdrawal of international economic and financial support, which was especially significant for Afghanistan, where international aid contributes to almost half of its GDP and continues to finance 75% of public spending[1]. This is a multifaceted strain on the economic centre and its periphery – at the centre, job loss and business closures, at the periphery, the small financial contributors like grants, aids, and microfinance essential to livelihood.

In reflecting on the contraction in post-regime change, there is considerable uncertainty regarding the future course of the country. The UNDP estimates Afghanistan's GDP declined by 22 percent between 2020 and 2021 and an additional 3.6 percent in 2022.[2] Furthermore, the World Bank estimates real GDP contraction would be 30-35% between 2021-2022; moreover the source estimated that 64% (25,663,643) of the Country's Population has difficulties covering basic expenses in 2022.[3]

Despite its shortcomings in Afghanistan's context, microfinance has been instrumental in promoting micro development, especially in rural areas with a highly unbanked population and a substantial informal sector (80 percent)[4]. Before the shift of power in 2021, the country had a significant microfinance sector in outreach (963,371 active clients in Q2-2021) and institutional diversity. Furthermore, one of the main target segments of the MFIs has been the agricultural sector, which is the primary source of income for most Afghans (with 44 percent of the total workforce) working in agriculture and 60 percent of households deriving some revenue from this sector. In 2020, the agricultural sector contributed 27 percent of the GDP, while the contribution of the service sector was 56 percent. In total, these two sectors' contribution to the national economy is about 83 percent. Considering that the agriculture and the service sectors have been the primary beneficiaries of microfinance, the urgent reinstating of the MFIs to continue their operation is paramount.

In Afghanistan, MFIs have been operating for almost two decades, some already providing a few Islamic microfinance tools. Major strengths of the sector are dedicated and experienced staff, strong data

[1] World Bank, *Afghanistan Development Update, April 2021: Setting Course to Recovery.*

[2] UNDP, *Afghanistan Socio-Economic Outlook 2023*

[3] *World Bank, Afghanistan Development Update October 2022*

[4] OECD, *Boosting Private Sector Development and Entrepreneurship in Afghanistan*, 2019.

collection and reporting mechanisms, and the presence of apex institutions, which have led to the sector's success and its ability to reach approximately one million clients.

Although access to microfinance was limited to cities and rural areas controlled by the government priorly, with the new security improvements, MFIs now have an opportunity to expand their outreach nationwide by increasing their branches and using branchless/digital services. In light of the new changes in the financial system and opportunities to establish an Islamic microfinance system through integration with international Islamic finance service providers, MFIs could broaden the financial inclusion.

Dependence on donor funds, absence of regulatory support, lack of collateral and limited credit guarantee schemes, lack of proper knowledge, and a lack of expertise among staff and the public have been MFIs' main shortcomings. In addition, post-conflict instabilities, financial instability, and talent migrations have resulted in the deterioration of the institutional environment in the sector. Moreover, the de-facto government does not have a firm grasp on the financial system, microfinance regulations, and professional staff support.

Impact of the Regime Change on Afghanistan's Microfinance Sector

The impact of the 2021 regime change on Afghanistan's microfinance sector was multifaceted, with specific challenges and changes reshaping its dynamics. Firstly, Microfinance Institutions (MFIs) faced a complex environment as the new regime introduced altered policies and regulations. These changes encompassed shifts in lending practices, suspensions of services, and heightened compliance requirements. In some instances, MFIs grappled with adapting to the shifting political landscape, struggling to maintain their client base and financial sustainability amidst the uncertainties. Secondly, borrower behavior underwent notable transformations in response to the regime change. Many borrowers became increasingly cautious, affecting borrowing patterns, repayment rates, and loan demand, particularly among different population segments. This shift in behavior added an additional layer of complexity for MFIs operating in the country.

The regime change also had significant implications for MFIs' funding sources. International funding and grants, pivotal for supporting microfinance initiatives, faced challenges due to shifting donor policies and international sanctions, placing the financial sustainability of MFIs at risk. Furthermore, the government's stance on microfinance became a critical factor. Regulatory changes and government statements regarding the sector's role in economic development became subjects of concern, creating an uncertain operating environment.

The 2021 regime change created widespread global scrutiny immensely affecting the MFIs and their operations. With the de facto government being under international sanctions, Afghanistan's microfinance institutions are under serious threat. The withdrawal of international donors and a near 50 percent decline in MFI portfolios vital to Afghanistan's economic growth poses an immanent threat to total MFI collapse. Financial institutions, including MFIs, operating in the country have been under pressure concerning their operation's Islamic legitimacy. MFIs were being led to terminate their operations and ordered to stop new loan disbursement as they were not in line with *Shari'ah* and were only allowed to collect principal amounts of the loans. The regime change implies that conventional microfinance is practically and pragmatically no longer an option, and it has to be offered as *Shari'ah*-compliant in line with the new order. A few Islamic financing offerings provided by some MFIs were also halted and subjected to review by the new regime. As of June 2022, the reviewing process has not been progressed and institutionalised yet, which results in further uncertainty. Some of the MFIs clients, on the other hand, have taken the opportunity of the regime change to avoid paying the principals of their loans by asserting that they previously paid interest on what they borrowed which should cover the principal.

Under the uncertainties generated by regime change in 2021, a dramatic adverse impact has been observed on the financial and risk indicators of the microfinance sector. The number of clients (-56.3 percent), the number of active savers (-72.7 percent), the number of active borrowers (-60.5 percent) and the gross loan portfolio (-24.7 percent) decreased significantly in the last quarter of 2021 compared to Q3-2021. After 15 August 2021, the gross loan portfolio of the sector shrank from 9,973 million AFN to 6,760 million AFN.

All MFIs have been witnessing very high PAR ratios due to the ongoing political and economic turmoil in the country. Especially in some regions, PAR levels were very high, threatening the sector's sustainability. In Helmand, Kandahar, and Kunar provinces, PAR rates were 100 percent, 99.8 percent and 92.6 percent, respectively.[5] According to Afghanistan Microfinance Association (AMA), the total number of clients of eight institutions under AMA went down from 961,129 in Q3-2021 to 420,384 as of Q4-2021.[6] Similarly, the total number of active borrowers drastically decreased from 306,728 in Q3-2021 to 121,049 borrowers by Q4-2021. Accordingly, the number of women borrowers sharply decreased from 209,019 as of Q3-2021 to 46,680 at the year-end of 2021.

Another adverse impact is also visible in micro-savings, which declined by 23.37 percent during Q4-2021 compared to Q3-2021. The same pattern was observed for the number of active savers (-72 percent), whereas women clients have been most affected with 89 percent decline. Furthermore, the deterioration in the sector continued in the first quarter of 2022[7] as the number of clients (-4.9 percent), the number of active borrowers (-22.8 percent), and the gross loan portfolio (-23.9 percent) decreased significantly compared to the previous quarter, Q4-2021.

There are serious concerns regarding the de facto regime's new restrictions on women's economic and social participation. Considering the substantial number of women utilizing microfinance as a tool for economic empowerment, policies excluding women from economic participation (and the microfinance sector in particular) exacerbate economic deterioration and hinder human development. According to estimates, restricting female employment may inflict an immediate economic loss of between US$600 million and $1 billion (3 percent to 5 percent of GDP). The income of households with working women will fall accordingly which has an adverse impact on the socio-economic life of all people.[8]

Considering existing social and institutional capital on the ground and the need for livelihood support in the country, the transformation of the existing MFIs into Islamic microfinance and their operationalization is urgent in overcoming the observed stalemate. Transforming microfinance offerings into Islamic or *Shari'ah*-compliant models aligns with the economic principles of the current regime as a *sine qua* non-Islamic microfinance is expected to provide workable solutions to the sector's ongoing challenges and help them restart their activities.

By doing so, the solid linkage between the Area-Based Approach to Development Emergency Initiatives (ABADEI) Programme and new Islamic finance offerings based on Afghanistan's socio-economic situation and the microfinance sector's capacities, can be built to provide a multiplier effect for empowering the microenterprises in the country. Considering the private sector with limited capital and capacity and the country's weak public sector, these efforts should be expedited to avoid further deterioration of the micro-foundations of development.

This report provides an integrated approach by proposing an Islamic microfinance model for the country, based on a *Shari'ah*-compliant value proposition comprising microcredit, micro-insurance and micro-savings through leveraging a mobile payment capability built on existing capabilities in the country. The model benefits from the highly successful Islamic microfinance experiences in Bangladesh, Indonesia, Malaysia, Tunisia and Pakistan. The primary data collected through interviews with relevant stakeholders and desk research have facilitated an effective understanding of the state of the microfinance sector in Afghanistan before and after the regime change and pointed out key challenges and opportunities. The insights obtained were utilised in developing a viable Islamic microfinance model and bringing policy recommendations.

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[5] AMA, *Microview Report 34*, 2021.
[6] AMA, *Microview Report 35*, 2021.
[7] AMA, *Microview Report 36*, 2022.
[8] UNDP, *Afghanistan Socio-Economic Outlook 2021-2022: Averting a Basic Needs Crisis*, 8.

The model covers eight components: (i) the list of key stakeholders, (ii) target segments, (iii) sources of funds, (iv) financing products, (v) risk-mitigating tools, (vi) IT infrastructure and digitalisation, (vii) *Shari'ah* governance, (viii) auditing, monitoring and reporting.

At this particular juncture, the support of international organisations for fostering the development of Islamic microfinance and the successful transformation of the existing MFIs in Afghanistan is vital. Therefore, potential global and local partners should work together in harmony to reconstruct the sector efficiently. By doing so, a long-term *Shari'ah*-compliant and inclusive microfinance ecosystem that involves all stakeholders to address the economic and financial vulnerabilities of Afghan MSMEs successfully can be built.

Policy Recommendations for a Smooth Institutional Transition

In light of the challenges faced by Afghanistan's microfinance sector and the recent regime change, short-term and long-term policy recommendations are presented to ensure a successful transition towards a Shari'ah compliant microfinance ecosystem as follows:

Short-Term Recommendations

1. Quick action is essential during transition. It is recommended to expedite the approval process of submitted Islamic offerings by assigning a responsible authority to transition from conventional to Islamic microfinance. This will provide immediate relief to the sector, enabling MFIs to adapt swiftly to changing circumstances.

2. To support the sector against potential failures, implementing credit guarantee schemes for Islamic microfinance in Afghanistan is crucial. This will instill confidence in borrowers and investors, ensuring financial stability.

3. Conduct thorough market research to understand the new demand-side dynamics that have emerged due to the recent changes in Afghanistan's economic and political landscape. Well-informed decision-making relies on a deep understanding of evolving market conditions.

4. Seek additional support from international institutions to develop and strengthen Islamic microfinance initiatives in Afghanistan to provide the necessary resources and expertise to bolster the sector.

Long-Term Recommendations:

1. Establish comprehensive regulations for Microfinance Institutions (MFIs) to create a robust and sustainable Islamic microfinance sector in Afghanistan. This will ensure a stable and well-functioning microfinance ecosystem.

2. Implement deposit guarantee schemes specifically designed for Islamic microfinance savings in the country to ensure financial stability, enhance trust in the financial system, and protect depositors.

3. Develop and launch a comprehensive financial literacy program focused on Islamic finance at the higher education level to enhance public awareness and understanding. Financial literacy empowers individuals and promotes responsible financial practices.

4. Conduct capacity-building initiatives for the financial sector to improve expertise and professionalism in Islamic microfinance. A skilled workforce is essential for the sector's long-term viability.

5. Encourage MFIs to diversify their operations by expanding into various economic sectors and geographic locations. Diversification promotes resilience and reduces risk in the microfinance sector.

These short-term and long-term recommendations form a comprehensive strategy to support the microfinance sector in Afghanistan during a transition period. Implementing these measures will contribute to the sector's stability, sustainability, and overall positive impact on the country's economic development.

To accommodate the requirement brought by the new regime, this report aims to build a long-term *Shari'ah*-compliant and inclusive microfinance ecosystem addressing the economic and financial vulnerabilities in Afghanistan. Integrating the Islamic microfinance solutions under the ABADEI Programme can produce a higher impact on the Afghan MSMEs by benefitting from the advantages of Islamic microfinance in general as well as its broader acceptance by a considerable proportion of the population in the country. Channelling part of the aid through Islamic microfinance can be instrumental in contributing to poverty reduction, economic empowerment and development, as well as resilience in a sustainable way while mitigating Afghanistan's ongoing and upcoming economic and financial risks.

Concluding Remarks

This report aims to establish a sustainable and self-sufficient Shari'ah-compliant microfinance ecosystem in Afghanistan. Integrating Islamic microfinance solutions under the ABADEI Programme has the potential to significantly impact Afghan micro, small, and medium-sized enterprises (MSMEs) by leveraging the advantages of Islamic microfinance. By channeling a portion of aid through Islamic microfinance, we can contribute to poverty reduction, economic empowerment, development, and resilience in a sustainable manner, thereby mitigating ongoing and future economic and financial risks in Afghanistan.

Photo Credit: UNDP Afghanistan

1. Introduction

1.1. Aim, Objectives, and the Scope of Study

Economic development remains a fundamental challenge for every country, paramount for developing or low-income countries. Realizing that development relates to changing micro-foundations rather than only making macroeconomy-related progress, individual economic empowerment and capacity building at the societal level have become critical success factors. For instance, in countries like Bangladesh, microfinance initiatives have empowered thousands of women to start small businesses, breaking the cycle of poverty in their communities. Considering the emergence of the 2030 Sustainable Development Goals (SDGs), economic empowerment is viewed as an imperative to ensure and secure the sustainability of human life in a dignified manner.

A critical institutional financial development in the post-1980 period has been the emergence of microfinance as a non-banking financing intermediation, which aims to mobilise financial resources for individuals' need for necessary financing so that individual functioning can be possible for a dignified life. However, while many academic and professional research and fact-finding exercises can testify to the success of microfinance offerings in low-income countries, the nature of financing can be a problem in specific settings leading to voluntary financial exclusion. For example, in rural Afghanistan, many individuals, particularly women, faced financial exclusion, limiting their access to essential resources and opportunities.

To overcome voluntary financial exclusion, Islamic finance should be considered a vital institutional and product emergence to create the necessary opportunity spaces within the financial sphere to overcome the observed voluntary financial exclusion by responding to the demand for interest-free financing alternatives.

Islamic economic philosophy essentialises inclusive socio-economic development and human flourishing. Its human-centric development framework positions Islamic finance as a crucial factor in the future of sustainable development as a key mobiliser of resources and supplier of necessary funding.
The global introduction of Islamic banking and the emergence of Islamic MFIs has enabled a new opportunity space for Although the microfinance landscape in the Organization of Islamic Cooperation (OIC) countries is still limited, the potential for the Islamic microfinance sector to develop is significant, as indicated by experiences in Bangladesh and Indonesia, among others.

Afghanistan is a low-income country with an essential need for individual empowerment along with macro development relating to infrastructure, as human security in terms of daily survival is essential. While a certain level of economic and financial infrastructure, including microfinance, emerged in the country in the last twenty years, the 2021 regime change created widespread global scrutiny affecting the MFIs and their operations.

Despite its shortcomings in Afghanistan's context, microfinance has been an important instrument to contribute to micro development in the country by enabling and getting people function to earn their lives. However, the regime change implies that conventional microfinance is practically and pragmatically no longer an option and therefore to continue to take advantage of microfinance, it has to be offered as *Shari'ah*-compliant in line with the new order.

Afghanistan's microfinance sector has been going through different development stages since the initial years of this century. When considering the country's highly unbanked population and informal sector

(80 percent)[9], MFIs have a vital role in supporting people, especially in rural areas. Before the regime change in 2021, the country had a significant microfinance sector in outreach (963,371 active clients in Q2-2021) and institutional diversity (such as corporation: OXUS Afghanistan, NGO: Hand-in-Hand Afghanistan, and microfinance focused commercial bank: First Micro Finance Bank), although they had already faced several vital challenges such as lack of regulation and liquidity shortages. While the banking sector, regarding total assets, only has 22 percent of GDP [10] as of the end of 2020, MFIs have the potential for reaching the vast majority of the people living in rural areas and support the livelihood of these people through financial and non-financial solutions. As of Q3-2021, the number of active borrowers of MFIs in rural areas was 217,000 (68 percent) and 103,000 (32 percent) in urban areas.[11] One of the main target segments of the MFIs has been also the agricultural sector which is the primary source of income for most Afghans (with 44 percent of the total workforce working in agriculture and 60 percent of households deriving some revenue from this sector). [12] They have played a significant intermediary role in effectively channel the available funds, especially in the Agricultural Development Fund (ADF), to the agribusinesses in the rural areas, which are excluded by the commercial banks mainly due to the high operational costs.

Under the uncertainties generated by regime change in 2021, a dramatic adverse impact has been observed on the financial and risk indicators of the microfinance sector. For example, Portfolio at Risk > 30 days grew exponentially from 7.1 percent during Q2-2021 to 28.3 percent during Q4-2021. In addition, the number of clients dropped by 56.3 percent over the same period. According to Afghanistan Microfinance Association (AMA),[13] the total number of clients went down from 961,129 in Q3-2021 to 420,384 as of Q4-2021. Similarly, the total number of active borrowers drastically decreased from 306,728 in Q3-2021 to 121,049 borrowers by Q4-2021. Furthermore, the number of female borrowers sharply decreased by 98 percent, from 209,019 in Q3-2021 to 46,680 as of Q4-2021. The same pattern was observed in the first quarter of 2022[14] as the number of clients (-4.9 percent), the number of active borrowers (-22.8 percent), and the gross loan portfolio (-23.9 percent) decreased significantly compared to the previous quarter, Q4-2021.

In the face of such adverse developments impacting the sector and the urgent imperative to ensure the sustainability of human life, immediate action must be taken to bolster the microfinance sector. This is necessary to prevent exacerbating adverse social and economic consequences, including heightened deprivation and abject poverty.

Considering such social and institutional capital on the ground and the urgent need for income generations for the citizens in the country, the transformation of the existing MFIs into Islamic microfinance emerges as a promising strategy to break the current deadlock. In particular, benefiting from the highly successful Islamic microfinance experience in several countries such as Bangladesh, Indonesia, Malaysia, Tunisia and Pakistan, Afghanistan's microfinance sector and institutions can be supported to enhance the existing Islamic microfinance offerings and develop new *Shari'ah*-compliant capacities and capabilities for institutions lacking such experience.

This report aims to 1) provide a detailed analysis of the Afghanistan microfinance sector before and after the regime change and 2) introduce viable institutional models and policy recommendations to transition MFIs toward Shari'ah compliance. Ultimately, the sector will become a more efficient and diversified catalyst for bottom-up economic recovery.

[9] OECD, *Boosting Private Sector Development and Entrepreneurship in Afghanistan* (OECD publishing, Paris, 2019).
[10] UNDP, *Policy Brief: The Afghan Banking and Financial System Situation Report*, Nov 22, 2021.
[11] AMA*, Microview Report 34*, 2021.
[12] United Nations Development Programme, *Economic Instability and Uncertainty in Afghanistan after August 15, A Rapid Appraisal*, September 2021. The World Bank Group, Afghanistan Development Update, April 2021.
[13] AMA, *Microview Report 34,* 2021.
[14]AMA, *Microview Report 36*, 2022.

Aligning microfinance offerings with Islamic or *Shari'ah*-compliant models is in line with the new regime's political and economic ideological framework. It is imperative, as Islamic microfinance is expected to provide viable solutions to the persistent challenges faced by the microfinance sector, facilitating the resurgence of its activities. By doing so, establishing a solid linkage between the Area-Based Approach to Development Emergency Initiatives (ABADEI) Programme and new Islamic finance offerings becomes crucial. Such an approach, accounting for Afghanistan's socio-economic situation and the microfinance sector's capacities, can assure the generation of a multiplier effect that empowers micro enterprises in the country.

Islamic microfinance can be a key mechanism contributing to poverty reduction, economic empowerment and development, and resilience. It can also play a role in mitigating Afghanistan's persistent and upcoming economic and financial risks. However, to build a sustainable *Shari'ah*-compliant and inclusive microfinance ecosystem that involves all the stakeholders effectively in addressing the economic and financial vulnerabilities of Afghan micro, small and medium enterprises (MSMEs), which form the backbone of the economy, a comprehensive assessment of the country's microfinance sector is essential. Therefore, this study aims to:

- **i)** Address the current issues faced by MFIs and microenterprises in Afghanistan,
- **ii)** Investigate the institutional capacities of the existent MFIs to develop a viable and integrated Islamic microfinance model for Afghanistan,Identify a road map and guidance for the emergence of Islamic microfinance synthesis against raised challenges,
- **iii)** Provide policy recommendations to create a sustainable Islamic microfinance ecosystem involving the participation of all stakeholders to effectively address the economic vulnerabilities of Afghan MSMEs, who are the backbone of the economy.
- **iv)** Investigate the feasibility of introducing Islamic finance products tailored to specific sectors, such as agriculture, manufacturing, services and technology and exploring potentially viable business regions within the country.

In addition, the report is expected to respond to the existing challenges in the microfinance sector in the country. It also seeks to provide a significant positive impact on pursuing SDGs in areas such as poverty eradication, economic empowerment, and fostering prospective economic growth in Afghanistan.

1.2. Research Methodology

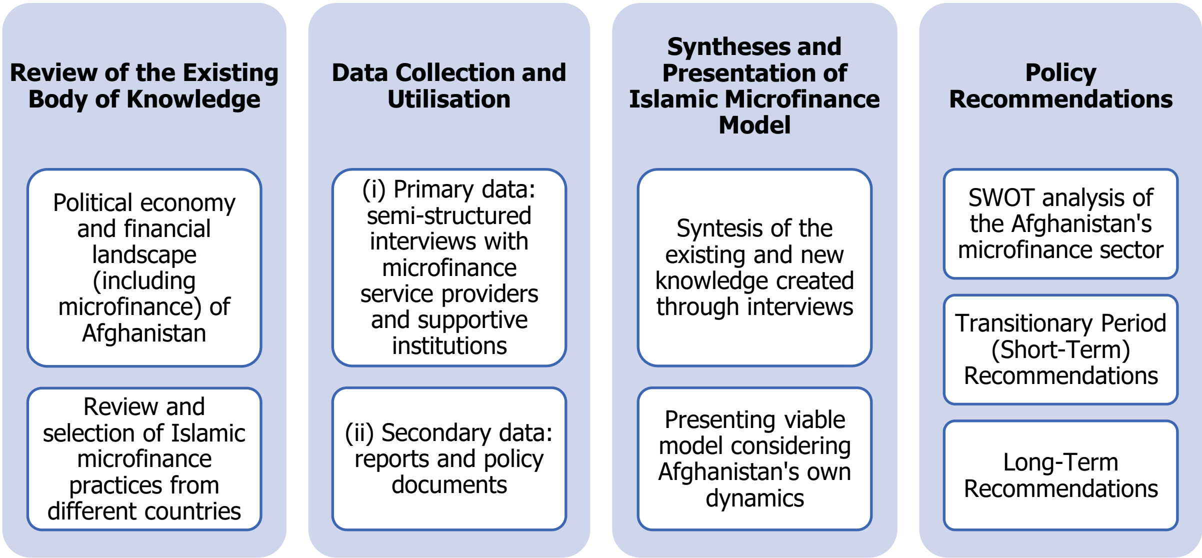
The report provides an integrated approach by integrating critical stakeholders of the Afghanistan microfinance sector and drawing on best practices from different parts of the world. Besides presenting the country's political economy and financial landscape both pre and post regime change, the study proposes a comprehensive Islamic microfinance model for the country.

The proposed model aims to provide a *Shari'ah*-compliant value proposition comprising microcredit, micro-insurance and micro-savings. Leveraging mobile payment capabilities and capitalizing on synergies from the components of the proposed model's ecosystem, as well as from key enablers of its success; this approach aims to facilitate financial inclusion and sustainable development.

Upon adoption of *Shari'ah*-compliant services, existing MFIs have the opportunity to enhance their organizational capacities, product development capabilities, and core IT systems.

The scope and methodology of the report are depicted in Figure 1.

Figure 1: Methodology of the Report



a) Review of the Existing Body of Knowledge

In order to achieve the objectives mentioned previously, the study renders a review of the existing body of knowledge. This review provides a comprehensive understanding of Afghanistan's political economy, financial landscape, and microfinance sector. Moreover, reviewing the current literature and sources about the Islamic microfinance best practices from different parts of the world provided the necessary intellectual insight in developing and proposing a model and deriving recommendations.

b) Data Collection and Utilisation

An essential pillar of the report is to include all key stakeholders in the process by receiving their views about the microfinance sector and the organisational level in particular. Therefore, interviews were conducted with the existing MFIs (OXUS, Mutahid, FMFB-A, FINCA-A, Agha Khan Network, IIFC Group), and representatives of other stakeholders (AMA, MISFA, ADF, Cooperatives). The primary data collected through interviews have facilitated an effective understanding of the state of the microfinance sector in Afghanistan before and after the regime change and pointed out key challenges and opportunities. These insights were utilised to propose an effective and efficient Islamic microfinance model and bring out policy recommendations.

Besides the primary data, up-to-date secondary data gathered from the reports and analysis of the MISFA and AMA have been used to evaluate the sector's trajectory and current state through various variables and levels such as the number of clients and outstanding loans portfolio, non-performing loans, etc.

c) Presentation of the Islamic Microfinance Model

Islamic microfinance model proposal, developed through the existing and new body of knowledge mainly obtained from the interviews with the stakeholders, is presented and explained in detail. The report focuses on the following aspects in an attempt to develop an effective model: (i) Roles of the key stakeholders, (ii) Target segments, (iii) Sources of funds, (iv) Financing products, (v) Risk-mitigating tools, (vi) IT infrastructure and digitalisation, (vii) *Shari'ah* governance, (viii) Reporting, monitoring, auditing. These dimensions are elaborated by synthesizing the best practices of several Islamic MFIs from different countries, the views obtained from the interviews, and the country's political economy. Also, a particular focus is put on fintech-based digital solutions to support the sector. Apart from providing a comprehensive analysis of products and governance possibilities, the model also offers policies for the conversion process from conventional to Islamic and capacity building.

d) Policy Recommendations

Based on the findings developed through a descriptive and analytical approach to the primary and secondary data, a SWOT analysis of the Afghanistan microfinance ecosystem is presented before delving into the policy recommendations. This analysis helps understand the different challenges and opportunities of the sector and presents recommendations more systematically. Later, the policy recommendations will be developed in terms of short-term and long-term recommendations. Short-term recommendations mainly focus on the transitionary period where quick action should be taken to support the sector against any failure, while long-term and structural recommendations are developed for the creation of a sustainable and self-sufficient Islamic microfinance sector in Afghanistan.

Feedback from the B2B consultations and comments of the relevant stakeholders in the validation workshop, "Microfinance Landscape in Afghanistan and Islamic Micro Financing Alternatives: Assessment and Strategic Recommendations", on 22 May 2022, were also reflected on the final version of the report.

1.3. Overview of Study

The report is structured as follows. Chapter 1 provides background about the report's aim, objectives and scope. In addition, the methodology of the report is presented in the first chapter.

Chapter 2 discusses the political economy of Afghanistan by focusing on the period from the Soviet invasion to the current new regime. The chapter helps to understand the trajectory of the political changes in the country over more than two decades and reveals the current challenges under the new regime.

Chapter 3 focuses on the financial landscape in Afghanistan, which has been struggling mainly due to the uncertainties stemming from the regime change. Banking and non-banking financial institutions are elaborated separately so that the role of the MFIs within the Afghani financial ecosystem can be understood more properly.

Afghanistan's microfinance sector, which is the main topic of the research, is presented and analysed in Chapter 4 in detail. Institutional and regulative environments for MFIs operating since the 2000s are discussed by considering the post and after the recent regime change. In this chapter, special focus is given to the Islamic finance offerings of the existent MFIs. Moreover, the current stalemate of the sector is provided from which the model and recommendations are developed. Primary data obtained from the interviews with stakeholders are benefitted to develop a comprehensive understanding of the subject matter.

Chapter 5 proposes an Islamic microfinance alternative model by reflecting Afghanistan's political economy in general and the microfinance sector in particular. Before elaborating on the model, Islamic microfinance best practices from different parts of the world indicate that the proposed model is viable and applicable. The Islamic microfinance model proposal, developed through the existing and new body of knowledge mainly obtained from the interviews with the stakeholders, is presented and explained in detail. The chapter focuses on the following aspects in an attempt to develop an effective model: (i) Roles of the key stakeholders, (ii) Target segment, (iii) Operational framework (sources of funds, financing products, risk-mitigating tools, reporting systems, IT infrastructure), (iv) *Shari'ah* governance. These dimensions were elaborated by sensitising the best practices of several Islamic MFIs from different countries, the views obtained from the interviews, and the country's political economy. Apart from providing a comprehensive analysis of products and governance possibilities, the model also offers policies for the conversion process from conventional to Islamic and capacity building.

Chapter 6 draws up concrete policy recommendations on transforming the microfinance sector of Afghanistan from conventional to *Shari'ah*-compliant and concludes the report. The policy recommendations are designed in the form of a roadmap from which different stakeholders, including government authorities, could benefit. Each policy recommendation is presented as precise, applicable, and result-oriented. Furthermore, short-term (transitionary period) and long-term recommendations are elaborated separately to reflect and prioritise some steps which are needed to be taken urgently to restore the institutional capacity of the microfinance sector and prevent human tragedies due to poverty.

Photo Credit: UNDP Afghanistan

2. Political Economy of Afghanistan

2.1. An Introduction to the Political Economy of Afghanistan

Being at the crossing roads of Central Asia, Afghanistan, with its rich history, has always been a geopolitically important land, which was "a center of the ancient Silk Road in Central Asia, a gateway to the Indian subcontinent, connecting China to western Asia and Europe, which carried trade from the Mediterranean to China".[15] The map of Afghanistan in Figure 2 evidences the gateway nature of the country demonstrating critical importance for trade.

Figure 2: Afghanistan's Map

Source: UN Geospatial, https://www.un.org/geospatial/content/afghanistan

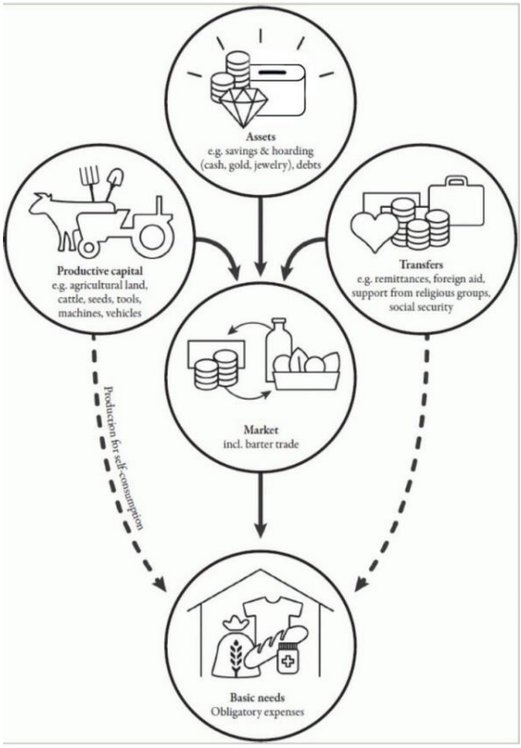
While such a geopolitical location could be an advantage in some other contexts, it proved to be a curse for Afghanistan, resulting in unceasing wars, political conflicts and regime changes, and human insecurity in history and contemporary times. As a large country with about 39.8 million population in 2021, and with a dynamic young population (55.5 percent population being between 15-64)[16], despite the contemporary wars and conflicts, the fate of the country and its people could have been much different if it was not for the contestation created by the cold war environment between the Soviet polity and communist economic system and the Western democracy and capitalism. The result for Afghanistan was nothing but a sustained cycle of fragility and a survival-based political economy.

Since survival and war economies have been the dominant nature of Afghanistan's political economy since the Soviet occupation in 1979, the nature of these economies needs to be explained before briefly describing the political economy of Afghanistan in each period.

[15] Ludwig W. Adamec, *Historical Dictionary of Afghanistan* (Scarecrow Press, 2011).
[16] World Bank, *Population Ages 15-64 (% of Total Population) - Afghanistan | Data*, 2022, https://data.worldbank.org/indicator/SP.POP.1564.TO.ZS?locations=AF. F.

The survival economy contains the features of a subsistence economy where the primary concern of individuals are their everyday basic needs in a minimal sense composed of food, clothing and shelter through a *bazaar* as an exchange mechanism rather than a market economy. While a survival economy does not necessarily mean poverty, when accessibilities come at a risk, such as not being able to cultivate the land people have due to shortages of resources or security concerns, it can easily turn into abject poverty. Thus, a survival economy is subject to critical vulnerabilities and uncertainties and therefore related to everydayness in the sense of protecting individual livelihood through 'the household economy'[17] rather than one having the opportunity to mitigate potential risks. The survival economy is, therefore, best described in Figure 3.

Figure 3: The Nature of the Survival Economy



Source: Carbonnier, Humanitarian Economics: War, Disaster, and the Global Aid Market, 158.

In a survival economy, the central state apparatus does not have any power or capacity to offer any systematic policy response beyond subsistence due to many different factors such as wars, civil wars, and political and social disturbances. Therefore, their role, in most cases, is relegated to the management of the war economy and distribution of rents received mainly as aid from different multilateral and donor agencies or countries as aid.

The war economy has shaped Afghanistan's political economy since 1979, along with the survival economy at the household level. The war economy appears in four categories, including the survival economy. These are "(i) conflict finance or activities to fund and sustain the war effort; (ii) survival activities associated with coping mechanisms and strategies to avoid destitution; (iii) criminal and informal activities that flourish under a general climate of impunity generated by the war; and (iv)

[17] Gilles Carbonnier, *Humanitarian Economics: War, Disaster, and the Global Aid Market* (Oxford University Press, 2016), https://doi.org/10.1093/acprof:oso/9780190491543.001.0001. *See also*: Abélès Marc, *The Politics of Survival* (New York: Duke University Press, 2010).

international trade and financial relations connecting the above three categories to the global marketplace"[18]. In this, international trade is mainly dominated by arms and armament-related trade. While since 2002, there have been internationally concerted efforts to help Afghanistan move away from war and survival economy, the country's fragility has come to the fore yet again with the recent regime change in 2021. Nevertheless, the initial indication is that a survival economy in the form of subsistence will remain for some time in the future by evidence that the change brings the continuity of the present rather than shifting into a new paradigm of political and economic development.

2.2. Continuity and Change in the Political Economy of Afghanistan

As a modern nation-state of the 20th century, as a kingdom, and later as a republic, Afghanistan followed a modern development path in its modern history. However, it has always remained a fragile state due to its internal structure and political economy as well as due to unceasing external interest in Afghanistan. Ethnic differences and the feudal system prevented the country from developing into a modern nation-state in its fullness, as external powers have always exploited such fragile lines. Religion, such as Islam, could not be a unifying source either due to various schools of thought or fractions fighting over legitimacy.

Due to the feudal nature of the state, patronage and clientelism have shaped the nature of social formation and political economy, which has always been dominated by the agriculture sector in a survival economy form. The survival economy nature has remained the leading political economy of the country in its contemporary period despite the efforts to develop a market economy between 2002-2021, where NATO and the Western presence dominated the politics of the country.

The development of the political economy of Afghanistan has been shaped by significant events in the country. As part of the contemporary political economy of the country, the Republic of Afghanistan (1973-1978) period is marked by efforts toward indigenous development in line with the global political economy of the period. As part of the modernisation paradigm, the country embarked on creating a national economy through nationalisation, which also saw the emergence of the banking sector to facilitate the country's development mainly through public sector domination.

The emergence of the Democratic Republic in 1978 resulted in a substantial political economy shift calling for a Marxist overturn of a very traditional society, which resulted in Soviet occupation and war against the Soviets by various fractions mainly led by Islamic movements supported by the West. This period lasted until 1989, marked by a wartime economy based on survival political economy and millions of Afghans were displaced within the country as well as took refuge in neighbouring countries.

Soviet defeat by Islamic movements backed by the support of Western countries and its withdrawal did not bring any peace to the country. 1989 to 1996 was marked by foreign interference and civil war between different factions of the fighting groups who fought against Soviet invasion. The absence of a central government did not allow the emergence of a structured political economy during this period either. It resulted in the continuation of a wartime economy and survival-based political economy in the country's periphery.

The emergence of the Taliban leading to the United Front during 1996-2001 did not bring any stability to the country either, as unity perse could not develop a state of peace economy with a development paradigm. This resulted in sustaining the war economy at the centre and survival at the large periphery.

2001 marked the international intervention to remove the Taliban from the country with heavy involvement of the NATO coalition. From 2001 to 2013, significant foreign military presence as part of the peacebuilding process resulted in investments through foreign aid and donations. The initial political institutionalisation through Loya Jirga provided legitimacy for the interim President. From 2014 onward,

[18] Carbonnier, *Humanitarian Economics: War, Disaster, and the Global Aid Market*, 69.

the decision to decrease the number of soldiers on the ground by NATO members, fatigue in the international community to support the central administration, the rising tensions in the security and political environment, weakness of the state apparatus, and intensifying systematic corruption in government bodies, resulted in a decline in private investments along with a decrease in international aid. On the other hand, the emerging banking and financial sector, along with the microfinance sector and cooperative movement with the increasing service sector, was giving confident hope for a new development strategy.

It is, however, essential to note that the post-2001 era political economy can be defined as a rentier state, which implies that the central administration became the front for generating rent or resources from international multilateral aid, donations from international NGOs, presence of foreign military and financial support from foreign countries. An important implication of being a rentier state through rent distribution is to generate consent and legitimacy to the existing political practices. Therefore, a rentierism political economy prevents the consolidation of democracy by undermining good governance resulting in crony capitalism marked with corruption and lack of accountability even to the international bodies providing the funds. Thus, as Afghanistan's experience in the post-2001 to 15 August 2021 demonstrates, rent distribution shaped the operative nature of the political economy at the centre through provision to the elite, including the peripheral elite such as tribal and religious leaders. In contrast, survival political economy remained the nature of economic life for the rest of the population in the periphery.[19]

The return of Taliban to power and hence the withdrawal of all foreign civil and military presence in the country on 15 August 2021 has dashed the initial development expectations, resulting in dire economic conditions and the emergence of abject poverty. While security issues seem to be resolved relatively, the economic sanctions against the new regime, including frozen Da Afghanistan Bank (DAB) funds in foreign countries, have not left any means for a potential recovery. In particular, the diminishing of grants and aid as part of the sanctions has created huge vulnerabilities even for the survival economy. The developments so far indicate that Taliban did not have any strategy for managing the country beyond taking power, and it seems that the presence of different factions in the ranks of Taliban will be deterministic in developing a 'rule of thumb' approach by 'handling the daily issues' rather constituting a development strategy. This shows that 'usurping the power' does not solve anything, while it is essential to have the necessary capacity to draw a development strategy.

This brief on the contemporary account of Afghanistan's political economy shows the difficulty in envisioning the emergence of a unified indigenous policy towards development, as the focus has been on usurping power without a policy-formation agenda for development. However, what remains common in the country's 'survival political economy' nature - regardless of who has been in power or dominant - is the vicious circle between abject poverty and 'survival' depending on the period and the nature of the international connections. Moreover, the ongoing war, violence and power change have not allowed the emergence of any kind of institutionalisation which could help to develop certain structures for socio-economic development. Hence, every change has somehow ensured the continuation of similar conditions as part of Afghanistan's political economy.

Currently, with the deterioration of the business environment and halting of microfinance business, as well as adverse developments in the global political economy along with the visible drought in the country, food security and hence famine is to become a real challenge even for the ongoing survival economy.[20]

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[19] For detailed analysis on the nature and consequence of rentierism state, see: Kate Clark, *The Cost of Support to Afghanistan: Considering inequality, poverty and lack of democracy through the 'rentier state' lens'*, Afghanistan Analysts Network, Special Report, May 2020, https://www.afghanistan-analysts.org/en/special-reports/the-cost-of-support-to-afghanistan-new-special-report-considers-the-reasons-for-inequality-poverty-and-a-failing-democracy/

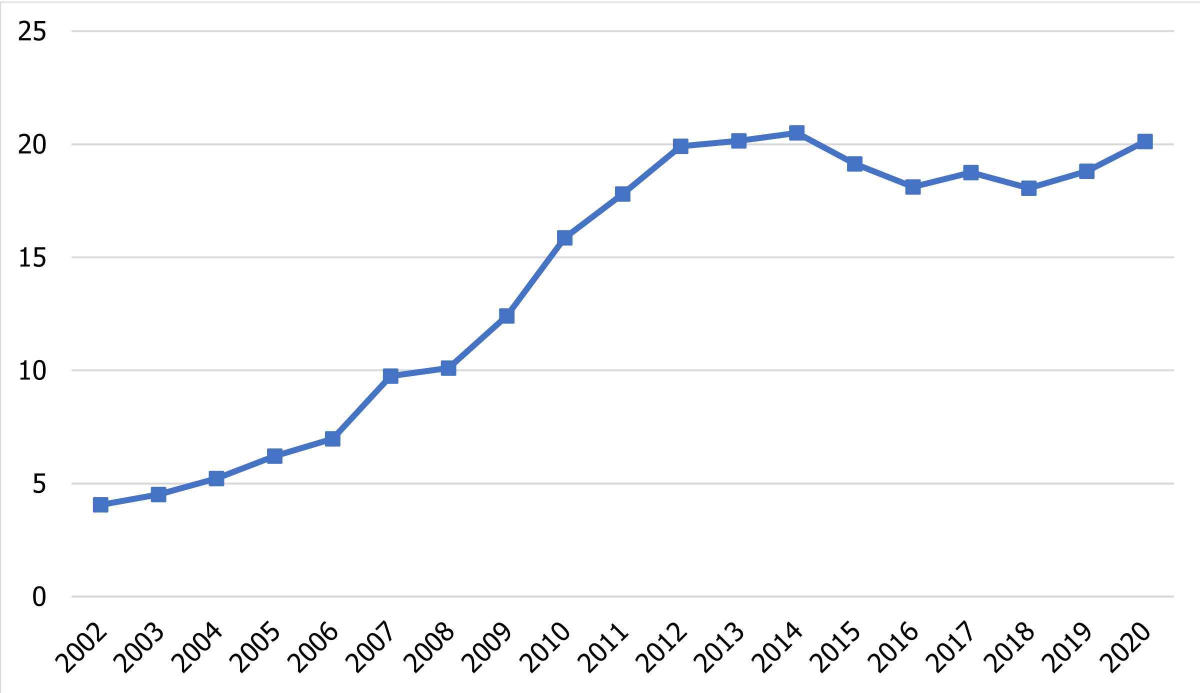
[20] Human Rights Watch, *Afghanistan Facing Famine | Human Rights Watch*, 11 November 2021, https://www.hrw.org/news/2021/11/11/afghanistan-facing-famine#.

A simple description of Afghanistan's political economy is fragility and aid dependence with heavy political contestation, resulting in conflicts and regime changes and shifts one after another. It is expected that such a trajectory will also determine its near future.

2.3. The Economic Trajectory

While it may not be plausible to discuss a 'normal' economic trajectory for Afghanistan beyond fragility and political conflict, Figure 4 depicts the developments and trends in the GDP of Afghanistan.

Figure 4: Trends in the GDP of Afghanistan (Current $, Billion)



Source: The World Bank Database, https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=AF

As shown in Figure 4, Afghanistan's GDP demonstrated a remarkable development since 2001, as international grants, aid, donations, and investment motivated the economy at the centre to grow and develop. Thus, seemingly partial stability provided an opportunity space for the economy to grow regardless of the source being mainly external various types of financing.

The country's economy recorded impressive growth rates (9.4 percent on average) between 2003 and 2012, driven by sizeable international aid amounts as well as strong agricultural growth. However, the economic growth rate slowed down to 2.5 percent in the period 2015-2020, mainly due to declining grants.[21]
Figure 4 illustrates a pronounced decline since 2015, stemming from political tensions among various political and traditional factions. The increasing trend by 2020 provided hope for a further positive increase in the GDP. However, such hopes were not futile as the regime change on 15 August 2021 implied the withdrawal of international economic and financial support. This created a complex problem for the dual nature of the economy – the impact on the centre has been the loss of jobs and businesses, while the peripheral economy lost small means of livelihood through grants, aid, and microfinance. Post-

[21] World Bank, *Afghanistan Development Update, April 2021: Setting Course to Recovery* (Washington, DC., 2021), openknowledge.worldbank.org/handle/10986/35363.

regime change, estimates indicate a significant economic contraction, "although there is considerable uncertainty regarding the future course of the country, with GDP expected to decline by 20 percent within a year, a decline that may reach 30 percent in the following years".[22]

As mentioned, Afghanistan stands as one of the most aid-dependent countries globally. Net official development assistance (net ODA) received by the country amounted to $4.3 billion in 2019, with a total of $43.7 billion of net ODA received between 2011 and 2019.[23] In fact, aid accounts for about 40 percent[24] of the country's GDP and three-quarters of government spending.[25]

As reported by the UNDP,[26] the following is an effective summary of the forecast of the socio-economic development in Afghanistan, which rationalises the immediate international support for the operations of microfinance to overcome a humanitarian crisis:

- "Afghanistan's GDP is expected to contract by 20 percent within a year, from $20 billion (2020) to $16 billion. If action is not taken, this decline may reach 30 percent.
- Annual per capita income may decline by nearly one-third, from just over $500 in 2020 to about $350 in 2022.
- Restricting women from working could result in an immediate economic loss between $600 million to $1 billion — or up to 5 percent of the country's GDP.
- Male unemployment may almost double from 15 percent (2019) to 29 percent (2022).
- With falling incomes and a growing population, it could take $2 billion (up to 15 percent of GDP) just to lift the incomes of all people in extreme poverty to the poverty line.
- Up to 97 percent of the population may be at risk of falling below the poverty line by 2022.
- It will require between $6 billion and $8 billion in international aid every year to fund basic services needs and support economic growth.
- The budget deficit could double as a percentage of GDP and reach $660 million in 2021. Imports could fall by almost half to $3.2 billion. This will significantly affect food and energy consumption, with attendant humanitarian implications.
- Investment could fall from $3 billion to almost $1 billion in 2022 and even decrease to just a couple of hundred million dollars the year after."

The following economic factors can explain the political economy crisis currently facing the country:[27]

i) "cessation of aid [which was equivalent to more than 40 percent of the GDP in 2019],
ii) major disruption to basic services (including basic health and education), which had previously depended on international aid support,
iii) a loss of hard-currency aid inflows, which had previously financed a very large trade deficit (equal to around 30 percent of gross domestic product (GDP),
iv) loss of access to the overseas assets of the central bank (around $9.2 billion),
v) the cessation of international payments by correspondent banks, undermining the capacity of firms to pay for imports or receive payment for exports, disrupting remittance flows, and leaving international humanitarian and non-government organizations (NGOs) unable to pay salaries or contractors within Afghanistan,

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[22] UNDP, *Afghanistan Socio-Economic Outlook 2021-2022: Averting a Basic Needs Crisis,* 2021, 7, https://www.asia-pacific.undp.org/content/dam/rbap/docs/Research & Publications/sustainable-development/UNDP-AFG-Afghanistan-Socio-Economic-Outlook-2021-2022.pdf
[23] World Bank, *World Development Indicators*, https://databank.worldbank.org/reports.aspx?source=2&series=DT.ODA.ODAT.CD&country=AFG
[24] Ashitha Nagesh, *Afghanistan's Economy in Crisis after Taliban Take-over - BBC News*, 25 August 2021, https://www.bbc.co.uk/news/world-asia-58328246.
[25] World Bank, Afghanistan: Public Expenditure Update, 29 July 2019, https://www.worldbank.org/en/country/afghanistan/publication/afghanistan-public-expenditure-update.
[26] UNDP, *Afghanistan Socio-Economic Outlook 2021-2022: Averting a Basic Needs Crisis*, 9.
[27] World Bank, *Afghanistan Overview: Development News, Research, Data | World Bank*, 13 April 2022, https://www.worldbank.org/en/country/afghanistan/overview#1 – slightly modified version.

vi) liquidity crisis in the banking system due to the loss of central bank access to supplies of Afghani and USD cash notes which has constrained firms' and households' access to working capital and savings held in commercial banks,

vii) the rapid decline in investment confidence due to uncertainty and fear,

viii) loss of human capital, due to immigration and the restriction on women's participation in the private and public sector".

Concerning the context of this report, it is crucial to highlight the de facto authority's decision on termination of microfinance activities. This decision, driven by different factors, including the prohibition of interest and the consequent inability to collect returns on previously issued loans has had an adverse impact on the survival of the population in the periphery as well as in the centre through impacting the service industry and government employees.

As reported by the World Bank, "Large inflows of in-kind humanitarian supplies and USD cash through humanitarian channels over late 2021 and early 2022 have supported some economic stabilization". [28] This influx of cash pushed the demand and boosted liquidity in the market. Such positive developments also resulted in certain improvements in essential services such as healthcare. It should also be noted that improved security in the country is a significant positive factor, which was repeatedly mentioned by some of the interviewees who participated in this study.

The Sectoral Distribution of the Economy

As a dual economy state, Afghanistan has a large peripheral economy dependent on agriculture-based economic activity, which is evident in Table 1.

Table 1: Sectoral Distribution of the Economy (as of December 2020)

Sectors / Subsectors	Share in GDP (%)		Growth Rate (%)	
	2019	2020	2019	2020
Agriculture	**25.77**	**27.01**	**17.46**	**5.31**
Cereals	9.43	9.92	19.01	5.65
Fruits	4.96	5.22	23.88	5.62
Livestock	2.89	3.04	-12.63	5.71
Others	8.49	8.84	26.62	4.62
Industry	**14.06**	**12.47**	**4.85**	**-4.22**
Mining & Quarrying	1.89	1.56	14.77	-8.28
Manufacturing	7.04	5.96	6.45	-3.52
Food and Beverages	5.08	4.04	7.30	2.09
Non-Food Manufacturing	1.97	1.92	4.68	-15.43
Electricity, Gas and Water	2.04	1.79	2.44	-3.78
Construction	3.09	3.16	-1.79	-3.38
Services	**55.47**	**56.07**	**-1.39**	**-4.76**
Wholesale & Retail Trade	7.44	7.16	4.44	-1.21
Transport, Repair of Motor Vehicles & Storage	5.34	6.83	-7.57	-5.24
Restaurants & Hotels	3.12	2.52	0.16	-23.82
Post and Telecommunications	3.03	3.70	1.82	0.95
Finance and Insurance	1.85	1.46	-12.73	-8.20
Real Estate	6.43	6.24	2.18	-13.37

[28] Available at: https://www.worldbank.org/en/country/afghanistan/overview#1.

Education	2.52	2.10	-26.72	-18.07
Health and Social Services	6.24	6.82	0.44	5.54
Other Services	19.51	19.23	0.14	-1.95
Other*	**4.70**	**4.45**	**-**	**-**

Source: DAB, 'Economic and Statistical Bulletin – Annual Bulletin 2020' (Kabul, 2021).
Note: The 'Other' category was added by the authors as the source did not specify the rest of the GDP's contributors out of 'Agriculture', 'Industry' and 'Services'.

As Table 1 demonstrates, after the service sector mainly operates in the centre, the agricultural sector remains the second-largest sector in the economy. In 2020, the agricultural sector contributed to the GDP by 27 percent with a 5.3 percent growth rate, while the contribution of the service sector was 56 percent. In total, these two sectors' contribution to the national economy is about 83 percent. The contribution of the industry was about 12.5 percent in 2020 with a -4.22 percent growth rate. Considering that the agriculture and the service sectors have been the primary beneficiaries of microfinance, the urgent reinstating of the MFIs to continue their operation is paramount.

It should also be noted that the agriculture sector is the primary source of income for most Afghans, with 44 percent of the total workforce working in the agriculture sector in 2021 and 60 percent of households deriving some income from this sector, and it is the country's main export.[29] As Table 2 depicts, this was around 42.3 percent in 2020, while 39.39 percent of the labour force was in the services. Hence, a lesser percentage of the labour force worked in the service sector, yet its value-added to the economy was higher in 2020. Thus, the large population working in the agriculture sector demonstrates the critical importance of microfinance provisioning and hence the rationale for the urgent reinstatement of the MFIs in its Islamised version.

Table 2: Distribution of Employment According to the Sectors (2020)

Labour Force, Total	**10,657,912**
Employment in Agriculture (% of total employment)	42.4
Employment in Industry (% of total employment)	18.3
Employment in Services (% of total employment)	39.4
Unemployment Rate	11.7

Source: https://globaledge.msu.edu/countries/afghanistan/economy

The private sector is constrained by political instability, weak institutions, insecurity, lack of infrastructure, corruption, and a challenging business environment[30] (Afghanistan was ranked 173rd out of 190 countries in the World Bank's Doing Business 2020).[31]

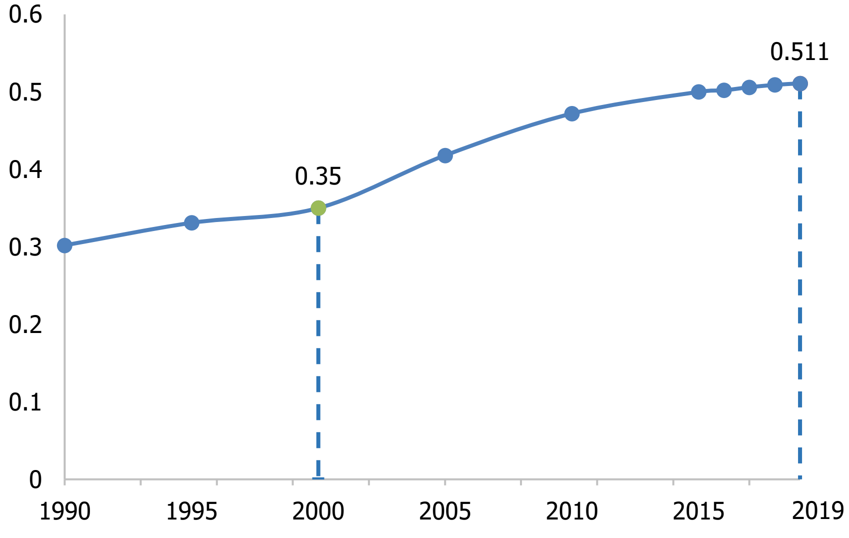
[29] World Bank, *Afghanistan Development Update, April 2021: Setting Course to Recovery*; *UNDP, Economic Instability and Uncertainty in Afghanistan after August 15,* September 9, 2021, https://www.undp.org/library/economic-instability-and-uncertainty-afghanistan-after-august-15.
[30] World Bank, *Afghanistan Development Update, April 2021: Setting Course to Recovery*.
[31] World Bank, *Doing Business 2020: Comparing Business Regulation in 190 Economies* (Washington, D.C.: World Bank, 2020), https://doi.org/10.1596/978-1-4648-1440-2.

Lastly, Afghanistan's economy relies heavily on imports of oil, food and machinery.[32] According to the UNDP's report: "due to the suspension of access to the Central Bank's assets, accessible foreign reserves now cover just one week of imports compared with 18 months earlier". [33] This will exacerbate the food security risk and increase poverty with enormous socio-economic implications, while undermining the scant industrial production, leading to increased unemployment and a growing reliance on subsistence economy.

2.4. Socio-Economic Development

Afghanistan achieved considerable human development gains over the last two decades. As shown in Figure 5, the country's Human Development Index (HDI) for 2019 was 5.011. Although this figure ranks Afghanistan in the low human development category, positioning it at 169 out of 189 countries, it is noteworthy that Afghanistan's HDI value increased by 46 percent between 2000 and 2019.

Figure 5: Afghanistan Human Development Index, 1990 - 2019



Source: Human Development Report 2020, 'Afghanistan', http://hdr.undp.org/sites/default/files/Country-Profiles/AFG.pdf

In detail, Afghanistan's life expectancy at birth increased by nine years, mean years of schooling increased by 1.7 years and expected years of schooling improved by 7.6 years over the past two decades. Besides, the number of students increased from 800,000 to 8 million, with more than 3 million girls entering the education system. In addition, the country's GNI per capita more than doubled in the period ranging from 2000 to 2019.[34]

Concerning health conditions, the Afghan population suffers from a wild polio transmission increase both in intensity and geographical coverage. Other diseases are on the rise as well, such as measles. Moreover, the takeover of power by the Taliban caused a massive drop in vaccination efforts against COVID-19.[35]

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[32] UNDP, *Economic Instability and Uncertainty in Afghanistan after August 15*.
[33] Ibid, 3.
[34] UNDP, *Economic Instability and Uncertainty in Afghanistan after August 15*.
[35] Ibid.

According to the Integrated Food Security Phase Classification (IPC)[36], food insecurity increased dramatically between 2020 and 2021. Afghanistan's food crisis has reached unprecedented levels as 18.8 million people (or 47 percent of the population) were highly food insecure in September-October 2021 (the post-harvest season). This represents a 30 percent increase (14.5 million people) from the same season last year. The worsening of the food insecurity conditions in Afghanistan is mainly due to the following:

- Prolonged drought where below-average cumulative precipitation during the wet season (October 2020 – May 2021) resulted in reduced snowfall reducing water for cultivation.
- Conflict drove over 664,000 people out of their homes between January and September 2021, disrupting their livelihood systems. This adds to about 3.5 million Afghans already displaced.
- Economic collapse was partly caused by the freezing of national assets held abroad and the halt of international aid, which resulted in a severe devaluation of the national currency, a disruption in the banking system and ultimately an economic crisis. All these factors have led to high unemployment and high food prices.

A further deterioration in food security is expected between November 2021 and March 2022 (the lean winter season), with the number of food-insecure people expected to reach 22.8 million.
It is essential to state that regime change has a direct and indirect impact on socio-economic development. First, considering that Afghanistan did not have high human capital, with the regime change, many educated and skilled Afghans left the country, which will have a detrimental impact on the future country. Secondly, the new regime restricting women's movements in the public sphere and also in the private sector implies excluding a well-developed women force from the labour force, as critical efforts put together by the international agencies to develop educational offerings for women and opening public and private spheres for their employment. It seems that all the efforts and structures will no longer benefit the country, as the new regime is adamant about heavily restricting women's lives. This will further reduce the human development standing of the country.

Considering the substantial number of women utilizing microfinance as a tool for economic empowerment, policies excluding women from economic participation (and the microfinance sector in particular) exacerbate economic deterioration and hinders human development. "Restricting female employment may inflict an immediate economic loss of between $600 million and $1 billion (3 percent to 5 percent of GDP). The income of households with working women will fall accordingly"[37], which has had an adverse impact on the socio-economic life of all people.
The termination of international donations and aid for health and education will also have an adverse effect on the human development standing of Afghanistan. Lastly, a visible reduction in the income level in the country due to a slowdown in economic and financial conditions will also have a declining impact on human development standing.

In conclusion, considering the weak private sector with weak capital accumulation as well as the weak public sector, any efforts should be expedited to develop opportunity spaces for developing the micro-foundations of development such as microfinance. Although, as has been identified, microfinance directly impacts the lives of ordinary people in their everydayness, in the face of the failed macroeconomy, sustaining the microfinance industry is critically important even if it means that existing MFIs must be Islamised.

[36] IPC, *Afghanistan: IPC Acute Food Insecurity Analysis*, 2021, https://www.ipcinfo.org/fileadmin/user_upload/ipcinfo/docs/IPC_Afghanistan_AcuteFoodInsec_2021Oct2022Mar_report.pdf.
[37] UNDP, *Afghanistan Socio-Economic Outlook 2021-2022: Averting a Basic Needs Crisis*, 8.

Photo Credit: UNDP Afghanistan

3. Formal Financial Landscape in Afghanistan

3.1. Banking Sector

Afghanistan has been going through many political turmoil and security issues for several decades, and these challenges have severely affected the country's entire society and economy. Consequently, the development process of the public economic institutions and private sector initiatives has been slow for many years. While a certain level of economic and financial infrastructure, including banking, microfinance, and insurance sectors, emerged in the country in the last twenty years, the regime change on 15 August 2021 created tremendous adversaries and uncertainties, which has immensely affected all the sector players and their operations.

Afghanistan's formal financial system is primarily dominated by banks albeit there has been a strong informal money market through which informal financial services could be arranged. For instance, *sarraf*s (money exchangers, or *hawaladars* sometimes used for *hawala* dealers) provide money transfer services to the Afghan people and NGOs[38] through the *hawala* system that has been available in Afghanistan for more than 200 years, and recently, its importance has increased due to the faltering in the banking system.[39]

In total, there are 12 banks in the country having more than 400 branches, the majority of which are located in Kabul, Herat, and Mazar-e-Sharif. As listed in Table 3, there are three state-owned banks, six private commercial banks, one private Islamic bank, and two foreign bank branches:

Table 3: List of Banks in Afghanistan

Bank name	Type	License date
Bank Millie Afghan	State-Owned Bank	2004
Pashtany Bank	State-Owned Bank	2004
New Kabul Bank	State-Owned Bank	2011
Azizi Bank	Private Bank	2006
Afghanistan International Bank	Private Bank	2004
Islamic Bank of Afghanistan	Private Bank	2009
Maiwand Bank	Private Bank	2008
Afghan United Bank	Private Bank	2007
The First Micro Finance Bank	Private Bank	2004
Ghazanfar Bank	Private Bank	2009
National Bank of Pakistan	Branch of Foreign Bank	2003
Bank Alfalah ltd	Branch of Foreign Bank	2005

Source**:** Central Bank of Afghanistan, https://www.dab.gov.af/Licensed-Finacial-Institutions, access date: 19.03.2022

[38] Samuel Munzele Maimbo, *The Money Exchange Dealers of Kabul A Study of the Hawala System in Afghanistan*, World Bank Working Paper No. 13, 2003.
[39] International Rescue Committee (IRC), *Afghanistan Banking Sector Assessment*, December 2021, https://reliefweb.int/sites/reliefweb.int/files/resources/Afghanistan%20Banking%20Sector%20Assessment.pdf

While private domestic banks had almost 67 percent of overall banking sector assets as of YE 2020, state-owned banks held around 27 percent.[40]

DAB and 12 banks besides the Afghanistan Banks Association (ABA)[41] are the main institutional stakeholders in the banking sector in Afghanistan. As for the main financial legislation, Da Afghanistan Bank Law and Afghanistan Banking Law were issued in 2003 and 2015, respectively.
The main activity of banks is primarily focused on money transfers and deposit collection. One of the striking observations of the Afghan banking sector is its low overall loan-to-GDP ratio, which is around 3 percent (the lowest in the world). In addition, the banking system is heavily dollarized with more than 60 percent of deposits made in foreign currency.[42] To reinforce the banking system, IMF recommended that a legal framework for deposit insurance schemes besides a resolution regime should be established.[43]
A selection of Afghanistan banking indicators is summarised in Table 4:

Table 4: A Selection of Afghanistan Banking Indicators

Indicators	**2018**	**2019**	**2020**	**Q1 2021**
Capital adequacy ratio	25.8	26.1	27.9	27.1
Total loans to assets	13.1	13.2	12.1	13.4
Non-performing loans to total gross loans	8.9	14.5	21.9	21.6
Return on Equity	6.7	4.4	4.5	-0.3
Foreign currency-denominated liabilities to total liabilities	68.6	66.5	60.3	64.3

Source: Central Bank of Afghanistan, https://www.dab.gov.af/Licensed-Finacial-Institutions, access date: 19.03.2022

Islamic finance started in Afghanistan with the introduction of Islamic banking in 2008-2009 through Islamic windows as part of conventional banking. In 2018, the Islamic Bank of Afghanistan (IBA) was granted an Islamic banking license by the DAB. Consequently, IBA became the first and only full-fledged Islamic bank in the country, and several conventional banks have offered Islamic banking windows alongside their conventional banking services. As of 2020, the total share of Islamic banking assets (including the Islamic windows of the five conventional banks) was 8.3 percent of the total banking assets.[44]

The supervision of Afghanistan Islamic bank and windows operations is ensured by DAB. DAB through its 'Islamic Banking and Financial Services Department[45] contributes to the development of the Islamic banking sector by, among others, the establishment of a comprehensive legal and regulatory Islamic banking framework, standardizing Islamic bank operations, raising public awareness about Islamic banking, etc.

In addition, the '*Shari'ah* Supervisory Board' is the only highest religious opinion (*fatwa*) issuing body concerning *Shari'ah*-related affairs of Islamic banking and financial services in general. The board is independent of DAB concerning decision-making.[46]

[40] UNDP, *Policy Brief: The Afghan Banking and Financial System Situation Report*, 2021.
[41] A non-political, non-government, not-for-profit, and autonomous association founded in 2004 representing all the 12 banks.
[42] UNDP, *Policy Brief: The Afghan Banking and Financial System Situation Report*, 2021.
[43] IMF, *Islamic Republic of Afghanistan: First Review Under the Under the Extended Credit Facility Arrangement and Request for Modification of Performance Criteria-Press Release; Staff Report; and Statement by the Executive Director for Islamic Republic of Afghan*, IMF Staff Country Reports 21, no. 138 (June 2021), https://doi.org/10.5089/9781513587202.002.
[44] DAB, 'Economic and Statistical Bulletin – Annual Bulletin 2020'.
[45] DAB, *Islamic Banking Department*, https://dab.gov.af/islamic-banking-department
[46] Ibid.

Although the experience of Islamic banking in Afghanistan is a recent phenomenon, the regulatory framework is quite substantial[47] covering matters such as Islamic assets classifications and provisioning, licensing of Islamic banks, regulations on capital adequacy, and liquidity as well as specific regulatory texts related to Islamic contracts (*murabahah*, *ijarah*, etc.), reporting of Islamic banks and *Shari'ah* compliance and verification regulations.
After the regime change in 2021, resulting international sanctions have caused a dramatic shock for the financial and payment systems due to the freezing of Afghanistan's international assets and reserves, including banks' foreign currency deposits at DAB, the suspension of the SWIFT system, international settlements and grants transfer.

DAB, as a result, was unable to provide the necessary liquidity to banks both in local and foreign currencies and has put consequently limits on bank daily deposit withdrawals. Individuals were first limited to a withdrawal of $200 and AFN 20,000 with a weekly 5 percent withdrawal on the balance of corporate accounts. Later on, individuals were permitted to withdraw up to $400 and AFN 30,000 weekly (or $1,200 and 100,000 AFN in a single transaction per month). This resulted in a sharp decline in total banking deposits that fell from AFN 268 billion as of YE 2020 to AFN 194 billion in September 2021. Recently, the limits on salary withdrawal of government and private employees were lifted by the DAB.[48]

The situation has also limited banks' ability to extend financing pushing down total credits from AFN 33 billion in YE 2020 to AFN 29 billion in September 2021 with non-performing loans sharply increasing to 57 percent in September 2021.[49]

3.2. Non-Banking Financial Institutions and Offerings

Apart from banks, MFIs are the other significant financial service providers in the country. According to the figures as of Q2-2021,[50] before the recent political turmoil, eight existing MFIs in Afghanistan reached 963,371 active clients; thereby, these institutions had the potential to touch the lives of roughly more than 7 million Afghan people (18 percent of the total population).[51] Some of these MFIs have already utilised Islamic financing instruments such as *murabahah*, *ijarah*, *wakala*, etc.

As regards the insurance sector, it remains underdeveloped in the country and covers only a small minority of Afghans.[52] As of 2020, there were five domestic insurance companies (one public, four private) operating in Afghanistan.[53] Although *takaful* is also a very new operational concept for the country, recently, there have been significant attempts by regulatory bodies to promote this sector in Afghanistan. Accordingly, a comprehensive draft *takaful* Law was prepared with the support of different stakeholders, including the Islamic Development Bank (IsDB), in 2019, which has not been finalized yet. Thus, the status of the *takaful* sector in the country remains uncertain.

Cooperatives are another non-banking financial service provider in Afghanistan. The country's movement toward agriculture cooperatives can be traced back to 1963.[54] By 1980, when the newly installed government refocused on making the cooperatives resemble the Soviet model of collective

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[47] DAB, *IBR*, https://dab.gov.af/Islamic-Banking-Regulations
[48] The Print, *Da Afghanistan Bank lifts limitations on salary withdrawal*, April 14, 2022, https://theprint.in/world/da-afghanistan-bank-lifts-limitations-on-salary-withdrawal/916757/
[49] UNDP, *Policy Brief: The Afghan Banking and Financial System Situation Report*, 2021.
[50] AMA, *Microview Report 34*, 2021.
[51] According to the "United Nations, Department of Economic and Social Affairs, Population Division (2019). Database on Household Size and Composition 2019." average household size (number of members) in Afghanistan is eight. Hence, the MFIs could have potential to reach 7,706,968 (963,371 X 8) indirectly.
[52] Afi, *Advancing the Financial Inclusion of Forcibly Displaced Persons: Case Studies on Rwanda, Mauritania and Afghanistan*, December 2020, https://www.afi-global.org/sites/default/files/publications/2020-12/AFI_FDPs_CS_AW_digital_0.pdf.
[53] General Directorate of Insurance Affairs of Afghanistan, *Insurance Sector Annual Report 2020,* 2021.
[54] Hamdullah Tokhi, *Agriculture Cooperatives Assessment, in Puli Khumri District of Baghlan Province*, Afghanistan. Diss. Wageningen UR, 2011.

agriculture, the total number of cooperatives had passed 2,500 through programme support from the United Nations, the Food and Agricultural Organization (FAO), and the International Labor Organization (ILO). These cooperatives remained non-functional during the Taliban regime from 1996 to 2001. After the establishment of the new government in 2002, the general strategy of the central government was to reactivate cooperatives and develop the capacity of the cooperative to receive credit and marketing services. As a result of this support, 170 new cooperatives were registered in the Ministry of Agriculture and Animal Husbandry (MAAH). With a focus on the local level (down-top), the MAAH's Department of Cooperatives consisted of divisions for Training, Registration, Accounting, Administration, Marketing, and Credit.

According to the Agriculture Cooperative Law, functions of agriculture cooperatives are defined as production of agricultural commodities, training for their members, marketing of outputs and inputs collectively, adding value to their members' products through sorting, packaging, and storing to access good markets, management of agri cooperatives activities, collective working, organization, planning and controlling, financial service provision to members.[55] Besides, per the law for agriculture cooperative enterprises of Afghanistan, the structure of cooperatives management includes a supervisory council, with at least three members, the management council has a minimum of four officers: director, assistant director, 'Writer' (Secretary), and 'cashier' (treasurer). The cooperatives are expected to submit their annual report to the Ministry of Agriculture.[56]

As of 2008, there were 1,832 agriculture cooperatives in Afghanistan.[57] These cooperatives are mainly located in the Bagram, Parwan, Nangarhar, Baghlan and Badakhshan provinces, and each cooperative focuses on several agricultural products such as grapes, raisins, tomatoes, onion, wheat, rice, potatoes and vegetables. The number of cooperative members also can vary between 100 and 300. Moreover, some cooperatives concentrate on livestock such as sheep, cattle and goats. Several women cooperatives operate in the country. For instance, in Badakhshan, the Department of Agriculture found that around 1,500 women are involved in the agricultural and business sector and there were 18 women's cooperatives in the province, each supported by international organizations in 2014.[58] Although cooperatives are an important institutional structure for supporting the agricultural sector in Afghanistan, they have several challenges such as lacking a sustainable agricultural system, the trading and marketing of agricultural products, lack of access to national and international markets, weak training opportunities, and lack of warehouses to store their products.

With the 2021 regime change in the country, the new administration halted financial activities and subjected the available products to review. They required that all the financial services must be *Shari'ah*-compliant. Consequently, banks and MFIs ceased further loan disbursements and were only allowed to collect the principal of their existing loans.

Currently, the insurance sector activities have also been halted until further notice, and their operations have been under review by the newly established governmental institution, Research Center for Islamic Banking and Contemporary Issues (RCIBCI) in December 2021.

Despite the significant disruptive impacts of the recent developments, there are some opportunities for the promotion of the *takaful* sector, particularly through the conversation of existing insurance companies from conventional to Islamic practices. In addition, as a backbone of the Afghanistan economy, MSMEs and the agricultural sector could benefit from the potential acceleration in the development of the *takaful* sector, providing broader coverage to various segments of society.

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[55] Ibid.
[56] Wakil Ahmad Sarhadi, Samadi Ahmad Fahim, and Kim Tangutan, *Sustainable Agricultural Development in Afghanistan*, *Journal of Developments in Sustainable Agriculture* 9 (2014): 41–46.
[57] Miraqa Hussain Khail, , and Chitose Atsushi. *The Effect of Agricultural Cooperatives on Farm Income in Rural Afghanistan*, *Japanese Journal of Farm Management*, 48.1 (2010): 118-123.
[58] International Cooperative Alliance, *Agricultural Co-Operatives Improve the Lives of Afghan Women | ICA,* 21 January 2014, https://www.ica.coop/en/media/news/agricultural-co-operatives-improve-lives-afghan-women.

Photo Credi: UNDP Afghanistan

4. Afghanistan Microfinance Landscape: Review and Assessment

4.1 Institutions, Regulative Environment, and Offerings

As of 2001, Afghanistan's formal financial sector was practically non-operational, with insolvent public financial institutions and no private banks.[59] At the time, there were few microfinance programmes with limited outreach and weak institutional structures, reaching approximately 10,000 clients only.[60] In 2002, 500 NGOs were working in Afghanistan, out of which 20 to 25 were providing some kind of credit products. However, their financing models were unsustainable for many reasons, including hyperinflation as well as interest rate caps imposed for religious reasons.[61]

The intervention of the World Bank in partnership with members of the new Afghanistan government members (after the Taliban regime ousted in 2001) was critical to addressing the situation and establishing a structured and well-governed microfinance sector. This resulted in the establishment of the Microfinance Investment Support Facility for Afghanistan (MISFA) as an apex institution in 2003, which is funded by the World Bank's Afghanistan Reconstruction Trust Fund (ARTF) to serve as a vehicle through which the Afghanistan government and international donors can channel technical assistance and funding to build Afghanistan's microfinance sector.[62] Later, the legal status of MFIs has been transformed from NGOs to that of non-profit companies registered with the Afghanistan Investment Support Agency (AISA).[63]
MISFA was created to serve the following objectives:[64]

- Co-ordinate donor funding so that the conflicting donor priorities endemic in post-conflict situations do not end up duplicating donor efforts and distorting markets,
- Help young microfinance institutions scale up rapidly by offering performance-based funding for operations and technical assistance,
- Build systems for transparent reporting and instil a culture of accountability.

In practice, donor agencies provided financing to the microfinance sector through MISFA or directly to MFIs.[65]

To further support the sector's development, MISFA created the Afghanistan Microfinance Association (AMA) as the national network of Development Finance Institutions (DFIs) in 2005. With support from United States Agency for International Development (USAID)'s Financial Access for Investing in the Development of Afghanistan (FAIDA) project and the continued backing of MISFA, AMA positioned itself as an association that promotes the broader development finance sector in Afghanistan.[66] MISFA, being one of the founding members of AMA, has been providing technical and financial support to the Association since its inception. This continued in 2018, with MISFA signing a funding agreement with AMA for that year. Under the agreement, MISFA committed to funding AMA's planned activities under its three core functions, namely Lobby & Advocacy, Knowledge Management, and Coordination and Networking during 2018. The grant helped AMA to provide better services to its members and stakeholders at national and regional levels. This is expected to lead to better access to financial services among low-income Afghans across the country. One of the key functions of AMA is to raise awareness among the general public and potential microfinance borrowers about development finance and to

[59] Institute of Microfinance, *State of Microfinance in Afghanistan*, 2009, https://www.findevgateway.org/sites/default/files/publications/files/mfg-en-paper-the-state-of-microfinance-in-afghanistan-2009.pdf
[60] Ibid.
[61] Ibid.
[62] MISFA, http://misfa.org.af/
[63] MISFA, *History*, https://misfa.org.af/history/
[64] Martin Greely, *Microfinance in Afghanistan: A Baseline and Initial Impact Study for MISFA*, 2007
[65] Institute of Microfinance, *State of Microfinance in Afghanistan*, 2009
[66] AMA, *Overview*, https://ama.org.af/archives/599

address misperceptions and misunderstandings about the sector through solid messaging consistent with the objectives of MISFA and partner institutions. MISFA supports AMA's networking and coordination activities, such as programme and legal awareness seminars, general assembly meetings, and CEOs coordination meetings. The coordination and networking activities of AMA have been effective in sharing lessons learned and good practices amongst stakeholders, as well as promoting efficiency and collaboration around risk and fraud mitigation. AMA was registered with Afghanistan's Ministry of Justice in 2007.

In 2010, USAID also established the Agricultural Development Fund (ADF) to support microfinancing operations in the agriculture sector. The principal function of ADF is to catalyse the delivery of finance and related non-finance services to commercial farmers and agribusiness entrepreneurs through a variety of intermediaries (including MFIs) as well as direct lending, in an unprecedented effort to revolutionise the Afghanistan's agriculture. Since its inception, ADF has been one of the main sources of MFIs for agricultural financing activities.

Due to funding constraints, the microfinance sector in Afghanistan initially remained at the scale of a pilot project.[67] It was in 2006 that the industry took off, achieving considerable growth rates since then. However, the extremely rapid growth of the sector with fragile institutions led to a repayment crisis in 2008. In their quest to increase the scale of their operations, MFIs did not appropriately manage tasks related to due diligence while extending credit, internal control processes, and performance monitoring. These factors, combined with inflation and security issues, caused the deterioration of the quality of portfolios of most MFIs.[68] In addition, some MFIs went bankrupt because of fraud cases.[69]

As a result, MISFA focused afterwards more on the monitoring of partner MFIs to ensure appropriate supervision and verification of the accuracy of reported data, as well as on the consolidation of the sector. As such, many financially weak MFIs exited the sector while others merged with financially stronger ones.[70] The number of MISFA's partner institutions reached 15, the highest level, in 2008 from 3 in 2003. After the failure of some MFIs and mergers and consolidation in the sector, the number decreased to 4 in 2014 and currently, four MFIs partner with MISFA: (i) The First Microfinance Bank Afghanistan (FMFB-A), (ii) OXUS Afghanistan, (iii) Mutahid Development Finance Institution and (iv) FINCA Afghanistan. MISFA functions as either the exclusive or primary provider of funds to its partners (grants and loans).[71] In exchange, MISFA requires partner MFIs to perform controls and reporting.[72] While some MFIs get financing from DFIs directly (e.g., USAID), most funding is channelled through MISFA.[73] In addition to FMFB-A, OXUS Afghanistan, Mutahid and FINCA Afghanistan, three other institutions, Islamic Investment & Finance Cooperatives (IIFC) Group, Aga Khan Foundation (AKF) and Hand in Hand Afghanistan (HiHAO), offer microfinance products and services that are not partner with MISFA.

Afghanistan's microfinance sector has a rich institutional diversity with different structures. The differences can be attributed to their business model and legal status. It is also to be noted that the microfinance sector is not regulated in Afghanistan. While FMFB is a commercial bank focusing particularly on microfinance business, Aga Khan Foundation and HiHAO are Community-based Savings Promoting Institutions (or CSPIs), which are both non-governmental and governmental organisations that offer some microfinance services along with other development activities. The rest of the organisations are classified as pure MFIs. All eight organisations, FMFB-A, OXUS Afghanistan, Mutahid, FINCA Afghanistan, IIFC Group, AKF, HiHAO and WEERDP programme,[74] are members of AMA (Table 5).

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[67] AREU, *Building a Viable Microfinance Sector in Afghanistan*, January 2010, https://reliefweb.int/sites/reliefweb.int/files/resources/3A01B8A4E3ECAF15492576B000182457-Full_Report.pdf
[68] MISFA, *Italian Support to Afghan Microfinance and Enterprises in Herat*, 2014
[69] Najeeburahman Lutfi, *MFIs in Afghanistan: Developments and Challenges*, 2021
[70] MISFA, *Italian Support to Afghan Microfinance and Enterprises in Herat,* 2014
[71] https://misfa.org.af/history/
[72] AREU, *Building a Viable Microfinance Sector in Afghanistan*, January 2010
[73]Institute of Microfinance, *Microfinance in SAARC Countries Overview Report*, 2010, http://inm.org.bd/wp-content/themes/inm/pdf/overview_report.pdf
[74] WEERDP suspended its operations by 15 August 2021.

Table 5: Microfinance Services Providers

Name	Inception Year	Type*/Legal Status	AMA/MISFA Membership/Partnership
FINCA-A	2003	Microfinance Institution / Joint Stock Company	Member of AMA/Partner with MISFA
IIFC Group	2009	Microfinance Institution / -	Member of AMA
Mutahid	2011	Microfinance Institution / Company	Member of AMA/Partner with MISFA
OXUS-A	2007	Microfinance Institution / Corporation	Member of AMA/Partner with MISFA
FMFB-A	2004	Microfinance Bank / Commercial Bank	Member of AMA/Partner with MISFA
AKF	2003	Community-based Savings Promoting Institution / NGO	Member of AMA
HiHAO	2007	Community-based Savings Promoting Institution / NGO	Member of AMA
WEERDP	2018	Programme / Implemented by Ministry of Women Affairs	Member of AMA

Note: *based on the AMA's classification

FINCA Afghanistan[75] was founded in 2003[76] with the support of FINCA International[77] and registered as a joint-stock company with the Ministry of Commerce and Industries of Afghanistan.[78] It is headquartered in Kabul and focuses on rural and urban areas of the country, primarily in the North, West and Central regions. Different loan products have been offered (including two *Shari'ah*-compliant products) such as SME loans, Emergency Credit Lines, Agriculture and Livestock Loans, as well as Women and Staff loans[79] based on individual and solidarity group loans. The loan size of FINCA starts from AFN 5,000 up to AFN 3.5 million with a duration of up to a max of 3 years (Interviewee). FINCA Afghanistan has received grant funds from MISFA for developing robust IT systems. These initiatives are the transformation of its core banking system for evolving an efficient, secure, and resilient technology-based Microfinance Core Banking System, increasing the effectiveness and efficiencies of its internal audit function by automating the audit process by utilising audit software.

OXUS Afghanistan was founded in 2007 as a part of the OXUS Development Network.[80] It is registered as a corporation under the Afghanistan Law.[81] Since its creation, OXUS Afghanistan has been supported by grants and concessional loans from MISFA and an equity investment from its main shareholder,

[75] FINCA Afghanistan's website (https://finca.af/) was closed its website after 15 August 2021, therefore the information about company was collected from different sources including interviews.
[76] FINCA, *History*, http://web.archive.org/web/20210411160017/https://www.finca.af/history/, 11 April 2021.
[77] FINCA International is based in Washington DC and operates in more than 90 countries in Eurasia, the Middle East, South Asia, Africa, and Latin America. FINCA estimates that it has impacted the lives of 75 million people since 1984 (including FINCA clients, their employees and immediate family members), served more than 4.5 million women in more than 40 countries (for more information, please see: https://finca.org/where-we-work/global/).
[78] FINCA Afghanistan, Customer Relationship Management Software (CRM): Request for Proposal, accessed from Agency Coordinating Body for Afghan Relief and Development (ACBAR) (04 February 2021), www.acbar.org/upload/1612859925415.pdf
[79] Ibid.
[80] OXUS Development Network, Paris-based, is part of a global network of MFIs created by ACTED, which is an international non-governmental organization implementing emergency, rehabilitation and development projects in more than 38 of the world's most vulnerable countries affected by conflicts, disasters or socio-economic hardship. OXUS Holding is the investment vehicle of OXUS Network that includes three microfinance affiliates including the one in Afghanistan, in Kyrgyzstan and in Tajikistan. And ACTED is the main shareholder of OXUS Holding (for more information, please see www.oxusnetwork.org/our-structure-and-shareholders).
[81] ACBAR, https://www.acbar.org/upload/1590996320187.pdf

OXUS Holding.[82] OXUS Afghanistan provides various types of loans such as collateral-free group loans, individual loans, SMEs loans, agriculture *murabahah*, etc.[83]

Mutahid (meaning 'united') was established in 2011 by the merger of six different MFIs, and it has been directly supported by MISFA, the World Bank, MEDA and USAID.[84] Previously operating as the retail arm of MISFA, Mutahid received a separate business license in April 2017 to become an independent and wholly-owned subsidiary of MISFA.[85] The company is registered with the Ministry of Commerce and Industries. Mutahid offers both conventional loan and Islamic financing products through individual and group-based structures. The group's average size varies from 2 to 6 members, with the loan amount ranging from AFN 10,000 to 150,000, while the loan tenor goes from 6 to 18 months. Mutahid also provides *Shari'ah*-compliant group *murabahah* financing to particularly women enterprises with the same features of conventional group loans. On the other hand, the loan amount in the individual SME loans, which requires collateral and higher repayment capacity than the group loan, ranges from AFN 250,000 to 1,000,000. The repayment period is between 12 months to 24 months.[86]
FMFB-A was founded in 2004 and is affiliated with the Aga Khan Development Network (AKDN), which provides financial services in more than ten countries through its banks. AKDN established two microfinance programmes in 2002 (the Emergency Microcredit Programme in urban areas and the Rural Microcredit Programme)[87], and they were transformed into FMFB-A. The Bank operates as a commercial bank regulated by the Central Bank of Afghanistan. The current ownership structure consists of Aga Khan Agency for Microfinance (AKAM)[88] (39.4 percent share), Kreditanstalt Für Wiederaufbau - KfW (31.9 percent), International Finance Corporation - IFC (16.8 percent) and Aga Khan Foundation USA - AKF USA (11.9 percent) as of 30 September 2021.[89] As a commercial bank with a microfinance focus, FMFB-A provides credit and deposit services to MSMEs along with commercial banking and international and domestic remittance services.[90] FMFB-A has been using a conventional individual lending method only since 2017. The bank is the largest MFI in Afghanistan regarding clients' outreach, the number of provinces operated and staff. MISFA has provided several grants to FMFB-A, such as AFN 11 million was given in 2018 for improving the quality of its workforce through training and development activities for staff.[91] The bank has offered commercial banking services (deposits, SME loans, trade finance products) alongside microfinance products, including individual enterprise loans, women's individual enterprise loans, housing loans, agriculture/livestock loans, healthcare loans, vehicle/student/marriage/home appliance loans, leasing and, etc.[92]

"FMFB is providing both banking and microfinance services. The focus more on SMEs other than big enterprises, but banking functions are happening. Our main focus is to promote small businesses and empowerment." (Interviewee)

The Islamic Investment & Finance Cooperatives (IIFC) Group was established in 2009 by USAID funding of about $18.6 million as a national association of the network of cooperatives in Afghanistan, named as Islamic Investment and Finance Cooperatives (IIFCs). IIFC Group, the apex entity of IIFCs, provides them with technical assistance, fundraising, and helps in IIFCs' staff capacity buildings, etc.[93] IIFCs have catered conventional and Islamic financing opportunities to microentrepreneurs in Afghanistan,

[82] Ibid.
[83] Mirwais Jahish, *Micro-Finance Institutions in Afghanistan and the Main determinants of Repayment Rate*, 2017, https://edepot.wur.nl/419667
[84] https://www.mutahid.org.af/
[85] http://ama.org.af/news/mutahid-operates-as-an-individual-entity
[86] https://www.mutahid.org.af/
[87] https://www.akdn.org/our-agencies/aga-khan-agency-microfinance/who-we-are/akam-timeline
[88] AKAM is an agency encompassing programmes of the Aga Khan Development Network that offers microfinance services and other programmes in the objective of reducing poverty, diminishing vulnerability and enhancing the socio-economic conditions of the poor. For more information about other shareholders, please see https://fmfb.com.af/shareholders/.
[89] FMFB Audited Financial Statement 2021, 3rd Quarter, https://fmfb.com.af/wp-content/uploads/2021/11/Audited-Financial-Statement-2021-Quarter-3.pdf
[90] https://fmfb.com.af/
[91] MISFA, *Annual Report*, 2019, http://www.misfa.org.af/wp-data/uploads/2019/12/Annual-Report-March-2019.pdf
[92] https://fmfb.com.af/
[93] https://www.linkedin.com/company/iifc-group/about/

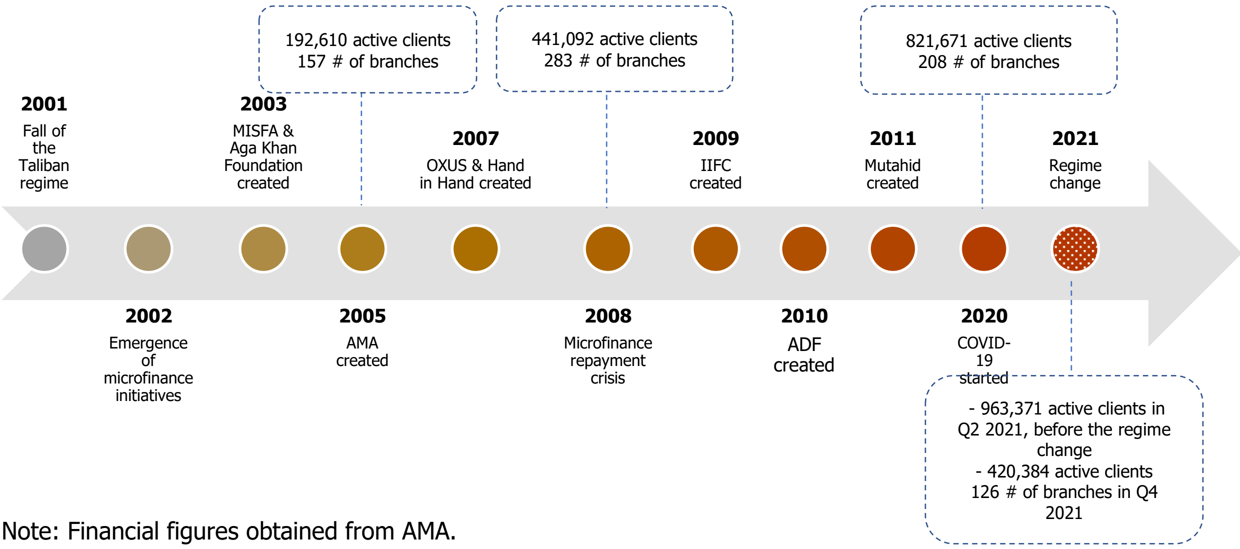
from 6 months to 24 months term loans.[94] IIFCs (alongside FMFB-A) are the only MFIs that provide formal savings services.[95]

The Aga Khan Foundation (AKF), classified as CSPIs, is a nondenominational, international development agency established in 1967 by the Aga Khan.[96] The AKF Afghanistan operates as an NGO that offers some microfinance services along with other development activities. In addition, AKF provides informal savings as well as financial services to their beneficiaries using several different models such as Village Savings And Loan Associations (VSLAs), Self Help Groups (SHGs), Community-Based Savings Groups (CBSGs), Savings and Credit Groups (SCGs), etc. The group members often save regularly and then borrow from the groups' internal savings funds.[97]

Hand in Hand Afghanistan (HiHAO) is a non-profit and non-governmental organisation registered as a national NGO with the Ministry of Economy of Afghanistan;[98] it started operating in 2007. HiHAO is part of Hand in Hand International, a non-profit organisation that has impacted the lives of roughly 3.5 million members around the globe, out of which 90 percent are women.[99] HiHAO also has a special focus on serving the needs of women.[100] HiHAO is also classified as a CSPIs.
Women Economic Empowerment Rural Development Programme (WEERDP) is funded by the International Development Association (IDA) of the World Bank Group, the Afghanistan Reconstruction Fund, and other funds contributed by bilateral donors and the Government of Afghanistan, whose objective is to increase social and economic empowerment of poor rural women in selected communities. The project started in 2018, and the closing date was 30 June 2023. The project's implementing agency is the Ministry of Women's Affairs (MOWA). [101]

In line with the individual institutional development trajectory of MFIs in Afghanistan, Figure 6 depicts the timeline of the Afghan microfinance movement, which shows different stages of the sector through the major milestones. It should be noted that the sector has been facing one of the main challenges, namely existential challenge, since the regime change on 15 August 2021.

Figure 6: Timeline of Microfinance in Afghanistan



Note: Financial figures obtained from AMA.

[94] Afghanistan Microfinance Association, *Micromag 12*, June 2020, http://ama.org.af/wp-content/uploads/2020/08/MM12.pdf
[95] USAID, *Demand and supply of agricultural financial services in Afghanistan*, June 2018, http://www.aba.org.af/uploaded/pdf/Surveys/National%20Survey%20in%20Brief%20-%20USAID%20Approved.pdf
[96] Afghanistan Microfinance Association, *Micromag 12*, June 2020, http://ama.org.af/wp-content/uploads/2020/08/MM12.pdf
[97] Ibid.
[98] https://handinhand.org.af/wp-content/uploads/2017/05/HiH-Afghanistan-SP-2017-2020.pdf
[99] https://www.handinhandinternational.org/how-we-do-it/
[100] https://handinhand.org.af/wp-content/uploads/2017/05/HiH-Afghanistan-SP-2017-2020.pdf
[101] World Bank, "Abstract", *Women's Economic Empowerment Rural Development Project*, 2019, https://projects.worldbank.org/en/projects-operations/project-detail/P164443

4.2. A Review of Islamic Finance Offerings in the Afghanistan Microfinance Sector

Several MFIs in Afghanistan have offered *Shari'ah*-compliant financing products to their clients. FINCA Afghanistan is the first microfinance programme in the country to provide some type of *Shari'ah*-compliant financing products since its inception in 2003.[102] Although FINCA had some Islamic products, its operation was almost based on two *murabahah* financing products since 2014 (Interviewee). Two *murabahah*-based products have been provided to the microenterprises on an individual and group basis: Business *murabahah* Agreement (BMA) and Women *murabahah* Group (WMG). These two types of products have different features in terms of loan size, collateral requirements, etc., which are presented in Table 6. It is also noted that FINCA had one more *murabahah*-base product called Market *murabahah* Group (MMG) loan which allowed group size to be between 3 to 40 with 5 months initial loan cycle.[103] As it seems that they had received a *fatwa* from a local religious scholar for the products.[104] Overall, *Shari'ah*-compliant products accounted for 33 percent of the total portfolio of FINCA as of 2018.[105]

Table 6: FINCA Afghanistan Murabaha Products' Details

Product	Target Group	Group Size	Loan Size	Loan Duration	Collateral	Financial Guarantor	Family Guarantor
Women *murabahah* Group (WMG)	Women Business Owners	2-6 women	AFN 10,000 to AFN 70,000	6 to 18 months	Not required	Community leader verification	Not required
Business *murabahah* Agreement (BMA)	Men and Women Business Owners	Individual	AFN 10,000 to AFN 500,000	6 to 24 months	Title deed*	Men and women business owners with the capacity to guarantee the loan	A close relative of the family is mandatory

Source: http://web.archive.org/web/20210513181423/https://www.finca.af/products/business-murabaha-agreement-bma/, 11 April 2021. Note: *Title deed below AFN 100,000 is optional, but it is mandatory for loans over AFN 100,000.

> "Still our products are Islamic however, the new regime rejected all the products. Even we had fatwas from ulama for our products. They [regime] told us to stop the operations. They in fact banned on all the operations. The Islamic products were based on *murabahah*. I don't know, we were also asked to stop the operations. All MFIs were asked to stop. We were also among them as well. Now we are waiting for them to allow us." (Interviewee)

Although FINCA states on their website that they have been providing *Shari'ah*-compliant products since 2003, it was also reported that Mutahid is one of the first MFIs in the country whose *Shari'ah*-compliant loan products based on *murabahah* was approved by the Islamic Religious Council of Afghanistan (IRCA)[106] during the previous regime. One of the interviewees pointed out that one consultant was hired from outside Afghanistan to help developing and enlarging the portfolio, while they had a consultation with traditional *ulama* in Herat about the *Shari'ah* compliance. This led to the testing of *murabahah* product with Mutahid and it proved to be a successful scheme. Consequently, *murabahah* products

[102] http://web.archive.org/web/20210411160017/https://www.finca.af/history/
[103] Paul Robinson and Nimrah Karim, *FINCA's Experiences in Afghanistan*, Presentation made at the International Islamic Finance Forum, Dubai, UAE, April 13-17-2008
[104] Ibid.
[105] MISFA, *Executive-Summary*, 2019, http://www.misfa.org.af/wp-data/uploads/2019/09/MFIA-Executive-Summary-June-2019.pdf
[106] Microfinanza, *Impact Assessment Microfinance Services in Afghanistan*, June 2019, http://www.misfa.org.af/wp-data/uploads/2019/09/MFIA-Executive-Summary-June-2019.pdf

have been used by other MFIs. This *Shari'ah*-compliant group *murabahah* financing has targeted mainly women enterprises with the same features of conventional group loans.[107] OXUS Afghanistan has provided *murabahah*-based *Shari'ah*-compliant financing products since 2018 along with its conventional products, and it was quite successful until the regime change (Interviewee). The interviewee also added that the product had the same profitability as the conventional loan with an interest of around 31 percent.

According to AMA,[108] IIFC is another MFI which have catered conventional and Islamic financing to microentrepreneurs in Afghanistan, from 6 months up to 24 months term loans. However, after the regime change, all microfinance providers were imposed to convert their activities from conventional to Islamic. Currently, MFIs including IIFC are not allowed to disburse any new loan, even actual Islamic products have been subjected to review by the regime authorities. The FMFB-A did not have any Islamic banking services before the 15 August; however, they had plans to start with an Islamic window in 2018, following the DAB's guidelines. They started the conversion to the Islamic banking process in November 2021 after the regime change (Interviewee).

4.3. The Trajectory of the Microfinance Sector Before the Regime Change

As detailed previously, eight institutions, members of the AMA, have been providing microfinance services in Afghanistan.[109] Examining the state of the microfinance sector in general and institutions in particular, from financial and finance-related variables is important in understanding how prepared they are to encounter the new challenges. Moreover, this examination provides us insights into the institutional capacities of the sector players.

Table 7: Key Indicators of Microfinance Providers (as of June 2021)

	# of Provinces	# of Branches	# of Staff	# of Clients	# Active Borrowers	Share of Women Clients	Gross Loan Portfolio (m, Afn)	PAR > 30
FINCA-A	10	19	334	22,628	22,628	56%	1,119.5	9.1%
IIFC Group	11	25	201	112,906	13,495	25%	720.2	34.5%
Mutahid	6	8	219	17,429	17,429	39%	506.6	4.7%
OXUS-A	10	25	484	26,150	26,150	56%	1,244.8	4.3%
FMFB-A	14	37	1,416	227,093	56,859	24%	5,619.4	5%
AKF	7	17	20	32,789	5,342	75%	42.9	-
WEERDP	34	76	1,287	523,106	171,981	82%	718.8	-
HiHAO	2	2	40	1,270	368	100%	1.2	-
Total	**34**	**209**	**3,990**	**963,371**	**314,252**	**66%**	**9,973.5**	**7.1%**

Source: Afghanistan Microfinance Association, Microview 33, June 2021, http://ama.org.af/wp-content/uploads/2021/09/MicroView-Report-33.pdf

As of June 2021, merely two months before the regime change, the main indicators for each MFI are presented in Table 7. Accordingly, the FMFB-A was the largest MFI with a 56 percent market share in terms of the gross loan portfolio. OXUS-A and FINCA-A followed it with 12 percent and 11 percent

[107] https://www.mutahid.org.af/
[108] AMA, *Micromag 12*, June 2020, http://ama.org.af/wp-content/uploads/2020/08/MM12.pdf
[109] WEERDP suspended its operations by 15 August 2021. FINCA Afghanistan also terminated its operations as of March 2022.

market shares, respectively. One of the other MISFA's partner MFIs, Mutahid, had 5 percent of the total microfinance gross loan portfolio. The other MFIs shared the remaining. These four MISFA partner MFIs had about 85 percent of the market share in this industry as of July 2021. In terms of geographical coverage, only the World Bank-supported programme, WEERDP, was operating in all provinces of Afghanistan. Other MFIs had several branches ranging from 6 to 14, mostly in urban areas located in the North region and Western Herat province, due to the security issues during the reign of the previous government (Interviewees). Thus, branch concentration was in urban areas.

The number of staff in the microfinance sector was around 4,000 in Q2-2021, and they were serving 963,371 clients out of 314,252 active borrowers. Women have always been better customers in the country (interviewee), and they had a 66 percent share of the total number of clients. In addition, MFIs have organised human resources accordingly, which is evidenced in the interview with a representative of an MFI that "most of the MFIs have a number of female officers, and they are better organised in the sense of servicing the loan and trying to increase the businesses."

As of Q2-2021, the majority of the MFIs' credit portfolio quality was quite manageable when we consider the COVID-19 impacts, which were still heavily prevailing. However, IIFC's PAR > 30 was alarming at 34.5 percent, making the MFI one of the most vulnerable MFIs after the regime change in 2021, with almost 100 percent PAR at the end of 2021.

Table 8: Key Indicators for Overall Microfinance Sector (Year on Year Comparison)

	2021-Q2	**2020-Q2**	**Change**
Number of Clients	963,371	601,020	60.3%
Number of Active Savers	718,449	378,295	89.9%
Number of Active Borrowers	314,252	175,611	78.9%
Amount of Savings (AFN, million)	3,732	3,193	16.9%
Gross Loan Portfolio (AFN, million)	9,973	8,044	24.0%
PAR>30 days	7.10%	15.30%	-820 bps
Average Loan Size (AFN)	31,737	45,808	-30.7%
Gross Loan Portfolio Per Loan Officer (AFN)	8,318,158	6,309,305	31.8%

Source: Afghanistan Microfinance Association, Microview 33, June 2021, http://ama.org.af/wp-content/uploads/2021/09/MicroView-Report-33.pdf

Regarding the overall microfinance sector performance[110] compared to previous quarters, some indicators showed a positive trend (Table 8). For instance, compared to the same quarter of the previous year, the number of clients increased from 601,020 (as of Q2-2020) to 963,371 in Q2-2021 (+60.29 percent). Similarly, this positive trend was visible in the amount of savings, the number of active borrowers and the gross loan portfolio grew by 16.87 percent, 78.95 percent, and 23.98 percent, respectively. Portfolio At-Risk / 30 days (PAR>30 days) continued its decreasing trend from 15.3 percent as of Q2-2020 to 7.1 percent as of Q2-2021. Moreover, as of Q2-2021, the average loan size disbursed by Afghanistan microfinance providers was AFN 31,737. While there were 314,252 active borrowers as of Q2-2021, most loans were individual (283,916 active individual borrowers vs 30,336 active group borrowers).

"Microfinance sector is very important for any future development of SMEs in the country. Commercial banks are not able to meet the needs of small SME sector. In the country mostly people are lacking higher education and financial literacy. Microfinance is extremely important. Otherwise, microfinance is not there, small borrowers getting the hand of moneylenders. They charge basically compounded interest. The rate can be 40-50 percent. Literally this kills the small borrowers." (Interviewee)

[110] All figures in this section were obtained from AMA's Microview 33, June 2021 publication, http://ama.org.af/wp-content/uploads/2021/09/MicroView-Report-33.pdf

Figure 7: Number of Active Borrowers by Gender (thousand)

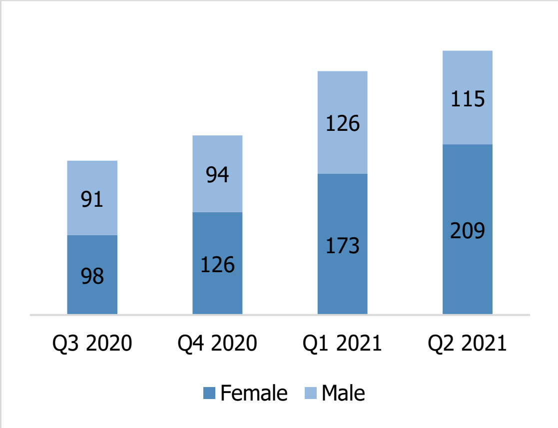
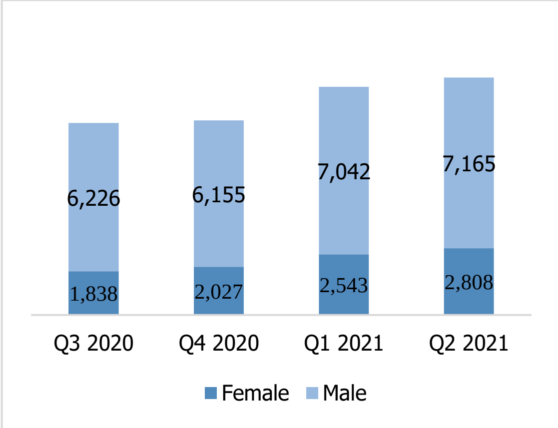


Figure 8: Gross Loan Portfolio by Gender



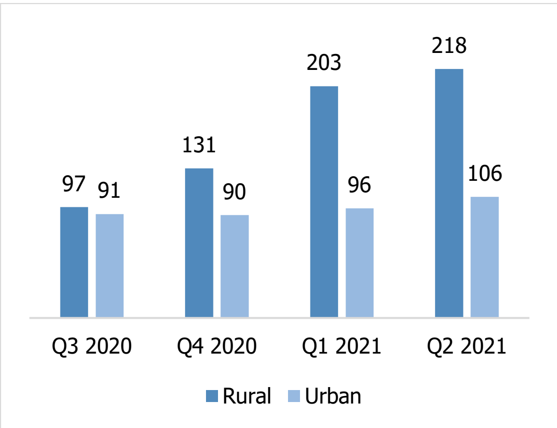
Source: Afghanistan Microfinance Association, Microview 33, June 2021, http://ama.org.af/wp-content/uploads/2021/09/MicroView-Report-33.pdf

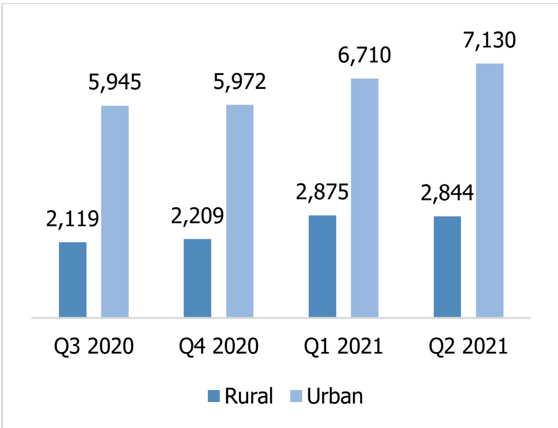
By gender, the number of active borrowers and gross loan portfolio has evolved in the last four quarters, as in Figures 7 and 8. Although the number of female borrowers was higher than male borrowers, they had a lower share in the gross loan portfolio of the microfinance sector.

In addition, as depicted in Figures 9 and 10, even though the majority of active borrowers are from rural areas, the gross loan portfolio in urban areas is almost two times and half the amount disbursed in rural areas.

Figure 9: Number of Active Borrowers by Origin (thousand)

Figure 10: Distribution of Gross Loan Portfolio (million, AFN) by Origin (million AFN)

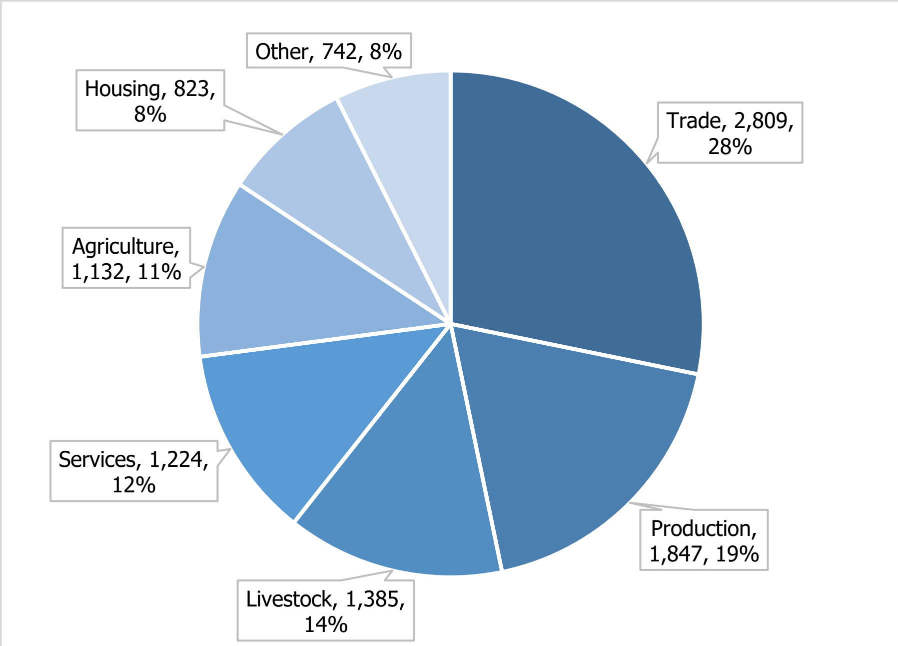




Source: Afghanistan Microfinance Association, Microview 33, June 2021, http://ama.org.af/wp-content/uploads/2021/09/MicroView-Report-33.pdf

As depicted in Figure 11, regarding sectoral distribution, the loan portfolio was primarily disbursed to the trade sector (28 percent), production sector (19 percent), livestock sector (14 percent), services (12 percent), agriculture (11 percent) and housing (8 percent) in Q2-2021. It should also be noted that the total share of agriculture and livestock was 25 percent.

Figure 11: Gross Loan Portfolio by Sector (million AFN, Q2-2021)



Source: Afghanistan Microfinance Association, Microview 33, June 2021, http://ama.org.af/wp-content/uploads/2021/09/MicroView-Report-33.pdf

The figures, as presented in Table 8 above, indicate an overall improving trend in the microfinance industry in Afghanistan. While this observation was true and encouraging, the sector was still facing substantial challenges hindering access to finance by both individuals and businesses, especially MSMEs. These challenges are summarised in Table 9:

Table 9: Challenges of the Afghanistan Microfinance Sector Before the Regime Change

Challenge	Cause
Absence of specific regulation for the microfinance sector	- Microfinance institutions, apart from FMFB, operated without specific regulation from DAB.
Limited outreach of microfinance institutions	- Ineffective outreach due to a shortage of microfinance branches compared to international standards - Absence of branchless /digital services
High operating costs of microfinance institutions	- High security-related expenses - Small-sized loans - Poor infrastructure - Costs and difficulties in hiring qualified staff - High staff turnover
Dependence on MISFA for funds and /or capacity building	- MFIs heavily relied on MISFA for funding and capacity building
High risk in the agriculture and livestock sector (25% of MFIs' portfolio)	- Borrowers struggled with insufficient collateral due to challenging government legislation regarding land as collateral

Source: Adapted from DAB, National Financial Inclusion Strategy 2020-2024, 2020

4.4. The Current Stalemate

> "We have received a lot of formal letters from different provinces. We operate in more than ten provinces across the country. The guidance we have from local authorities is not from single sources, every district governor or police were issuing their own instruction. There was one common thing in all instruction is that no one can collect mark-up."

After 15 August 2021, MFIs were ordered to stop new loan disbursement as they were not in line with *Shari'ah* and were only allowed to collect principal amounts of the loans. Under such unexpected circumstances, Islamic financing offerings provided by several MFIs were also halted and subjected to review by the new regime. As of June 2022, the review process has not been institutionalised yet by the new regime, which results in further uncertainty. Apart from these issues related to the MFIs operations, the uncertainties and deterioration in the fiscal and banking sector of the country have adversely impacted the financial performance of MFIs which had already been struck by the COVID-19 conditions.

The effects of the new regime started to surface by the third quarter of 2021. To reveal the financial impact of the regime change, Q4-2021, as the year-end data provided by AMA, is compared with Q3-2021 figures, which includes Q2-2021 data of IIFC-Group, AKF, and WEE-RDP since they did not report their Q3-2021 financials to the AMA. It should also be noted that WEERDP, which is a World Bank-funded development project, was removed from the Q4-2021 report of AMA as the programme was suspended. The changes between Q3-2021 and Q4-2021 in the key performance indicators for the existing MFIs are summarised in Table 10.

Table 10: Changes in Key Indicators of Microfinance Providers between Q4 and Q3-2021

		# of Provinces	**# of Branches**	**# of Staff**	**# of Clients**	**# Active Borrowers**	**Share of Women Clients**	**Gross Loan Portfolio (m, Afn)**	**PAR > 30 (%)**
FINCA-A	Q3	10	19	317	21,263	21,293	56%	966.2	25.4
	Q4		18	243	19,379	19,379		763.8	54.5
IIFC Group	Q3	11	25	201	112,906	13,495	25%	720.2	34.5
	Q4			166	100,407	12,857	19%	623.8	96.4
Mutahid	Q3	6	8	206	16,871	16,871	39%	452.5	51.8
	Q4			203	16,178	16,178		390.6	90.6
OXUS-A	Q3	10	26	441	24,977	24,977	57%	1,107.7	24.2
	Q4		25	391	22,150	22,150	56%	886.1	28.9
FMFB-A	Q3	14	37	1,478	227,956	52,392	24%	4,977.2	45.8
	Q4			1,418	230,562	46,623		4,055.3	7.1
AKF	Q3	7	17	20	32,789	5,342	75%	42.9	-
	Q4		12	18	31,319	3,473	72%	39.7	
HIHAO	Q3	2	2	40	1,231	377	100%	1.1	-
	Q4	1	1	27	389	389		1.2	
*WEERDP**	*Q3*	*34*	*76*	*1,287*	*523,106*	*171,981*	*82%*	*718.8*	*-*
Total	**Q3**	**34**	**209**	**3,990**	**963,371**	**314,252**	**66%**	**9,973.5**	**36.5**
	Q4	**17**	**126**	**2,466**	**420,384**	**121,049**	**30%**	**6,760.4**	**28.3**

Source: Afghanistan Microfinance Association, Microview 34 and 35, https://ama.org.af/archives/101
Notes: * AMA does not include WEERDP for Q4 figures since the programme suspended its operations. The coloured figures show the indicators that did not change over the two quarters.

Before presenting the development of the financial figures of the microfinance sector, it should be mentioned that in the first days of the turmoil in August, MFIs stopped their operations and day by day, they restarted with the settlement of the uncertainties. For instance, OXUS has frozen its operations for only three days to analyse the situation and reopened all its branches by obtaining letters of authorisation from each provincial new authority (Interviewee). On the other hand, another MFI closed their branches for three weeks. But eventually, all MFIs, except WEE-RDP, resumed their activities under the limitations of the new regime.

As of Q4-2021, the existent seven MFIs had 126 branches in the 17 provinces and provided direct employment to 2,466 people, including 898 loan officers. On the other hand, the number of active staff in the sector in 2022 will be much lower than the Q4-2021, as one of the interviewees stated that "our current active employees are 93 people right now including core and operational staff. Some people left the country, and we have some vacant positions in the office". So, the regime change has impacted the MFIs not only financially but also regarding human resources. Through available capacities, the MFIs served 420,384 clients, of which 28.3 percent were women. While these MFIs are mainly focusing on lending, at the same time, some of them also have saving groups (AKF and HIHAO) and micro-savings (IIFC Group and FMFB). According to Q4-2021 data, the microfinance sector had 196,339 active savers (39 percent women) majority of which (57 percent) were the FMFB's customers as it is a commercial bank with different deposit products. After the 15 August 2021, the gross loan portfolio of the sector shrank from 9,973 million AFN[111] to 6,760 million AFN. Similar to the previous figure, the FMFB has a 60 percent share of the sector's gross loan portfolio.

The loan portfolio quality of all MFIs, except the FMFB, significantly deteriorated in Q4-2021. IIFC Group and Mutahid have almost a hundred per cent PAR meaning that they will start from scratch if they are able to survive. OXUS had a comparatively solid quality in its loan portfolio with 28.9 percent PAR as of Q4-2021 and 24.2 percent in Q3-2021. The only positive development has occurred in the FMFB in terms of PAR, which was not due to a real increase in the repayment quality due to the new regulation on asset classification issued by the Central Bank, which changed asset classification effective from June 2021 to June 2022. However, the overall PAR was estimated at around 80 percent if the impact of this regulation was not considered (Interviewee). Therefore, all MFIs have been witnessing very high PAR ratios due to the ongoing political and economic turmoil in the country.

When we look at the Afghanistan microfinance sector's performance in general, Table 11 clearly shows a significant deterioration in the sector's key indicators. The number of clients (-56.3 percent), the number of active savers (-72.7 percent), the number of active borrowers (-60.5 percent) and gross loan portfolio (-24.7 percent) decreased significantly in the last quarter of 2021 compared to Q3-2021. On the other hand, PAR>30 days slightly improved by 810 bps and recorded 28.3 percent (36.5 percent for Q3-2021) because the progress in FMFB-A's PAR ratio stemmed from regulatory change by the Central Bank of Afghanistan, as mentioned before.

Table 11: Microfinance Key Performance Indicators in Afghanistan (Quarterly Comparison)

	Q3-2021	**Quarterly Change**	**Q4-2021**	**Quarterly Change**	**Q1-2022**
Number of Clients	961,129	-56.3%	420,384	-4.9%	399,728
Number of Active Savers	719,920	-72.7%	196,339	0.6%	197,544
Number of Active Borrowers	306,728	-60.5%	121,049	-22.8%	93,443
Amount of Savings (AFN, million)	3,206.60	-23.4%	2,457.30	-6.5%	2,298.18
Gross Loan Portfolio (AFN, million)	8,986.70	-24.8%	6,760.40	-23.9%	5,145.47
PAR>30 days	36.5%	-820 bps	28.3%	470 bps	33.0%
Average Loan Size (AFN)	29,299	90.6%	55,849	-1.4%	55,065
Gross Loan Portfolio Per Loan Officer (AFN, thousand)	7,780.70	-3.2%	7,528.30	-10.3%	6,752.59
Number of Borrowers Per Loan Officer	266	-49.2%	135	-8.9%	123
Number of Clients Per MF Staff	241	-29.5%	170	8.8%	185
Operationally Self-Sustainable Institutions	0	0.0%	0	0.0%	0
Number of Microfinance Providers	7	0.0%	7	-14.3%	6

Source: Afghanistan Microfinance Association, Microview 34, 35 and 36, https://ama.org.af/archives/101

[111] AFN/USD exchange rates have been fluctuating in the range of min 0.089 to max 0.013 since the 15 August 2021. As of 31 March 2022, the AFN/USD exchange rate is 0.011.

The deterioration in the key indicators of the Afghanistan microfinance sector continued in the first quarter of 2022. The number of clients (-4.9 percent), the number of active borrowers (-22.8 percent), and the gross loan portfolio (-23.9 percent) decreased significantly compared to the previous quarter, Q4-2021. Additionally, the PAR>30 days ratio increased to 33.0 percent as of Q1-2022 from 28.3 percent in Q4-2021. Similar to the previous quarter's figure, as expected, there was not any operationally self-sustainable MFI. FINCA became the second MFI in Afghanistan, which suspended operations after the regime change, and the total number of MFIs decreased to six as of Q1-2022.

a) Trends in Credit Risk Indicators

> "Due to all the current challenges even collecting principle is difficult. It is not that they do not want to pay, they don't have any money. We are visiting and they say, 'We don't have money; if you want to sell my home or other things, you can sell it, but I have nothing to give you'. Emarat says you can collect the principal, but it is still difficult. It is not about that they are unwilling to pay, basically, they don't have money. This is the issue. Otherwise, they will pay."
> (Interviewee)

Regarding the microfinance sector, as depicted in Figure 12, Portfolio at Risks > 30 days grew exponentially from 7.1 percent as of Q2-2021, before the regime change, to 36.5 percent at Q3-2021, then slightly fell to 28.3 percent as of Q4-2021. However, it again increased to 33.0 percent in Q1-2022. Figure 13 shows high variations of non-performing loans across regions ranging from 100 percent in Helmand to 2.4 percent in Nangarhar. Especially in some regions, PAR levels were still very high, threatening the sector's sustainability. For example, in Helmand, Kandahar and Kunarha provinces, PAR rates were 100 percent, 99.9 percent and 98.7 percent, respectively. If such a level of non-performing loans continues in the next quarters, the sustainability of the microfinance industry in Afghanistan will be at stake.

The main reason behind the significant increase in the PAR ratio of the sector was that the borrowers had lost their repayment capacities due to the disruption in the economy. Before the regime change, some of the MFIs have been disbursing loans to government employees, the majority of whom have lost their jobs and become unemployed. These people do not have sufficient income to repay their loans. Moreover, the borrowers dealing with non-basic economic activities who were one of the main target segments of the MFIs, have faced challenges in generating income as the priorities in the society have shifted to basic needs. In addition to these problems, drought in the agriculture sector, limitation in the travel of the businessmen dealing with export-import, evacuation of some MFIs clients and other issues have led to the substantial deterioration in the loan portfolio of the MFIs.

Figure 13: Microfinance Sector PAR> 30

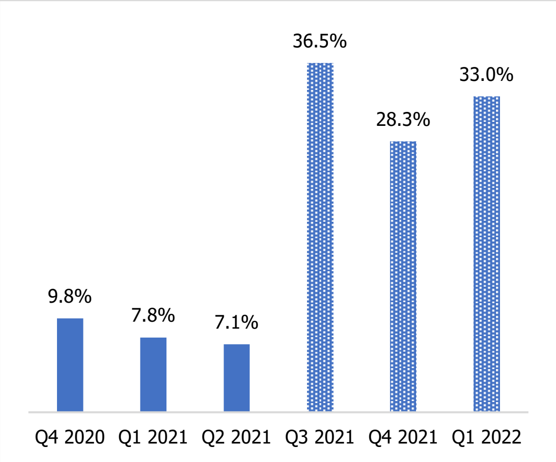
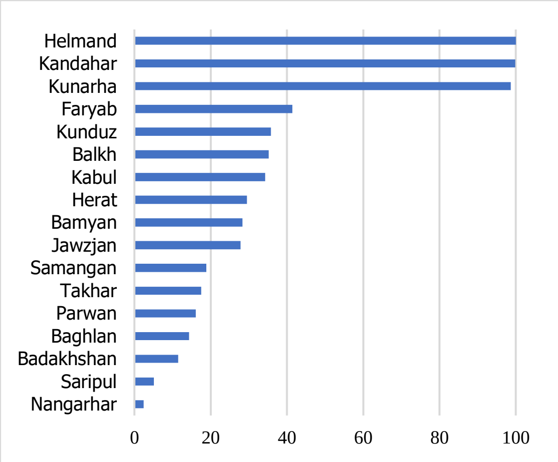


Figure 12: PAR> 30 Across Regions (Q1-2022, %)



Source: Afghanistan Microfinance Association, Microview 34, 35 and 36, https://ama.org.af/archives/101

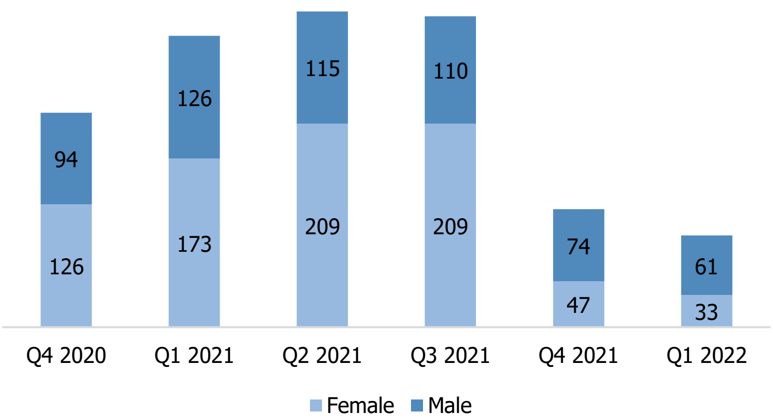
Some of the MFIs clients, on the other hand, have taken the opportunity of the regime change to avoid paying the principals of their loans by asserting that they already paid lots of interest on what they borrowed which should cover the principal. However, when the MFI insist on repayment of principal, the borrowers complain to the regime, which in some cases reacted as "For example, your clients paid last two-year, whatever mark-up during the last two year he has paid, you need to consider this as a principle and if you follow another time that will be legal action. In this situation, sometimes loan officers are hesitating to follow up with these customers because of the regime." (Interviewee). Consequently, some borrowers' changed attitude by not paying their principal amount although they have the capacity has also worsened the financial state of the MFIs.

b) Trends in Borrowers Indicators

> "The other issue from a client perspective is that MFIs are not disbursing any loan which means they are not able to finance any economic activity in the country. December 2020, MFIs were serving a million customers directly out of which 32-39 percent was women. So, indirectly millions of people were involved with these MFIs' clients. Now they are unable to have access to financing." (Interviewee)

As can be seen in Figure 14, with the regime change, the total number of active borrowers drastically decreased from 306,728 as of Q3-2021 to 121,049 as of Q4-2021. This is mainly due to the WEERDP's suspension of its operations after the regime change, which has 171,981 active borrowers, 85 percent of whom were women. Accordingly, the number of women borrowers sharply decreased from 209,019 as of Q3 2021 to 46,680 at the year-end of 2021. While the share of women borrowers was 66 percent by Q2-2021, the share recorded 39 percent in Q4-2021. The decreasing trend continued in the first quarter of 2022. This is one of the most notable negative impacts of the regime change on women enterprises, who have already been the most suffered stakeholders in the country for decades. In addition to such an adverse impact in the sector in terms of the number of active borrowers, OXUS has been the only MFI continued loan disbursement thanks to a newly developed zero-interest loan. They have disbursed 20 million AFN to 400 entrepreneurs after the regime change with an average loan of 40,000 AFN based on the zero-interest loan since the first week of December 2021 (Interviewee).

Figure 14: Number of Microfinance Active Borrowers by Gender (thousand)



Source: Afghanistan Microfinance Association, Microview 34, 35 and 36, https://ama.org.af/archives/101

The regime change on 15 August 2021 has also impacted the lending methodology of the microfinance finance sector. Specifically, the individual lending scheme compared to group lending number of active borrowers remained more stable (Figure 15). Unlike individual lending, group lending refers to a lending mechanism that allows a group of individuals - often called a solidarity group to provide collateral or loan guarantees through a group repayment pledge. The incentive to repay the loan is based on peer pressure. If one group member defaults, the other members make up the payment amount. In addition, Figure 16 shows that the proportion of borrowers by sector has been distorted by the consequences of the 15 August 2021 events as well. Especially agriculture and livestock sectors which are the backbones of Afghanistan's economy along with trade, have been heavily affected.

Figure 16: Number of Active Borrowers

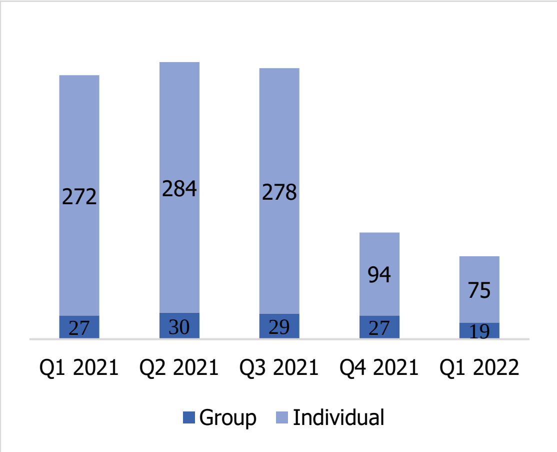
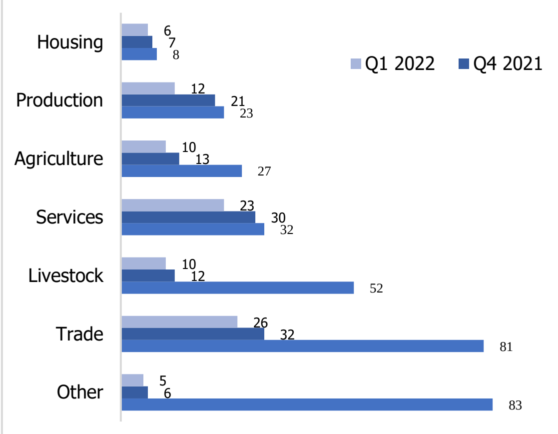


Figure 15: Number of Active borrowers by sector (thousand)



Source: Afghanistan Microfinance Association, Microview 34, 35 and 36, https://ama.org.af/archives/101

c) Trends in Micro-savings Indicators

As indicated in Table 12, the adverse impact of regime change is also visible in micro-savings, which declined by 23.37 percent during Q4-2021 compared to Q3-2021. The same pattern was observed for the number of active savers (-72 percent), whereas women clients have been mostly affected with 89 percent decline. It is also noted that while the amount of savings had a decreasing trend for both genders, the average saving size increased for men and women. The figures regarding micro-savings showed slight improvements in the first quarter of 2022.

Table 12: Micro-saving Indicators in Afghanistan Microfinance Sector

		Male	Female	Urban	Rural	Total
Number of active savers	Q1-2022	142,339	55,205	114,950	82,594	197,544
	Q4-2021	141,253	55,086	138,352	57,987	196,339
	Q3-2021	235,822	484,098	123,658	596,262	719,920
Amount of savings (million, AFN)	Q1-2022	1,783	515	1,609	689	2,298
	Q4-2021	1,887	570	2,280	177	2,457
	Q3-2021	2,301	905	2,582	624	3,207
Average savings size (AFN)	Q1-2022	12,527	9,331	13,999	8,342	11,634
	Q4-2021	13,359	10,351	16,482	3,052	12,515
	Q3-2021	9,759	1,870	20,883	1,047	4,454

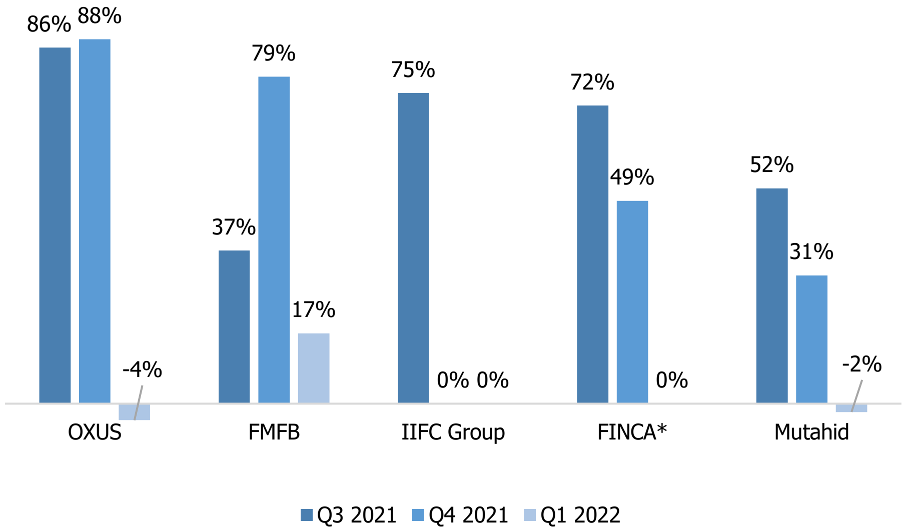
Source: Afghanistan Microfinance Association, Microview 34, 35 and 36, https://ama.org.af/archives/101

d) Sustainability Indicators

Operational Self Sufficiency (OSS), expressed in percentage terms, indicates whether an MFI is earning sufficient revenue (through interest, fees and commission income) to cover its total costs, including financial costs, operational costs and loan loss provisions. Figure 17 indicates a clear deterioration of

OSS for five MFIs in Q1-2022, mainly as a result of growing non-performing loans and termination of the loan disbursement by the new regime. Only FMFB-A had positive OSS with 17 as of Q1-2022.

Figure 17: Operational Self-Sufficiency (Quarterly Comparison)



Source: Afghanistan Microfinance Association, Microview 34, 35 and 36, https://ama.org.af/archives/101
Notes: * FINCA terminated its operations in Afghanistan as of March 2022.

e) Major Challenges for Microfinance Sector after the Regime Change

The adverse impacts of the political power change on 15 August can be easily seen in the financial figures of each MFI as well as consolidated data of the microfinance sector. The majority of the challenges that have caused the deterioration in the sector are external to the MFIs which however directly or indirectly affect MFIs, as the adverse impact of political, economic and social upheaval is highly substantial. Indeed, intrinsic weaknesses of the sector and some MFIs have also worsened the current state. By considering all the external and internal factors and the view of the relevant stakeholders of the microfinance sector, the major challenges can be listed as follows:

- *International sanctions of the government* have increased uncertainties and hampered the efforts for re-functioning the microfinance sector.
- *Lack of liquidity or equity* is one of the main challenges for MFIs as they cannot generate income due to the halting of the new loan disbursement and difficulties in collecting principal amounts. Moreover, the problem has been worsened by international sanctions, which block capital injections from international donors or shareholders of the MFIs.
- *Due to Regime change, fiscal problems led to a decrease in business activities, a rise in unemployment rates and reduced consumer spending power, eventually borrower's ability to repay their loans which strained credit risk of MFIs, in addition to that Redundancy of employees could result in Job losses, income insecurity and reduced purchasing power for those affected and could have direct impact on those who receive Government salaries to repay their loans,unable to repay their loans,would eventually lead to deterioration of loan portfolio quality* of MFIs, followed by the sustainability of the organisations.
- *The mere focus of aid agencies and international organisations on humanitarian activities* provides short-term solutions to people's basic human needs rather than supporting institutionalisation in the economy and development. However, support for MFIs as an example of institutionalisation has contributed to people sustaining their lives with economic activities

rather than being donor-dependent. Hence, long-term and sustained development requires institutional development, thereby contributing to Afghanistan's micro and macro-level development. Beyond sustaining a rentier economy, international agencies must have and should essentialise institutional development efforts.

- *The dysfunctional banking sector* has caused MFIs and their clients to reach available funding sources since the authorities have restricted the maximum withdrawal amount. The restrictions have also negatively affected the repayment performances of microfinance clients who cannot transfer money due to the limits.
- *The recent drought* has caused a decline in agricultural products and the economic capacities of the farmers, who are one of the main target segments of MFIs.
- *Uncertainties* in governing bodies and other functions of the state have prolonged the approval processes and issuance of proper guidance, especially in terms of MFIs' newly submitted *Shari'ah*-compliant products or conversion processes, without which they could not function again.
- *The mandate to shift from conventional to Islamic microfinance* has imposed additional costs on already struggling MFIs, which must cover operational expenses.
- *Declining demand in non-basic needs production sectors* such as tailoring, construction materials, garments, etc., has significantly decreased the income level of those borrowers, leading to higher Portfolio-At-Risk (PAR) ratios for MFIs. *The decline in property values* has negatively affected the risk mitigation policies and tools of the MFIs as the deeds of the properties given to MFIs by borrowers as collateral to guarantee the loans.

5. Islamic Microfinance: Proposing an Alternative Offering for Afghanistan

5.1 A Survey of Islamic Microfinance Models

5.1.1. Overview of the Global Islamic Microfinance Sector

Despite progress in achieving Sustainable Development Goals (SDGs), poverty remains one of the crucial challenges in Muslim-majority nations, where 22.3 percent of the population lives below the international poverty line.[112] Among other strategies, Islamic microfinance is considered an effective tool for combating poverty and contributing to financial inclusion for Muslims, as several survey results demonstrate that up to 40 percent of potential microfinance clients reject non-*Shari'ah*-compliant financial instruments,[113] which is an indication of the potential role of Islamic microfinance for poverty alleviation.

There is significant literature emerging about the alignment of sustainable development and Islamic finance. Several successful impact finance initiatives have also been available, especially in Southeast Asia – notably Baitul Maal Wat Tamwil (BMT), the largest and most prominent Islamic microfinance model in Indonesia.[114] Nevertheless, the market has not yet seen the potential of the Islamic microfinance industry for driving socio-economic outcomes at scale. This is mainly because Islamic microfinance is a relatively new industry with untapped potential. Moreover, although academic research on Islamic microfinance is bourgeoning, it has yet to reach the critical level of conventional microfinance studies.

In addition, Islamic microfinance proved effective in addressing financial challenges during the COVID-19 pandemic, especially for MSMEs, as reported in a COMCEC report.[115] Islamic MFIs ranked second most effective tool after Islamic banks but ranked better than *zakat* funds, Islamic fintech institutions, *waqf*, *takaful* companies, etc., supporting businesses during the crisis. BAZNAS Microfinance in Indonesia provided support to MSMEs by offering payment delays (Moratorium)for 3,933 recipients, mainly in the trade, production, and home industry sectors.[116]

For more than two decades, Islamic MFIs have operated in different countries under various institutional structures. Many of these institutions have local, small-scale operations; therefore, it is difficult to quantify the number of Islamic MFIs and their outreach.

An exact count is challenging due to consolidated data, but around five hundred Islamic MFIs are estimated to be operating in 44 countries.[117] According to a study by the Consultative Group to Assist the Poor (CGAP) covering Islamic MFIs in 19 countries, about 92 percent of microfinance providers were concentrated in East Asia and the Pacific, and the Middle East and North Africa[118].

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[112] SESRIC, *Measurement of Poverty in OIC Member Countries*, 2015, https://sesricdiag.blob.core.windows.net/sesric-site-blob/files/article/502.pdf

[113] Nimrah Karim, Michael Tarazi, and Xavier Reille, *Islamic Microfinance: An Emerging Market Niche*," *International Technical and Economical Co-Operation " Faculty of Business Administration Islamic Microfinance* (Washington, USA, 2008), https://www.cgap.org/sites/default/files/CGAP-Focus-Note-Islamic-Microfinance-An-Emerging-Market-Niche-Aug-2008.pdf.

[114] Bridget Kustin, I*slamic (Micro) Finance: Culture, Context, Promise, Challenges*, *Bill & Melinda Gates Foundation*, no. August (2015): 50, https://docs.gatesfoundation.org/Documents/Islamic (Micro) Finance Culture, Context, Promise, Challenges.pdf%0Awww.gatesfoundation.org.

[115] COMCEC, *The Role of Islamic Finance in Supporting Microenterprises and SMEs Against COVID-19*, October 2021, http://ebook.comcec.org/Kutuphane/Icerik/ac185b1d-28f8-4188-b6a7-377ed54bd382.pdf

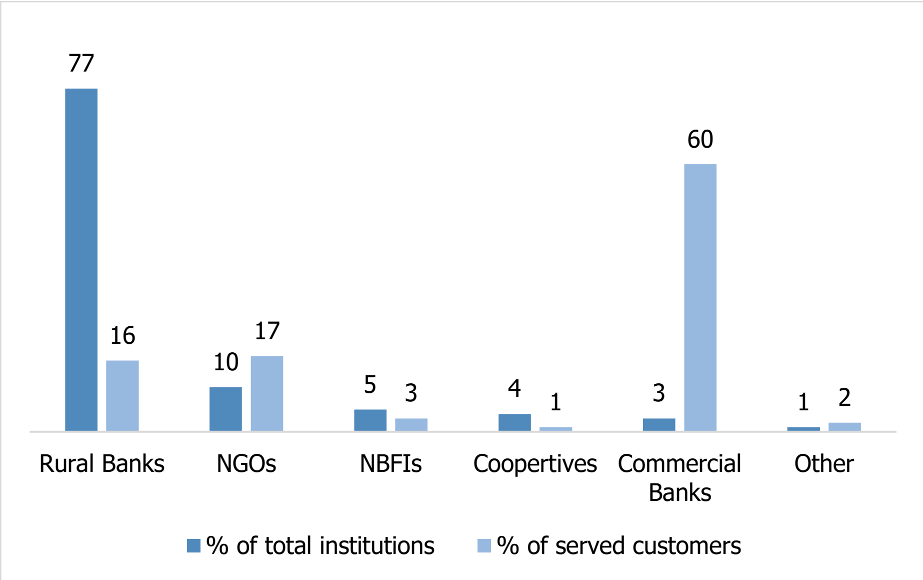
[116] Ibid.

[117] Muhammad Zubair Mughal, *Funding Sources for Islamic Microfinance Institutions*, 2020. http://www.alhudatoday.com/funding-sources-for-islamic-microfinance-institutions/

[118] Mayada El-Zoghbi, *Trends in Sharia-Compliant Financial Inclusion*, Focus Note 84 (Washington, USA: CGAP, 2013).

Islamic MFIs operate in different institutional forms, mainly varied according to each country's regulative environment or common practices, such as rural banks, non-banking financial institutions (NBFIs), NGOs, etc. Most of the Islamic MFIs (in terms of absolute numbers) are rural banks, mostly prevalent in Indonesia (Figure 18). Commercial banks with a microfinance focus have the largest Islamic microfinance products and service providers, constitutiong 3 percent of the total Islamic MFIs globally, but serving 60 percent of the customers base. Therefore, it is noted that if the microfinance offerings are made through commercial banks, they can reach a significant number of people. Although it is not updated data, the trend in Figure 18 is in line with the FMFB-A's leading role in the Afghanistan microfinance sector.

Figure 18: Share of the Islamic Microfinance Institutional Types in Total Number of Institutions and Served Customers (%)



Source: Mayada El-Zoghbi, "Trends in *Shari'ah* -Compliant Financial Inclusion," Focus Note 84 (Washington, USA: CGAP, 2013)

On the demand side, as of 2011, Islamic MFIs served roughly 1.28 million customers in 19 countries.[119] The majority of these (nearly 82 percent) resided in Bangladesh, Sudan and Indonesia. Indonesia came first with $347 million, followed by Lebanon ($132 million) and Bangladesh $92 million) in terms of the outstanding portfolio.[120]

Regarding the Islamic mode of financing, Islamic MFIs have served microenterprises by offering a wide range of products such as *murabahah*, *qard al hasan*, *musharakah* and *mudarabah*. *murabahah* is the most common method used by Islamic MFIs, followed by *qard al hasan*.[121]

5.1.2. Case Studies for the Proposed Islamic Microfinance Model

As detailed previously, Islamic MFIs have provided various financial and non-financial services to low-income people in different institutional settings. The experience of some of these institutions may offer critical lessons to the microfinance sector in Afghanistan, particularly after converting their operations from conventional to *Shari'ah*-compliant offerings. The study focuses on five Islamic MFIs located in Bangladesh, Pakistan, Indonesia, Malaysia and Tunisia. These institutions hold key lessons applicable

[119] Ibid.
[120] Ibid.
[121] Ibid.

to the proposed Islamic microfinance model for Afghanistan, as Table 13 provides an overview of these these Islamic MFIs and their relevance to the proposed model, offerig insights into their operational practices and achievements.

Table 13: Selected Islamic MFIs from Different Countries

Name	Country	Type	Key Beneficiaries	Relevance
Islami Bank Bangladesh Limited (IBBL)	Bangladesh	Commercial Islamic Bank	FMFB-A and other banks	Having specific rural development Islamic microfinance programme within its organisation, along with commercial banking services
Akhuwat	Pakistan	NGO	All MFIs, especially for the first phase of the transition of the microfinance sector	Operating fully *qard al hasan* based structure and its geographical and cultural closeness to Afghanistan
Baitul Maal Wat Tamwil (BMT)	Indonesia	Financial Cooperative	All microfinance sectors, particularly cooperatives	Their prevalence across Indonesia, including rural areas and integrating financing and charity-based support in the business model
Amanah Ikhtiar Malaysia	Malaysia	NGO	All microfinance sector	Providing a wide range of services, including financial education, entrepreneurship training, value chain support and social services
Zitouna Tamkeen	Tunisia	Company	All microfinance sectors and particularly their agriculture businesses	Developing value chains for microenterprises

a) Islamic Bank Bangladesh Limited (IIBL)

Bangladesh known for pioneering microfinance through initiatives like the Grameen Microfinance programme, hosts many institutions offering microfinance services, both conventional and Islamic, [122] The programme has been serving the rural population, which mainly focuses on agricultural production, since its inception in 1995. The RDS aims to meet the financial needs of the agriculture and rural sector to create new employment and raise rural people's income levels, with a vision to eradicate poverty in the country. What sets the RDS apart is its integrated approach. Beyond offering Islamic microfinance services to the poor people living engaged in income-generating activities in rural areas, the RDS provides non-financial support. This support includes capacity building training, humanitarian aid, and initiatives related to health and environmental protection, all aimed at empowering[123][124]

The RDS was first implemented in one of the IBBL's branches as a pilot study and later expanded to all branches. The programme applies different financing upper limits and durations for each economic

[122] https://islamibankbd.com/rds/introduction.php

[124] https://islamibankbd.com/rds/development_approach.php

activity by considering the needs of the businesses. For instance, the crop production limit is 25,000 BDT ($280) for a 1-year duration, whereas the fisheries' limit is 50,000 BDT ($560) for 1 to 2 years. The sectors are generally related to agriculture and animal husbandry.[125]

Group-based lending is a hallmark of the RDS, where each member in the group vouches for one another and collectively monitors the repayment performance of the group. The programme uses two types of Islamic offerings: *bai-muajjal*[126] (similar to *murabahah*) and *musharakah*. The choice between any of them depends on the sector and purpose of investment.[127] The rate of return is determined by the authority for *bai-muajjal* and currently is 12.5 percent, with a a 2.5 percent rebate is offered to the clients who make repayments timely.[128] However, in *musharakah* financing, having a profit-loss sharing nature, the profit or loss is determined after finalising the project.

The RDS also has compulsory micro-savings programmes where each group member must open a Mudaraba Savings Account (MSA-RDS) in the bank and deposit small savings, a minimum of 20.00 BDT weekly basis.[129] The main aim of micro-saving is to ensure that low-income people develop saving culture. In addition to savings accounts, each member must deposit 5 TK per week to the Central Fund, which is kept in a different *mudarabah* savings account in the name of the respective centre. The savings in the fund are operated jointly by Centre Leader and Deputy Centre Leader and utilised for the welfare of the members in the respective centre through *qard al hasan* financing following the decision of the centre in the weekly meeting.[130]

Photo Credit: Aref Karimi/AFP/Getty Images

[125] https://islamibankbd.com/rds/ceiling_of_investment.php
[126] Unlike *murabahah*, under the *bai-muajjal* contract, it is not required to the bank for disclosing the cost price and mark-up separately to the client (https://www.islamibankbd.com/prodServices/prodServBaimuajjal.php).
[127] https://islamibankbd.com/rds/modes_of_investment.php
[128] https://islamibankbd.com/rds/rate_of_return.php
[129] https://islamibankbd.com/rds/saving_plan.php
[130] https://islamibankbd.com/rds/center_fund.php

Table 14: Performance of Rural Development Scheme (as of 28 February 2022)

Indicators	Total
No. of Branches (includes RDS)	319
No. of Villages	29,111
No. of Districts	64
No. of Centres	37,022
No. of Groups	228,931
No. of Members (existing)	1,488,430
Percentage of Women Members	92%
No. of Clients (who availed investment, million BDT)	799,269
Cumulative disbursement (since inception, million BDT)	384,343
Present disbursement outstanding (million BDT)	45,539
Percentage of Recovery	98.31%
Balance of Members' Savings, including Centre Fund (million BDT)	14,129.79
No. of Field Officers	2,385

Source: https://www.islamibankbd.com/rds/performance.php, Note: 1 Bangladeshi Taka equals $0,012 as of 31 March 2022.

As depicted in Table 14, IBBL operates the activities of RDS in 319 branches, 29,111 villages (the country has 87,000 villages), and all 64 districts of the country as of 28 February 2022. The programme has 1,488,430 existing members, 92 percent of whom are women. In addition, 799,269 clients have already received financing from the programme, and cumulative disbursement reached 384,343 million BDT (around $4.5 billion) on 28 February 2022. The current outstanding disbursement is 45,539 million BDT, and the programme has a 98.31 percent recovery, meaning that only 1.69 percent of the financing has defaulted.

In sum, the IBBL's microfinance programme, RDS, for supporting low-income people, particularly women entrepreneurs, has successfully operated in many parts of Bangladesh since 1995. This programme demonstrates that microfinance can be effectively integrated within the Islamic bank and reach more than a million people.

One of the key lessons from the RDS programme for the Afghanistan microfinance sector and the proposed model is that commercial banks can sustainably provide microfinance services through a tailored programme using Islamic financing offerings. Hence, as previously mentioned, banks can reach more people compared to other non-banking institutions since they have different sources of funds, operational and staff capacities, as well as a *Shari'ah* supervisory committee[131] for approval of the

[131] https://www.islamibankbd.com/abtIBBL/abtIBBLSc.php

products. The FMFB-A is the only microfinance specialised commercial bank in Afghanistan, and other banks in the country can benefit from IBBL's best practices to introduce new Islamic finance offerings (especially *musharakah*), micro-savings products (compulsory savings and contribution to central fund), and charity-based instruments (*qard al hasan* from central fund to needy group members).

b) Akhuwat

Akhuwat was founded in 2001 in Pakistan to provide interest-free microfinance services to low-income families to help them become economically independent. The organisation derives its name from the Arabic word 'Akhuwat' means 'brotherhood' and was chosen to represent the organisation's vision – namely, "to alleviate poverty by empowering socially and economically marginalised families through interest-free microfinance and by harnessing entrepreneurial potential, capacity building and social guidance". [132] Over the year, the institution has expanded its programmes from Islamic microfinance to five major development programmes: Akhuwat Islamic Microfinance, Akhuwat Education Services, Akhuwat Clothes Bank, Akhuwat Khwajasira Support Programme, and Akhuwat Health Services. The underlying goal of all these programmes is to provide financial access and support to the poor.[133] Akhuwat operates as a registered society (a not-for-profit organisation) under the Societies Registration Act, of 1860, [134] and offers Islamic microfinance services through its entity, Akhuwat Islamic Microfinance (AIM) company. Akhuwat is the Islamic microfinance market leader in Pakistan and defines itself as the "World's largest interest-free microfinance organisation which envisions a poverty-free society built on the principles of compassion". [135]

Akhuwat adopts five pillars to reach its targets: (i) interest-free microloan, (ii) use of religious places, (iii) volunteerism, (iv) transforming borrowers into donors, (v) diversity and inclusion.[136] Since its inception in 2001, Akhuwat adopted *qard al hasan*-based financing - called the interest-free microloan in the pillars - in all microfinancing operations, and it is seen as the core strategy for microfinance.[137] Currently, Akhuwat offers eight financing products based on *qard al hasan*; the Family Enterprise Loan constitutes 85-90 per cent of all loan products. Agriculture Loan follows it with 5-10, and the rest consists of Liberation Loan, Housing Loan, Education Loan, Health Loan, Marriage Loan and Emergency Loan. Each product has a specific characteristic and serves the different needs of the target segment. For instance, while the Family Enterprise Loan is between Rs.10,000 [$54][138] to Rs.50,000 [$270] with a 10 – 36 months duration, the maximum amount for Liberation Loan, which "is given to the person who has taken loans from the exploitative money lenders to save them from undue interest rates", can be Rs.100,000 [$540] with 10-36 months duration.[139] Akhuwat only charges up to Rs 200 initial application fees to the client, which is utilised for the operational costs of the institution in all financing types except Agriculture Loans. Akhuwat follows both individual and group-based financing methods in the loan disbursement process. Instead of physical collateral, the institution focuses on the social collateral of the borrower, meaning whether the person is trustworthy and has good social and moral character in his community. Group members guarantee each other in group loans, whereas two guarantors out of the applicant's family who accept the responsibility of monitoring the borrower and ensure to persuade the borrower for timely repayment are asked in individual lending.[140]

As an interest-free institution, Akhuwat relies on charity and donations for its lending base and to cover operational expenses. The "transforming borrowers into donors" pillar, which is one of the distinct

[132] https://akhuwat.org.pk/about/
[133] Bilal Hussain, *How Akhuwat Impacts Lives through the Miracle of Interest-Free Microfinance*, *PT Profit*, 2018, https://profit.pakistantoday.com.pk/2018/05/13/how-akhuwat-impacts-lives-through-the-miracle-of-interest-free-microfinance/.
[134] Akhuwat Balance Sheet, June, 2021, https://akhuwat.org.pk/wp-content/uploads/2022/01/AKT-2021.pdf
[135] https://www.akhuwat.org/who-we-are
[136] https://akhuwat.org.pk/about/
[137] Ibid.
[138] Reference exchange rate for PKR to USD is 0,0054, as of 1 April 2022.
[139] https://akhuwat.org.pk/loan-products-offered/
[140] https://akhuwat.org.pk/loan-process/

features of Akhuwat, helps it diversify its sources of funds. Around 60 percent of the expenses are covered by donations from borrowers who donate voluntarily to support the programme. With the momentum that the donations have, the organisation believes that the donations will be able to cover the operational costs in a few years fully.[141] Moreover, Akhuwat receives international and local support, which facilitates the expansion of its operations. For instance, the institution experienced rapid growth after a credit injection from a provincial government in 2010, resulting in a sevenfold increase in its loan portfolio.[142] In addition, to be sustainable under the *qard al hasan* model, without any mark-up on financing, Akhuwat keeps its operational expenses low, at around 10 percent of the disbursed amount, by operating in mosques and churches instead of offices, which constitutes another distinct feature and pillar of the institution. Consequently, all these factors have contributed to the sustainability of Akhuwat operating this business model for more than two decades.

Regarding the corporate governance of the Akhuwat, a highly complex management structure has been developed to manage all the activities along with Islamic microfinance effectively. It is also noted that there is no particular management unit related to *Shari'ah* governance in the organisation, which is probably due to only providing *qard al hasan* financing, having a comparatively more straightforward structure than other Islamic financing methods. However, Akhuwat has a *zakat* officer unit in the structure,[143] highlighting its utilization of *zakat* for community empowerment activities, particularly educational programmes.[144]

Table 15: Progress Report till March 2022

Progress Indicator	**Total**
Total Benefiting Families	5,240,968
Total number of loans disbursed – Males	3,018,831
Total number of loans disbursed – Females	2,222,137
Amount Disbursed PKR	164,837,755,026
Percentage Recovery	99.96%
Active Loans	714,866
Outstanding Loan Portfolio PKR	25,694,379,902
Number of Branches	858

Source: https://akhuwat.org.pk/akhuwat-progress-report/

As summarised in Table 15, as of March 2022, Akhuwat has 858 branches in over 350 cities[145]. While Akhuwat's total disbursement has reached PKR 165 Billion [$884 million] since its inception, the outstanding loan portfolio is recorded as PKR 25,7 billion [$138 million]. The institution emphasises 'families' in products and also reporting, which is one of the distinct features of Islamic microfinance

[141] Muhammad Amjad Saqib, *A Discussion with Dr. Amjad Saqib, Executive Director, Akhuwat*, Berkley Center for Religion, Peace and World Affairs, 2010, https://berkleycenter.georgetown.edu/interviews/a-discussion-with-dr-amjad-saqib-executive-director-akhuwat.
[142] Mohsin Bashir, Ashar Saleem, and Ferhana Ahmed, *Akhuwat: Measuring Success for a Non-Profit Organization*, Asian Journal of Management Cases 16, no. 1 (2019): 100–112, https://doi.org/10.1177/0972820119825973.
[143] https://akhuwat.org.pk/organizational-structure/
[144] Akhuwat Balance Sheet, June, 2021, https://akhuwat.org.pk/wp-content/uploads/2022/01/AKT-2021.pdf
[145] https://akhuwat.org.pk/year-wise-progress-report/

from conventional. In addition, Akhuwat has served more than 5.2 million underprivileged families for two decades, and females constitute 2,222,137 of them (42.4 percent). Its recovery rate is almost a hundred per cent (99.96 percent).

Consequently, key lessons from Akhuwat for the Afghanistan microfinance sector and the proposed model can be summarised as follows: (i) it operates entirely *qard al hasan* based microfinancing, while initial application fees and philanthropic donations cover its operating costs instead of any mark-up from the loans, (ii) improving the operational efficiency of the institution by lowering the cost of funding and operational expenses through benefitting from religious places in training and disbursing the financing, (iii) adopting a holistic approach that goes beyond solely providing financings for transitioning beneficiaries from being reliant on others to be self-sufficient.

c) Baitul Maal Wat Tamwil (BMT)

Baitul Maal Wat Tamwil (BMT) is Indonesia's oldest and most prominent Islamic MFI,[146] established in 1980. In 1996 there were still only eight BMT units. However, their presence grew to 53 in 1998 and 3,307 in 2010. As of 2014, there were 5,000 BMT units throughout the country with assets of IDR 4.7 trillion ($326 million) and more than three million customers.[147]

The Small Business Incubation Center of Indonesia (PINBUK) defines BMT as a pivotal supporting institution dedicated to to improve the quality of the economic business of micro-entrepreneurs based on *Shari'ah* and cooperative principles.[148] Conceptually, BMT has two functions – namely, (i) Baitul Maal or 'treasure house', with social functions as a collector and distributor of charity funds, and (ii) Baitul Tamwil or 'property development house' as a manager of charity funds to improve the economies of profit-oriented micro and SME businesses.[149]

Consequently, the primary key lessons of BMT for the Afghanistan microfinance sector are: (a) providing services to the poorest people, (b) establishing sustainable microfinance operations that are not reliant on donations to function effectively. This sustainability is a key takeaway for the Afghanistan microfinance sector., (c) increasing the accountability of institutions reported as *zakat* and other Islamic charity and as Islamic MFIs, (d) BMT has effectively managed the inherent risks in microfinance, resulting in a low failure rate and reduced levels of bad debts. This ability to maintain a robust and resilient microfinance system is a valuable lesson for the sector. Furthermore, This approach not only fosters motivation among impoverished individuals but also resonates well within society. It has enabled BMT to achieve profitability while positively impacting the lives of those it serves. a spiritual approach that not only fosters motivation among impoverished individuals, but also resonates well within society. I has enabled BMT to achieve profitability while positively impacting the lives of those it serves .[76]

d) Amanah Ikhtiar Malaysia

Amanah Ikhtiar Malaysia (AIM), an Islamic MFI, established in 1987 and is currently Malaysia's largest microfinance provider.[150] AIM aims to reduce poverty in Malaysia by providing interest-free microcredit facilities to poor and low-income households to finance income-generating activities. In 2014, AIM served 347,907 active clients through 135 branches nationwide. In the same year, AIM had cumulatively disbursed more than MYR 11.3 billion ($2.77 billion) in financing to its clients compared to MYR 891,488 ($218,823) in 1990. In addition, a nationwide survey involving 269,470 of AIM's clients revealed that

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[146] *Priyonggo Suseno, Baitul Maal Wat Tamwil (BMT): A Faith and Community-Based Microfinance Islamic Business Cases Series* (Yogyakarta: Universitas Islam Indonesia, 2020).
[147] H. Hasbi and M. Moeljadi, B*aitul Maal Wat Taamwil: The Strategy of Performance Improvement in Indonesia*, *International Journal of Economics and Financial Issues* 10, no. 2 (2020): 61–71, https://doi.org/https://doi.org/10.32479/ijefi.9179.
[148] Milla Himmatuz Zahra and Provita Wijayanti, A*ntecedent Financial Performance of Baitul Mal Wat Tamwil (BMT): Study in BMT Binama Semarang, Journal of Islamic Accounting and Finance Research* 1, no. 1 (2019): 47–78, https://doi.org/10.21580/jiafr.2019.1.1.3729.
[149] Ibid.
[150] *Norhaziah Binti Nawai and Mohamed Sharif Bashir, Evaluation of Micro Credit Programme for Poverty Alleviation: A Case of Amanah Ikhtiar Malaysia (AIM)*, in *USIM Lecturer's Conference Papers*, 2006, 1–10.

94.7 percent of the respondents had been successfully lifted out of poverty and that 30 percent of these were earning monthly incomes of more than MYR 3,500. In 2010, AIM also reported a 99.2 percent repayment rate.[151]

AIM receives financial support for its operations from the Islamic Economic Development Foundation (YPEIM), the Asian-Pacific Development Centre (APDC), the Selangor State Government, the Credit Guarantee Corporation and the Islamic Bank of Malaysia.[152]

Over the three decades of its existence, AIM's business model has progressively focused on creating micro-entrepreneurs among poor and low-income households. AIM adopts a client-centred approach to microfinance by creating an ecosystem conducive to the development of the entrepreneurship capabilities of the clients. In addition to financial products and services, AIM, therefore, provides a wide range of services, including financial education, entrepreneurship training, value chain support and social services. The microfinance ecosystem developed by AIM serves not only to reduce clients' credit risks but also to support them in becoming small- and medium-scale entrepreneurs.[153] These particularities of the AIM provide key lessons for the proposed Islamic microfinance model in Afghanistan.

- A) emphasis on client-centric microfinance, characterized by comprehensive support services, underscores the importance of tailoring offerings to the specific needs and aspirations of impoverished individuals. This approach can be instrumental in fostering entrepreneurship and reducing poverty in Afghanistan. B) success is underpinned by its diverse service portfolio, which extends beyond credit to include financial education, entrepreneurship training, value chain support, and social services. C) holistic microfinance ecosystem, designed to propel clients toward small- and medium-scale entrepreneurship, demonstrates the value of providing a comprehensive support structure to micro-entrepreneurs. D) remarkable success in lifting a significant percentage of clients out of poverty is a testament to the transformative potential of Islamic microfinance. E) financial stability and growth have been bolstered by partnerships with various entities, including government agencies and development organizations. Exploring similar collaborations in Afghanistan can strengthen the sustainability and reach of Islamic microfinance initiatives.

e) Zitouna Tamkeen

Approved by the Tunisian Ministry of Finance in 2016, Zitouna Tamkeen is the first Islamic MFI in the Maghreb region. It currently has 16 branches across Tunisia and serves 65,000 clients.[154] Zitouna Tamkeen aims at promoting the financial and economic inclusion of young people and individuals in social distress. It offers a variety of *Shari'ah*-compliant instruments to finance and provide technical assistance to projects with social and economic impacts. It offers four main services:[155]

- **i)** targeting high potential value chains and selecting specific touch-points to reach a large number of beneficiaries through economic empowerment,
- **ii)** providing micro-insurance to beneficiaries via existing *takaful* operators,
- **iii)** providing microfinancing through a wide range of *Shari'ah*-compliant financing products,

[151] Matthew Fox, *MicroCapital*, Microcapital Brief: Malaysian Microfinance Institution (MFI), Amanah Ikhtiar Malaysia (AIM), Claims "World's Highest" Microcredit Repayment Rate of 99.2 Percent, 2010, http://www.microcapital.org/microcapital-brief-malaysian-microfinance-institution-mfi-amanah-ikhtiar-malaysia-aim-claims-worlds-highest-microcredit-repayment-rate-of-99-2-percent/.
[152] *R. Ismail, Economic and Social Impact of Amanah Ikhtiar Malaysia (AIM) Scheme: A Case Study in Kedah and Terengganu*, *Humanomics* 17, no. 1 (2001): 141–55, https://doi.org/10.1108/eb018866.
[153] Cordelia Mason, Raymond Madden, and Wan Nursofiza Wan Azmi, *Aiming for Greater Financial Inclusion through Sustainable Development: The Story of AIM* (Amanah Ikthiar Malaysia)" (Kuala Lumpur, Malaysia, Malaysia, 2018), Asian Institute of Finance.
[154] Guesmi Fadhila, La Micro Finance Islamique En Tunisie : La Réalité et Les Défis, *Revue Internationale Du Chercheur* 1, no. 2 (2020): 661–77.
[155] http://zitounatamkeen.com/ (accessed on 5 March 2021)

iv) capacity building and human capital development through training and development.

Zitouna Tamkeen is sponsored by the IsDB and the Tunisian Zitouna Bank, along with several other nationally and internationally recognised institutions.[156] Regarding the partnership with IsDB, Zitouna Tamkeen is one of the examples of the Economic Empowerment (EE) programme led by IsDB. The EE is an approach that enables economically disadvantaged populations to play an active role in the economic cycle in their communities and lets them realistically aspire for a decent living. This approach considers the multifaceted needs of the poor, which go beyond financial services. Lifting a person out of poverty requires necessarily dealing with at least six obstacles:[157] (a) difficult access to well-designed and profitable project opportunities, (b) lack of intelligent partnerships supporting the economic activities of the poor, (c) insufficient affordable and appropriate supporting infrastructure, (d) lack of access to appropriate funding, (e) lack of capacity and weak self-belief in potential, and (f) difficulty in access to relevant markets.

IsDB EE's approach emphasises business engineering and design. By combining access to finance and access to markets, capacity building, supporting regulatory environment, and supporting infrastructure, this approach endeavours to ensure that the poor are economically included and embedded into the mainstream economy as active participants and contributors to sustainable growth and development. Through IsDB's EE programme, Zitouna Tamkeen carried out more than 16,000 income-generating projects and created more than 40,000 direct and indirect jobs.

Adopting a comprehensive EE approach and its dimensions for supporting micro-enterprises is one of the key lessons from Zitouna Tamkeen for the proposed Islamic microfinance model. Secondly, the synergy between IsDB and the Zitouna Tamkeen provides valuable experiences to the MFIs in Afghanistan for future collaboration areas with international organisations, particularly IsDB.

key lessons learned from Zitouna Tamkeen for Islamic microfinance in Afghanistan:

A) Embrace a comprehensive approach, addressing financial access, capacity building, and market engagement to empower micro-entrepreneurs effectively. B) Explore collaborations with international organizations like IsDB to expand reach and impact, enhancing microfinance initiatives in Afghanistan. C) Prioritize strategies that integrate marginalized populations into the mainstream economy, addressing their multifaceted challenges. D) Focus on creating both direct and indirect employment opportunities through microfinance, contributing to economic growth. E) Facilitate market access for micro-entrepreneurs to scale their businesses and drive sustainable development.

Searching for Alternative Model(s)

In this section, a tailored, comprehensive Islamic microfinance model is elaborated by reflecting the views of the relevant stakeholders. The proposed model is presented in eight components to identify its underlying features in a concise and systematic manner:

- **Key Stakeholders:** Identifying the primary actors involved.
- **Target Segments:** Defining the specific groups this model aims to serve.
- **Sources of Funds:** Outlining where the financing for this model originates.
- **Financing Products:** Describing the range of financial offerings.
- **Risk Mitigation:** Exploring tools and strategies to manage risk.
- **IT Infrastructure and Digitalization:** Emphasizing the role of technology.
- **Shari'ah Governance:** Ensuring adherence to Islamic principles.
- **Reporting, Monitoring, Auditing:** Establishing mechanisms for oversight.

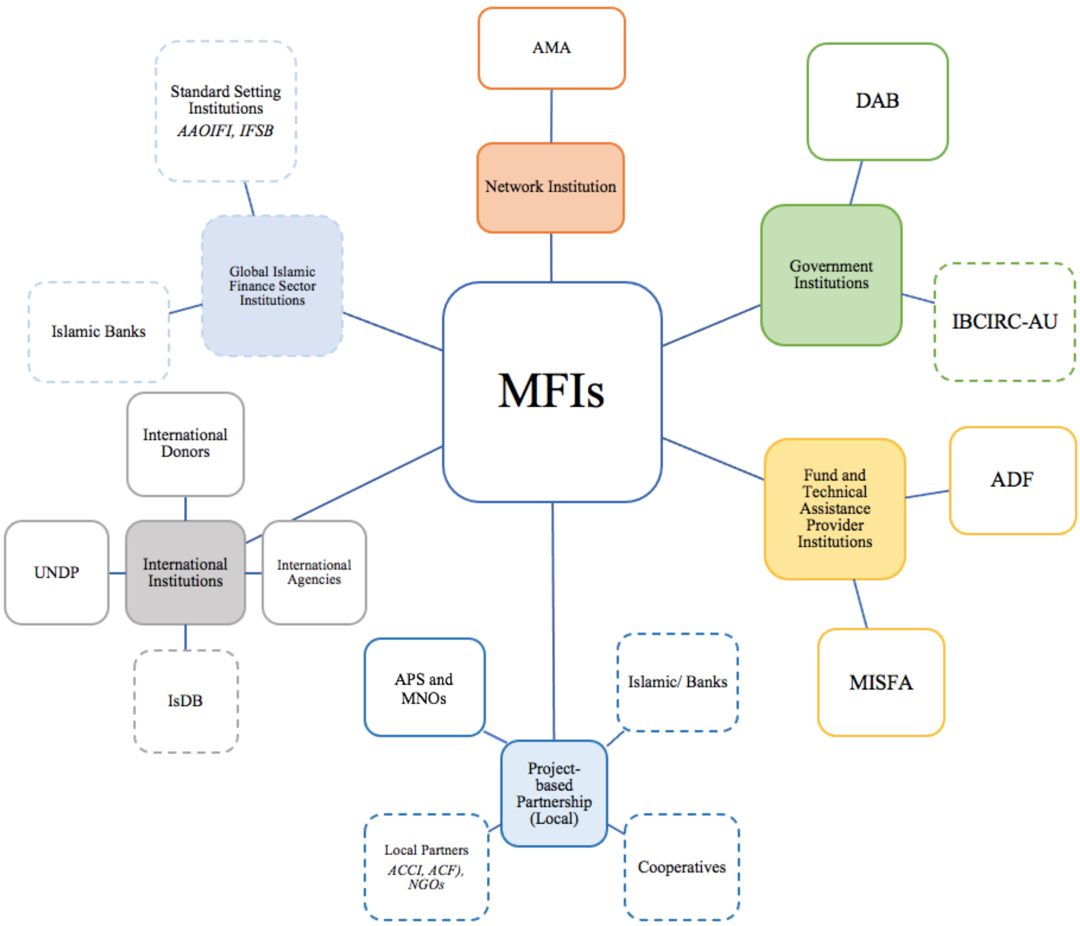
[156] IsDB, "Zitouna Tamkeen: The Innovation in the Service of Employment and Poverty Alleviation (Jeddah, Saudi Arabia, 2018), https://www.isdb.org/news/zitouna-tamkeen-the-innovation-in-the-service-of-employment-and-poverty-alleviation.
[157] IsDB, Economic Empowerment For Financial Institutions: Economic Empowerment Design Toolkit, 2021.

These dimensions are elaborated by synthesizing the best practices of several Islamic MFIs from different countries, the views obtained from the interviews, and the country's political economy. Also, a particular focus is put on fintech-based digital solutions to support the sector. Apart from providing a comprehensive analysis on products and governance possibilities, the model also offers policies for the conversion process from conventional to Islamic and capacity building.

5.2.1. List of Key Stakeholders

MFIs have been operating in Afghanistan for around two decades, and during these years, many stakeholders have been involved in the development and operation of the sector at different levels. Some of these institutions are still the main significant partners for ensuring the sustainability of the MFIs. However, after the regime change on 15 August 2021, the MFIs were imposed to transform into *Shari'ah*-compliant MFIs. The new circumstances and conditioning require collaboration between and support of various existing and new stakeholders. Figure 19 shows the relevant six stakeholder clusters in the proposed model, and their potential contributing areas are discussed.

Figure 19: Possible Stakeholders



Note: Dotted lines show the newly planned partnerships with MFIs. The list of stakeholders is not exhaustive; new partners can be added.

a) The Microfinance Institutions

Currently, six MFIs are operating in Afghanistan: OXUS, IIFC, MUTAHID, AKF, FMFB, and Hand in Hand.[158] Naturally, they are the main stakeholder and players in the microfinance sector. They will continue to provide financial and non-financial services to the microenterprises in a *Shari'ah*-compliant method which is the must condition imposed by the new regime.

b) Network Institutions for MFIs

AMA is the only network organisation for MFIs and is still active, which has several active roles in addition to their current activities. Their main role is to bridge relevant government authorities, including newly-established RCIBCI and MFIs. Secondly, they can be the focal point for organising trainings and other technical assistance to the staff of MFIs, existing and potential clients, and relevant government authorities about Islamic finance in general, particularly in Islamic microfinance, with the support of the international or local institutions.

c) Fund and Technical Assistance Provider Institutions

There are two important organisations under this category: MISFA and ADF. However, the pressing challenge facing MISFA is the need for adequate liquidity in the sector. Currently, securing funding is the sector's most critical challenge. MISFA, being an APEX organisation, has been the main supporter of the microfinance sector of Afghanistan. Its primary role is to channel wholesale funding and establishing new MFIs and AMA. However, the pressing challenge facing MISFA is the need for adequate liquidity in the sector. Currently, securing funding is the sector's most critical challenge. Secondly, MISFA should focus on creating new fund opportunities with international donors to provide the much-needed liquidity to the microfinance sector. However, it should also be noted that under the current international sanctions on the regime, MISFA's position in terms of its link to the current regime should be taken into consideration. Unless either sanctions are lifted or MISFA's independence from the government is ensured, it may be difficult for MISFA to play this crucial role. This should not mean that they will not be communicating with the relevant government bodies, but the reference is the direct control of the government on the institutions through ownership, governance and other strategies and operations. Therefore, the third role of the MISFA is to convince the government authorities of the significance of the sector, which can facilitate their efforts in finding new funding sources for the sector. Lastly, not for the short-term but long-term projections, MISFA can be the issuer body of the micro-sukuk for generating a new alternative source of funds for the microfinance sector in Afghanistan.

The Agriculture Development Fund (ADF),is a key player in the agricultural sector, providing both financial and non-financial support. Currently, 80% of its loan portfolio is Islamic, and 20% is conventional, but ADF is transitioning towards Islamic modes of financing.

ADF's significant role lies in promoting agro-MSMEs, especially in rural areas where cooperatives and MFIs are the primary financial service providers. ADF ensures that MFIs can continue their financing activities in these regions.

Beyond financial support, ADF offers comprehensive training in agribusiness, benefiting microenterprises and MFIs. It aims to stimulate the nation's economy by creating new value chains. Moreover, ADF supports MFIs' agricultural clients with essential inputs like fertilizers and seeds.

Is a key player in the agriculture sector, providing both financial and non-financial support. Currently, 80 of its loan portfolio is Islamic and 20 percent conventional, but ADF is transitioning towards Islamic modes of financing. This will allow ADF to play a more significant role in promoting the agro-MSMEs,

[158] FINCA Afghanistan continued its operation after the regime change; however, according to an update by the interviewee, FINCA Global decided to withdraw from Afghanistan due to the seizure of FINCA-A's available liquidity by MISFA and terminated its operations as of March 2022.

those particularly residing in rural areas where only cooperatives and MFIs are active as financial services providers. Therefore, ADF is an essential component of the model for ensuring particularly MFIs’ financing activities in rural areas. ADF will continue disbursing wholesale loans in line with *Shari’ah*. In addition, they should provide technical assistance and training to MFIs and their clients about agribusiness, which will support the success of both microenterprises and MFIs and even the country's overall economy by creating new value chains. Moreover, the ADF can support MFIs' agricultural clients through much needed inputs such as fertiliser, seeds etc.

a) Government Institutions

According to the policy recommendations to be provided in the following chapter, the DAB is the key government organisation for the microfinance sector. They can play a central role in regulating the sector, which is currently not regulated, and this is seen as one of the sector's major challenges. The DAB, having previously collaborated closely with the microfinance sector, is well positioned to take on a crucial role in governance and regulative system. DAB should prepare the draft legislation, which should include the central bank as the regulatory body of the MFIs. If an effective regulatory environment can be created for the microfinance sector, DAB will assume the supervision, licensing and auditing roles. In addition, DAB should be in a position to provide short-term liquidity to the sector, particularly during the transitional phase when funding sources remain frozen due to international sanctions.

It should be noted that as stakeholders, the role of several government institutions are important for the sector, such as DAB as it was one of the main stakeholders previously. The Shari’ah Supervisory Board (SSB) under DAB was the main authority to ensure *Shari’ah* compliance in Islamic banks and windows in Afghanistan. As stated by DAB, “Shari’ah Supervisory Board is the only highest decision making and Fatwa issuing body concerning the *Shari’ah* related affairs of the Islamic banking and financial services at the national level”. [159]

In addition, as a newly emerged stakeholder, RCIBCI is currently the key institution for *Shari’ah* compliance for financial institutions including the microfinance sector, which is akin to a centralised Shari’ah Supervisory Board in some Muslim jurisdictions. While the functionality of DAB is yet to be determined under the new regime, the role of RCIBCI is particularly important during the transition period, as their decision in relation to reviewing the *Shari’ah*-compliant nature of the submitted Islamic products by MFIs will have an important impact on the current state of the microfinance sector in the country. In addition, in the long run, RCIBCI’s decisions on the new products and operations will determine the future success and functioning of the sector. Therefore, RCIBCI is and will remain the essential and critical stakeholder which is integrated into the proposed *Shari’ah* governance component of the model as discussed in a later section.

It is important that the new regime initiated new institutionalization in addition to RCIBCI. For example, under Article 2 of Resolution 15 of the Cabinet of the Islamic Emaret of the Taliban, on 9/29/1400, (20 December 2021) the responsibility of preparing the Islamic banking plan was entrusted to a committee headed by the President of the Academy of Sciences.[160]

Additionally, the Ministry of Finance and Ministry of Trade under which the MFIs were registered are the other relevant government stakeholders of the model. Considering the critical importance of the microfinance sector for the country, such bodies should develop coordinating departments for the development of the industry and should consider incorporating their presence and operations in their public policies.

[159] Available at: https://dab.gov.af/islamic-banking-department
[160] www.avapress.com/fa/255482/مرکز-تحقیقات-بانکداری-اسلامی-و-مسایل-معاصر-توسط-طالبان-ایجاد-شد

b) International Institutions

International institutions have played a significant role in Afghanistan's microfinance sector, providing grants, technical assistance and capital for its development. However, since the regime change in 2021, some of these institutions have reduced or halted their activities and operations. Consequently, currently, Afghanistan's microfinance sector is in the direst position and merely trying to survive. Therefore, strong support from international bodies is essential for the survival of the sector.

To foster the development of Islamic microfinance in Afghanistan, UNDP Afghanistan Country Office and UNDP Istanbul International Center for Private Sector in Development (IICPSD) are working together with its partners, including the United Nations Capital Development Fund (UNCDF), the IsDB, and the IsDB's subsidiary organisations such as Islamic Corporation for the Development of the Private Sector (ICD) and Islamic Financial Sector Development Department (IFSDD). IsDB, a multilateral institution, is known to generate *Shari'ah*-compliant funds through various instruments to support SMEs development in OIC member countries.

A promising synergy can also be established with UNDP's Area Based Approach to Development Emergency Initiative (ABADEI)[161] which is a highly integrated, yet decentralised community resilience programme started by UNDP. This programme aligns well with the Islamic microfinance model and complements it in several ways:

- ABADEI can disburse cash for market grants to microenterprises, empowering them financially.
- UNDP can offer financial and technical support to formal and informal businesses, community-led enterprises, and expansion to new markets. The proposed Islamic microfinance offerings can complement grants' mechanisms, enhancing their effectiveness.

From a humanitarian perspective, channelling aid and benefits from the ABADEI Programme through Islamic microfinance solutions can substantially impact Afghan MSMEs. This approach leverages the advantages of Islamic finance, which resonates with a considerable portion of the population,[162] particularly given the new regulatory landscape that emphasizes Shari'ah-compliant financing. This transformational strategy must be acted upon immediately to effectively respond to emerging challenges in human survival, as human sustainability must be essentialised beyond positioning of the regime.

In addition, international Islamic charities like Islamic Relief have the potential to become donors for Afghan MFIs. Islamic Relief has a successful track record of running Islamic microfinance programs in various countries and could extend its operations to Afghanistan to support the livelihoods of Afghan citizens.

Islamic Relief has a successful track record of running Islamic microfinance programmes in Albania, Bangladesh, Bosnia, and Pakistan, among other countries; and could extend its operations to Afghanistan to support the livelihood of Afghan citizens.

Moreover, it's important to note that international partners, and financial institutions need not exclusively be Islamic finance-oriented institutions. For instance, 85 percent of the bids for the $500 million socially responsible *sukuk* issuance by the International Finance Facility for Immunisation (IFFIm) Co in 2014 came from new investors, mainly out of the Middle East and Asia.[163] With this

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[161] UNDP Afghanistan, *New UN Development Programme emergency initiative to support Afghan people in need,* October 21, 2021, https://www.af.undp.org/content/afghanistan/en/home/presscenter/pressreleases/2021/ABADEI.html
[162] UNDP, *Afghanistan: Socio-Economic Outlook 2021-2022: Averting A Basic Needs Crisis* (Kabul, 2021); Afghanistan Socio-Economic Outlook 2021-2022 | UNDP in the Asia and the Pacific
[163] Bernardo Vizcaino, sukuk for vaccine fund ushers Islamic finance into ethical sphere, December 5, 2014, https://www.reuters.com/article/uk-iffim-sukuk-idUKKCN0JJ0MX20141205

success, IFFIm continued to issue *sukuk* in 2015 and pulled the attention of the conventional socially responsible investors.[164] Such examples demonstrate that *Shari'ah*-compliant financing for MFIs through international bodies can be possible and available. Thus, international donors and financial organisations should be able to provide financing for Islamic structures as has been the case in many examples within global Islamic finance sector.

Lastly, successful Islamic MFIs from other countries should also be considered important stakeholders. Organizations like Akhuwat in Pakistan, one of the biggest Islamic MFIs in the world, have several collaborations with global organisations, including the British Asian Trust to support economically active women in some rural areas through interest-free loans (*qard al hasan*).[165] Other international organisations, such as ACTED, Italian Development Cooperation, and USAID, could also be considered among possible donors.

a) Global Islamic Finance Sector Institutions

Converting their conventional microfinance operations into Islamic microfinance poses significant challenges for current MFIs in Afghanistan. For this reason, technical support and expertise from international Islamic finance institutions are needed. The Islamic Development Bank Institute (IsDBI),[166] Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB) can provide technical assistance to the MFIs for the conversion process. In addition, various Islamic/conventional financial institutions and bodies or banks also can deliver similar assistance to the existing MFIs. Apart from these technical supports, considering the urgency of the matter, Islamic banks from different countries could channel their especially their non-*Shari'ah*-compliant income as charity-based donations to Afghani MFIs for charity-based programmes.

b) Project-based Partnership with Local Organisations

New synergies in different areas can be created between relevant local stakeholders, such as the Afghanistan Banks Association (ABA), the Afghanistan Chamber of Commerce and Investment (ACCI), the Afghanistan Chambers Federation (ACF), NGOs, cooperatives and banks/Islamic banks for efficiently serving the microenterprises by providing the necessary liquidity and operational support. One of the main cooperation areas can be technical training of the potential target segments of the MFIs. Additionally, collaboration areas with MNOs can be revisited for the microfinance sector's digitalisation process.

5.2.2. Target Segments

After identifying the potential stakeholders in the model, the first critical step lies in delineating the target segments. The dynamics of Afghanistan's Microfinance sector underwent a significant shift following the regime change on 15 August 2021 precipitating a series of socio-economic challenges. Before the regime change the number of active clients was around one million, and this figure decreased drastically.

The majority of the client portfolio of the MFIs was engaged in diverse non-basic activities ranging from trading construction materials, garments, and electronics, to rural pursuits like doing animal husbandry , and producing dry and fresh fruits. In addition, many borrowers were in the service sector such as the tailoring business, which particularly created jobs for women. Due to the regime change and its adverse effects on the economy, the majority of the non-basic activities were stopped and -as expected-

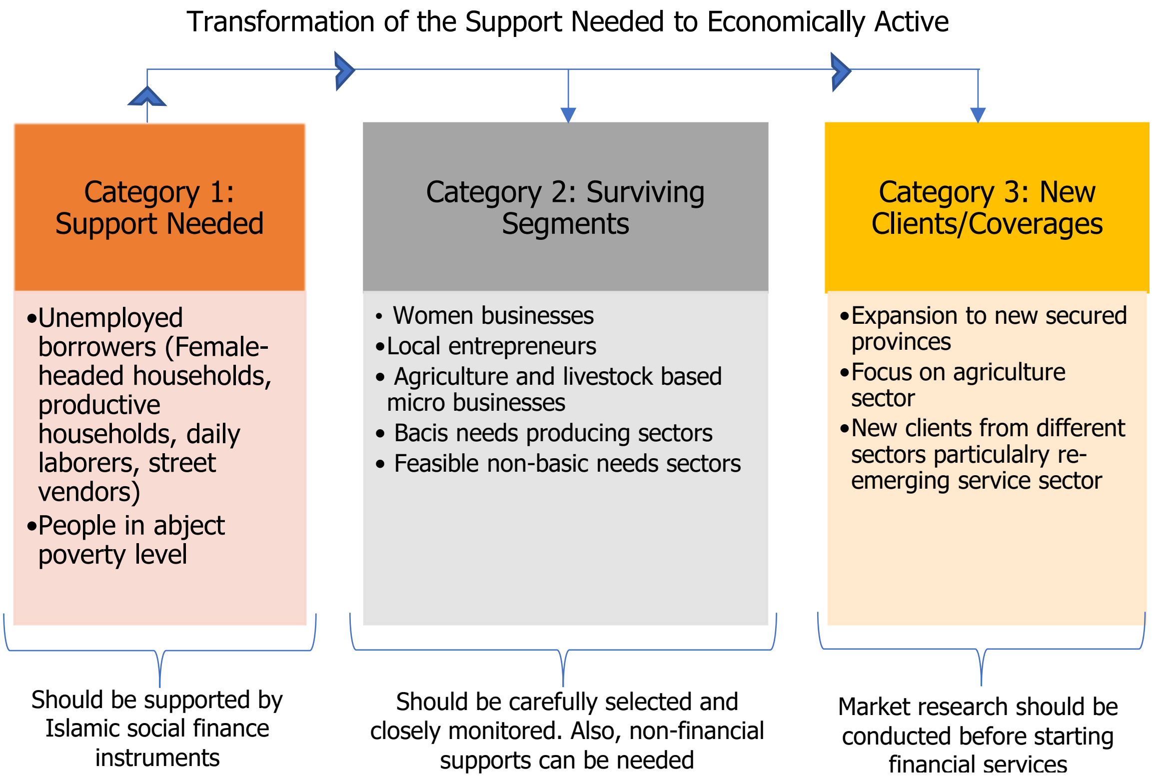
[164] Michael Bennett, *Vaccine Sukuks: Islamic securities deliver economic and social returns*, October 29, 2015, https://blogs.worldbank.org/arabvoices/vaccine-sukuks-islamic-securities-deliver-economic-and-social-returns
[165] https://akhuwat.org.pk/british-asian-trust/
[166] Formerly known as Islamic Research and Training Institute (IRTI).

people prioritised the basic needs in order to sustain their livelihood instead of investing in non-basic activities such as buying construction materials for enlarging or repairing their homes.

Apart from the disruptions in the production and trade sectors contributing to a significant portion of the MFIs, many people working in the government used to be the main customers of some MFIs due to their low salaries to support their families. The government employees having relatively high financial literacy, were among the favourite clients of some MFIs (Interviewee). Moreover, the agriculture sector was also affected by the recent drought in the country on top of the MFI support. Therefore, such adverse developments in various economic sectors must be considered. Such a comprehensive evaluation of the economy and its components will provide an essential potential of the Islamic microfinance in the country. In other words, target segments of the MFIs, at least in the short run, will be slightly different from the previous focuses by considering the active sectors and needs of the society under the changing circumstances implying that a larger number of people and sectors will need microfinance. Accordingly, the target segments for the model are separated into three categories, as depicted in Figure 20.

> "We were supporting government employees as well as, we were providing them loan. And business community, MSME loans we had. It was cash loans as well as support for their small businesses they had. Because in Afghanistan they [government employees] have small salaries which may not be enough to support their families. These two products are very very good." (Interviewee)

Figure 20: Target Segments of the MFIs



The first category consists of the people who were the clients of the MFIs before the regime change. However, they have been in a dire situation where they could not meet their basic needs, such as farmers severely affected by the drought or unemployed borrowers. Providing any Islamic financing in the form of mark-up pricing to such people that puts costs on the principal, for instance, *murabahah*, will not ease their condition because they will not be able to pay it back due to not having a prospect to generate enough income. In other words, they will probably use the financing to meet their families' basic needs. Although the main target of microfinance is to finance the poor, the poorest segment of the poor can also be included through Islamic solidarity or Islamic social finance instruments such as international *zakat*, *waqf*, *qard al hasan* and *sadaqah*-based support system. The main aim to support this target segment is to transform them into economically active again and ensure that they regain their capacity to earn their lives. When they develop such a capacity, they can get loans and repay them to MFIs. However, when we consider the current liquidity problems of the MFIs, it is difficult for them to provide cash or in-kind support to this segment. Therefore, there is a need to create new sources of funds for MFIs, which are to be used only for these activities or to establish cooperation with international humanitarian NGOs and MFIs. Thus, external support from MFIs, having such kind of new sources, or NGOs and charities will support the target segment by using such as *zakat* to meet the basic needs of this vulnerable segment to uplift them to become economically active status. After the basic needs of those people are met, they will be eligible for microcredit from the MFIs.

The second target segment is the sectors which are under the surviving conditions. As mentioned, some sectors are more feasible for financing under the new circumstances. Therefore, MFIs should focus on these sectors until the economy stabilises and functions normally. Women entrepreneurs are one of the main target segments since they were constituting a significant portion of the MFIs portfolio previously. Due to the new restrictions including travel limitations and restrictions imposed on women, they are in a very difficult position under the current political circumstances. Moreover, the majority of the MFIs' human resources consists of women staff who were closely monitoring and supporting the women entrepreneurs. Thus, they were contributing to the success of the microfinance programmes in both ways, implying that through employing women staff MFIs created more jobs for the women and also having woman staff with close relationships with women enterprises increased the repayment performance of the women entrepreneurs. Therefore, women entrepreneurs remain as the main target segment of the MFIs.

"We have 80 percent female employees in office. We were mostly focused on women clients., women tailoring businesses at home, handicrafts. Women clients mostly involved with handicraft making. We had a lot of disbursement to these sectors. Our female employer was going home to home, marketing, finding those female who need money for handicraft, tailoring, etc." (Interviewee)

Basic needs producing sectors are the other significant target sectors to be financed by the MFIs. As one of the MFI upper-level managers stated "for example, you have grocery shop and the market. This thing [microcredit] can help because they are both needed in the society. You can serve these people, and you can generate money from them. You can give them the money so they can increase the stock, increase the inventory so that it will help us and for them". (Interviewee). Surviving sectors, including basic needs providers, should be considered as the prior clients in the transitionary period.

The agriculture sector continues to hold a pivotal position as the main target segment for MFIs, mirroring the landscape before the regime change. One of the MFIs representatives stated that " 45 percent of our portfolio was on agriculture mostly, because we have agricultural land in southern part Helmand and Kandahar, and in the northern part there are lots of lands. We were supporting farmers in those areas (Interviewee)".

The critical importance of agriculture sector as part of their business portfolio is obvious for all the MFIs. In addition to the sectoral importance of the sector for the MFIs and the general economy, it should be noted that there is an urgency to support the agriculture sector as they are in dire need due to the recent drought, which brings a huge risk on the availability of produce and hence food in the

"After 15 August, when the winter started in rural areas, I think the impact was not very visible. As the months passed, now we are in March, we see that the entire supply chain is disturbed, and now we see impact on microfinance sector, especially in the agriculture. So, there is no one now to finance agriculture. As part of agri-business was supporting the food supplies in the country. This country is agriculture country, and it depends mostly on the agriculture. So far during this winter season from August to February there is low demand of loans. But from March onward, normally microfinance businesses pick up, the demand raises. At the moment there is a huge demand. The active clients reached to 94,000 clients, which is a huge decrease. It used to be 961,000. Almost from 1 million to 94,000 clients. It is decreasing day by day. As the months passed, I think MFIs which used to be very active in lending businesses they may closed down." (Interviewee) country. One of the interviewees emphasised the urgency by stating that "One of the most urgent needs today in Afghanistan is food. Food shortage will increase if we are unable to support the agriculture sector. The agriculture season starts from March to August. This is the time in the past we used to give microloans to farmers and the agriculture sector to produce. In winter they are covered by snows". Therefore, it is extremely urgent to provide customised *Shari'ah*-compliant financing in the form of *salam* and *murabahah* to the agriculture sector to overcome potential famine in the country. Such urgent finance facilitation is not only important for MFIs to extend their businesses but also to sustain the livelihood of the many people by ensuring the food supply chain.

As pointed out by the interviewees, the financing methodology of MFIs to agribusiness should also be examined and revised accordingly to have more efficient models. In other words, the MFIs were used to provide loans to the farmers around eight months grace period where they were not making any repayment during the season, and when the season was completed, they were making a bullet payment to the MFIs. However, this period was used to apply to all farmers by MFIs without considering how many months were needed to produce each agricultural product (Interviewee). Therefore, market study should be conducted to identify the grace periods should be given for each agricultural produce business. Such a market research is also urgent for MFIs planning to introduce *salam*, which requires the delivery time of produce -mainly the harvest time- that the parties (MFIs and farmers) agreed on. ADF can play a significant role in conducting such specialisations' required research.

Overall, women entrepreneurs, basic needs producing sectors and agriculture are the main sectors under the second target segment category of the model. However, it should also be noted that according to several comments of the interviewees, although there is a huge demand for microfinancing in the market, due to current political and economic reasons, some people are still looking for financing to migrate to other countries, which constitutes an important risk in the disbursement of loans. For this reason, clients should be selected carefully - even the current clients (interviewee)- and be ensured that they will stay in the country. Otherwise, the MFIs may face further challenges with their new loans under the current liquidity shortages and high PAR ratios.

"We have this philosophy that a permanent positive change will come if we do a proper work. So even If you target SME clients, you need to work on microfinance. Because in Afghanistan the engine of the economy is microfinance clients. If they are graduated from microfinance sector, then they can become successful SMEs. And after from successful SME they can graduate to corporate. So, there is a process." (Interviewee)

Lastly, although there are many challenges due to the political change, the current environment provides new opportunities to the microfinance sector. Almost every interviewee pointed out that there is no longer any security concern all over the country, so they can expand their operations where they could not do business before due to the security issues. Therefore, under the new security environment, MFIs can do business in all the provinces where especially agribusinesses are an essential part of the economic activity. In addition, new clients from different sectors who "have skill, but no money" (Interviewee) can be served by MFIs. However, market research should be conducted to identify the feasible sectors before starting financing disbursement.

When we consider the low penetration of the banking sector and taking into account that 70 percent of the people living in rural areas, target segment strategies based on the comprehensive market research funded by international agencies or local institutions can provide MFIs new opportunities to expand their business to new microenterprises. By doing so, MFIs can play a significant role in supporting other segments of the Afghanistan economy, namely SMEs, and indirectly even corporates, because all the economic agents are dependent on each other to some extent.

5.2.3. Sources of Funds

Liquidity is currently one of the major challenges -may be the most important one since it directly affects their survival- faced by MFIs since the new regime only allowed MFIs to collect principal amounts from their outstanding loans by prohibiting the return (interest) part. Furthermore, the MFIs could not generate any new income because new loan disbursing is not permitted by the regime due to non-*Shari'ah*-compliant nature of their product. All the products, including available Islamic products, are being subjected to review. Although the regime authorities have started to review the submitted Islamic finance products by MFIs, any response is yet to come as of June 2022. Moreover, the borrowers' repayment performance, even for principal amounts of their loans, is very weak due to the slowdown in the economy and other external factors along with the disappearance of clients who left the country. Furthermore, some of the borrowers are misusing the regime change by not paying the principal amount, which creates an additional burden on the MFIs.

> "We all need financial support at this point of time. Because we are all eating our capital very fast. I don't know how long we will do that in case we don't receive financial support from anybody. Definitely all institutions will collapse because we don't have any other support right now." (Interviewee)

On the cost side, since the microfinance business is labour intensive, staff cost constitutes the highest cost. Under the circumstances where they are not generating income and still have huge staff costs, the MFIs promptly are losing their capital. Many interviewees emphasised that this situation is not sustainable for the MFIs and may lead to their failure in a short span of time unless some new sources of funds are created. Overall, liquidity is one of the major challenges to be tackled urgently. Therefore, as mentioned above and detailed below, the proposed model suggests several potential sources of funds to finance the activities of the existent MFIs.

a) International Funding Supports

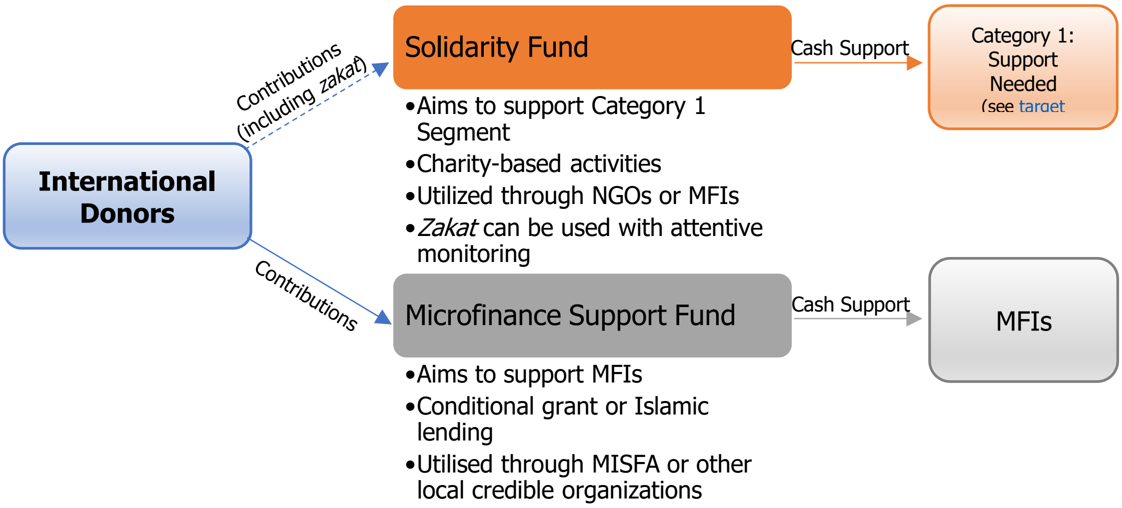
Due to the war economy and instability in the following years, Afghanistan has become an aid-dependent country, and the microfinance sector is one of the beneficiaries of this support. In fact, some of the MFIs were directly founded by international funds or indirectly by MISFA, which was established for channelling donations to the microfinance sector. Consequently, international donations are identified as one of the major sources of funds by all interviewees to overcome the current challenges. In these challenging times, MFIs need international financial support not only to meet current operational costs but also to convert their operations and portfolios from conventional to fully Islamic microfinance, which brings new costs to MFIs such as core banking systems, etc. If the RCIBCI, which acts as a centralised *Shari'ah* governance institution for MFIs, approves the recently submitted microfinance products and the MFIs start loan disbursement in a *Shari'ah*-compliant way, it is clear that it will take a long time for them to become operationally sustainable again. It is also noted from the interviews that some of the MFIs do not have sufficient capital even if they start the loan disbursement due to the conversion costs.

Funding from international institutions in the short run, hence, is urgent for the survival of the microfinance sector. However, the current sanctions on the new regime are the main obstacle for MFIs to receive international support. After 15 August 2021, international sources of funds, either in the type of grant or capital for the MFIs such as FINCA, a part of a well-known international organisation, have been stopped due to the sanctions on the new government. Any uplifting or ease of the sanctions will obviously help MFIs to tackle the current liquidity for reaching international funds as donations or equity. However, this issue needs macro and policy-level interventions; hence it is out of the report's scope.

The structure of the proposed model based on international donations depicted in Figure 21 proposes two types of international funds that may differ in terms of both nature and targets. While the Solidarity

Fund aims to support potential microfinance clients with charity-based funds, the Microfinance Support Fund directly provides fresh liquidity to the MFIs as a conditional grant.

Figure 21: International Donations



The Solidary Fund consists of donations from international organisations, which were mentioned in the Key Stakeholders section of the report. In addition to general contributions from international organisations, the Fund can have two specific contributions from Islamic banks or other Islamic affiliated institutions including international Islamic charities and international *zakat* funds from OIC member countries, one of which is *zakat*.

The Fund can accept *zakat* under the condition that it has to be transferred under Islamic microfinance to the poor people who meet certain eligibility criteria determined according to Islamic jurisprudence. Therefore, the donation based on *zakat* should be utilised with careful monitoring, and the rules toward *zakat* recipients have to be followed. Secondly, Islamic banks could channel their especially non-*Shari'ah* compliant funds which have to be spent as a charity, to the Solidarity Fund. With these different sources, the Solidarity Fund is expected to support the Category 1 target segment, which includes the people who are economically inactive because they do not meet their basic needs. The Solidarity Fund will be used to support these people in order to transform them into economically active so that they can use the financing products of the MFIs in income-generating activities. The Fund can be utilised through credible local NGOs or MFIs under the condition that the MFIs have to manage them for charity purposes only.

The second proposed Fund is the Microfinance Support Fund (MFS). The aim of this Fund is to finance existing MFIs in the short run until they become operationally sustainable. The Fund can be used for meeting the conversion costs of the MFIs, which is one of the main challenges in front of them. The MSF can be utilised through MISFA, the apex institution before the regime change, or other credible local organisations. Moreover, ADF can play an intermediary role in channelling the funds to the agriculture sector through MFIs. The utilisation of the Fund by the MFIs should be closely monitored. Regular reporting should be provided to the donor organisations to

> "My suggestion is that disbursement of hard cash as a humanitarian support which has been done for past few months, that is good, but I think this is a question that need to be asked for that how long this can continue? If instead of giving free cash, if this cash is used for lending with one-month shipment of cash we can activate economic activities for millions of people. There will be a cycle of this fund. Through loans to microfinance sector, we can also activate SMEs and corporates. Because if microfinance doesn't work, the farmers doesn't work, if they don't work there is no production from the agriculture, then there will be no import, no activities for SMEs and corporates." (Interviewee)

ensure that the funds are effectively channelled to the microenterprises.

In addition to the international donations, the MFIs, who are part of international organisations, can benefit from the capital injections by their shareholders. However, based on the interviews, the shareholders of some MFIs have been hesitant due to the sanctions. Consequently, there is not much room to consider MFIs in terms of capital injection unless the sanctions are lifted.

b) Funds from MISFA and ADF

MISFA and ADF were the main funding sources of MFIs in Afghanistan. These institutions were providing loans to the MFIs at a low-interest rate, and then the MFIs were disbursing them to their clients. As the current regime does not allow interest-based lending, these two institutions should restructure their lending methods in a *Shari'ah*-compliant manner.

ADF already has Islamic financing products based on *wakala* contract and can easily continue its disbursement activities. However, they stated in the interview that the limitation of the central bank on the deposit withdrawal from the banks restricts them to extend new financing to the MFIs as well as cooperatives. If a relaxation occurs in deposit withdrawal, ADF can be the leading fund provider for the MFIs in their agriculture financings. Furthermore, it is noted that the ADF, as USAID funded institution, restructured their board of directors after the regime change to ensure its independence. Therefore, in addition to financing the MFIs in agriculture lending from its available sources, the ADF can also play an intermediary role in channelling the new international funds to the microfinance sector.

On the other hand, MISFA, which was the main funding source for the MFIs before the regime change, were inactive for several months after 15 August 2021. Currently, they do not have Islamic lending products, but when we consider that they were financing the MFIs through only one type of loan, it will not be easy for them to introduce *Shari'ah*-compliant loans in a short time, which probably will be based on *wakala*. It is also noted from the interviews that while the MISFA is not currently providing any financing to MFIs, it is recalling most of its loans from some MFIs, which will further risk the operational survival of these institutions, as they are already struggling due to liquidity problems.

c) Micro-Savings

Micro-saving products are another source of funds for MFIs. The only deposit-taking MFI is FMFB-A since it is a commercial bank regulated by the DAB. The regime also required all commercial banks to convert from conventional to Islamic banking. Consequently, FMFB-A is expected to introduce Islamic deposit products for all customers, including microenterprises. As a commercial bank, FMFB-A has a different position from the rest of the MFIs. Therefore, the model does not cover FMFB-A in terms of micro-savings.

> "That [to be deposit taking MFIs] was the one of the projects that for many years we have worked and finally gave everything to the central bank, but the process of 15 Aug. put everything away.”." (Interviewee)

It is noted from the interviews that several MFIs have made progress in getting permission from the DAB, which the previous government assigned to oversee the process. The operating MFIs, hence, have had close relationships and communications with the central bank, and they were expecting to have the permission shortly. However, they could not succeed to be deposit-taking MFIs due to the regime change. Currently, this process should be done according to *Shari'ah*-compliant micro-savings products. This plan probably is not on the agendas of MFIs or central bank's short-term agendas because more important challenges have to be tackled. Even if it is not realistic or feasible for MFIs to have micro-savings products in the short run, however, in the long run, the *Shari'ah*-compliant micro-savings products can make a significant contribution to the funding sources of MFIs. Thus, one issue pointed out by an interviewee is the importance of the communication process with government authorities for the micro-savings products for future plans: "The issue was that central bank did not have regulation for deposit-taking microfinance. So, they were looking to find regulation as how they can regulate and how they can give license. (Interviewee)". As evidenced by this statement, a comprehensive legislation should be introduced for the microfinance sector, and MFIs should be supervised and regulated by the DAB for deposit taking which will immensely help with their liquidity shortage. Besides, the experiences of FMFB-A, which will convert their conventional deposit products to Islamic, will be beneficial for the other MFIs.

Although collecting micro-savings through new *Shari'ah*-compliant deposit products can provide additional opportunity spaces for MFIs, this feature brings significant responsibility and risks to the MFIs, such as liquidity management. Therefore, if new regulation initiatives are to occur in the future, MFIs licenses should be divided into deposit-taking and not-deposit-taking categories. However, further capital should be required for the deposit-taking ones as the global experiences evidence.

d) Micro-Sukuk Issuance

Recently *sukuk* issuance for social purposes or green finance has been gaining popularity in Islamic finance sector. The investor base for these types of securities is also on the increase, indicating strong motivation on supply and demand side for such *sukuk*. Besides, the global microfinance sector witnessed the issuance of first micro-*sukuk* by the end of 2019 by the Indonesian MFI, BMT Bina Ummah. This micro-*sukuk* issuance was in a *mudarabah* structure, and the proceedings, 710 Million Indonesian Rupiah ($50,000), were planned to be used by the Yogyakarta-based Islamic microfinance cooperative.[167] This first initiative is important to show that micro-*sukuk* issuances can be new sources of funds for the microfinance sector. For the microfinance sector in Afghanistan, micro-*sukuk* issuance can be a long-term plan because *sukuk* structure and issuance has complicated procedures and can be costly. In the future, *sukuk*, as the new opportunity space, for Islamic microfinance can be utilised by Afghanistan's microfinance sector to generate new funds for financing. Accordingly, MISFA or MFIs by themselves can issue micro-*sukuk* if the economic and regulatory environment in the country is supportive. However, for international investors, the prospect of economic environment should be incentivising, which is a difficult condition in the short-run. It should however be noted that an arrangement with IsDB and similar Islamic organisations can be considered to launch *sukuk* for microfinance.

5.2.4. Financing Products

Islamic finance has many *Shari'ah*-compliant financing-based business models, ranging from profit-loss sharing to debt-based instruments. One of the most commonly used methods by Islamic financial institutions is *murabahah* because it allows pre-determined profit as it facilitates efficient capital and risk management. Other income-generating financing methods such as *ijarah*, *istisna* and *salam* are also commonly used by Islamic financial institutions, including Islamic MFIs.

One of the most preferred financing methods in Islamic microfinance is *qard al hasan*,[168] which is based on the principle that the lender does not charge any profit or mark-up on the loan, so the borrower is only expected to pay the principal back. Several Islamic MFIs in the world successfully use *qard al hasan* in their operations. For instance, Akhuwat in Pakistan, which is one of the largest Islamic MFIs in the world, solely uses *qard al hasan* financing. But the problem with *qard al hasan* can be the sustainability of the microfinance programme because no surplus is asked from the borrower for the loan. On the other hand, a small application fee, independent of the loan amount, can be charged for operational costs. For instance, while Akhuwat charges Rs. 200 ($20) application fee on their most

[167] Blossom, *World's First Primary Sukuk Issuance on Blockchain Closes*, October 16, 2019, https://blossomfinance.com/posts/worlds-first-primary-sukuk-issuance-on-blockchain-closes

[168] *Qard al hasan* is the preferred usage in the Islamic microfinance literature. It is also called as interest free loan or benevolent loan.

popular loan, namely Family Enterprise Loan, they do not charge any fee for Agriculture Loan.[169] Charging fee on the financing is not a requirement for MFIs, which can be determined by the organizational strategy of the respective MFIs. Despite the sustainability of the *qard al hasan*, it is the most suitable contract type for supporting microenterprises during difficult times as it does not bring any cost to the borrower, as well as it is easy to implement due to its simple structure.

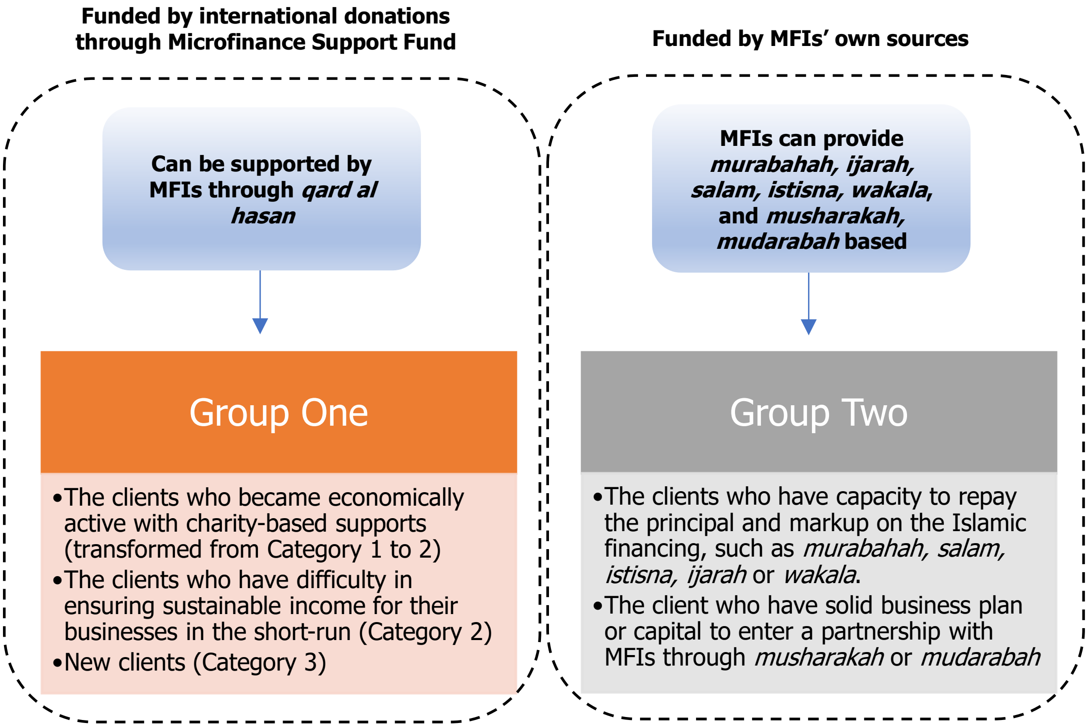
It should be noted that some of the MFIs in Afghanistan, FINCA, Mutahid and IIFC, had Islamic financing products particularly based on *murabahah* before the regime change. However, these Islamic products, as the normal *Shari'ah* screening process requires were approved in the past, are being reviewed by the new authority, namely RCIBCI, and they have not finished the review process yet as of June 2022. In addition, it is noted in the interviews that all the MFIs have already submitted their Islamic microfinancing products, which include *murabahah*, *salam* and *istisna*, to the authorities including RCIBCI. One of the MFIs representatives also added that they are planning to offer *musharaka* and *wakala* based financing. If the regime approves them, the MFIs will start loan disbursements based on these types of Islamic contracts. As of June 2022, OXUS is the only MFI continuing loan disbursement through *qard al hasan* (OXUS calls it zero-interest lending), which was introduced at the first week of December 2021 (Interviewee). Since this new zero-interest loan does not have any mark-up on the principal amount, the regime does not interfere in the disbursements. The rationale was to support the microenterprises that have already suffered since 15 August 2021, because of the uncertainties and the economic disruption, without putting any debt burden on them. This initiative of OXUS is praiseworthy that they have shown that the empowerment role of microfinance still continues even in this very challenging environment.

"The question is that is it the time now in 2022 with this extreme difficult economic and monetary situation in Afghanistan to come up already with any product which has a cost in addition to the principal. The situation is so bad for the entrepreneurs if we want them to succeed and to have business running, should we not just decide for this year to zero interest lending." (Interviewee)

Considering the difficult situation of the microenterprises, the problems faced by MFIs, and the stakeholders' views in the interviews, the model adopts a mixed approach at the financing product level. In other words, the model proposes different Islamic financing contracts tailored according to the customer needs and capacities under two phases, as depicted in Figure 22.

[169] https://akhuwat.org.pk/loan-products-offered/

Figure 22: Financing Methods



Interviews indicated that many borrowers are in a dire situation due to the adverse impacts of the regime change in the economy. As stated by the interviewees, some of the borrowers have had difficulties repaying the principal amount of the loan they received before. Therefore, *qard al hasan*, not including any mark-up, can be the most suitable financing product, at least in the short run. In addition to supporting the business activities of the microenterprises, it will also contribute to the microfinance sector in a way that the discipline of repaying the principal can be ensured (Interview).

One of the MFI representatives saw this repayment discipline as a significant feature of the microfinance business, for the sustainability of which every effort must be expedited. The valuable experiences of OXUS, since December 2021, indicated that the clients who have got a zero-interest loan are loyal to their debt, and zero PAR was achieved so far (Interviewee); even they had new clients despite the difficult conditions. Therefore, in the short run -maybe for one year- the group of clients, as stated in Figure 22 should be supported by the MFIs. In order to not add any further burden on the MFIs, such a *qard al hasan* programme should be funded by the previously mentioned Microfinance Support Fund. By doing so, this group of people can be uplifted to a more secure economic position where they can apply for MFIs' other income-generating financing instruments such as *murabahah*. Moreover, by *qard al hasan*, in the case of new clients, trust can be constructed between MFIs and borrowers for further financing processes.

> "I am very happy to say that what we started in the first week of December as of this day we have 0 PAR we have not a single loan out of 600 which is in default even in the PAR (1-30 days)."
> (Interviewee)

It should also be noted that, based on the interviews, the MFIs charged around 30 percent interest on the loans, which was similar to the *murabahah* financing, before 15 August 2021. Moreover, it is emphasised by an interviewee that at least 20 percent of income has to be generated by MFIs to meet operational expenses and cost of risk, which may increase under the *Shari'ah*-compliant financing structure. Accordingly, the MFIs have to provide income-generating Islamic financing products to their clients to be self-sustainable. Therefore, the MFIs, in addition to *qard al hasan*, can use *murabahah, ijarah*, *wakala*, *salam* and *istisna* products for financing clients who have the capacity to repay the principal and mark-up on the loan. Moreover, they can introduce innovative profit and loss sharing based products (*mudarabah* and *musharakah*) to those clients who have a solid business plan or capital. In the global experiences, several Islamic MFIs are using hybrid products that combine risk-sharing and debt-based instruments, such as the programme using value-based *salam* and *mudaraba* in Sri Lanka.[170] However, it is also noted that these types of products may contain high risks; hence feasibility studies and necessary infrastructure for monitoring the projects should be established within the MFI sector. Group Two, shown in Figure 22, can be financed by these products, and these programmes should be funded by the MFIs' own sources different from the *qard al hasan* product because the MFIs will generate income from their loans.

The integration of *qard al hasan* into the business model of MFIs can be structured as a short-term method; however, the MFIs can use this method in their activities along with other income-generating Islamic financing products. For instance, one MFI, Start Microfinance, provides both *murabahah* and *qard al hasan* products in Kosovo.[171] These two products can be compatible; however, this preference depends on the MFIs' own strategies.

5.2.5. Risk Mitigating Tools

Afghanistan has faced significant political and economic challenges for several decades as a lower-income country. The recent regime change has intensified the nature and magnitude of these challenges by adding further challenges. The country's financial sector was detrimentally affected by the recent development because the new regime halted banking activities, which imposed that all activities have to be in line with the *Shari'ah*. While the country has low banking penetration operating mainly in the urban areas (around 10 percent of the population has a bank account), [172] relatively well-developed microfinance sector in the country reached around a million active clients, including women and farmers. Among the main challenges, MFIs have always suffered from liquidity problems, which remains an important challenge. However, now they are also facing extra costs related to conversion from conventional to Islamic microfinance. Therefore, effective risk mitigation tools are now more required under the current difficult environment for financial institutions and clients. Micro-*takaful* and credit guarantee schemes, social collateral and peer monitoring lending methodology, and developing a central credit scoring system are possible instruments to mitigate the microfinance sector's potential risks.

An additional risk seems to be the *Shari'ah* compliance risk, which is expected to be mitigated by the central Shari'ah Supervisory Body or RCIBCI. Training from international Islamic finance agencies (IsDB, AAOIFI, IFSB and CIBAFI) can help to develop the necessary skills in *Shari'ah* scholars and audit for Islamic finance institutions including for Islamic MFIs. This is expected to develop the necessary social capital to mitigate the potential risks from operation risk areas relating to *Shari'ah* skilled knowledge workers.

a) Micro-Takaful (Islamic Insurance)

The main aim of microfinance is to empower low-income people, including farmers and women entrepreneurs, through financial and non-financial services. The target beneficiaries mainly consist of vulnerable and very low-income people who may be subjected to many risks ranging from health problems in one of the family members to drought in agricultural production. Therefore, these unexpected risks directly impact the lives of the borrowers and affect their loan repayment

[170] Mohammed Obaidullah, and Mohamed-Saleem Amjad, *Innovations in Islamic microfinance: lessons from Muslim Aid's Sri Lankan experiment*, (2008).
[171] Mucahit Ozdemir, *İslami Mikrofinans: Teori, Uygulama ve Model Önerileri [Islamic Microfinance: Theory, Practice and Model Proposals]*, *Albaraka Yayınları*, 2019.
[172] OECD, *Boosting Private Sector Development and Entrepreneurship in Afghanistan*, 2019.

performances to the MFIs. For this reason, integrating the micro-*takaful* products, which include small premium payments by the microfinance clients, into the microfinance activities will protect the beneficiaries who may face unexpected risks and become economically inactive for a while. Moreover, micro-*takaful* positively impacts the financial sustainability of the MFIs by mitigating the default risks of the microenterprises who otherwise will not be able to repay their loans under the collapse of their activities because of the occurrence of unexpected risks. Therefore, creating a linkage model between microfinance and micro-*takaful* can help to ensure the economic empowerment of low-income people in an effective and sustainable manner, both for microfinance service providers and their clients. In addition, *takaful* operators will encourage the MFIs by providing risk assurance in cases of genuine defaults and assets of the clients.

The development of a *takaful* sector in Afghanistan, which was essentialized recently by the previous government with the preparation of the draft *takaful* Law, can be one of the most supportive tools for the economic empowerment of the Afghan people. Since the new regime imposes all financial institutions to operate in a *Shari'ah*-compliant way, the existing insurance companies will be required to convert their activities from conventional to Islamic insurance, which can include micro-*takaful* services. Therefore, apart from the current economic challenges, the *takaful* sector can benefit from the opportunities to reach out to new clients of Islamic MFIs in different economic sectors, especially agriculture, which is vulnerable to various natural risks such as the recent drought in the country. Moreover, micro-*takaful* can be a key mechanism to facilitate the MFIs to introduce new *Shari'ah*-compliant products to the microenterprises and SMEs in the rural areas mainly dealing with agriculture and livestock. By doing so, it can also contribute to poverty reduction, economic empowerment and development, and resilience while mitigating the ongoing and upcoming economic and financial risks.

The integration of micro-takaful to MFIs in Afghanistan to mitigate their risks can be achieved by creating tailored micro-*takaful* products by available insurance companies. On the other hand, *takaful* companies can be founded by international funds or *takaful* companies outside Afghanistan to serve different economic segments, including microenterprises, with a customized approach.

b) Credit Guarantee Scheme

Credit guarantee schemes (CGS) support particularly MSMEs lacking enough collateral to access financing services of formal institutions, mainly banks. With the engagement of the CGS mechanisms, both parties could have benefits in a way that borrowers can get financing without sufficient collateral, and financial institution can mitigate their credit risks, whereby they are encouraged to disburse loans to MSMEs.

There has been only one type of scheme available in Afghanistan, namely, German-based the Afghan Credit Guarantee Foundation (ACGF), which was established in 2014 and has provided guarantees to customers of commercial banks and MFIs since its inception. The ACGF also has *Shari'ah*-compliant offerings, constituting 20 percent of total guarantees (Interview). Although ACGF suspended its activities after the regime change, one of the upper managers recently noted that the ACGF expect to start new lending and to guarantee in the third quarter of 2022.

It is noted from the interviews that only a few MFIs worked or sought collaboration with ACGF, as one of the MFIs' 50 percent portfolios was assured by ACGF before the regime change. In addition, another MFI had a discussion with ACGF and was about to sign a contract; however, it did not succeed due to the regime change in 2021.

After 15 August 2021, the ACGF is not functional due to uncertainties. Therefore, UNDP's "Pre-Feasibility Study on Engaging Islamic Finance Modalities in Credit Guarantee Funds in Afghanistan" proposed a new 'Credit Guarantee Fund of Afghanistan' (CGFA), which includes the MFIs to promote financial access of the MSMEs, as well as the diversity of MFIs' risk mitigation tools. Consequently, the proposed

Islamic microfinance model integrates the CGFA since it is planned to be organised in a *Shari'ah*-compliant way and cover MSMEs.

5.2.6. IT Infrastructure and Digitalisation

IT infrastructure and fintech based solutions are significant enablers for the microfinance sector in different ways, such as decreasing transaction costs, simplifying disbursement and collection processes, minimising the operational risks caused by human errors, and easing the follow-up processes, ensuring transparency and financial access of the clients. MFIs in Afghanistan have already developed a certain level of digitalisation in their operations before the regime change, as emphasised in the interviews. Several internal and external dimensions have emerged during the discussion with stakeholders about integrating digitalisation into the microfinance business.

The internal dynamics are mainly related to the IT infrastructure of the MFIs, some of which have already introduced innovative solutions to make operational processes, including monitoring, auditing, and credit scoring, more effective. As detailed by an interviewee, FINCA Afghanistan is one of the most progressed MFIs that started the digitalisation process in 2017 in accordance with FINCA International's FINCA 2.2 digitalisation programme. They introduced fully digitalised paperless lending in which loan officers were processing all the information about the clients through tablets and sending them to the centralised loan processing unit for credit approval. FINCA Afghanistan has also implemented a central-scoring system where loans up to AFN 100.000 were automatically approved based on the client's credit scoring. In addition, FINCA Afghanistan successfully digitalised even audit processes.

> "We removed paper from all our loan processes because before that we need to have 12-13 pages for one customer. We just print a one-page contract. Signing hard copy of is acceptable, one-page contract. We have signed another contract with MNOs – M-PAISE- that our customers could go and pay all of their repayments to any of those agents closed to their homes. They were not supposed to visit the branch. There was ease for the customer." (Interviewee)

Another noteworthy initiative by OXUS for digitalisation was that they have substantially achieved the triple zero strategies of OXUS, which are zero exclusion, zero carbon, and minimum use of papers for digital finance (Interviewee). Also, the FMFB-A have had progress in the digitalisation of its operational processes. These initiatives show the willingness and capacities of the MFIs to benefit from digital solutions to increase their effectiveness.

All these digitalisation efforts must be supported by a robust core banking system to be successfully implemented. This is also one of the critical success factors for providing financial services in a *Shari'ah*-compliant way since the previous system was mainly developed for conventional orientation. However, as evidenced by the interviewees' statements, the current core banking systems used by the MFIs are not sufficient for even fulfilling conventional microfinance requirements. Furthermore, they pointed out that they can only process the typical *murabahah* product used by some MFIs before the regime change; however, they need a new proper core banking for initiating fully Islamic microfinance with more complicated transactions. In addition to different Islamic financing offerings other than *murabahah*, if any MFI aims to have Islamic micro-savings products, it must have a robust system because some micro-savings products are structured on a profit-and-loss sharing (*mudarabah*) structure which includes complicated profit calculations and distribution processes. Hence, a new core banking system with an Islamic finance

> "For basic operations we have the system in place but for more complicated operations definitely the IT infrastructure needs development." (Interviewee)

> "We have already integrated with national switch (APS). The only thing we don't have is the core banking. Other initiatives are in place, we just need reactivating. Audit software, tablet learning, centralized unit, call centre, all of them in the office. But we need to go some of the cost cuttings. Technical aspects are available inside the office as of now. We can use it from next day when the business is there." (Interviewee)

orientation could be one of the significant enablers for implementing the products and services in the proposed model. However, under these challenging environments for MFIs where they could not generate income to meet even the operational costs, the new core banking will bring high costs, estimated by one of the interviewees by $2 million. In other words, currently, it seems not possible for the MFIs to have a proper core banking system or transform the existing ones for carrying out new Islamic microfinance activities without external funding and technical support. Accordingly, as mentioned in the key stakeholders' section, Islamic financial institutions can be one of the key possible supporters for the MFIs regarding core banking as they already have core banking systems for processing a significant number of Islamic finance products and services transactions. For instance, the most prominent Islamic bank in Turkey, Kuwait Turk Participation Bank (KTPB), has developed in-house software systems through its technology company, which has been used in more than 20 countries.[173] So, the KTPB may provide technical and software support to the MFIs in Afghanistan as corporate social responsibility.

"If the agent networks of all MNOs are all connected with the APS there would be more access to the people in Afghanistan. The project was just completed before the 15 August. Everything is tested. There are different channels in APS. But I think that it will take time to cover 100 percent of microfinance customers with technology. Because they are in rural areas and even infrastructure is not there. And even some people don't have mobile phone. Rural areas there is no infrastructure, in those areas we need hard cash currency." (Interviewee)

The second wing of digitalisation is related to an external dimension: integrating digital payment systems. MFIs have connected to the mobile network operators (MNOs), especially the M-PAISA product of Roshan telecom company, which defines itself as "Afghanistan's first mobile money service provider bringing financial inclusion and transparency" [174] for facilitating loan disbursement and repayment. Accordingly, the MFIs have started disbursing loans and collecting payments through the M-PAISA system. OXUS asserts that it is the first MFI connected to mobile banking and finance through Rohsan and Etisalat Afghanistan. However, this process was stopped by the central bank since they said that every activity should be done through the Afghanistan Payments System (APS) (Interviewee), which is the National e-Payment Switch of Afghanistan operating under the umbrella of DAB. FMFB-A has also connected to APS to work with mobile services to digitalise their loan disbursement and collection processes. AMA has played a significant role in integrating MFIs into the APS system (Interviewee).

"As of now digitalisation initiatives are not functioning. Because it is only collection and even the M-PAISA is not supporting any more. Now we are the same as usual microfinance, the typical one. We just collect the cash and deposit the cash to the bank, that's all." (Interviewee)

It should also be noted that before the APS system, some of the MFIs had already integrated digital solutions into their operations for servicing their clients. For instance, FMFB-A, an affiliated body of AKDN, has been working with Roshan [175] to disburse loans and collect the instalments through its M-PAISA platform for seven years. In addition, even the Bank has one cashless branch in Mazar where there is not any cash, and all the processes are carried out digitally, and the clients are using M-PAISA agents for collecting and repaying their loans through mobile phones (Interviewee). As evidenced in the interviews, MFIs were ready to cater financial services to their clients through APS; however, these attempts were interrupted by the regime change on 15 August 2021. The first loan disbursements were expected to start in September 2021. All the mentioned efforts, including the digitalisation process within the MFIs, have been suspended because they are struggling to sustain their basic activities with limited available funds as the new regime does not allow disbursing a new loan and collecting mark-ups. Investing in new IT infrastructure and digitalisation programmes can put new burdens on the

[173] https://www.kuveytturk.com.tr/en/about-us/about-kuveyt-turk/news/boa-banking-platform-the-local-software-of-kuveyt-turk-is-to-be-used-in-20-countries
[174] https://www.roshan.af/m-paisa#
[175] https://www.roshan.af/about-us

MFIs. Therefore, international institutions should support the MFIs in their digitalisation process as they have already made significant progress. The mentioned digitalisation efforts of MFIs were generally promoted by MISFA[176] and other international organisations, including USAID, before the regime change. Without the support and assistance of International Organizations the MFIs would face challenges to adapt their operations to Islamic microfinance and even protect previous advancements in digitalisation. Furthermore, after the approval of their Islamic financing offerings by the regime's authorities, the APS system should be reactivated, and the MFIs should start disbursing Islamic financing offerings and collect profits through digital channels so that they can have a chance to decrease their operational costs.

It is also to be noted that while all interviewees have agreed on the possible contribution of integrating technology into the business model, particularly in reducing costs, some of them emphasised the importance of human interaction in microfinance. In other words, the MFIs in Afghanistan closely monitor the clients and visit them in their places to prepare a business plan, calculate the risk, etc., all of which require close contact with clients going beyond just providing financing. Since a significant portion of the targeted population of the MFIs lacks financial literacy and education, human interaction is also considered a fundamental component of microfinance in Afghanistan. Therefore, fintech based solutions for loan disbursements and collection of the instalment should be through fintech solutions such as M-PAISA; however, at least in the short run, human interaction will be the main working style MFIs when the financial education level of the people is considered.

"We come from humanitarian field, and we like human interaction. And I have been taught Know Your Customer which is used to be fundamental in microfinance and it is not only to know him, but it is also to assist him. Because the loan officer who has been financing 300 shops, can really give a good advice to the borrower on how to run the shop, making business plan, etc. I think it is very valuable and cannot be replaced just by sending SMS as through the digitalisation. While I fully agree and we are introducing those measures in other places to reduce the cost and the interest at end of the day for the borrowers, but in Afghanistan currently we still think that a bit of interaction and assisting the customers is important." (Interviewee)

Photo Credit: UNDP Afghanistan

[176] http://www.misfa.org.af/wp-data/uploads/2021/08/Annual-Report-2021.pdf

5.2.7. Shari'ah Governance

Shari'ah governance is an essential operational part of Islamic finance offerings, including Islamic microfinance, as products and offerings of Islamic financial institutions must comply with *Shari'ah* rules and principles. As identified by the experience in the Islamic banking and financial sector, the following functions are considered as part of *Shari'ah* governance: *Shari'ah* committee for 'oversight and accountability on *Shari'ah* related matters', '*Shari'ah* review function', '*Shari'ah* audit function', '*Shari'ah* risk and control function' and '*Shari'ah* research function'.[177] For *Shari'ah* governance covering all these functions, AAOIFI and IFSB issued several standards as listed in Table 16.

Table 16: Existing Shari'ah Governance Standards and Regulations

1999	AAOIFI Governance Standard for Islamic Financial Institutions (GSIFI) No. 1: Shari'ah Supervisory Board: Appointment, Composition, and Report
1999	AAOIFI GSIFI No. 2: Shari'ah Review
1999	AAOIFI GSIFI No. 3: Internal Shari'ah Review
2001	AAOIFI GSIFI No. 4: Audit & Governance Committee for IFIs
2005	AAOIFI GSIFI No. 5: Independence of Shari'ah Supervisory Board
2005	AAOIFI GSIFI No. 6: Statement on Governance Principles for IFIs
2006	IFSB-3: Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services (Excluding Islamic Insurance (*takaful*) Institutions and Islamic Mutual Funds)[178]
2008	IFSB-6: Guiding Principles on Governance for Islamic Collective Investment Schemes
2009	AAOIFI GSIFI No. 7: Corporate Social Responsibility (CSR) Conduct and Disclosure for IFIs
2009	IFSB-8: Guiding Principles on Governance for *takaful* (Islamic Insurance) Undertakings
2009	IFSB-10: Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services[179]
2011	*Shari'ah* Governance Framework (SGF) for IFIs
2017	The Securities Commission of Malaysia (SC) issued the new Malaysian Code on Corporate Governance (MCCG 2017)
2019	Bank Negara Malaysia Shari'ah Governance Policy Document

[177] See for details: BNM, *Guidelines on Shariah Governance Framework for Islamic Financial Institutions* (2021) Available at: https://www.bnm.gov.my/documents/20124/761709/02_Shariah_Governance_Framework_20101026.pdf; also BNM (2019). *Shariah Governance Available* at: https://www.bnm.gov.my/documents/20124/761679/Shariah+Governance+Policy+Document+2019.pdf
[178] Available at: https://www.ifsb.org/download.php?id=4359&lang=English&pg=/published.php
[179] Available at: https://www.ifsb.org/download.php?id=4366&lang=English&pg=/published.php

Source: COMCEC (2020), p. 15-16. Available at: http://ebook.comcec.org/Kutuphane/Icerik/5da9134b-2438-4ee5-890c-d78ad3669d41.pdf

AAOIFI developed standards for *Shari'ah* governance and hence *Shari'ah* boards by detailing the working mechanisms of, for example, Central Shari'ah Board (GS 8), Shari'ah Compliance Function (GS 9) and Internal Shari'ah Audit (GS 11) including the issuing of Shari'ah Annual Reports as a product of institutional level internal Shari'ah audit.[180] Thus, there exist well-developed standards for corporate and *Shari'ah* governance in guiding the operations of Islamic financial institutions. Furthermore, individual countries have also developed their *Shari'ah* governance system in line with the IFSB and AAOIFI standards. For example, the Shari'ah Governance Policy Document,[181] last updated by Bank Negara Malaysia in 2019, provides a guideline for Islamic financial institutions in their efforts for *Shari'ah* compliance.

The experience demonstrates that mainly two *Shari'ah* governance models have emerged through the development of the Islamic financial ecosystem to respond to Shari'ah compliance. In the primary model, namely decentralised *Shari'ah* governance, *Shari'ah* compliance process is organised at the individual Islamic finance institutional level, while in the centralised model, overarching *Shari'ah* governance and compliance is provided by the central *Shari'ah* board along with individual *Shari'ah* board or Shari'ah Committee reporting to the Board at Islamic banks and financial institutions. Thus, the centralised system offers two layers of *Shari'ah* governance and compliance – the central *Shari'ah* board and individual *Shari'ah* board at the institutional level.

In the centralised *Shari'ah* governance system, two sub-models have emerged. In the first model, the Central Shari'ah board is located under the official regulatory body, such as the Central Bank or Banking Regulation Authority. For example, in Malaysia, the central Shari'ah Advisory Board operates under the jurisdiction of the central bank. In the second model, such as in Indonesia and Turkey, the central Shari'ah board is located under civil society organisations. In Indonesia, it is operated under a religious establishment in the civil society, while in Turkey, the central *Shari'ah* board operates under the Participation Banks Association of Turkey. Regarding Afghanistan, as mentioned above, SSB at the DAB, as the centralised *Shari'ah* governance, functioned to ensure *Shari'ah* compliance in Islamic banks and windows. However, the new regime has also institutionalised RCIBCI in December 2021. Therefore, the roles and functionality between SSB at DAB seems dormant, as the existing MFIs have submitted their existing Islamic finance based microfinance products to be reviewed by the RCIBCI rather than the SSB at DAB. The distribution of functionality, if any, will emerge in the coming months.

It is important to note that there are no particular *Shari'ah* governance standards available for Islamic MFIs, as they are expected to operate within the guideline standards set by IFSB and AAOIFI. Therefore, global experience - such as Bangladesh, Indonesia and Pakistan - demonstrates that due to being relatively small institutions, Islamic MFIs have developed a precarious operation method in ensuring *Shari'ah* compliance. For instance, Akhuwat, one of the largest Islamic MFIs in the world, does not have any specific unit in its organisational structure responsible for *Shari'ah* governance. This involves Islamic MFIs asking advice from locally respected *Shari'ah* scholars and imams on the Shari'ah compliance of their products and operations, avoiding any institutional linkage. Such a practical solution has been recognised as efficient, as due to their operational size and the magnitude of their financial position, having institutionalised corporate governance and a *Shari'ah* board can be too costly for them.

In responding to the *Shari'ah* governance of small Islamic financing institutions, IFSB's Technical Note (TN-3 Technical Note on Financial Inclusion and Islamic Finance)[182] published in 2019 provides guidance as an effective solution to the Shari'ah governance mechanism in Islamic MFIs. However, due

[180] GS 8: Central Shari'ah Board Available at: https://aaoifi.com/issued-standards-2/?lang=en
[181] Available at: https://www.bnm.gov.my/documents/20124/761679/Shariah+Governance+Policy+Document+2019.pdf
[182] Available at: https://www.ifsb.org/download.php?id=5519&lang=English&pg=/published.php

to their small operational nature, Islamic MFIs should not be expected to follow AAOIFI and IFSB standards to the letter as long as they show the aptitude toward *Shari'ah* governance within the non-institutional method as mentioned above.

IFSB's TN-3 (Note: 301, p. 75-76), accordingly, states that:

"For both *Shari'ah* and corporate governance functions .., the TN recognises a proportionate approach for non-prudentially regulated service providers in financial inclusion, particularly those smaller-sized entities that may utilise shared centralised services. This proportionality would involve outsourcing the corporate and *Shari'ah* governance functions to a professional services entity in exchange for a fee. The service provider will benefit from the entity's expertise while saving on the costs of having in-house corporate and *Shari'ah* governance functions. Specifically for *Shari'ah* governance, an option to reduce the costs of operations may be for each smaller service provider to rely on a single Shari'ah adviser, or for a number of such providers to collectively engage one adviser or a *Shari'ah* consultancy firm. An additional modality may be when voluntary *Shari'ah* services may be offered by *Shari'ah* advisers, *Shari'ah* advisory firms or *Shari'ah* boards of firms (e.g. Islamic banks) to smaller service providers as part of their social solidarity/CSR efforts."

Considering that MFIs in Afghanistan are mostly smaller in operational and financial size, IFSB's TN-3 will be helpful to overcome the burden that may be faced due to *Shari'ah* governance. Thus, as in other countries, they can be advised to develop a precautious informal arrangement with respected Shari'ah scholars closer to the regime to ensure the Shari'ah compliance process. In addition, as has been identified during the interviews, RCIBCI will act as the centralised *Shari'ah* supervisory body within the state apparatus, which will be the equivalent of the Central Shari'ah Board for Islamic finance in various jurisdictions. Hence, RCIBCI will ensure the central *Shari'ah* compliance, and local *Shari'ah* scholars can act as an individual institutional solution. It was clear from the interviews that those MFIs, which had already had Islamic offerings in place, submitted for *Shari'ah* approvals to RCIBCI.

Alternatively, as IFSB's TN-3 identifies, MFIs can get into a collective arrangement between themselves to establish a formal relationship with a *Shari'ah* scholar who can provide *Shari'ah* advice on their operations and products, which can reduce their operational cost. Importantly, as also advised by IFSB's TN-3, international *Shari'ah* advisory companies such as Malaysian and GCC based ones may consider extending their Islamic solidarity and provide advisory services to MFIs on *Shari'ah* compliance as part of their Islamic CSR and solidarity. This is an important cause, as Afghanistan needs urgent restructuring so that dire economic conditions can be healed.

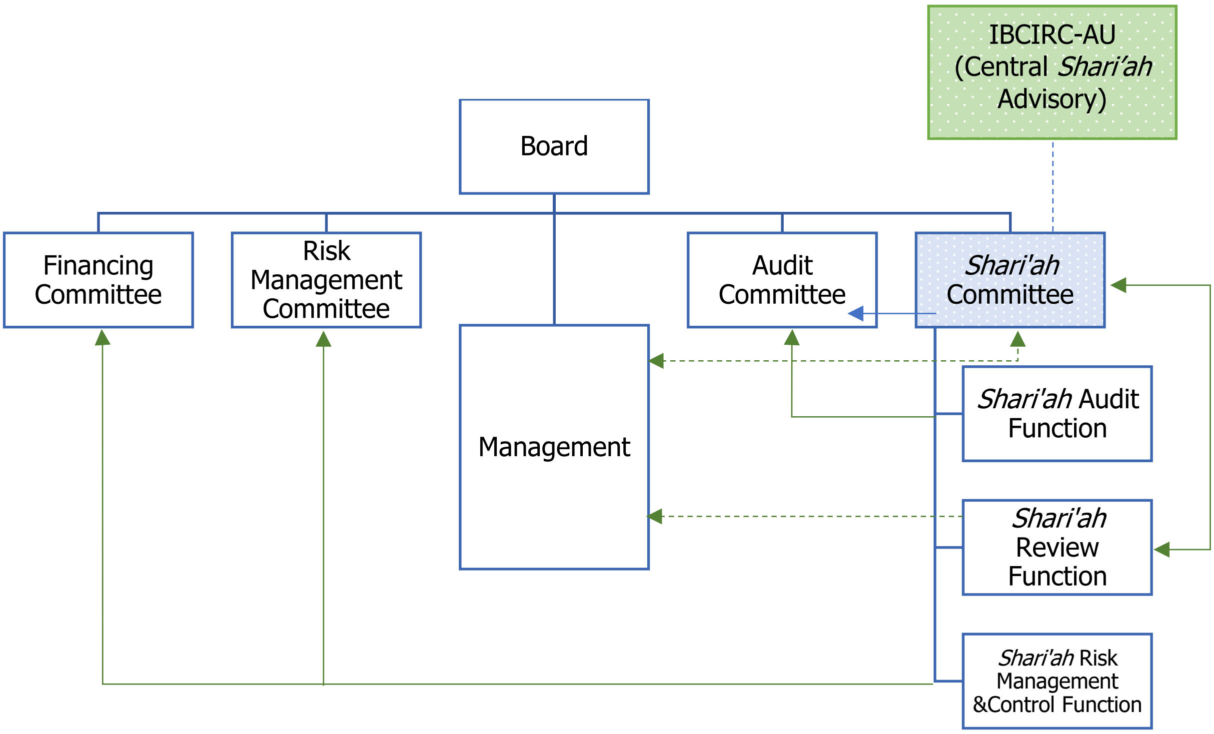
As for the Islamic finance offerings by large institutions, as can be seen in the case of the Islamic Bank of Bangladesh, their Islamic microfinance operations benefit from the bank's *Shari'ah* governance system, which operates in line with AAOIFI and IFSB standards. Similar arrangements, along with centralised *Shari'ah* governance by RCIBCI, can be considered for a relatively larger bank-based MFI in Afghanistan. For example, FMFB-A is a commercial bank that will be subjected to Islamise its operations under the central *Shari'ah* governance advice provided by RCIBCI. FMFB-A already institutionalised a *Shari'ah* governance through an internal *Shari'ah* advisor before the regime change and they have submitted their Islamic product for approval by the RCIBCI, which is evident in the following statement provided by an interviewee from FMFB-A:

"We already have the structure. We have an in-house Islamic banking department; we have already established. We have a *shari'ah* board, *Shari'ah* advisor. This is our internal corporate governance that we have already established. It will be completed after the central bank approval; few positions are remained. That will be completed within this month." (FMFB)

Therefore, after the transitionary period, FMFB-A type institutions, which as banking operations, can be advised to develop the *Shari'ah* governance model proposed in Figure 23. This model endogenies the Central Shari'ah Governance (provided by RCIBCI) and also forms an internal Shari'ah Committee.

The depicted *Shari'ah* governance mechanism will directly inform the microfinance operations and ensures their *Shari'ah* compliance.

Figure 23: Shari'ah Governance Model for Banking Model Based MFIs

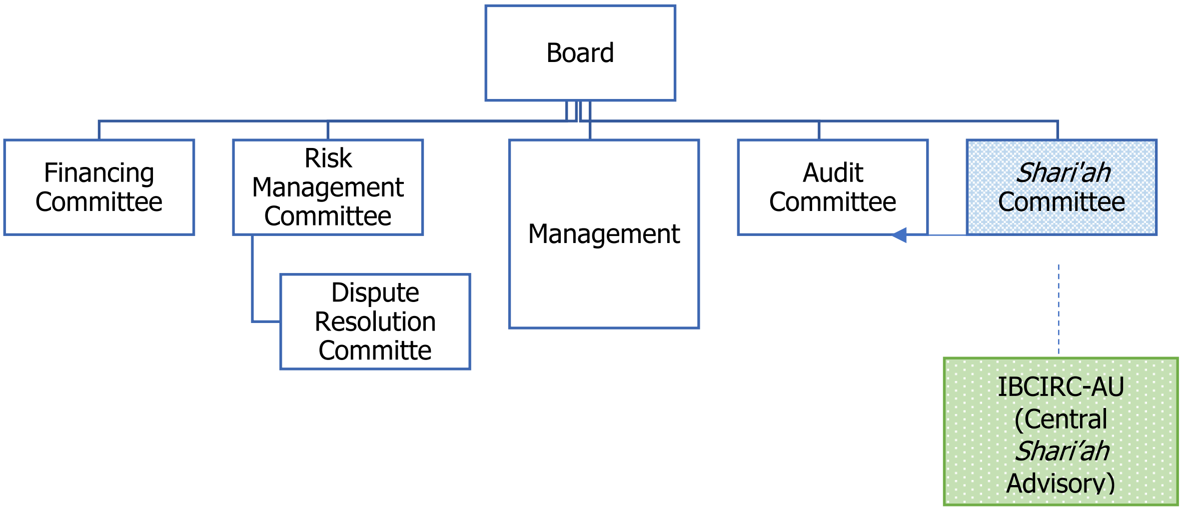


As for the rest of the MFIs, after the initial transitionary period, they are advised to follow IFSB's TN-3 as discussed above to reduce the cost of corporate and *Shari'ah* governance. Such a formulation seems to prevail in some of the MFIs, as evident in the following statement provided by an interviewee:

"If they [RCIBCI] have any view on this [submitted Islamic products] we can have their feedback and we ask our *Shari'ah* advisor if they have any comments or anything. Our advisor may meet with them as he is also a *Shari'ah* advisor. He can give them more convenient comments about our policy. Because sitting with Academi Ulum people you should be a kind of *Shari'ah* person. If I go there they will not talk to me. Yes, operationally I am ok. But sitting with these *Shari'ah* people you should have an Islamic background. Our *Shari'ah* advisor can give them details about our products and policies. I hope they will understand our challenges. Even in the previous government, there were Islamic leaders who have given approval for us. I hope to get their feedback as soon as possible."

As for long-term progress when they are stable and extend their operations, they may consider developing their own model as proposed in Figure 24. This model, by definition, considers the centralised *Shari'ah* Supervision provided by RCIBCI and institutional MFI level *Shari'ah* committee but avoids bank-type *Shari'ah* governance system.

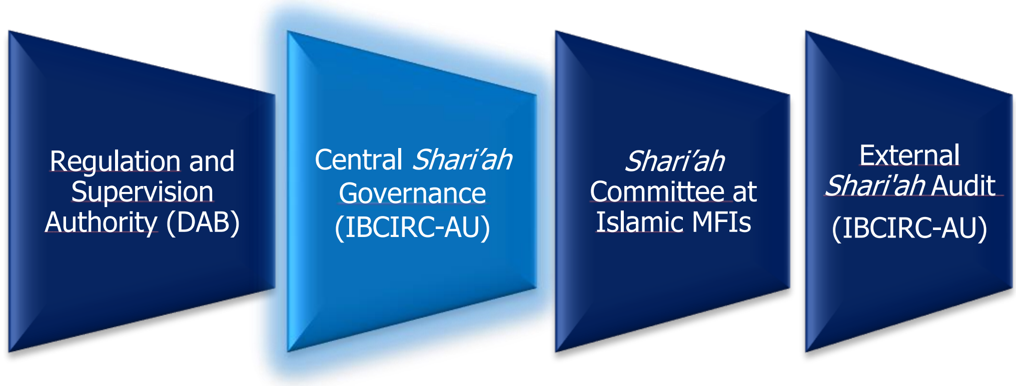
Figure 24: Shari'ah Governance Model for MFIs in Long-Term



As a result, the proposed *Shari'ah* governance ecosystem for Afghanistan for the long-term is depicted in Figure 25. Accordingly, while robust regulation and supervision are provided by the DAB, RCIBCI will act as Central Shari'ah Board, while in the long-term, individual Islamic MFIs are proposed to develop their individual Shari'ah Committees/Boards

In addition, in this model, it is proposed that the RCIBCI should provide the external Shari'ah Audit. However, the decision on SSB at DAB regarding its jurisdiction and functionality will determine the distribution of functions between RCIBCI and SSB at DAB. This decision will be important to determine which organisation will be in charge of 'oversight and accountability on *Shari'ah* related matters', '*Shari'ah* review function', '*Shari'ah* audit function', '*Shari'ah* risk and control function'. It is, however, clear that the new regime allocated the *Shari'ah* research function to RCIBCI in its decision in December 2021. Regardless of the distribution of the functions, as advised by IFSB's TN-3, *Shari'ah* compliance in smaller MFIs in Afghanistan will remain precarious and limited in scope and nature as in some other Muslim jurisdictions.

Figure 25: Shari'ah Governance Ecosystem for Islamic MFIs



As an urgent action, it is important to note that RCIBCI should respond to the Islamic microfinance products submitted to them by some of the MFIs by providing advice on their *Shari'ah* compliance and then approve them when they fulfil *Shari'ah* conditions. This will help to overcome the current stagnant position of MFIs, and it will also ease the economic tension and survival needs of the larger population benefiting from microfinance services. It is also important that RCIBCI must consider recognising AAOIFI and IFSB standards which went through the *Shari'ah* approval process with the involvement of respected *Shari'ah* scholars by the new Afghani regime.

5.2.8. Auditing, Monitoring and Reporting

Good corporate and *Shari'ah* governance process requires that financial and non-financial transactions and operations as well activities of MFIs should be subject to internal and external systematic and independent review and control. As part of the governance process, monitoring process ensures of assessing the quality of performance in the same areas so that institutional objectives can be achieved. Similarly reporting function requires that the results of the such processes in relation to financial and non-financial operations should be disclosed in a transparent manner.

These functions, therefore, refer to the corporate governance system, which requires properly identified roles and duties with the relevant departments within an organisation. As identified under the *Shari'ah* Governance section of this report, an effective governance mechanism is essential to ensure MFIs are operating within their institutional objectives and achieve their expected performance level. Therefore, as can be seen in Figure 23 and Figure 24, under the Board, Financing Committee, Risk Management Committee, Audit, and Shari'ah Committee should be placed to ensure risks are managed, operations are controlled, performances in all the operational areas are monitored, and outcomes are audited by the relevant departments.

In a market economy which is based on property rights, corporations constitute the operational nature of the societies. However, a survey of corporate structures and their governance demonstrates varying degrees and nature of corporate governance from the Anglo-Saxon shareholder-based model to the European stakeholder-centred model. In recent years, the theory of the Islamic corporate governance model has been underway in the face of increasing presence of Islamic banks and financial institutions as well as *Shari'ah-compliant* companies as part of the emerging halal markets. The common features of these models are their essentialisation of auditing, monitoring and communicating the results in terms of reporting. Thus, 'good governance' is determined by the effectiveness of institutions in developing the necessary measures and reporting the outcome of auditing and monitoring functions so that the risks in relation to financial and non-financial operations and measures (such as prevention of fraud, financial performance, governance measures) can be managed effectively. However, what is common in all these models is the good governance practices as identified by international agencies, such as the OECD, as well as the specific Islamic standards developed by AAOIFI and IFSB.

While extensive corporate governance practices developed for banks and corporations, microfinance in general and Islamic microfinance in particular have not been offered specific governance models and practices.

Islamic corporate governance model is based on considering all the stakeholders including ensuring *Shari'ah* compliant nature of the operations and businesses.[183] The Shari'ah Governance Standards were developed by AAOIFI and IFSB for banks and financial institutions offering Islamic financing. However, they do not particularly refer to Islamic microfinance offerings. IFSB's TN-3,[184] on the other

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[183] See: Abdullah, Hanimon & Asutay, Mehmet (2021). Constituting Islamic Corporate Governance Theory through Islamic Moral Economy, in T. Azid, M. Mukhlisin, N. Akbar and M. Tahir (eds.), *Monetary Policy, Islamic Finance, and Islamic Corporate Governance*. pp.13-36. London: Emerald.
Sencal, Harun & Asutay, Mehmet (2021). Ethical Disclosure in the Shari'ah Annual Reports of Islamic Banks: Discourse on Shari'ah Governance, Quantitative Empirics and Qualitative Analysis. *Corporate Governance: The International Journal of Business in Society*, 21(1): 175-211. DOI: https://doi.org/10.1108/CG-01-2020-0037.
[184] Available at: https://www.ifsb.org/download.php?id=5519&lang=English&pg=/published.php

hand, in covering financial inclusion implies all the non-banking financial institutions including Islamic MFIs. Hence, the relevance of IFSB standards for Islamic MFIs, which are now relevant for Afghani MFIs as they are expected to be converted into Islamic. Similarly, due to being transformed into Islamic offering-based MFIs, AOOIFI standards for *Shari'ah* governance will be relevant to the Islamised MFIs.

It is commonly agreed that the development of 'good governance' discourse, determining measuring benchmarks, monitoring performances, auditing operations and transactions and then reporting the outcomes will enhance the trustworthiness and credibility of Afghanistan's (Islamic) MFIs. Considering that international financing and aid has been an essential part of the resources of the Afghani MFIs, monitoring, auditing and reporting will enhance their credibility and trustworthiness in the eyes of the stakeholders, while it will enhance their Islamic legitimacy in the eyes of the stakeholders.

While international practices developed by OECD and ISO, among others, for transparency and accountability in developing the necessary structures for monitoring, auditing and reporting, this requires Afghanistan to develop the necessary governance structures, codes and institutions. It should however be stated that achieving security all over the country provides an essential criterion for good governance to develop corporate governance structures. However, it still requires essential effort along with political willingness, and therefore, this report considers developing corporate governance structures as a long-term objective for the administration as well as for the MFIs.

Having stated this, some of the MFIs are part of banking operations, for such institutions, it is inevitable that they must develop their corporate governance structure with their *Shari'ah* governance in the form of *Shari'ah* boards becomes inevitable even in the short-run.

Shari'ah governance requires that operations and transactions as well as the products of MFIs be Shari'ah compliant. AAOIFI standards for *Shari'ah* compliance require Shari'ah Annual Report (SAR) as a "*Shari'ah* compliance report to disclose the necessary information to assure stakeholders that the operations are conducted according to Shari'ah rules and principles". [185] AAOIFI standards provide the items as the contents of the SAR. Thus, SAR is a product of internal auditing to mitigate Shari'ah risk and report *Shari'ah* non-compliant income and activities so that *Shari'ah* compliance can be monitored. Thus, from now on, Afghani MFI based on banking structures such as FMFB-A type institutions should consider developing their SAR to be communicated. However, the rest of the MFIs can consider following the advice provided by IFSBs TN-3[186] by consulting *Shari'ah* scholars in a precarious manner to avoid further costs.

Regardless of the necessity for *Shari'ah* governance, all the MFIs, regardless of whether they are bank based operations or not, must audit and monitor their financial and non-financial operations, business services and report (disclose) the outcomes to be considered as trustable and accountable organisation to attract international support and financing or aid. For example, prevention of fraud and transparency remains an important objective of governance, which have to be tackled effectively to ensure good governance status. In addition, SAR will provide further legitimacy in the eyes of international Islamic finance connectivity to attract funding.

The audit, monitoring and reporting "is concerned with the health and the well-being of the institution. They should be viewed as advocates, guardians and trainers of the MFI". [187] Hence, long-term robust operation and sustainability of the business of MFI in Afghanistan require developing good governance involving auditing, monitoring and reporting.

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[185] Sencal, Harun & Asutay, Mehmet, *Ethical Disclosure in the Shari'ah Annual Reports of Islamic Banks: Discourse on Shari'ah Governance, Quantitative Empirics and Qualitative Analysis. Corporate Governance:* The International Journal of Business in Society (2021), 21(1): 175-211. DOI: https://doi.org/10.1108/CG-01-2020-0037.
[186] Available at: https://www.ifsb.org/download.php?id=5519&lang=English&pg=/published.php
[187] MicroSave (2007). *MFI Internal Audit and Controls Toolkit*. Available at: www.MicroSave.org

5.2 Conversion Process

Since the internationalisation of Islamic banking and finance set at the beginning of this century and its successful implementation in the dual banking system, several conventional banks have converted into Islamic banks. On the other hand, a limited number of countries, such as Iran and Sudan, opted for full Islamisation of their economy and financial system after the Iranian revolution in 1979 and Sudan's military rule until recently (as Sudan has recently opted out of Islamic system). Thus, the conversion process of Islamic banks in the dual banking system indicates voluntary conversion either due to benefiting from the opportunity space created with the expansion and diffusion of Islamic banking globally or following ideational politics in institutional formation. Such examples include Exim Bank of Bangladesh (2004), Albaraka Bank Egypt (2010), Kuwait International Bank (2007), Public Islamic Bank Berhad, Malaysia (2007), Bank Al-Jazira, Saudi Arabia (2005), Emirates Islamic Bank (2005), among others.[188] Similar conversions took place in Libya and Oman in the post-Arab Spring period.

Among other regulative bodies, the Islamic Banking Department of the State Bank of Pakistan, for example, issued Guidelines for Conversion of a Conventional Bank into an Islamic Bank.[189] Similarly and significantly, DAB issued the Regulation for Conversion of a Conventional Bank into an Islamic Bank[190] in May 2018 to support the conversion of conventional banks into Islamic banks, which should be considered a crucial foundational base for the conversion of the financial system into Islamic after the 15 August 2021 regime change in Afghanistan.

Regarding the conversion from a conventional bank to an Islamic, AAOIFI issued *Shari'ah* Standards No. 6 - Conversion of a Conventional Bank to an Islamic Bank[191] in 2002, which "explain procedures, mechanisms and treatments that are required for converting a conventional to an Islamic bank (bank/banks) that observes the rules and principles of *Shari'ah* in its operations and financial relationships, and, at the same time, embraces the objectives and functions of Islamic banking services". [192] Thus, the standards providing the necessary guidelines for effective transformation will be critical for Afghanistan's MFIs at this new juncture. However, the institutional distinction between a banking organisation and MFI should not be missed in applying the standards, as the latter have entirely different dynamics, organisational structures and operational mechanisms. Nevertheless, a description of Islamic financing products for the conversion process will also be helpful for MFIs along with the sub-standard relating to the 'effect of conversion on the interest based receivables and their *Shari'ah* alternatives'.

A number of banking conversion model has emerged within the practice of the dual banking system. The first model involves conventional banks opening Islamic branches, while the second model is more structured in terms of creating Islamic windows. The third model in the dual banking system is the conversion into a full-fledged model.[193] These are all applied in different jurisdictions based on the dual banking system as the examples provided above. However, with the regime change on 15 August 2021, Afghanistan's new regime imposed the conversion of the entire system into an Islamic economy and finance. Therefore, the first two models will not apply in the Afghanistan case, while the third model will be helpful for institutional conversion. Therefore, DAB's previously mentioned regulation will be useful to facilitate the process. Additionally, relevant official bodies such as SSB at DAB and RCIBCI

[188] For further details, see: Al Harbi, Ahmad (2020). The Effect of Conversion of Conventional Banks to Islamic Banks: Evidence from the GCC Countries. *International Journal of Islamic Business*, 5(1), 1-35.
[189] Available at: https://www.sbp.org.pk/ibd/2017/C1-Annex.pdf
[190] Available at: https://dab.gov.af/sites/default/files/2019-01/Regulation%20for%20Conversion%20of%20a%20Conventional%20Bank%20into%20an%20Islamic%20Bank-converted%20%281%29.pdf
[191] AAOIFI (2002). *AAOIFI Shari'ah Standards No. 6. Conversion of a Conventional Bank to an Islamic Bank*. Available at: http://aaoifi.com/ss-6-conversion-of-a-conventional-bank-to-an-islamic-bank/?lang=en
[192] Ibid. p.151.
[193] See: Al Harbi (2020).

must expedite the process of developing the necessary foundation for the conversion of the system along with the conversion of individual banks by using the 2018 issued document as a base.

Available literature and practical experience identify measures of the conversion process, which are listed in the scant literature,[194] as follows:

- "setting-up necessary procedures and required tools of conversion
- changing operating licence according to *Shari'ah*
- restructure organizational structure to fit the conversion process
- changing employing procedures to fit conversion process
- formation of a *Shari'ah* supervisory board
- formation of the *Shari'ah* auditing department in the bank
- reformatting contracts to comply with *Shari'ah* standards
- open local and international Islamic bank accounts
- revamping accounts that are maintained with conventional banks".

Furthermore, the literature and practice concerning the conversion process in banks identify following road map items in relation to receivables and investments, which are:[195]

- "Liquidating all the previous traces of conventional transaction
- Increasing the bank capital by increasing the shareholder's capital or any other permissible means
- Issuance of Islamic certifications such as *musharakah*, *mudarabah* and *ijarah*
- Destroying impermissible tangible assets
- Employing all lawful means to avoid paying interest
- In case of liabilities, the bank refuses to provide non-permissible services even if it has to pay compensation
- Accelerating the redemptions of all impressible pledges attached to the assets of the bank
- Any interest or impressible earnings should be channelled to charity or general utility
- Paying *zakat*"

Regarding successful transformation in the banking sector, it requires "willingness to change", "effective and Islamic finance skilled human resources", "institutionalisation of Islamic capital market to support the transformation process", such as liquidity creation purpose, and "relevant experience".[196]

While there is scant academic literature and well-established guides, regulation and practice in the conversion of banks into Islamic banks, there is hardly any practice, regulation and academic literature on the conversion of microfinance institutions from conventional into Islamic MFIs. However, above mentioned Regulation issued by DAB in 2018 provides some indications concerning the operational aspect of the conversion of MFIs into Islamic MFIs.

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[194] Ahmed, F and Hussainey, K, *Conversion into Islamic Banks: jurisprudence, Economic and AAOIFI Requirements* (2015). *European Journal of Islamic Finance*, 3, 1-8.
[195] Ahmed and Hussainey (2015), pp. 6-7.
[196] See: Abdalla, M.; Aziz, M. R. and Abdalla, M. (2015). Analyzing the Impact of Banking laws and Legislations on the Converting of Conventional Banks into Islamic in Libya. *International Journal of Management and Applied Research*, 2(4), 156-171. Available at: https://doi.org/10.18646/2056.24.15-016.

Considering the regime change, the willingness to change is no longer an option available for the MFIs. However, effective and Islamic finance skilled human resources development in a short span of time can pose a huger challenge considering the urgency of the conversion process due to imposed political will. Therefore, international Islamic finance related multilateral institutions such as IsDB, AAOIFI and IFSB, among others, should extend their solidarity with Afghanistan to develop the necessary social capital through training programmes to meet the requirements of the conversion. As regards 'relevant experience' for effective conversion, as pointed out in various sections of this Report and as evidenced by the interviewees, some of the MFIs had already Islamic microfinance offerings operating in the field, which have been submitted for approval to RCIBCI. Considering that there is also an Islamic bank in Afghanistan as well as certain experience at the DAB, it can be concluded that a certain level of critical expertise exists in the country and the microfinance industry. Therefore, it is crucial that those MFIs with experience in Islamic offerings should extend their support to the MFIs who do not have such expertise through which collectivism of the Islamic spirit can be expressed. As for the 'Islamic capital market', it should be considered a long-term institutional development in the country.

The conversion process requires an oversight process, which is essential in ensuring an effective Islamisation. For this, RCIBCI, as the new centralised *Shari'ah* governance authority along with the experience developed in DAB as well as in the Islamic bank, should develop an oversight process in line with the regulation issued by the DAB. This should be developed urgently, if necessary, again in further collaboration with the international Islamic finance related bodies so that MFIs can be operationalised immediately to rescue people from dire economic conditions.

> "Conversion the business model from conventional to Islamic model products is hugely costly. Because they don't have any sources of income, they are covering opex from equity. It needs IT infrastructure investment, development of procedures, requires capacity building, staff training, technical assistance etc. So huge costs are associated to convert their model from conventional to Islamic. Considering that institutions are paying their operation cost from their equity right now." (Interviewee)

One of the requirements of an effective conversion process is the creation of the *Shari'ah* board or committee in the banks. However, as mentioned in the *Shari'ah* governance section (see: Section 5.2.7.), following IFSB's TN-3-based guidelines, due to being small operations, MFIs can benefit from other options, as detailed in Section 5.2.7.

Regarding the receivables and investment-related process listed above, the new regime has already banned any interest-bearing contracts, which resulted in the halting of new loan disbursement. In addition, under the new rules, all returns on loans were removed, implying that such a condition for effective conversion has also been fulfilled de facto.

Since some of the MFIs had already offered *mudarabah* and *ijarah-based* Islamic microfinance, they have experience in product development. However, other MFIs must also develop the same capability and capacity, for which the Islamic finance experience of those MFIs, along with the support from RCIBCI and DAB's Islamic finance department, will be essential. Therefore, knowledge and skills sharing and transfer between these institutions must be expedited to overcome the current stalemate. Furthermore, in the long run, they should develop the necessary capacity to innovate new Islamic financing tools to fit into the country's new economic realities, including *musharakah-based* structures. Moreover, they should also develop capabilities as to how to treat Islamic donations such as *sadaqah* and *zakat* as well as *qard al-hasan* for microfinance purposes, which requires a different setting.

An important issue that remains to be tackled is the source of funds, as some of the MFIs have received funding and donations to be able to operate and extend their businesses. In most cases, if not all, these funds were coming from non-*Shari'ah* compliant international institutions and funds. It should be noted that this does not constitute a *Shari'ah* breach, which is evident with the global capital movements within Islamic finance, including Islamic capital markets. Beyond political considerations, RCIBCI, similar to any other Islamic finance *Shari'ah* governing body in the OIC member countries and beyond, must accept such funding sources as *Shari'ah* compliant, which is essential for the survival of these institutions but also essential for the survival of thousands of families.

It should be mentioned that the conversion of MFIs can be structurally and politically controversial issues for those foreign institutions and funds which has provided funding for the start-up and operation of some of the MFIs. However, considering the human catastrophe Afghanistan is facing, continued financing to these institutions and also international *Shari'ah* compliant and otherwise further funding from different sources are critically important for human survival and security.

The interviewees conducted for this study, however, show that there is not a particular concern over Islamisation among the foreign funded MFIs. As one member of such an MFI stated: "We have also looked to the organization in Pakistan which manages to do zero interest lending but they are very religious, they are located in mosques and they rely on the generosity of the borrowers who at the end of his repayments by himself gives a present, financial contribution to the organisation they manage to be successful fully in this Islamic solidarity scheme. Now first of all we are a foreign organization, so it is not that we will be working in the mosque tomorrow. Of course, we can adapt if this is the way forward. But still, for the moment we thought that the situation is so dire in Afghanistan that the borrowers we see they just do not have the means to make present at the end of the loan or to give a contribution to the organization because life is so hard for them already." Still, some of the representatives of foreign financed MFIs were not sure about the Islamisation process despite the fact that they offered Islamic microfinance for a while. However, their main concern proved to be international sanctions. In the worst-case scenario, to ensure the operations of these MFIs and facilitate their efforts in making people's lives better, some of the shareholders or donors may consider withdrawing by not affecting the operation of the respective institution.

Lastly, to facilitate the process of conversion and Islamisation, Islamic finance related multilateral institutions such as IsDB should extend their solidarity fund to Afghanistan's MFIs. In addition, global and leading Islamic banks and financial institutions should direct their CSR related financial activities to Afghani MFIs with the same objective. At the same time, international standard bodies such as AAOIFI and IFSB should provide training, and international *Shari'ah* advisory institutions should provide their services as CSR – so that the transition period can be smoothly and effectively completed.

5.3 Capacity Building

Microfinance goes beyond financing and includes a developmental process with capacity building programmes. Afghanistan's microfinance sector also has the same approach concerning its target population. The interviews with the MFIs suggest that all MFIs already have specific training programmes for their staff and clients. They have also provided training to their clients in different areas such as business plans, dealing with challenges, and how to spend wisely. For instance, OXUS have prepared financial education videos in local languages (Interview). In addition, AMA has played a significant role in increasing the capacities and capabilities of the relevant stakeholders through lobbying toward local and central government officials, providing technical support to the MFIs' clients, supporting MFIs' employees to attend local and international training programmes, introducing radio programmes on microfinance to reach a vast majority of the people. Consequently, the MFIs and AMA have the capacity to implement a wide range of capacity building programmes for different segments of society. However, after the regime change, the contents of these capacity-building programmes and target segments should be revised because all microfinance

> "We have separate department for everything, agriculture department where still we have people who can support farmers. They were going to rural areas where they were providing information about new products, about new things. It is common in Afghanistan to train them in mosques and elders houses, guest houses. We were inviting them to come, and providing trainings about agriculture and other things." (Interviewee).

activities have to be *Shari'ah* compliant, which is a new practice for all stakeholders even though the MFIs have had some kind of Islamic financing offerings, which have not been approved by the regime authorities yet.

Islamic microfinance comprises different financing disbursement processes, sources of funds, risk-mitigating tools and even, in some cases, Islamic social finance instruments. Therefore, capacity building programmes should cover all the relevant stakeholders at different levels and contents. As evidenced in the interviews, although some of the regime authorities have a particular level of understanding of *Shari'ah*, there is a lack of understanding in finance, microfinance, and even Islamic finance among them, particularly it is valid for lower-level officials, as emphasised by interviewees.

In addition to the new authorities affiliated with government staff, current human resources who were working in the government's financial sector related units, particularly the Ministry of Finance and DAB before the regime change, should also be included in the training programmes to develop skilful human capacity for ensuring synergy and effectiveness in the entire sector. Furthermore, as evidenced by the interviews, human resources of the microfinance sector have been adversely affected by the regime change in a way that some of the skilled people left the country, including upper-level MFIs' employees and government officials in the Ministry of Finance and DAB. This deterioration in human resources also enhances the urgency of capacity building programmes for the sustainability of the microfinance sector in the newly emerging business environment.

Accordingly, as depicted in Table 17, the capacity building programmes should target four segments, including new clients who can be reachable by MFIs due to the uplift of the security issues across the country: (i) MFIs staff, (ii) existing clients, (iii) government officials, (iv) new clients.

Table 17: Capacity Buildings Programmes and Target Segments

MFIs' Employees	Existing Clients	Government Officials	Society
• Have some level of knowledge about Islamic finance and microfinance • Should be trained about Islamic microfinance products and services, and business model • Tailored training programs should be provided to the different levels of the staff • Comprehensive training should be provided to field officers, particularly loan officers, on the Islamic economy and finance • Financial and technical support is required from International organisations • Online training methods should be utilised • Along with MFIs, AMA should have an active role	• Have limited knowledge about Islamic finance and microfinance • Should be provided training about Islamic economy and finance • Islamic financial literacy on microfinance products and services should be increased • Training on business plan, accounting, risk management methods should include Islamic finance aspects • Loan officers should be active in informing them and answering their questions • Along with MFIs, AMA should have an active role	• Have some level of knowledge about the Islamic economy and *Shari'ah* • Have limited knowledge about Islamic finance and microfinance • Should be informed about the importance of microfinance and its business nature • Should be trained about Islamic finance architecture and regulatory environment • Experts from international Islamic finance organisations should provide training • Online training methods should be utilised • AMA can play an active role	• Lack of knowledge about microfinance and the MFIs • Have limited financial literacy • Should be trained on Islamic economy and finance • Community awareness programmes should be organised by MFIs and AMA • Radio programmes should be introduced • Lobbying toward local authorities and elders • AMA can have an active role

a) MFIs' Employees

Microfinance is a labour-intensive business and requires close monitoring and assistance services to clients by MFI staff. Currently, microfinance staff in Afghanistan have a certain level of knowledge about Islamic finance and microfinance, as some of the MFIs have already provided Islamic financing offerings. On the other hand, all staff should adopt the new Islamic microfinance business model, which includes various products and approaches different from conventional microfinance. Accordingly, they should be trained about Islamic microfinance products and services and a business model. The key staff are loans officers who usually work in the field and contact existing or potential clients. In the current situation where all microfinance businesses will convert to Islamic, loan officers must be trained in Islamic economy and finance. Furthermore, because the clients also need to be informed about Islamic microfinance, which will be a new practice for many microfinance clients, the loan officers will be the focal points for clients on their questions about Islamic microfinance.

> "The training of the loan officers is extremely important. Most of the clients cannot come to the bank to pay the loan in case of any MFIs. These loan officers would complete the forms on their behalf and give them for signing. And when it comes to the collection loan officers are going to the recipients or small places of the business. Loan officers have to be mobile. They are all provided motorbikes, or some means of transport to go to visit the customer and educate them. The most critical one is the loan officers. We also provide ongoing training to our customers in any line of the business." (Interviewee)

Tailored training programmes should be provided to different levels of the staff, including the staff who will be responsible for *Shari'ah* governance issues. All these capacity-building programmes require expertise in Islamic economy and finance. Although it is noted from the interview that one MFI contacted with *Shari'ah* consultant from Pakistan to train the staff on *murabahah* just before the regime change to get ready for the possible power change in the country, there is much comprehensive training needed for staff on Islamic finance. However, such efforts require financial sources and expertise, which can only be available with the support of international Islamic financial institutions such as IsDB Institute, IFSB and AAOIFI and Islamic banks and Islamic MFIs. In addition, Afghanistan's microfinance sector can have support from different countries where Islamic finance is prevalent and close ties with Afghanistan, such as Pakistan, Bangladesh, Malaysia, Indonesia and Turkey.

MFIs should organise these training programmes for MFI's staff. Similarly, due to its previous experience in organising such programmes, AMA could also contribute with the support of MISFA or other international institutions. In addition, digital platforms should be utilised so that Islamic finance experts and practitioners from different countries can be part of the training programmes.

b) Existing Clients

Some of the existing clients of MFIs have already used Islamic financing, mainly in the form of *murabahah* and *ijarah*. While these clients have knowledge about Islamic microfinance, many of the existing clients do not, as they did not get any types of these financings. In addition, as evidenced by the interviewees, the MFIs have been providing some training about business plans, risk assessments, and other types of training that have improved their financial literacy. However, the clients who used to have conventional financing have to switch to Islamic products, which is the only option after the regime change. Therefore, MFIs should train and inform their clients on Islamic economy and finance and increase their Islamic financial literacy on new microfinance products and services. Besides, the available training programmes on business plans, accounting, and risk management methods should be revised according to Islamic microfinance. MFIs should provide the capacity building programme for existing clients of the MFIs with the support of AMA and other external stakeholders.

c) Government Officials

After the regime change, the human capacity of the government bodies responsible for the financial sector deteriorated because some of them left the country. As pointed out by an interviewee, the DAB is likely to get some expertise from Middle Eastern countries or Pakistan, particularly for the conversion process of conventional banking to Islamic banking. There is a different level of understanding of Islamic finance among government officials. One of the interviewees summarised the situation as follows:

"There are different people in the current government. At the top-level management, there is more understanding; at the low-level management seems, knowledge of Islamic finance is lower, and less understanding is shown. When you come to a low level, their knowledge is limited about microfinance."

Therefore, government officials charged with the portfolio of banking and finance and Islamic microfinance, in particular, should be first informed about the importance of microfinance and its business nature. Additionally, they should be trained in the Islamic finance architecture, which includes Islamic financial institutions, legal environment, supervisory bodies, *Shari'ah* governance structure and other components,[197] benefitting from the best practices in different countries. International Islamic finance experts should deliver such sessions and training programmes. AMA can organise such training programmes with the support of international partners. Online training methods can be the most critical enabler to getting expertise from different countries and improving the quality of the courses.

d) Potential Clients

Apart from the adverse impact of the new regime change, all the interviewees have pointed out that the microfinance sector would have some opportunities. As an essential potential success factor, security is ensured across the country; they can expand their operations to the provinces where they did not operate before due to security issues. New capacity-building strategies should be developed for these niche markets as the potential clients do not have knowledge about microfinance and MFIs. Besides, it is most likely that they have limited financial literacy and knowledge about Islamic microfinance products and services. Accordingly, they should be trained in Islamic economy and finance, along with financial training such as preparing business plans, dealing with risk management issues, budget planning, etc. MFIs and AMA should organise community awareness programmes through face-to-face meetings with people in urban and rural areas. TV and Radio programmes should be introduced as carried out by AMA before. Furthermore, meeting with local authorities and community elders should be arranged to facilitate the capacity building process for the target population. AMA can play a key role with the support of international and local institutions.

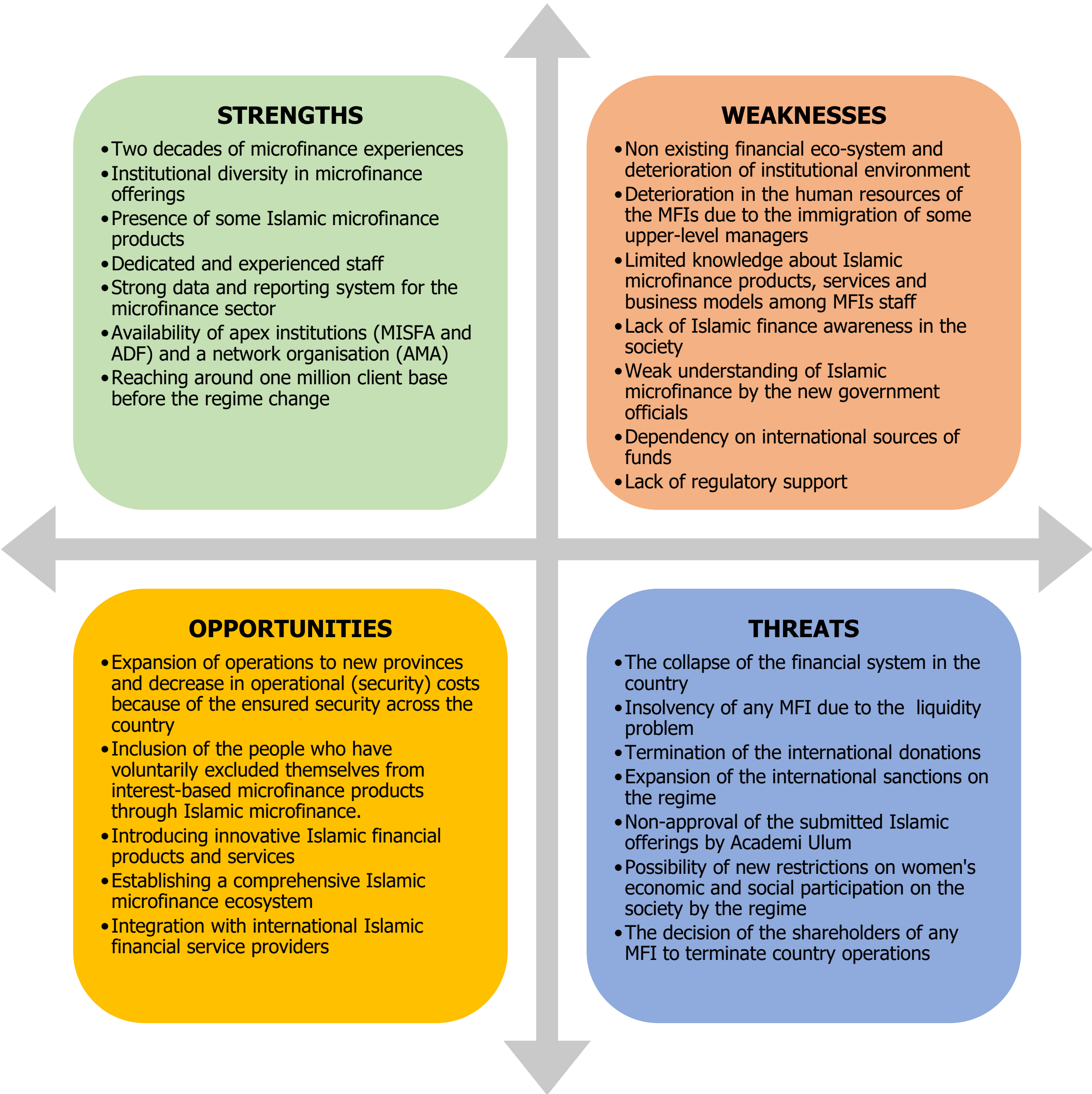
[197] https://www.comcec.org/wp-content/uploads/2021/07/7-FIN-AR.pdf

6. Potentials, Challenges, and Strategies

6.1 SWOT Analysis

Figure 26 summarises the findings of the Report in the form of SWOT. It should be noted that institutional uncertainties created by the current political environment have been affecting the operations of MFIs as the main threat. However, as identified, considering the development need in the society for human survival, there is an urgent necessity to re-instate the institutional offerings so that the opportunities can be captured despite the ongoing challenges.

Figure 26: SWOT Analysis of Microfinance Ecosystem in Afghanistan



6.2 Policy Recommendations

6.2.1 Reflections and Introduction

The preceding sections aimed at developing a critical understanding of Afghanistan's microfinance sphere by mainly focusing on the challenges and the implications of regime change in August 2021.

As a financial resource and capital poor country, Afghanistan's economy has been incentivised over the last twenty years with external finance, international aid, and donations as cash and as projects in various forms. As a result, the economy had been in a recovery mode between the post-war economy and micro development in the periphery until the regime change in August 2021. As discussed in detail throughout this report, initial institutionalisation in various forms in the economy and society, including the institutionalisation of MFIs, was taking place to uplift people's lives by negating abject poverty.

With the regime change, the existing social formation and developed social capital have nearly disappeared. As a result, the remaining institutions operating in the country came under heavy questioning concerning their Islamic legitimacy leading to the termination of their operations. MFIs are included among such institutions whose operations are *de facto* halted.

As the *conclusive recommendation* developed from research for this Report, it is stressed that considering that development is an essential message of Islam, it is incumbent on the new regime to develop an Islamic development agenda. Thus, such a developmentalist strategy with its institutional forms must be prioritised by the new regime in Afghanistan, as justice and *Shari'ah* essentialises development. On the ground, in the face of resource unavailabilities, MFIs have been developing a vital base to achieve micro-development by enabling individuals and helping them function so that the empowerment process of development can be achieved.

It is, hence, incumbent on the regime and the administration to facilitate the process of MFIs to deliver Islamic microfinance in the face of abject poverty and human catastrophe facing the country. Therefore, based on the philosophy of Islamic development, in the preceding sections, the transformation of the microfinance sector and MFIs are discussed in great detail to draw policy recommendations as summarised in the following sections so that the human-centred development objectives of Islam can be achieved through Islamised MFIs. The recommendations are organised as 'urgent actions', 'institutional transformation', and the 'long term'.

6.2.2 Urgent Actions in the Transitionary Period

a) Accelerating the Approval Process of the Submitted Islamic Offerings by the Regime Authorities

Considering the paramount importance of re-instating the operations and transactions of MFIs in a *Shari'ah*-compliant manner, it is of utmost importance that international bodies and multilateral Islamic finance organisations make the necessary representation with the current administration and RCIBCI so that abject poverty can be overcome with the operations of Islamised MFIs.

The authorities, hence, should be contacted, for example, by respected international *Shari'ah* scholars or organisations to persuade them to accelerate the approval process of the submitted products. One of the interviewees pointed out that leading international *Shari'ah* scholars involved in the Islamic microfinance industry may help to convince the regime's authorities to permit the operations of MFIs which provide Islamic financing products. However, the MFIs are struggling to start the conversion process due to the lack of guidance from the regime authorities. They are still waiting for a response from the RCIBCI about the submitted Islamic financing offerings.

b) Assigning the DAB as Responsible Authority for Transition of Conventional Microfinance to Islamic

Considering that the DAB has been functioning relatively stable manner since the early 2000s, it is important to ensure that it functions to ensure the stabilisation of the economy, overcome the liquidity constraints and mobilise the resources in the economy in line with the realities of the economy in a *Shari'ah*-compliant manner. Therefore, the urgent transition of *Shari'ah* compliance is a must with the DAB, for which the internal dynamics of the Bank will be essential and also the support from international agencies such as IsDB Institute, AAOIFI and IFSB must be sought. In addition, the existence of an Islamic finance department within the DAB will be an essential starting point to accelerate the process for the approval of the urgent transition of MFIs into the Islamic finance sphere and for the approval of their existing Islamic finance products.

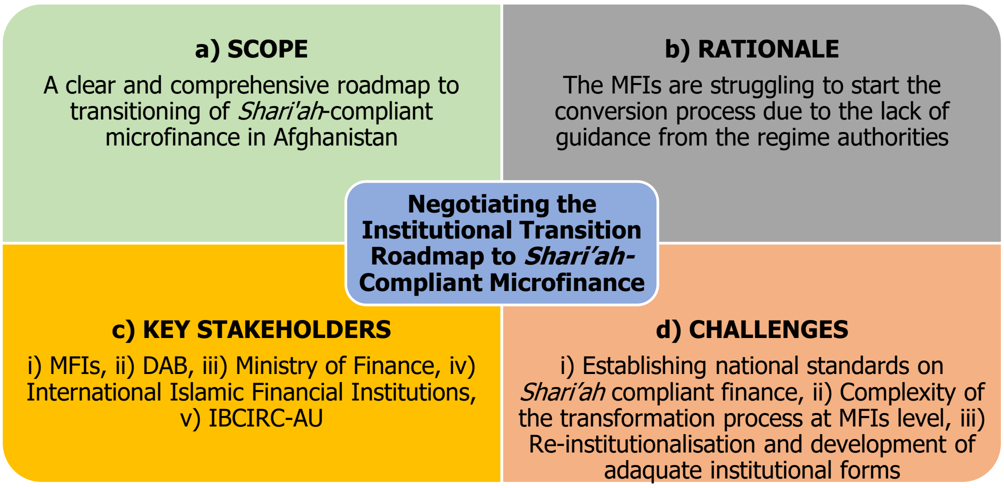
6.2.3 Institutional Transformation

This section details institutional transformation related recommendations based on the research presented in the proceeding section and the development philosophy expressed in the initial part of this section.

i) Negotiating the Institutional Transition Roadmap to Shari'ah-Compliant Microfinance

Based on the presentations and discussion identified in the preceding sections, the following figure summarises the recommendation.

Figure 27: Recommendation: Negotiating the Institutional Transition Roadmap to *Shari'ah*-Compliant Microfinance



The pillars of recommendations are detailed as follows:

a) Scope

This recommendation is about having a clear and comprehensive roadmap that describes how microfinance in Afghanistan should convert to a *Shari'ah*-compliant business model. This roadmap will provide clarity on standards to be followed by existing MFIs in the country. The roadmap should shed light on the following aspects, among other things:

- Products and services description,
- Processes,
- *Shari'ah* governance,
- Refinancing instruments,
- Dealing with outstanding loans contracted before the transition.

Relying on global best practices (such as AAOIFI standard number 6) for conversion of financial institutions from conventional to Islamic is a good starting point towards the objective of adopting *Shari'ah* standards.

b) Rationale

One factor that explains the surge of non-performing loans in MFIs is the new regime's position on the need to align microfinance activities with *Shari'ah* rulings. Given the current context, adopting a business-as-usual approach is no longer an option for MFIs. Furthermore, supporting mechanisms such as credit guarantee funds would be ineffective as MFIs are unable to collect payments.

c) Challenges

Challenges to this recommendation include:

- Establishing national standards on *Shari'ah*-compliant finance is not an easy task unless international standards such as AAOIFI as adopted integrally,
- The complexity of the transformation process at the MFIs level.

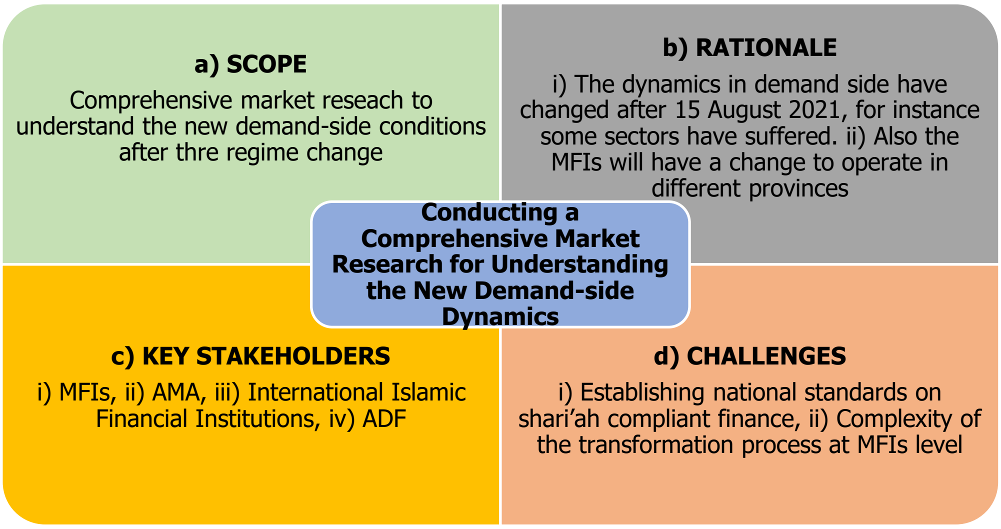
d) Stakeholders

Key stakeholders related to the transition to *Shari'ah*-compliant finance include (i) MFIs, ii) DAB, (iii) Ministry of Finance, (iv) International Islamic Financial Institutions, (v) RCIBCI.

ii) Conducting a Comprehensive Market Research for Understanding the New Demand-side Dynamics

Based on the presentations and discussion identified in the preceding sections, the following figure summarises the recommendation.

Figure 28: Summary of the Recommendation: Conducting a Comprehensive Market Research for Understanding the New Demand-side Dynamics



The pillars of recommendations are detailed as follows:

a) Scope

The MFIs, after the new authorities approve their submitted Islamic microfinance products, will encounter new market conditions, which they should adopt promptly and effectively. Therefore, extensive market research will facilitate this process.

b) Rationale

After the regime change, the dynamics for MFIs in terms of demands have changed, as some sectors, for instance, the non-basic needs producing sector and service sector, have been severely affected by the economic slowdown. On the other hand, the MFIs have had an opportunity to expand their operations to all provinces of the country that they could not cover before due to security issues. Accordingly, there is a need to understand the demand-side dynamics in these areas, especially the rural areas where agricultural production is everyday economic activity. Therefore, comprehensive market research should be conducted to evaluate the changing economic environment and the dynamics in the new markets.

c) Challenges

Challenges to this recommendation include:

- The MFIs do not have spare funds to conduct these market surveys,
- Lack of qualified experts in preparing and conducting these researches in the country.

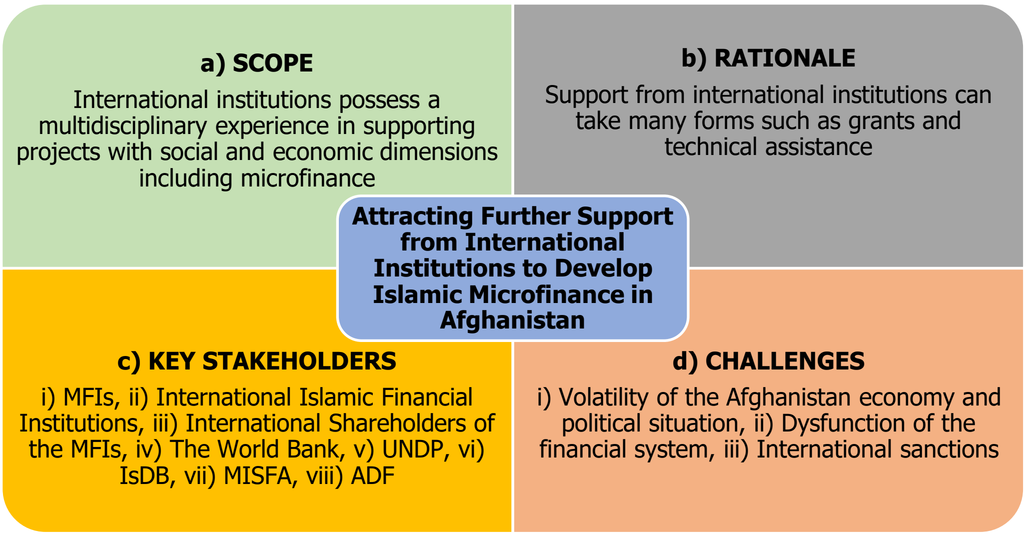
d) Stakeholders

Key stakeholders related to conducting a comprehensive market research include (i) MFIs, ii) AMA, (iii) International Islamic Financial Institutions and (iv) ADF.

iii) Attracting Further Support from International Institutions to Develop Islamic Microfinance in Afghanistan

Based on the presentations and discussion identified in the preceding sections, the following figure summarises the recommendation.

Figure 29: Summary of the Recommendation: Attracting Further Support from International Institutions to Develop Islamic Microfinance in Afghanistan



The pillars of recommendations are detailed as follows:

a) Scope

Afghanistan has partnered with several international institutions to strengthen its microfinance sector. International institutions, whether multilateral, bilateral, private institutions or foundations, possess a multidisciplinary experience in supporting projects with social and economic dimensions. Afghanistan should double its efforts to attract this kind of support.

b) Rationale

Supporting the Islamic microfinance sector is the intended objective of this recommendation that can be achieved through several international institutions' support mechanisms:

- *Shari'ah*-compliant debt financing to MFIs,
- Equity financing to MFIs,
- Technical assistance programmes to strengthen the operational capacities of these institutions. Particularly, the *Shari'ah* side is of particular concern where IsDB expertise can be solicited,
- Grants,
- Credit Guarantees Funds,
- Deposits Guarantee Funds.

c) Challenges

Challenges to this recommendation include:

- International sanctions targeting the new regime,
- The volatile status of the Afghanistan economy and political situation currently impacts the perception of financiers that are reluctant to extend lines of credit in the country,
- Current situation of Afghanistan's financial market.

d) Stakeholders

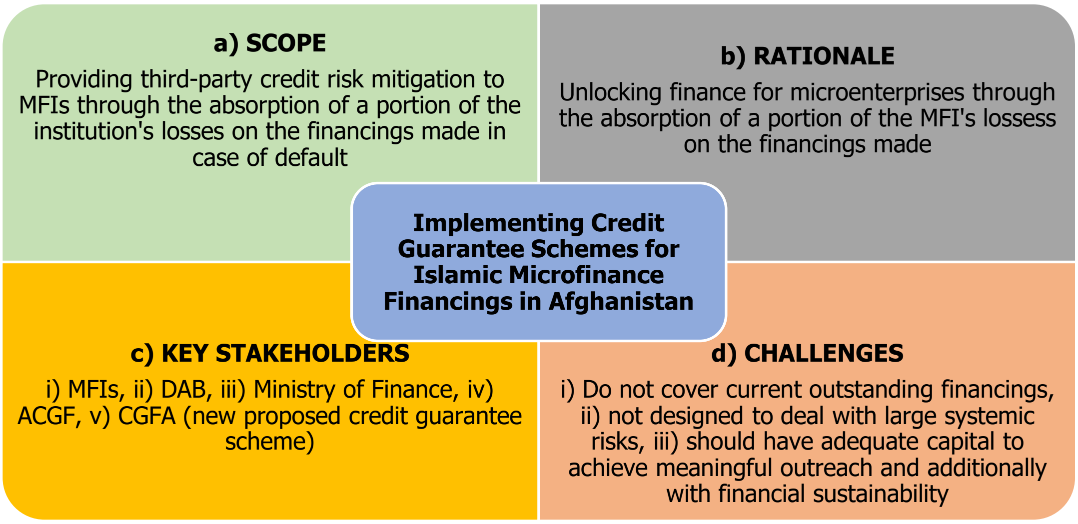
Key stakeholders related to attracting further support from international institutions include:

(i) MFIs, ii) International Islamic Financial Institutions, (iii) International Shareholders of the MFIs, (iv) The World Bank, (vi) UNDP, (vii) IsDB, (viii) MISFA, and (iv) ADF

iv) Implementing Credit Guarantee Schemes for Islamic Microfinance Financings in Afghanistan

Based on the presentations and discussion identified in the preceding sections, the following figure summarises the recommendation.

Figure 30: Summary of the Recommendation: Implementing Credit Guarantee Schemes for Islamic Microfinance Financings in Afghanistan



The pillars of recommendations are detailed as follows:

a) Scope

A credit guarantee scheme provides third-party credit risk mitigation to lenders through the absorption of a portion of the lender's losses on the loans made in case of default, typically in return for a fee.[198]

There are two primary types of partial credit guarantee schemes: an individual (loan-by-loan) scheme and a portfolio scheme. In a loan-by-loan scheme, each application from a lender is sent to the scheme for a credit review. In a portfolio scheme, the credit decision is fully delegated to the lender in exchange for limits on the number of loans a lender can approve and controls on future production based on the performance of the portfolio. A portfolio approach is usually more attractive for the banking community because it is faster to use which does not involve sending an application to the national guarantee fund for review, waiting for the decision on the guarantee, and transmitting the decision back to the lender.

The guarantee coverage ratio is a crucial feature of any guarantee scheme. However, care must be taken to provide enough coverage to encourage lenders to participate in the scheme while retaining sufficient risk to ensure that a thorough credit analysis is performed and that the MFI uses the same level of care when servicing the financings that it uses on its nonguaranteed financings. To illustrate, the coverage ratio must not be so high that the MFI has no risk of loss. If the coverage ratio is 100 percent or closes to that level, the MFI has little incentive to analyse the credit application properly. Furthermore, after the financing is approved, the MFI has little incentive to spend staff time and money on the proper servicing of the financing.

b) Rationale

Access to finance remains one of the critical constraints to the growth of microenterprises. Credit guarantee schemes are a common form of policy intervention to unlock finance for microenterprises through the absorption of a portion of the MFI's losses on the financing made.

c) Challenges

First, credit guarantee funds adopt a forward-looking perspective and, as such, do not cover outstanding financings. Second, as in the case of insurance products, guarantee funds are not designed to deal with significant systemic risks. Therefore, the level of non-performing loans in guaranteed portfolios should not exceed a certain threshold. Finally, the guarantee fund dedicated to Islamic microfinance should have adequate capital to ensure effective implementation of its operations and achieve meaningful outreach and additionality with financial sustainability.[199]

The level of funds needed will depend on:

- The expected size of the Islamic microfinance portfolio,
- The average duration of the Islamic microfinance portfolio,
- The risk profile of the Islamic microfinance portfolio (expected non-performing loans' ratios),
- The guarantee coverage ratio.
- Fees paid by the Islamic MFI to the fund.[200]

d) Stakeholders

Key stakeholders related to the credit guarantee funds include:

(i) MFIs, ii) DAB, (iii) Ministry of Finance, (iv) ACGF or CGFA (new proposed credit guarantee scheme).

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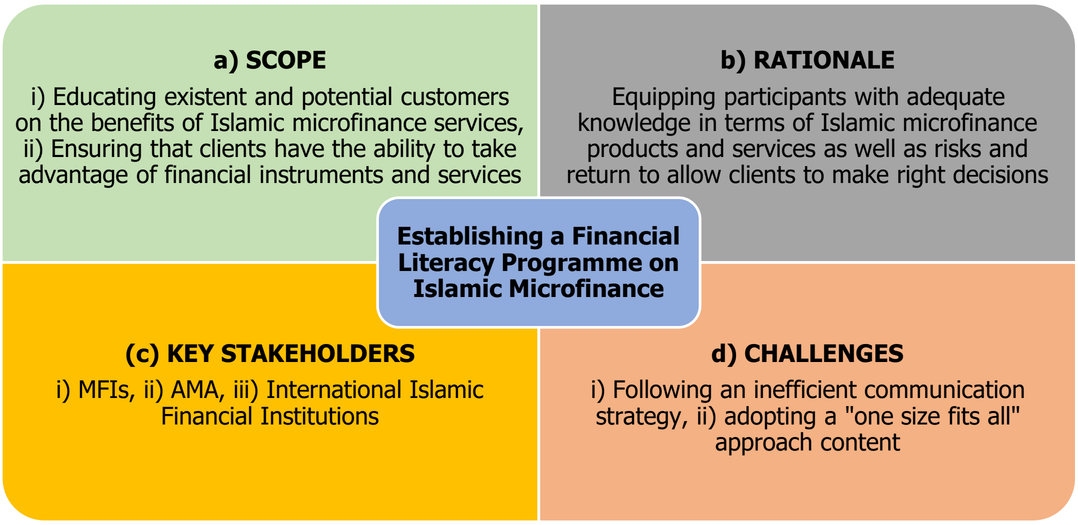
[198] World Bank, Principles for Public Credit Guarantee Schemes (CGSs) for SMEs, 2021.
[199] World Bank, Principles for Public Credit Guarantee Schemes (CGSs) for SMEs, 2021.
[200] From a *Shari'ah* standpoint, there are many limitations on paying fees in exchange of guarantee coverage

v) Establishing a Financial Literacy Programme on Islamic Microfinance

Based on the presentations and discussion identified in the preceding sections, the following figure summarises the recommendation.

Figure 31: Summary of the Recommendation: Establishing a Financial Literacy Programme on Islamic Microfinance



The pillars of recommendations are detailed as follows:

a) Scope

The financial literacy concept covers financial education, the ability to take advantage of financial instruments and services and financial behaviour. In addition, Islamic finance literacy emphasises the specificities and dimensions of compliance with *Shari'ah*.[201] One of the pre-requites of financial literacy is the establishment of public discourse and an impact narrative on using Islamic microfinance.

In the context of Islamic microfinance, financial literacy is a multidimensional concept that covers:

- Educating customers and potential customers on the benefits of microfinance services as well as on the impact of *Shari'ah* compliance on instruments,
- From a financial behaviour standpoint, ensuring that clients have the ability to take advantage of financial instruments and services.

b) Rationale

From the Islamic microfinance perspective, this programme should focus on some dimensions, namely:

- Equipping participants with adequate knowledge in terms of Islamic microfinance products and services, their risks and return (eventually) as well as encouraging a saving behaviour and avoiding over-indebtedness,

[201] Demirgüç-Kunt, Asli and Klapper, Leora F. and Randall, Douglas, *Islamic Finance and Financial Inclusion: Measuring Use of and Demand for Formal Financial Services Among Muslim Adults* (2013), World Bank Policy Research Working Paper No. 6642, Available at SSRN: https://ssrn.com/abstract=2341370; Jouti, Ahmed Tahiri. 2021. "What Policy for Islamic Financial Literacy?" *Turkish Journal of Islamic Economics* 8(2):531–51.

- The *Shari'ah* dimension is also important as providing participants with knowledge in this area not only strengthens customers' understanding of *Shari'ah* matters but also improves the credibility of this industry.

Part of this strategy will consist of conducting surveys to better understand customers' needs in terms of Islamic microfinance products. It is also important to grasp their current level of proficiency and understanding both in terms of Islamic microfinance concepts and technology dimensions. This would help design the best products that fit customers' needs while maximising their satisfaction.

c) Challenges

Implementing an Islamic microfinance literacy programme faces the following challenges:

- Effective communication about this strategy is crucial to its success. An inefficient communication strategy has one or many of the following features:
  - Does not understand the audience's socioeconomic attributes,
  - Does not leverage the diversity of possible communication channels,
  - Adopts a "one size fits all" approach as far as the content is concerned,
  - Do not rely on impact indicators.
- Some technical concepts can be complicated to explain in plain language. This could be addressed by simplifying concepts so that the policy suits everyone's level of understanding.

d) Stakeholders

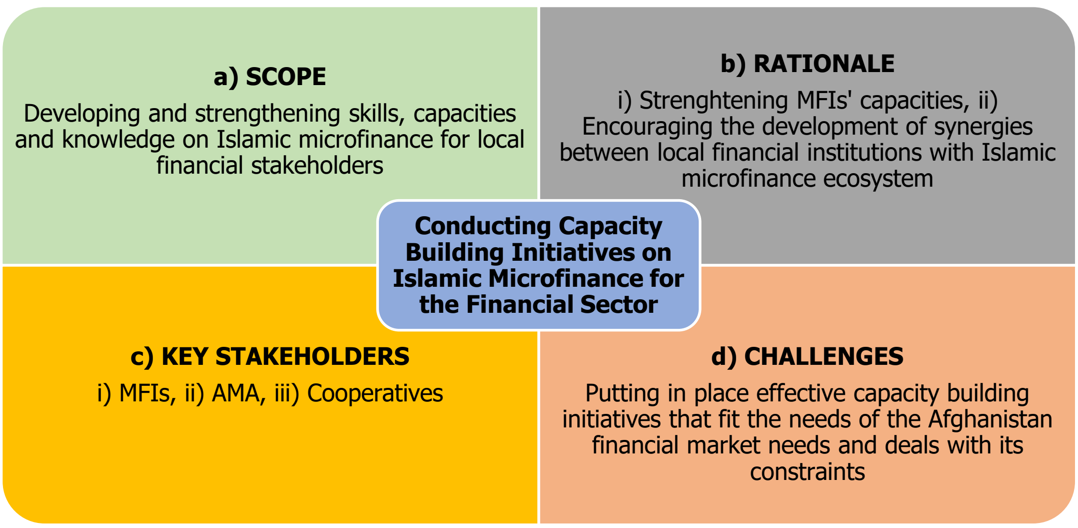
Key stakeholders related to establishing a national financial and digital literacy programme covering Islamic microfinance include:

(i) MFIs, (ii) AMA, (iii) International Islamic Financial Institutions

vi) Conducting Capacity Building Initiatives on Islamic Microfinance for the Financial Sector

Based on the presentations and discussion identified in the preceding sections, the following figure summarises the recommendation.

Figure 32: Summary of the Recommendation: Conducting Capacity Building Initiatives on Islamic Microfinance for the Financial Sector



The pillars of recommendations are detailed as follows:

a) Scope

Capacity building refers to the process of developing and strengthening skills, capacities and knowledge necessary for organisations to thrive in a fast-changing environment. In the context of Islamic microfinance, capacity building is a prerequisite for success, especially since this industry is still in its early development stages.

Knowledge sharing between different stakeholders (mainly international institutions and local market players) through training and seminars can achieve excellent results where practical issues can be exposed, and insights can be shared for the benefit of the industry.

b) Rationale

The objectives of this recommendation are multiple:

- Diversifying the Islamic microfinance products (savings and financing sides) to meet the needs of customers,
- Strengthening Islamic microfinance institutions' capacities in complementary areas such as fintech, business, internal audit, risk management and marketing,
- Providing local financial institutions with technical knowledge on Islamic microfinance to encourage the development of synergies with this industry,
- Equipping political leaders with the necessary knowledge and capacity development allowing them to better monitor and support the Islamic microfinance sector.

c) Challenges

One of the main challenges of this recommendation is putting in place effective capacity-building initiatives that fit the needs of the Afghanistan financial market needs and deal with its constraints. The customer surveys are examples of mitigation strategies that identify stakeholders' preferences to better serve them. In addition, a well-planned capacity-building strategy is a key to the success of this policy.

As international partners play a central role in providing Islamic microfinance institutions with the necessary capacities to grow and succeed, establishing a poor strategy to attract them will not help achieve the intended objective. However, a good strategy that targets potential partners with a precise definition of their added value and a well-crafted promotion strategy of the sector is highly beneficial.

d) Stakeholders

Key stakeholders related to strengthening Islamic microfinance institutions' capacities include:

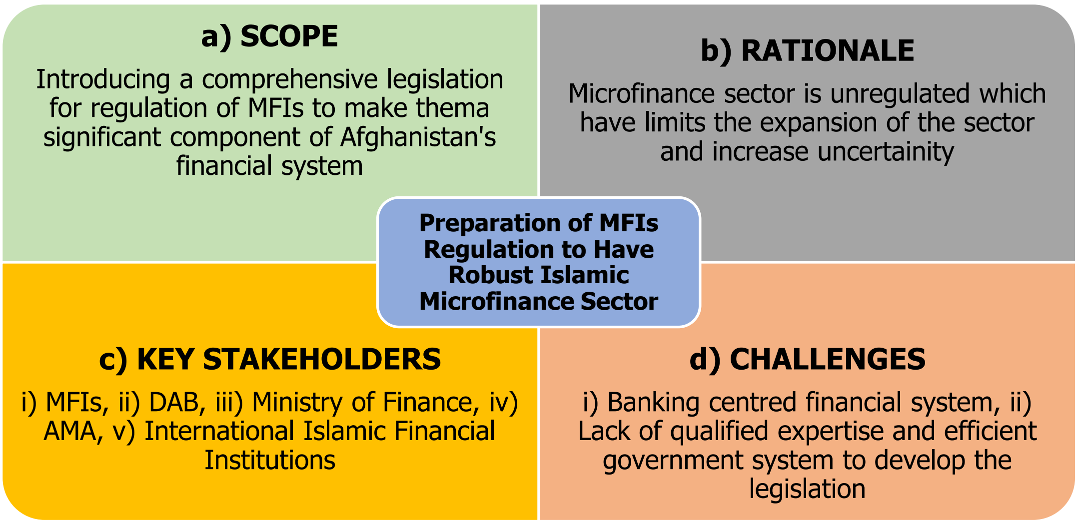
(i) MFIs, (ii) AMA, (iii) Cooperatives

6.2.4 Long-Term Recommendations

i) Preparation of MFIs Regulation to Have a Robust Islamic Microfinance Sector

Based on the presentations and discussion identified in the preceding sections, the following figure summarises the recommendation.

Figure 33: Summary of the Recommendation: Preparation of MFIs Regulation to Have Robust Islamic Microfinance Sector



The pillars of recommendations are detailed as follows:

a) Scope

The microfinance sector in Afghanistan has reached out to a significant number of clients for two decades. However, the sector is still unregulated. The recommendation includes comprehensive legislation for MFIs where the DAB can be the regulatory body for the sector. The legislation should also comprise details about the deposit-taking Islamic MFIs.

b) Rationale

The microfinance sector in Afghanistan is not regulated, except for the FMFB, a commercial bank focusing on microfinance business. This has brought new challenges to the MFIs during the transformation period after the regime's imposition to convert their operations to Islamic microfinance. They have had difficulty finding responsible authority in the government. Furthermore, before the regime change, they had faced problems when they wanted to expand their operations in new directions, such as becoming a demand taking MFI. Therefore, in the long run, the microfinance sector should be regulated under the supervision of the DAB or other relevant government institutions.

c) Challenges

These are the main challenges for introducing comprehensive legislation for the regulation of the microfinance sector in Afghanistan:

- Banking centred financial system,
- Lack of qualified expertise and efficient government system to develop the legislation.

d) Stakeholders

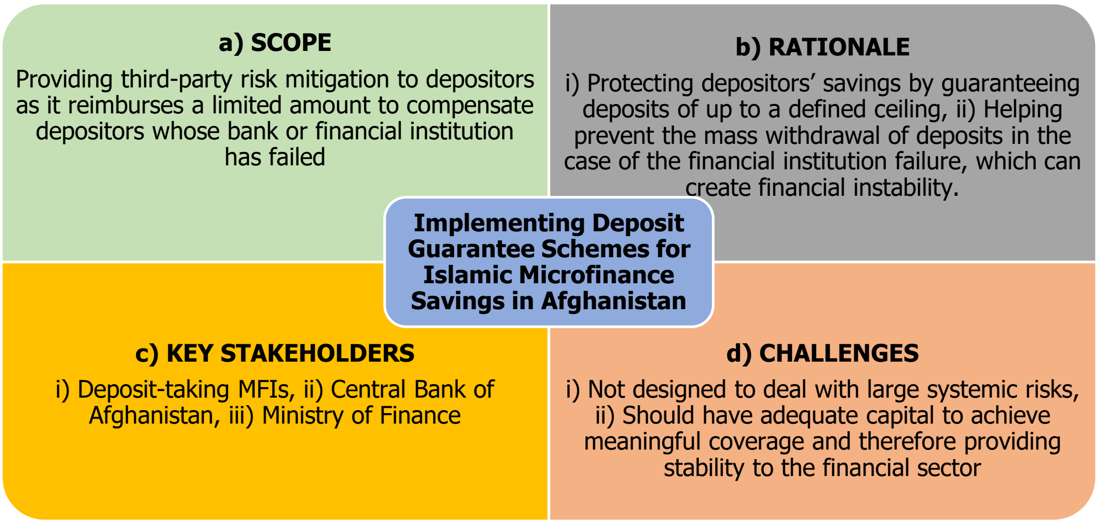
Key stakeholders related to the credit guarantee funds include:

(i) MFIs, ii) DAB, (iii) Ministry of Finance, (iv) AMA, (v) International Islamic Financial Institutions.

ii) Implementing Deposit Guarantee Schemes for Islamic Microfinance Savings in Afghanistan

Based on the presentations and discussion identified in the preceding sections, the following figure summarises the recommendation.

Figure 34: Summary of the Recommendation: Implementing Deposit Guarantee Schemes for Islamic Microfinance Savings in Afghanistan



The pillars of recommendations are detailed as follows:

a) Scope

A deposit guarantee scheme provides third-party risk mitigation to depositors as it reimburses a limited amount to compensate depositors whose bank or financial institution has failed. This mechanism is essential to preserve trust in the financial system and dissuade people seeking to withdraw their savings simultaneously at times of crisis.

b) Rationale

A deposit guarantee scheme aims at:

- Protecting depositors' savings by guaranteeing deposits of up to a defined ceiling
- Helping prevent the mass withdrawal of deposits in the case of the financial institution failure, which can create financial instability

c) Challenges

As in the case of insurance products, deposit guarantee funds are not designed to deal with significant systemic risks impacting the entire financial system. Additionally, the level of funds needed to set up the deposit guarantee scheme in Afghanistan will depend on:

- The expected size of the Islamic Microfinance savings,
- The deposit guarantee ceiling,
- The level of contribution of Islamic MFIs to the deposit guarantee fund.

d) Stakeholders

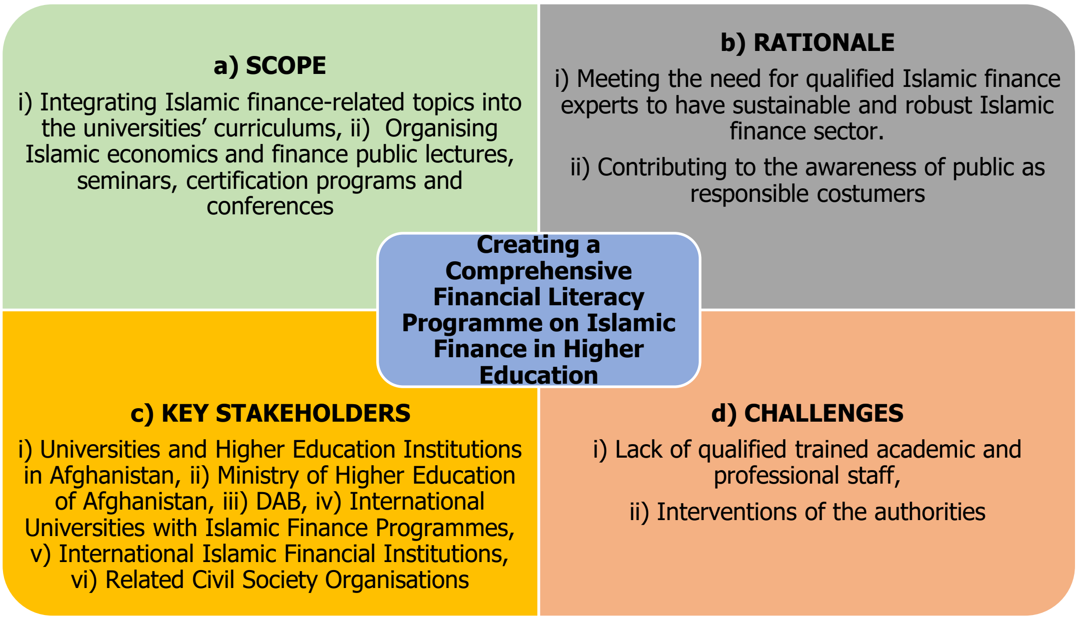
Key stakeholders related to guarantee funds include:

(i) Deposit-taking MFIs, (ii) DAB, (iii) Ministry of Finance

iii) Creating a Comprehensive Financial Literacy Programme on Islamic Finance in Higher Education

Based on the presentations and discussion identified in the preceding sections, the following figure summarises the recommendation.

Figure 35: Summary of the Recommendation: Creating a Comprehensive Financial Literacy Programme on Islamic Finance in Higher Education



The pillars of recommendations are detailed as follows:

a) Scope

As stated previously in the short-run recommendation, there is a need for financial literacy programmes which includes training on basic financial topics such as bookkeeping, business plans, and Islamic finance for microfinance customers. However, more comprehensive financial literacy programmes are needed on Islamic finance in higher education in Afghanistan as all financial institutions, including MFIs, must be *Shari'ah*-compliant as dictated by the regime. These programmes should be integrated into the curriculums of the related departments of universities such as *Shari'ah*, economics, and law, because the MFIs and other financial institutions, as well as government institutions, which are responsible for the Islamic finance sector in Afghanistan, can employ new graduates in their relevant departments to have more sustainable and robust Islamic finance system.

The recommendation includes the following aspects

- Integrating Islamic finance-related topics by benefitting from international experiences into the universities' curriculums,
- Organising Islamic economics and finance seminars and certification programmes for university students,
- Organising Islamic and finance conferences with the participation of international Islamic finance experts,
- Organising public lectures for the ordinary people who will have access to MFIs.

b) Rationale

As part of the Islamic finance system, Islamic microfinance has its own particularities compared to conventional microfinance concerning product diversity and philosophy. Furthermore, as discussed in the proposed Islamic microfinance model section, there are many collaboration areas between microfinance and other Islamic financial sectors, including Islamic capital markets and *takaful*. Since the regime authorities imposed the existing financial institutions in Afghanistan to convert their operations into *Shari'ah*-compliant, and more organisations can be established within this structure in the future, there will be a need for qualified experts on Islamic finance. Therefore, higher education institutions should integrate Islamic finance courses or programmes into their curriculum to have the required human capital. Considering that a research unit specialised in Islamic finance related research was established in December 2021, this unit should consider taking the lead to develop the necessary strategies for financial literacy in *Shari'ah*-compliant finance.

It should, however, be noted that these efforts require a long-term and inclusive perspective, meaning that all relevant stakeholders should come together to have a comprehensive programme and technical support from international institutions which have experience and knowledge of Islamic finance education, such as IsDBI or International Centre for Education in Islamic Finance (INCEIF) in Malaysia.

c) Challenges

Creating a comprehensive financial literacy programme on Islamic finance in higher education institutions in Afghanistan may face several challenges. One of them is the lack of qualified Islamic finance experts in the financial sector and educational institutions in Afghanistan. This challenge cannot be solved in the short run within the country's sources; hence support from outside is required. Student and academic exchange programmes with other countries that have developed Islamic finance education programmes or Islamic finance experiences and collaborations with international institutions should be established to tackle this challenge. Additionally, possible intervention from the regime authorities on the aims to integrate international experiences or materials into the curriculum can be another challenge. In other words, the regime sees that based on its own understanding of *Shari'ah*; therefore, experiences from other countries might not fit this understanding.

d) Stakeholders

Key stakeholders related to creating a comprehensive financial literacy programme on Islamic finance in higher education include:

(i) Universities and Higher Education Institutions in Afghanistan, (ii) Ministry of Higher Education of Afghanistan, (iii) DAB, (iv) International Universities with Islamic Economics and Finance Programmes, (v) International Islamic Financial Institutions, (vi) Related Civil society organisations

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