Policy Brief

The Afghan Banking and Financial SystemSituation Report

November 22, 2021

Objective

The purpose of this Brief is to document the status of the banking and financial system infrastructure prior to 15 August 2021, as well as the current situation in the three months since. In documenting the challenges and shortcomings of the system, the paper also provides recommendations on how its functionality can be restored, in collaboration with key finance and banking actors, partner countries and with due regard to current sanctions regimes. The Troika message of November 11, 2021, "Acknowledged international humanitarian actors' concerns regarding the country's serious liquidity challenges and committed to continue focusing on measures to ease access to legitimate banking services."

Summary: Afghanistan's financial and bank payment systems are in disarray. The bank-run problem must be resolved quickly to improve Afghanistan's limited production capacity and prevent the banking system from collapsing. Furthermore, protecting, at a minimum, some of the commercial banking system is also critical to continue the humanitarian and other basic human needs programmes, supported by the UN, NGOs, and bilateral partners. The economic cost of a banking system collapse, with its concomitant negative social consequences, would be colossal. The longer the delay in the full restoration of the financial and banking system, the longer the recovery period, due to the subsequent lack of confidence by international markets. This erosion is hard to repair and could take decades. Coordination of actions proposed include: a deposit insurance for depositors; adequate liquidity ensured for the banking system to meet both short- and medium-term needs; and credit guarantees and loan repayment delay options for the real economy. Coordination with the International Financial Institutions (IFIs), with their extensive experience of the Afghan financial system, would be critical to this process. The lack of updated data and on-site analysis will have to be considered; and given the lack of IFI presence in Afghanistan at this time, other options possibly through the UN system, to gather and verify ongoing banking and financial system data will be key.

A brief background – Afghanistan's Banking and Financial System pre-August 15, 2021

1. The Da Afghanistan Bank Law (2003), the Afghanistan Banking Law (2015), and the Regulation for Conversion of a Conventional Bank into an Islamic Bank (2018) are the three main foundations of Afghanistan's financial legislation. Afghanistan Banks Association (ABA), a non-political, non-government, not-for-profit, and autonomous association founded in 2004 to satisfy the demands of the growing banking sector as a unified body representing all 12 banks, is another institution involved in the banking business.

2. Afghanistan's financial system continues to be underdeveloped, in the context of its growth over the last 15 years. At the end of 2020, the total assets to GDP ratio was approximately 22 percent. The banking industry dominates the financial system, with 12 banks: six private commercial banks, one private Islamic bank, three state-owned banks, and two foreign bank branches. There are over 400 branches, the majority

of which are in Kabul, Herat, and Mazar-e-Sharif. While private domestic banks had roughly 67 percent of overall banking sector assets as of the end of 2020, state-owned banks held around 27 percent.

3. The banking system's activities were primarily focused on money transfers and deposit collection. Despite the international credit guarantee plan, the overall loan to GDP ratio was around 3 percent, the lowest in the world. The total loans to banking system assets ratio was only 13.4 percent at the end of the first quarter of 2021.

4. In 2019 and 2020, the return on equity was around 4.5 percent, but in the first quarter of 2021, it was approximately zero. The banking system's capital adequacy ratio, on the other hand, was roughly 27 percent, which is quite high by worldwide standards. Demand deposits are the banking system's primary liability. The loan-to-deposit ratio was only around 17 percent at the end of the first quarter of 2021. The banks hold most of their liquidity with the Central Bank (DAB) in the form of necessary reserves, free deposits, or capital notes purchased from the DAB.

5. The banking system is also heavily dollarized, with approximately 60 percent of deposits made in foreign currency. Domestic currency (AFN) liquidity, and more importantly Foreign Exchange (FN) liquidity, is critical in the event of a bank-run to maintain financial stability.

6. In June, the International Monetary Fund (IMF) highlighted two major concerns that should be prioritised for a more robust financial system (Country Report No. 21/138): (i) procedures for bank resolution; and (ii) the deposit insurance mechanism.

Developments in the Banking and Financial System after 15 August

7. Following the Taliban takeover and subsequent international sanctions, Afghanistan's international reserves, including banking sector FX deposits at the DAB, were frozen; the SWIFT system and international settlements were suspended; grant transfers were suspended; and AFN liquidity printing was interrupted, causing a dramatic adverse shock in the financial and payment systems.

8. As a result, a perfect bank-run scenario has emerged. Due to liquidity constraints (FX and AFN), the central bank was unable to provide the necessary FX and AFN liquidity to banks to meet deposit withdrawal demands. This has heightened tensions, and DAB has limited daily bank deposit withdrawals.

9. The DAB did not completely prohibit the withdrawal of FX deposits, but instead restricted withdrawals of USD and AFN from both individual and corporate accounts. Individual depositors were permitted to withdraw up to USD 200 and 20,000 AFG, with a weekly 5 percent withdrawal on the balance of corporate accounts. Individual deposit withdrawal limits have recently been increased to USD 400 and 30,000 AFN weekly, with individuals able to withdraw up to USD 1,200 and 100,000 AFN in a single transaction per month.

10. According to ABA data, while total banking system deposits were 268 billion AFN at the end of 2020, they fell to 209 billion in June and 194 billion in September of this year. With the current trend and withdrawal restrictions, they are expected to fall to 165 billion AFN by the end of 2021 – which means approximately 40 percent of the deposit base will be lost.

11. The credit market is another critical issue confronting the Afghan banking system. The banking system's total loan book is relatively small. There has been a lot of international support for developing credit facilities for micro-small- medium-sized enterprises. Amid the current turmoil, banks ceased extending new credit. According to ABA data, while total credits stood at 33 billion AFN at the end of 2020, they fell to 30 billion in June and 29 billion in September. Non-performing loans (NPL), on the other hand, had increased from around 30 percent at the end of 2020 to 57 percent in September of this year.

12. According to IMF projections, the Afghan economy could contract by up to 30 percent in 2021-2022. In addition to the decline in economic activity, problems in the banking system will further reduce MSMEs' probability of survival, which is critical for the Afghan economy and people. Under current conditions, the NPL ratio appears to be increasing, which will likely lead to the collapse of MSMEs and the banking sector.

13. Prompt and decisive action is urgently needed, with delays in decision-making expected to increase the cost of a banking system collapse – a grim predicament, as it may become increasingly difficult to restore the system in the long.