

**FOR
INFORMATION**

FO/DIS/15/77

CONFIDENTIAL

May 29, 2015

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Islamic Republic of Afghanistan—Deletions—Staff-Monitored Program**

Board Action:

The attached deletions from EBS/15/48 (5/8/15) have been proposed by the authorities of the Islamic Republic of Afghanistan and agreed with staff in accordance with the policy on publication of papers:

**Operational Details of
Policy Intentions**

Pages 11, 38, 46

Comments:

The authorities noted that information provided in these paragraphs is not in the public domain and consists of some operational details of the sale of New Kabul Bank. They pointed out that premature disclosure of these operational details would, in itself, seriously undermine the ability of the authorities to successfully conclude the privatization of New Kabul Bank.

Questions:

Mr. Ross, MCD (ext. 38973)
Mr. Demirkol, MCD (ext. 35936)

26. **A sound and robust fiscal regime for natural resources is being designed.** This regime should help attract investment and ensure the government receives a reasonable share of the economic rents. The Fund has provided capacity development assistance to review the current framework and will provide recommendations on tax administration for the fiscal regime for natural resources in full compliance with the Extractive Industries Transparency Initiative.

Financial Sector Reforms

27. **The authorities have acted to address banking vulnerabilities.** DAB has issued enforcement actions for the vulnerable systemic bank to ensure the bank recorded losses on its assets and restored capital levels and ratios. The bank has made significant progress in these areas. DAB will continue to monitor the bank closely and is ready to put the bank under conservatorship in the case of noncompliance. DAB has also issued enforcement actions against the other vulnerable state-owned bank, which needs improved management and additional capital. The bank has been prohibited from extending any further loans and its management positions will be filled with fit and proper bankers swiftly. An independent external party will be hired to audit bad debt recoveries. The authorities also committed to restore capital to required minimum levels by end-2015. The bank will also prepare a five-year operating strategy, which will be submitted to DAB by end-June 2015 and finalized by end-August 2015. Should the strategy not be effective, and the bank is not able to achieve an operational break-even within 18 months, i.e., by end-February 2017, the bank will be put into conservatorship followed by its liquidation or sale. For other weak banks, DAB has started to implement a plan to address their weaknesses and increase their CAMEL ratings significantly by end-February 2016.

28. **The sale of New Kabul Bank (NKB) will be re-started.** NKB's management has already cut losses significantly, from \$22 million in 2012 to \$6 million in 2014 and plans further measures to reduce losses that will make NKB profitable by end-2015. The authorities believe that NKB's improved profitability will attract more bidders and a higher sales price at its privatization, which they will initiate by end-September 2015. ~~If it is not possible to sell NKB, the authorities are determined that it should not be merged with another state bank, and will wind up the bank as soon as the government salary function has been transferred to other banks.~~ The World Bank is financing national payment system upgrades that over time will facilitate the transfer of the government salary function.

29. **The new banking law will be promulgated by June 2015.** The legislation drafted in consultation with Fund staff strengthens corporate governance, capital requirements, large and related parties lending exposures, enhances supervision and bank resolution provisions. Revised regulations and information circulars will be issued once the new banking law is enacted. The authorities will also submit to parliament amendments to the central bank legislation by end-December 2015 to make its new capitalization framework operational, a critical ingredient for central bank independence.

Financial Sector Reform**30. We have acted to address banking vulnerabilities and will take further action if needed.**

- DAB has issued enforcement actions for the vulnerable systemic bank to ensure the bank recorded losses on its assets and restore capital levels and ratios. The bank has made significant progress in these areas and DAB will continue to monitor the bank closely and is ready to put the bank under conservatorship in the case of noncompliance.
- DAB has also issued enforcement actions against the other vulnerable state-owned bank, which needs improved management and additional capital. This bank suffers from fundamental weaknesses in governance, risk management, internal controls and management, which led to a near 100 percent nonperforming loan ratio, capital dissipation and fraud. In response, the bank has been prohibited from extending any further loans. To this end, we will ensure management positions are filled with fit and proper bankers swiftly, and we commit to restore the capital required minimum levels by end of 2015 through a minimum aggregate capital injection of \$20 million during 2015. The bank will also prepare a five-year operating strategy with projected financial statements, key performance objectives, and quarterly reporting to monitor performance, which will be submitted to DAB by end-June 2015 and finalized by end-August 2015. An independent external party will be hired to audit bad debt recoveries. Should the strategy not be effective, and the bank is not able to achieve an operational break-even within 18 months, i.e., by end-February 2017, the bank put into conservatorship followed by its liquidation or sale.
- DAB has prepared a plan to deal with the other weak banks and started to implement it. This plan envisages increasing CAMEL ratings significantly for all weak banks by end-February 2016. It will improve weak banks' CAMEL ratings by focusing on management, capital adequacy, and asset quality areas, and DAB will issue corrective action in case of no improvement as envisaged under its action plan for weak banks.

31. We will re-start the sale of New Kabul Bank (NKB). When NKB was formed in 2011, it was not properly capitalized and since then it has incurred further losses. It is therefore imperative first to reduce and then eliminate further losses at NKB. NKB's management has already reduced losses significantly, from \$22 million in 2012 to \$6 million in 2014. Further, NKB management is implementing further measures that will make NKB profitable by end-2015. We believe reducing losses at NKB will make its privatization more attractive and result in a higher sale price. Accordingly, we wish to implement additional measures to reduce losses before initiating its privatization. We therefore plan to initiate NKB's privatization by end-September 2015. ~~If it is not possible to sell NKB, we are determined that the bank should not be merged with another state bank, and we will wind up the bank as soon as the government salary function has been transferred to other banks.~~ The World Bank is financing national payment system upgrades that will over time make the transfer of the government salary function to other banks possible.

Table 3. Islamic Republic of Afghanistan: Structural Benchmarks (concluded)

Measure	Date	Status/Rationale
Implement reform plan and re-start sale of NKB. NKB should be offered for sale either through a public announcement of a new tender or by a written letter inviting the bidders that made approved bids in early 2014, requesting them to indicate whether they remain interested in purchasing the bank and to respond by November 15, 2015.	End-September 2015	Strengthen financial sector.
Afghanistan Revenue Department to implement a data driven risk based audit case selection process. Develop and implement a data driven process to effectively identify and prioritize high-risk areas. Based upon high-risk areas identified, implement ARD audit plan to effectively allocate available resources to accelerate revenue collections. Establish key performance indicators to continuously assess performance of the risk-based audits. Based upon performance results, update existing audit policies, procedures and guidelines.	End-October 2015	Strengthen tax administration and mobilize budget revenue.
Revise the banking regulation on related party lending. The revisions to the regulation on related party lending limits should include: (i) revising the definition of related parties according to international standards; (ii) confirming the limit on related party aggregate exposures to a maximum of 15 percent of the bank's unimpaired capital and reserves; and (iii) in case of any exposure over the limit prescribed in the regulation, deduct such exposure from capital when assessing capital adequacy, unless sufficiently and satisfactorily collateralized.	End-December 2015	Align key regulations with international standards and best practices.