

AFGHANISTAN RESEARCH NETWORK

# The Future of the Banking Industry in Afghanistan

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## Afghanistan Research Network

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## Key Takeaways

- ▶ The fall of Kabul in August 2021 precipitated a paradigm shift for the banking industry. Not only did banks lose income, but foreign aid and donor-funded development projects ceased, creating uncertainty for the sector's growth.
  - ▶ Banks increased service costs, losing more ground to the informal and shadow banking sector (known as Money Service Providers, or MSPs) in collecting deposits and extending loans. This makes it harder for commercial banks to expand their customer base.
  - ▶ The banking industry should consider adopting a multi-pronged approach to survive, by automating routine processes and investing in digital technologies; cutting operational expenses; closing under-performing branches; streamlining processes; downsizing personnel; exploring Shariah-compliant products and/or strengthening Islamic banking windows; and reducing competition through consolidation and mergers.
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# Introduction

In 2021, as Taliban forces advanced and took over more cities in Afghanistan, the public panicked and a serious bank-run ensued. Taliban's takeover of Kabul in August 2021 and subsequent foreign aid cessation marked a paradigm shift for the banking industry. The sudden loss of revenues, especially interest income, led banks to take necessary measures to cover the costs of doing business. These measures were not enough to make the industry profitable in 2022. The question that merits an answer is whether the banking sector is a going concern in Afghanistan, and how it can survive.

## Background

In 2021, as Taliban forces advanced and gained control of cities across Afghanistan, the public panicked and started withdrawing their deposits from banks. The banking sector lost \$1.5 billion (41 percent) of its deposits. Total deposits dropped from \$3.6 billion to \$2.1 billion. The private banks lost 44 percent of their deposits (\$1.2 billion), while state-owned banks lost 33 percent (\$313 million). The run severely affected two private banks, causing them to lose almost 80 percent of their reported deposits.

On August 15, 2021, the Taliban took control of Kabul and became the de facto government in Afghanistan. The Da Afghanistan Bank (DAB), Afghanistan's central bank, could not provide liquidity to the banking sector as it lost access to its foreign assets and the ability to ship physical USD banknotes into the country. In 2020–21, before the fall of Kabul, DAB had been facing serious challenges in accessing its \$9.5 billion of foreign reserves deposited at international financial institutions, including the Federal Reserve Bank of New York, due to technical and de-risking measures adopted by these institutions. To avoid delays in honouring its domestic payments for government withdrawals,<sup>1</sup> DAB desperately needed both USD and Afghani (AFN) banknotes. Therefore, to relieve USD banknote shortages – which were needed for weekly Forex (FX) auctions – DAB instructed commercial banks to deposit their excess USD cash with the Central Bank. Banks complied, as historically they were highly liquid.

On the other hand, to alleviate Afghani (AFN) shortage, DAB mopped up Afghani liquidity from the market by aggressively using its capital notes (CN), a central bank's monetary policy tool. DAB was still negotiating with the Federal Reserve authorities about USD shipments when Kabul fell to the Taliban.

As a result of both measures, by the end of 2020, almost 52 percent of the banking sector's deposits were parked with the central bank. The Afghanistan Central Bank reported \$1.9 billion dues to commercial banks, which included \$707 million foreign currency denominated claims. By the end of 2021, total dues had dropped to \$947 million, including the FX-denominated claims that stood at \$554 million (UHY Shafiq Umar Daraz & Co., 2019; UHY Shafiq Umar Daraz & Co., 2021a). This demonstrates the banks' ability to withdraw almost 50 percent of their claims on DAB to meet the increasing demand of deposit withdrawals.

At the end of 2021, DAB still held approximately 45 percent of commercial banks' deposits, making it more difficult for banks to meet ever-increasing withdrawal pressures. The situation was further complicated when, in addition to DAB's inability to access foreign reserves, DAB's treasury also began to run out of Afghani banknotes. This was an issue for banks, as they could have converted their USD deposits to Afghani to meet customers' needs. The subsequent U.S. freeze of DAB assets added to the public's concerns about the future of their deposits with commercial banks and escalated the run on the banks.

In response to these developments, the Taliban imposed a \$200 withdrawal limit per account per week for individuals. Corporate accounts were not allowed to withdraw any amount at this stage. Subsequently, these restrictions were modified and the limit for individuals increased to \$400 per week, while corporate accounts were allowed to withdraw up to \$25,000, or five percent of their deposited assets per month, whichever was lower (Macro Poverty Outlook [MPO], 2022). These restrictions slowed deposit withdrawals, allowed banks to assess the new situation, and adopted necessary measures to address liquidity tightening. As of March 2023, these limits are still in place for pre-August 2021 deposits, but fresh deposits are exempt in an attempt to bring back deposits to the banking sector.

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In spite of these restrictions and subsequent off-budget aid resumption amounting to at least \$2 billion — including \$1.2 billion humanitarian aid through direct cash shipment between November 2021 and August 2022 that financed essential government functions, such as health and education (Macro Poverty Outlook [MPO], 2022) — banking deposits continued to fall in 2022, albeit at a lower rate. In addition, there is a widespread lack of trust in the banking sector, as five banks have either collapsed or run into serious trouble over the last 20 years. Therefore, the question that merits an answer is whether the banking sector is still a going concern in Afghanistan.

The remainder of this paper will attempt to answer this question. First, a summary is presented of the banking sector in Afghanistan, followed by a discussion of how banks performed after August 2021, looking at deposit trends, credit portfolio, and profitability. Second, the measures adopted by the banking sector in response to the new situation will be discussed. Finally, different scenarios and conditions will be presented that will determine and shape the future of the banking industry in Afghanistan.

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## Overview of the Banking Sector

As of September 2022, there were 12 commercial banks functioning in Afghanistan. Of these 12 banks, three were state-owned banks, two were foreign banks, one was a microfinance bank, and the remaining six were private banks. For the remainder of this study, the two commercial banks that were severely affected by the run have been excluded for several reasons:

- ▶ They have not published their financial statements for 2022;
- ▶ One of these banks is under undeclared conservatorship of the Afghan central bank;
- ▶ Considering the current anecdotal information, the previously publicly-available data on these banks is not reliable; and
- ▶ They lost almost 80 percent of their deposits in 2021 run.

Table 1 provides an overview of Afghanistan's banking sector as of September 2022.



**Table 1**  
*Overview of Afghanistan's Banking Sector*

| Bank  | Assets          | Loans         | Deposits        |
|---|-----------------|---------------|-----------------|
| <b>Total Revenue</b>  |                 |               |                 |
| Afghanistan International Bank (AIB)                          | 709.42          | 12.43         | 658.33          |
| Afghan United Bank (AUB)                                      | 203.84          | 54.71         | 166.96          |
| Ghazanfar Bank (GB)   | 135.45          | 30.51         | 84.91           |
| Islamic Bank of Afghanistan (IBA)                             | 88.71           | 4.38          | 68.53           |
| First Micro Finance Bank (FMFB)                               | 134.54          | 25.78         | 91.98           |
| Alfalah Bank (AFB)  | 123.42          | 0.00          | 105.07          |
| National Bank of Pakistan (NBP)                               | 39.48           | 0.75          | 24.46           |
| <b>State-Owned Banks:</b>                                     |                 |               |                 |
| Bank-e-Millie Afghan (BMA)                                    | 489.44          | 45.80         | 375.25          |
| Pashtany Bank (PB)  | 252.12          | 0.29          | 202.68          |
| New Kabul Bank (NKB)  | 142.01          | 0.00          | 99.69           |
| <b>Total</b>  | <b>2,318.44</b> | <b>174.66</b> | <b>1,877.87</b> |
| <b>Banks excluded from the study (As on 31 December 2021)</b> |                 |               |                 |
| Azizi Bank (AZB)  | 182.45          | 42.90         | 114.33          |
| New Kabul Bank (NKB)  | 125.48          | 63.45         | 98.51           |
| <b>Total</b>  | <b>307.93</b>   | <b>106.35</b> | <b>212.84</b>   |

Note. As on 30 September 2022 except, unless otherwise mentioned (millions USD.)

Source: Compiled by the author based on audited financial statements of banks retrieved from their respective websites.

Table 2 provides basic indicators of Afghanistan's banking sector, and will be elaborated on in later sections. As evidenced by Table 2, two banks (AIB and BMA) dominate the banking sector of Afghanistan, as they jointly hold more than 55 percent of the sector's deposits. On the other hand, four banks (AUB, GB, FMFB, and BMA) have extended almost 90 percent of the banking sector's loans. On September 2022, only AIB declared profits, while all other banks made a loss.

**Table 2**

*Some of Afghanistan Banking Sector's Indicators*

| Bank               | Sector's Share |        |          | Loans/<br>Assets | Loans/<br>Deposits | Comprehensive<br>Income/<br>(Loss) |
|--------------------|----------------|--------|----------|------------------|--------------------|------------------------------------|
|                    | Assets         | Loans  | Deposits |                  |                    |                                    |
| Private Banks:     |                |        |          |                  |                    |                                    |
| AIB                | 30.6%          | 7.1%   | 7.1%     | 1.8%             | 1.9%               | 6.46                               |
| AUB                | 8.8%           | 31.3%  | 8.9%     | 26.8%            | 32.8%              | (9.13)                             |
| GB                 | 5.8%           | 17.5%  | 4.5%     | 22.5%            | 35.9%              | (0.43)                             |
| IBA                | 3.8%           | 2.5%   | 3.6%     | 4.9%             | 6.4%               | (2.26)                             |
| FMFB               | 5.8%           | 14.8%  | 4.9%     | 19.2%            | 28.0%              | (5.61)                             |
| AFB                | 5.3%           | 0.0%   | 5.6%     | 0.0%             | 0.0%               | (4.98)                             |
| NBP                | 1.7%           | 0.4%   | 1.3%     | 1.9%             | 3.1%               | (0.41)                             |
| State-Owned Banks: |                |        |          |                  |                    |                                    |
| BMA                | 21.1%          | 26.2%  | 20.0%    | 9.4%             | 12.2%              | (1.42)                             |
| PB                 | 10.9%          | 0.2%   | 10.8%    | 0.1%             | 0.1%               | (4.74)                             |
| NKB                | 6.1%           | 0.0%   | 5.3%     | 0.0%             | 0.0%               | (0.25)                             |
| Total              | 100.0%         | 100.0% | 100.0%   | 7.5%             | 9.3%               | (22.77)                            |

Note: As on 30 September 2022 (millions USD, except if percentage.)

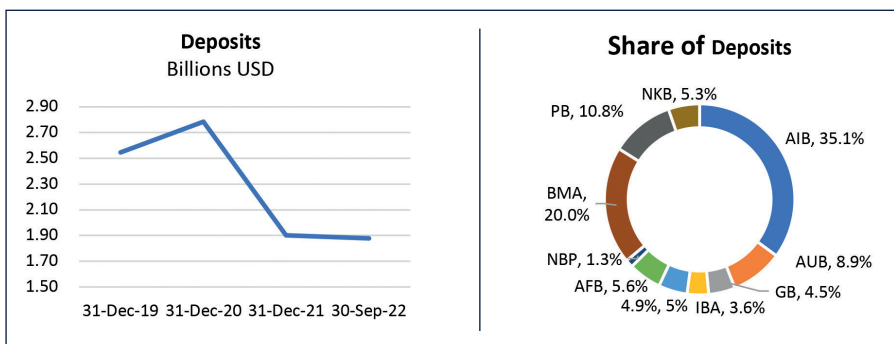
Source: Compiled by the author based on audited financial statements of banks retrieved from their respective websites.

## Banking Deposits

The banking sector in Afghanistan has been highly liquid due to the dearth of safe investment opportunities, which is one of the main reasons that banks could meet the influx of withdrawals as the run started in early 2021. Afghanistan International Bank (AIB) and Bank-e-Millie Afghan (BMA) dominate the banking sector, jointly holding 55 percent of the sector's deposits.

The banking sector (12 banks) reported \$3.6 billion in deposits at the end of 2020. Due to high dollarization in the country, 62 percent of all deposits were denominated in foreign currencies (Da Afghanistan Bank (DAB), 2020). By the end of 2021, total deposits had dropped by \$1.5 billion (almost 42 percent) to \$2.1 billion. Two banks were severely affected as they lost almost eighty percent of their reported deposits (\$611 million) in 2021. However, for the remaining 10 banks under our consideration (Figure 1), the total deposits dropped from \$2.8 billion to \$1.87 billion, indicating a 32 percent fall in total deposits.

**Figure 1**  
*Share of Deposits and Total Deposits*



Note: As on 30 September, 2022 (billions USD.) Source: Compiled by the author based on audited financial statements of banks retrieved from their respective websites.

## Credit Portfolio

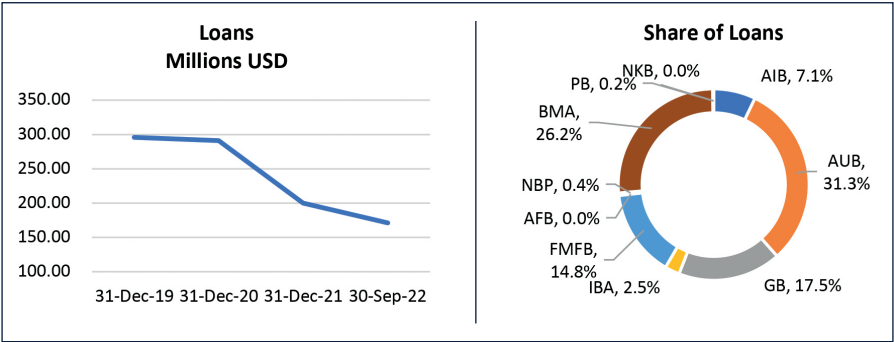
At the end of September 2022, the 10 banks in the industry had collectively extended \$174 million in loans. The loans-to-deposits and loans-to-assets ratios were reported to be 9.3% and 7.5%, respectively. It can be noted from the Table 2 that four banks had somewhat significant exposure to credit risk: Afghan United Bank (AUB); Ghazanfar Bank (GB); First Micro Finance Bank (FMFB); and Bank-e-Millie Afghan (BMA). These banks collectively had extended almost 90 percent of the sector's loans. Two other banks, namely Alfalah Bank (AFB) and New Kabul Bank (NKB) had no loans on their books at all.

When the run on the banks started in early 2021, the industry started recalling their loans. At the end of 2020, the 10 banks had \$291 million in credit facilities. By the end of 2021, this had dropped to \$200 million, which indicates a 31 percent decline in their credit portfolio. Subsequently, in the first nine months of 2022, banks reduced their credit portfolio by another \$28.8 million.

After the fall of Kabul in August 2021 and cessation of foreign aid — which mainly funded development projects — some borrowers ceased servicing their debts. This meant that most of these loans would be classified as non-performing, which required different levels of loan-loss provisioning, considering their respective classifications. As a result, the capital base of banks with a significant amount of credit exposure would have been eroded. The central bank of Afghanistan's timely intervention to freeze asset provisioning<sup>2</sup> offered some breathing space (Afghan United Bank; 2022). Nevertheless, banks vulnerable to credit shocks may require targeted supervisory assistance until they completely absorb the potential losses.

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**Figure 2**  
*Share of Loans and Total Loans*



Note: As on 30 September, 2022 (billions USD.) Source: Compiled by the author based on audited financial statements of banks retrieved from their respective websites.

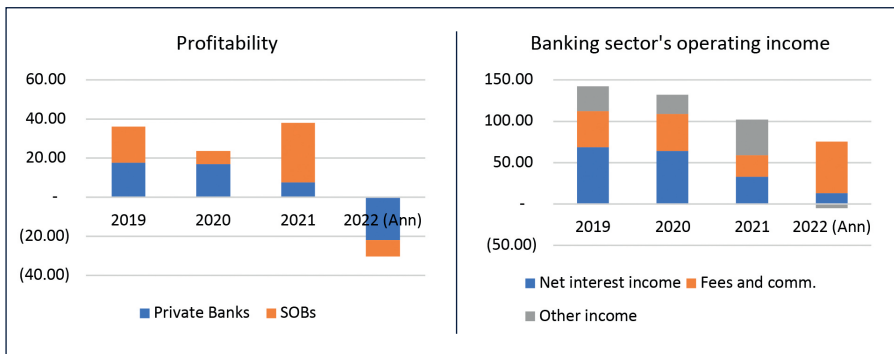
## Profitability

The developments in 2021 introduced a sudden paradigm shift in the banking business — with the Taliban's block on interest, the banking sector lost a significant portion of its interest income, which constituted a major source of revenue. As a result of the cessation of foreign aid to the government and the suspension of donor-funded projects, many borrowers tied to development spending stopped servicing their debt. Banks lost the interest income from investing in DAB's Capital Notes, which were the central bank's monetary policy instrument of different maturities used to mop up AFN liquidity from the market. Likewise, banks lost the interest they had been earning by investing excess liquidity with regional banks.

Further related to development projects, banks used to collect significant amounts of commissions for issuing different types of bank guarantees. As the donor-funded projects halted, banks also lost those commissions and fees.

As a result of these developments, the profitability of the banking industry was adversely affected in 2021, and suffered a negative turn in 2022. In the first nine months of 2022, the ten banks lost almost \$23 million, which, if annualised, would be \$30 million. Only AIB reported a profit of \$6.5 million on September 2022; the other nine banks all reported losses. It is reasonable to assume that AIB stayed profitable owing to commissions earned from channelling foreign aid, mostly in the form of UN cash shipments – its annualised fees and commissions for 2022 increased by almost 250 percent compared with the previous "normal" years of 2019 and 2020.

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**Figure 3***Banking Sector's Profitability and Breakdown of Operating Income*

Note: Figures in millions USD. It is worth mentioning that SOBs 2021 profits include more than \$10 million in revaluation gains on assets of BMA, which is booked under "Other incomes." Source: Compiled by the author based on audited financial statements of banks retrieved from their respective websites.

After Kabul fell in August 2021, the main loss to the banking sector originated from a drastic reduction in net interest income. Historically (2019 and 2020), net interest income contributed almost 50 percent to total net operating income of the banking sector. In 2021, this ratio dropped to 32 percent, and subsequently is projected to have dropped to 19 percent in 2022.

In 2020, the total net interest income of the ten banks was almost \$64 million. This figure dropped to \$33 million in 2021, and to \$13 million (annualised) in 2022, which shows a sixty percent drop in this category. The net interest incomes of both private and state-owned banks show similar trends, dropping by almost the same amount.

However, to compensate for the loss of revenue from interest income, banks significantly increased their commissions and fees for other banking services, especially remittances. In some instances, banks even added new services to their schedule of charges and fees. As a result, net other fees and commissions, which contributed around 35 percent to net operating income in 2020, increased to 88 percent in 2022.

The banking industry earned \$62 million (annualised) in net fees and commissions in 2022. This shows an increase of 141 percent compared with 2021, and an increase of 80 percent compared with 2020 (a normal year).

Surprisingly, the data show that state-owned-banks were less responsive to the changing circumstances as their interest income, fees, and commissions dropped in 2021, and did not increase in 2022. They earned \$19 million in 2020 in fees and commissions, which dropped to \$9.5 million in 2021. This figure is projected to have been \$10.5 million in 2022.

On the other hand, the private banks' net fees and commissions, which were reported to be \$26 million in 2020, dropped to \$16 million in 2021, and are projected to have increased to \$38 million in 2022. This shows more than a 217 percent increase compared to 2021, and a growth of 135 percent compared to 2020 (a normal year.)

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## Measures to Counter Adverse Developments

In response to these developments, banks adopted a series of measures that could be summarised as follows;

### Revision of Fees and Commissions

After the fall of Kabul in August 2021, banks – predominantly private – immediately revised their schedule of fees and commissions for different banking services, especially for remittances, to compensate for the loss of interest income. Total fees and commissions earned during 2021 were \$25.6 million. This was despite the fact that before August of that year, banks used to earn reasonable commission from issuing different bank guarantees for development projects. In the first nine months of 2022, despite issuing a low number of new bank guarantees, banks earned \$46.4 million in fees and commissions. This translates to \$61.8 million, if annualised, and shows a 141 percent increase in this category compared to 2021, which is considerably higher than 2020, when banks earned \$45 million.

### Reducing Credit Portfolio

At the end of 2020, the banking industry had a total credit portfolio of \$291 million. As the run on the banks intensified in 2021, banks started recalling their loans, and their portfolio was reduced to \$120 million by September 2022. Considering the current circumstances of low trust in the banking sector and economic fragility, this trend is expected to continue. Not only will banks continue to reduce their credit portfolio, but it is also unlikely that they will take the risk of extending new loans.

As stated earlier, in response to borrowers not servicing their debts, the central bank issued a timely directive that froze loan loss provisioning until February 2023. This has postponed the adverse effects of non-performing loans on banks' profitability, and ultimately their capital. The regulations and accounting standards require banks to make provisions for expected losses from bad assets.

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## **Reducing Security Costs**

Security expenses used to be one of the biggest expenditure items of the banking industry before 2021. As the security situation improved and the new administration did not extend the APPF (Afghan Public Protection Force) contracts – which provided security services to different institutions – banks laid off some security personnel. However, it is expected that this unit will be reinstated, and banks will need to enter into new contracts from 2023, substantially increasing the banking sector's security expenses.

## **Laying Off Staff or Closing Branches**

There is no evidence that the 10 banks laid off staff or closed any under-performing branches as a result of the significant reduction in business in 2022. However, it is expected that some banks with the greatest number of branches will have no other option but to close some branches to contain the losses.

## Is Banking a Going Concern in Afghanistan?

Channelling the economy's savings to investors is a widely accepted idea, when every economy needs a robust and efficient banking sector to help it achieve its development goals. Unfortunately, this main intermediary function of banks in Afghanistan will remain subdued, or worse, will be a source of constant credit risk accumulation, until other structural impediments are addressed. The most important of these impediments are lack of "well-developed public infrastructure," (Bank for International Settlements; 2012) which includes, inter alia, a system of business laws, an efficient and independent judiciary, independent and credible external audit firms, reliable contract enforcement procedures, and availability of competent professionals. Further, it is paramount that banks adhere to corporate governance principles in their decision-making processes to control and mitigate different types of risks inherent in the banking industry.

Going forward, banks in Afghanistan will probably not engage in lending. However, they are needed to provide the following functions, and therefore will continue to operate, albeit at a limited capacity:

- ▶ Facilitate international payments. Afghanistan imports approximately \$7 billion worth of goods every year, which might have declined to \$5 billion in 2022. Due to various reasons (beyond the scope of this paper) most of the payments for imports are done using money service providers (MSPs).<sup>3</sup> However, many established businesses around the world require their payments to be routed through banking channels. These businesses include telecom services, electricity exporters, and remittances, such as Money Gram, Western Union, etc. Therefore, banks provide international payment services to some strata of the business community;
- ▶ Collect government taxes and customs, and other bills;
- ▶ Manage payrolls for businesses and government agencies;
- ▶ Issue non-fund-based facilities, such as bank guarantees;
- ▶ Channel foreign aid, whether in the form of UN cash shipments or otherwise;

The drastic reduction of interest income and increase in banking commissions and fees will inevitably make banking services less affordable and less attractive to the general public. Afghanistan has one of the lowest financial penetration rates in the world, and with these developments, it will become more difficult to attain financial inclusion. Moreover, the two private banks are still struggling to honour their commitments, which negatively affects general trust in the banking industry. As a result, deposits continue to fall, making it harder for banks to attract new deposits.

Furthermore, in the last 20 years, five banks have either collapsed or run into serious trouble, and three banks were liquidated: Afghanistan Development Bank (2009), Kabul Bank (2010), and Afghanistan Commercial Bank (2018). Two banks are struggling, one bank is under DAB undeclared conservatorship, while another's shareholder is injecting capital to fill the asset-liability gap. Although back in 2010, Despite the government's intervention in 2010, where it paid \$850 million to Kabul Bank's depositors — its collapse left a dent in the public's trust in the banking industry. Before the Kabul Bank scandal could fade, a new cycle of bank runs happened. It is difficult to measure the public's mistrust in the banking sector after several rounds of banking predicaments, but one can assume that it will take many years, along with solid measures, both by the government and the banks, to restore people's trust.

In the medium term, banks may function mainly as payment institutions and may avoid taking undue credit risk to ensure they are sufficiently liquid to meet any sudden withdrawals. If the last twenty years can provide any guidance, it is that banks with the least credit exposure have performed better and found alternative channels of generating income while paying negligible rates on their deposits. Some of these banks resorted to insuring their loans, which added an extra layer of safety in case the loans went wrong. However, banks that extended significant credit have been struggling to recover their claims by taking possession of or selling their collaterals, mainly due to structural impediments mentioned earlier.

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## Conversion to Islamic Banking

Furthering complications for the weakened banking industry, the Taliban government has asked all commercial banks to convert to a fully Islamic banking model in three years. Currently, banks are working on their conversion plans, which will require the banks to acquire or customize their management information systems (MIS); recruit new staff or train current staff in Islamic banking; draft new policies and procedures; and update all customer documents and contracts to comply with Islamic banking principles. Fortunately, there are two factors that are expected to help both commercial banks and the central bank of Afghanistan to manage this transition smoothly. In 2017, DAB approved and established the first, fully-fledged Islamic Bank of Afghanistan (previously Bakhtar Bank). Therefore, the central bank now has the experience of converting a conventional bank into an Islamic bank, which should help others during transition. In addition, eight out of ten banks already have Islamic banking windows. This means that most of the Islamic banking structure, like a Sharia Board, policies and procedures based on Shariah, and staff familiar with Islamic banking, exists, making passage even smoother. Nevertheless, conversion will still cost banks and may require hiring a third-party to plan and manage the process. Nonetheless, it is expected that banks will lose the interest income they have been earning from investing in different assets with their correspondent banks in the international market. It will take time for banks to find alternative Islamic financial institutions to conduct both international payments and manage liquidity. Therefore, banks that maintain their current correspondence relationships will lose income on their excess liquidity, as they will not be allowed to invest in interest-bearing products.

## Afghan Fund

The Afghan Fund was established in 2022, and \$3.5 billion of DAB's assets have been transferred to it. So far, the Fund has not found any useful way to contribute to economic development in Afghanistan. However, the Fund can help the banking sector in the following ways:

- As stated previously, almost \$1 billion worth of banking sector deposits were still with the DAB as of December 31, 2021. These deposits include both required reserves and excess reserves. If the Board of Trustees allow it and with clear instructions from DAB, the Fund can transfer the excess liquidity to commercial banks to help ease the sector's needs.

- ▶ Since the central bank of Afghanistan finds it difficult to function as the lender of last resort, the Fund can prepare a framework through which it can provide loans to commercial banks in need. This will help banks during the transition and buy them the time needed to address regulatory concerns.
  - ▶ The Afghan Fund can also assist commercial banks, and more broadly financial institutions, in moving physical cash in and out of Afghanistan. With the increased restrictions on MSPs, who manage transferring money out of Afghanistan mostly for import payment purposes, the economy needs a transparent way of settling its international dues. Otherwise, with the restrictions on MSPs and the inability of banks to transfer individual payments, Afghanistan's international trade will be disrupted, which may cause more economic hardship for the population.
  - ▶ Finally, the Afghan Fund should explore ways to facilitate international payment services, especially for individual customers. For more than a decade, the de-risking trend in international financial institutions has hit most commercial banks hard in Afghanistan, like their counterparts in Africa and other developing countries. One particular bank in Afghanistan has been able to maintain a USD correspondence relationship with international financial institutions by spending a significant amount on its compliance system. However, this does not mean that no other bank in Afghanistan has any correspondence relationships; banks have established correspondence relationships with regional banks to facilitate payments, especially in currencies other than USD. The Afghan Fund can step in and assist Afghan banks in overcoming international payment issues.
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## Conclusion and Recommendations

The fall of Kabul and the change of regime in August 2021 precipitated a paradigm shift for the banking sector in Afghanistan. Not only did banks lose a major portion of their income, especially interest income, but the cessation of foreign aid and suspension of donor-funded development projects created an environment of uncertainty regarding prospects for economic growth. It is likely that the banking industry has closed 2022 with losses: if this trend continues, 2023 will also close in the red. Under these circumstances, the main question that merits an answer is whether the banking industry in Afghanistan can be sustainable.

Undoubtedly, this is a very difficult question to answer, as the future depends on so many variables and unknowns. The public's trust in the banking sector has been affected adversely, mainly due to the collapse of several banks over the last twenty years, especially Kabul Bank in 2010. Additionally, with GDP falling, it is reasonable to assume that bank deposits will continue to fall, and it will be even harder for banks to generate revenue. On the other hand, banks have increased the cost of banking services in an effort to compensate for the loss of interest income. This will make banking more expensive, and with the already low financial penetration rates, it would be difficult to find ways to make banking services more attractive to the masses. In addition, the traditional MSPs, which act as the main competitor to the banking industry, will continue to flourish as they informally collect deposits and extend loans. This shadow banking will make it harder for commercial banks to expand their customer base.

Given the needs for banks in any economy, banks in Afghanistan will continue to function as depository institutions, mainly serving as saving institutions and providing payment services. Their main role as intermediary between savings and investments will be subdued. There is an urgent need for various measures by the regulator and the banks to restore public trust. The measures should address the weaknesses in "public infrastructure," especially contract enforcement and the availability of reliable external auditors, improving risk management and corporate governance, and providing timely and accurate information to the public. Additionally, both government and banks should work together to make banking services more affordable. To alleviate the burden on banks during these challenging times, the regulator can consider abolishing certain reporting and risk management requirements that do not provide the intended benefits or are not critically important, considering the local context, as banks do not engage in complex business models, but impose notable costs on the banking industry.

Going forward, the economy will further shrink, and foreign aid will not resume to pre-2021 levels. Therefore, to survive, the banking industry should consider a holistic approach that leads to increasing efficiency, cutting costs, finding alternative revenue sources, and reducing competition.

## Recommendations

- ▶ To increase efficiency, banks need to automate some of their routine processes and invest in digital technologies, such as mobile apps and online banking platforms. This can provide customers with more convenient banking services and reduce the need for in-person interactions.
  - ▶ As well as managing losses, banks need to cut operational expenses, by closing under-performing branches, streamlining processes, and downsizing personnel, which substantially reduces overhead costs. Simultaneously, banks can rely on agent banking models to provide banking services in areas where having a physical branch is not viable.
  - ▶ Banks must adapt to new realities and seriously explore Shariah-compliant products and/or further strengthen Islamic banking windows. On the asset side, they can mainly rely on trade financing products as they contain less risk than other financing modes.
  - ▶ The banking sector, especially banks with less than ten percent of the market share, should consider reducing competition through consolidation and mergers. Although mergers can be extremely challenging – especially for troubled banks – if performed well, they should be highly rewarding for all stakeholders. As a result of mergers, the new entity's operational costs will decline considerably, and it will have access to diverse expertise that can take on larger projects without breaching any regulatory limit.
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In addition, the government needs to work on a practical financial inclusion strategy, focusing mainly on banking industry digitization and removing structural impediments to increase access to finance. Likewise, the government can involve the International Monetary Fund (IMF) and initiate informal discussions to conduct Financial Sector Assessment Program (FSAP) that will "provide a comprehensive, in-depth analysis of the resilience" of Afghanistan's financial sector. As "FSAPs are done jointly by IMF and World Bank staff" (International Monetary Fund), the project can take advantage of the World Bank's presence on the ground since it has resumed many development projects. This assessment will help policymakers, and the international community to identify vulnerabilities and weaknesses, and preempt financial crisis should the risks materialize.

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## Endnotes

<sup>1</sup> Most of Afghanistan's budget used to be financed by international grants. In 2020, 56 percent of \$5.9 budget was financed by donors. These funds were deposited at DAB accounts with international financial institutions and DAB made domestic payments on behalf of the government in Afghani (AFN). Since Afghanistan has been a cash-based economy, DAB needed AFN banknotes to make these payments, which it collected periodically either through FX auctions or auctioning AFN-denominated capital notes (CN). DAB increased CN interest rates from 0.5 percent to 3.0 percent in 2020 (International Monetary Fund, 2021).

<sup>2</sup> "A provision is an amount set aside from a company's profits to cover an expected liability or a decrease in the value of an asset, even though the specific amount might be unknown." By freezing the asset provisioning, the expected losses from bad loans are not realized as expenses which can overestimate the total assets and income of banks.

<sup>3</sup> The term "Money Service Providers" (MSPs) is commonly used to refer to a range of informal and formal financial service providers that offer money transfer services (both domestic and international), foreign currency exchange, and other related services. In Afghanistan, the use of MSPs is widespread and many people rely on MSPs to transfer money to family members or for business purposes, and the sector plays an important role in the country's economy. Undoubtedly, due to its nature of being a trust-based institution, this sector is prone to being exploited by the money launderers and drug traffickers. In the last 20 years, the DAB has taken many steps to regulate and strengthen MSPs supervision and enhance its compliance.



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