



ARIES

Agriculture, Rural Investment
and Enterprise Strengthening
Program in Afghanistan

MISFA-SME
Program Brief No. 2



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The Financial Integration, Economic Leveraging, Broad-Based Dissemination Leader with Associates (FIELD-Support LWA)

The ARIES Program is a sub-award under the FIELD-Support Leader with Associates (LWA) cooperative agreement — a single, 5-year award created to both advance the state-of-the-practice in microenterprise development and microfinance as well as assist USAID missions and other operating units to design and implement innovative, integrated, market-based approaches to sustainable economic growth with poverty reduction.

Through sector assessments, program design, technical evaluations, and implementation of multi-year projects, FIELD-Support allows USAID Missions and other operating units to pursue their strategic objectives to:

- Strengthen livelihoods and food security for marginalized groups, youth, women and other vulnerable populations such as people affected by HIV/AIDS and natural disasters;
- Foster enterprise development, job creation and broad-based economic recovery in conflict and post-conflict situations as well as other fragile environments;
- Extend the reach of microfinance and develop more inclusive financial systems;
- Upgrade and improve the competitiveness of value chains in which microenterprises participate; and
- Facilitate institutional strengthening and policy reform for broad-based economic growth.

MISFA SME Program Brief

The following is one in a series of briefs highlighting the experiences and lessons learned under the USAID Agriculture, Rural Investment and Enterprise Strengthening (ARIES) Program. A \$100 million, three-year initiative, ARIES aims to create a strong private sector foundation for a sustainable, market-driven rural finance system in Afghanistan. ARIES targets USAID's Alternative Development Program (ADP) regions in the east, south and north of Afghanistan, as well as Herat Province in the west.

ARIES is managed by the Academy for Educational Development (AED) in partnership with ACDI/VOCA, the World Council of Credit Unions (WOCCU), the Microfinance Investment Support Facility for Afghanistan (MISFA), FINCA and ShoreBank International (SBI). Each partner focuses upon a different component of the financial landscape, from household micro-loans of less than \$200 to loans of over \$1 million to larger scale Small and Medium Enterprises (SMEs). In addition, WOCCU's affiliate in Afghanistan also offers savings services to members.



Activity Profile

Goal: The objective of creating an SME wholesale finance window at MISFA has been to support investment in this sector in areas outside of Kabul, and to build the capacity of local financial institutions to provide ongoing SME financing. This component of ARIES complements the program's efforts both to stimulate microfinance lending in rural areas through MISFA, WOCCU-A and FINCA-A, as well as to advance SME investment at a higher scale through the ACDI/VOCA-managed Afghan Rural Finance Company (ARFC). Specific targets established for the MISFA/SME effort are to disburse a cumulative total of 1,200 loans worth US \$30.6 million, by the end of the ARIES Program in December 2009.

Implementing Partners: ARIES' primary implementing partners in the establishment of the MISFA SME Wholesale Department are MISFA and ShoreBank International (SBI), the international consulting branch of a US bank corporation. SBI is well positioned for this task: it has been active in Afghanistan since 2003, when it supported the rural finance component of the USAID-funded Rebuilding Agricultural Markets Program (RAMP), a precursor program to ARIES.

The MISFA SME Unit presently partners with seven financial institutions, including four banks and three upscaling MFIs.¹

Funding Level: The MISFA SME Department has been initiated with a US \$15 million loan capital from ARIES. The Department currently has no other source of funding.

Role within ARIES: The MISFA SME window is dedicated to developing SME lending at selected local financial institutions through wholesale credit lines and loan guarantee facilities, for loans ranging from US \$5,000 to over \$100,000. Within the overall ARIES scale, this is in the mid-range of loan products supported: the program's microfinance partners provide loans of \$100–\$2,000, and the ARFC offers SME loans from \$20k to over \$2 million.

Overview

MISFA was established in 2003 at the request of the Government of Afghanistan to coordinate donor funding and techni-

cal assistance to strengthen the country's microfinance sector. MISFA functions as an independent apex organization, and bilateral grant support for MISFA is channeled primarily through the Afghanistan Reconstruction Trust Fund. MISFA currently coordinates with 15 MFI partners.

MISFA plays two major roles in the ARIES program. First, it on-lends funds to microfinance institutions that operate in the ARIES target areas that are not currently served by the program's primary partners). Second, through ARIES support, the scope of MISFA's wholesale lending expertise has been expanded beyond microfinance with the development of an SME window.

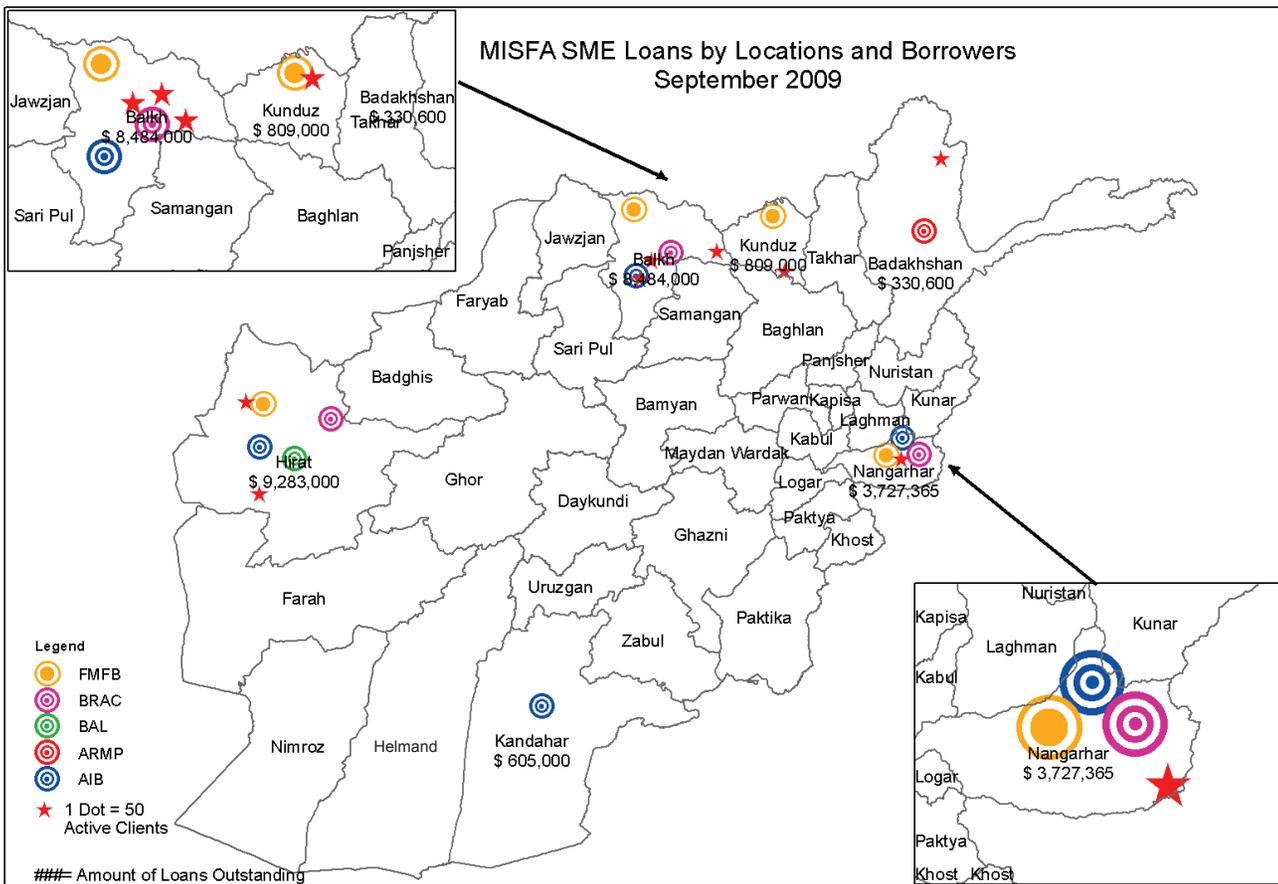
The SME Wholesale Lending Department at MISFA was established and capitalized in late 2006 with a US \$15 million loan capital from ARIES, its sole donor to date. This department is dedicated to developing SME lending for local financial institutions through wholesale credit lines and loan guarantee facilities, for loans ranging from US \$3,000 to over \$300,000, or the so-called "missing middle" of SME financing. In Afghanistan, this approach to SME lending is highly innovative; it was previously less structured and under-developed within the formal financial sector.

Each of the seven MISFA SME partner financial institutions offers a different size of loan to the SME market. With ARIES support, MISFA has made much progress in the SME sector, and it now operates as a self-sufficient organization. Given the operational difficulties in Afghanistan, however, MISFA is still working towards becoming a truly commercial entity.

Operations: With ARIES support, SBI provides the MISFA SME Department and its seven partners with a comprehensive technical assistance package. This includes wholesale credit lines and guarantee facilities, as well as training in appropriate lending methodologies. SBI has assisted MISFA in establishing SME partner selection criteria by adapting a more thorough due diligence process. SBI has also expanded MISFA's SME services to regions across the country, and created a series of SME financial products and incentives. Additionally, SBI has trained over 150 credit officers in partner financial institutions.

Partner Selection Criteria: Potential partners are selected for the MISFA SME initiative based on their capabilities and commitment to SME lending. They must be legally registered in Afghanistan as financial institutions, and they must

¹ The four banks are Afghanistan International Bank (AIB), Bank Alfalah, BRAC Afghanistan Bank (BAB) and The First Microfinance Bank (FMFB). The three MFI partners are Parwaz, Oxus and the Afghanistan Rural Micro-credit Program (ARMP).



receive a sound due diligence report. Other selection criteria include area of operations and congruence of the MISFA SME initiative with the institution's strategy in Afghanistan.

Foreign-owned institutions active in Afghanistan are also eligible to participate in the MISFA SME initiative. Generally, the MISFA SME program targets 100% privately-owned companies, but a government-owned bank may also be accepted if its proposal is exceptionally strong.

Areas of Operation

Though MISFA is based in Kabul, the SME partners to whom MISFA lends are active in several provinces within the ADP regions, as well as in Herat province. The following table illus-

trates where MISFA/SME partners operate by region.

Financing instruments/products

Through the MISFA SME window, both lines of credit and loan guarantee facilities are offered to financial institution partners. Interest is charged with both types of products. MISFA SME partners offer a range of conventional as well as *Sharia*-compliant products.

Lines of credit: MISFA manages credit lines in Afghan currency for its SME partners. Partners use credit lines to finance SME projects in the ARIES targeted economic zones based on their own lending terms. The duration of a credit line may be up to five years.

MISFA SME Finance Partners							
ADP Region	FMFB	AIB	BAB	al-Falah	Oxus	Parwaz	ARMP
North (Balkh, Badakhshan, Kunduz)	X	X	X				X
South (Kandahar)		X					
East (Nangarhar)	X	X	X				
Other	Herat, Kabul	Herat, Kabul	Herat, Kabul	Herat, Kabul	Kabul	Kabul	

An original credit line may be as high as Afs 100 million (US \$2 million). If the MISFA SME partner uses its credit line satisfactorily, it may have access to additional tranches of up to Afs 200 million (US \$4 million). If the partner does not utilize the funds, MISFA has the option to reduce its commitment to the partner.

Credit lines are disbursed from MISFA's SME account to a partner in tranches corresponding to approved business deals. MISFA offers credit lines at interest rates of 3% to partners in the ADP-South region, and at 7% to partners in the ADP-North and ADP-East regions. Rates are differentiated to take into account the higher security risks of operating in the South.

Under the ARIES Program, acceptable uses of MISFA SME funds include purchases of equipment, inventory or raw materials for growth or a new line of business; purchases and/or renovations of real estate for business production or provision of service; and working capital for specific purposes.²

Performance

As of September, 2009, three credit lines and one loan guarantee totaling US \$14 million have been established. The MISFA SME Partners have disbursed a total of 806 loans to some 470 clients, with a cumulative amount of US \$23.2 million, reflecting a strong demand for credit from the SME sector. The MISFA SME portfolio has an outstanding balance of over US \$7.9 million and the PAR₃₀³ is currently 1.7%.

Although loans have been made to a wide range of businesses in the agricultural, service and trade sectors, 80% have been issued to traders based in the larger provincial cities of Herat, Mazar and Jalalabad. This reflects banks' reluctance to lend to agri-business producers, whom they view as high risk clients, despite their strong demand for credit. It is also indicative of a general hesitation to invest in businesses outside of the relatively more secure urban areas.

² Unacceptable uses include: military-connected production; tobacco production or products derived from tobacco; casinos or other forms of gambling; production of nuclear energy or other radioactive products; activities identified as environmentally hazardous (as included in the relevant list of USAID); currency speculation; securities investment; speculative investments in real estate or commodities; refinancing of existing debt; and production or processes that do not comply with Afghan laws.

³ Portfolio at Risk (PAR) is calculated by dividing the outstanding balance of all loans with arrears over 30 days, plus all refinanced (restructured) loans by the outstanding gross portfolio as of a certain date. Since the ratio is often used to measure loans affected by arrears of more than 60, 90, 120 and 180 days, the number of days must be clearly stated (for example PAR₃₀). A total of 4,112 jobs sustained to date, as well as 843 jobs created as of September 2009.

Achievements

- A functional SME wholesale department has been created at MISFA, and an SME Department Manager has recently been hired. MISFA now includes SME lending as an integral part of its services for local financial institutions.
- As of September 2009, MISFA SME partners have processed some 806 loans worth US \$23.2 million to SME borrowers in target areas outside of Kabul; the average monthly output is now over US \$1 million.
- Nearly 5,000 jobs have been created and/or sustained as a result of MISFA's SME lending activities.

Challenges, Adjustments and Lessons Learned

For all of the ARIES partners project goals have remained the same while the strategy for achieving them has evolved. MISFA SME has faced significant hurdles, many of them impossible to anticipate at the project's outset. The following points illustrate challenges, how the project has adjusted in response, and the lessons learned for others working in similar contexts.

Challenge: *Most banks are reluctant to undertake SME lending, particularly to agricultural producers, whom they consider too risky. They prefer instead to lend to traders; approximately 80% of the MISFA SME current clients are traders based in urban areas. Furthermore, with few exceptions, bank management continues to have a very conservative approach to the sector overall, considering it not to be a profitable line of business.*

Adjustment: *MISFA's SME Department is looking beyond banks to MFIs and other institutions for SME lending, e.g. the latest MISFA SME partners are the MFIs, Parwaz and Oxus.*

Lessons learned: *Banks may not be the partners of choice for SME lending, particularly for agribusiness financing, in Afghanistan.*

Challenge: *There are significant security constraints to the delivery of financial services, particularly in the transfer of funds from Kabul to branches outside the capital, as well as in loan repayments.*

⁴ A total of 2,882 jobs sustained to date, as well as 698 jobs created as of March 2009.



Adjustment: Adapt alternative savings, lending and money transfer systems which would complement existing structures, such as M-Commerce. At least one of the MISFA SME partners, FMFB, already has experience with the branchless banking system “M-PAISA”, which is offered by the Kabul-based telecommunications provider ROSHAN. SME clients and bank officers interviewed for this case study are enthusiastic about the security, and time-saving advantages that electronic banking could offer. This system is currently being piloted by the ARIES Program.

Lessons learned: Since AED finalized the original ARIES Program description in early 2006, the context for field operations in Afghanistan, particularly security conditions, has continued to deteriorate. ARIES is operating in an unstable and socially restrictive country environment, and its partners require flexibility and creativity to adapt the program.

Challenge: Human resource capacity within lending institutions, including knowledge of value chain and SME financing, remains limited.

Adjustment: SBI has provided ongoing training and mentoring of SME loan officers at partner institutions.

Lessons learned: In Afghanistan, the concept for offering donor-supported funds for SME lending through formal financial institutions is innovative; the ARIES program has been one of the greatest catalysts to the growth of this sector. The need for capacity building in partner financial institutions is enormous. The process will be lengthy, as it involves training Afghan bankers in concepts and methodologies of Western banking previously unknown in the country.

Challenge: There is resistance to non-Sharia compliant products, particularly in more conservative regions of Afghanistan.

Adjustment: MISFA has engaged two scholars of Sharia law to review current MF and SME products, and advise on standardization of Sharia-compliant product lines for MISFA partners. It is expected that conventional financing will remain available, and clients will be able to choose from either traditional or Islamic loan products.

Lessons learned: The demand for Islamic financial products and services in many areas of Afghanistan is high. Although

this demand is usually associated only with the lower tiers of microcredit, SME clients also require Sharia-compliant products, as indicated by the recent SBI report on Access to Financial Services in Southern Afghanistan. The MISFA SME Department will standardize the SME products it offers to meet this demand.

Challenge: The ARIES Program, which is currently the sole donor to the MISFA SME Department, will be completed in December 2009.

Adjustment: MISFA is seeking other funding to complement USAID support and to expand beyond the ARIES program. These efforts include leveraging existing USAID funds, as well as identifying support from other donor programs.

Lessons learned: Although SME partner institutions are beginning to realize reflows from their initial loans through the ARIES credit lines, it is premature to expect that the MISFA SME window will reach sustainability by the end of the ARIES Program (this was not a Program target). The SME Department began lending in late 2007; continued donor support will be necessary if it is to operate after 2009. MISFA will need donor support for increased on-lending and expansion.

Moving Forward

To achieve the goals of outreach, “Afghanization”, and sustainability for the MISFA SME Department, MISFA and SBI will focus on the following activities:

- Growing and developing partnerships and strategic alliances with:
 - Additional financial institutions. MISFA’s goal is for its SME department to have as great an influence in the SME lending sector as MISFA has in the microfinance sector. To achieve this, MISFA, with SBI, will continue to increase the number and diversity of its financial partners. MISFA is a development institution that aims to become commercially viable, and it is looking beyond banks to other institutions for SME lending. It is therefore anticipated that additional MFIs who wish to up-scale lending products will become MISFA SME

partners⁵, as will some of the recently established private banks in Afghanistan.

- Other ARIES actors. MISFA SME partner the AIB for example, has engaged with ARFC in co-financing one loan to leverage ARFC expertise in venture-capital style investment along with its own commercial bank resources.
 - Other USAID funded projects. MISFA will, for example, continue to coordinate with ASMED to fund bank sector trainings, source SME deals, and develop SME client capacity in areas like BDS.⁶;
- Continuing to build local institutional capacity for SME financing;
- Increasing the number of female SME clients. MISFA intends to increase its numbers of female SME borrowers, who currently constitute less than 1% of its SME clients;
- Developing appropriate products for agricultural lending—which MISFA recently signed an agreement with IFAD to do.

⁵ The MFIs Parwaz and Oxus have recently become MISFA SME partner institutions.

⁶ The capacity of SME borrowers is variable, and bank managers, loan officers and others interviewed for this study noted that many of their SME clients were unable to produce business plans or marketing strategies.

The Microfinance Investment Support Facility for Afghanistan (MISFA) is a wholesale lending institution that channels funds from bilateral donors to microfinance institutions that offer competitive, transparent and effective services. MISFA was established as a vehicle through which the Afghan Government and international donors could channel technical assistance and funding to build Afghanistan's microfinance and small and medium enterprises (SME) lending sectors.

www.misfa.org.af



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