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Helping Afghanistan's Poor and Small & Medium-sized Enterprises (SMEs) through Improved Access to Capital via Islamic Banking Windows & Related Financial Services

New AACC Report Executive Summary:

Assisting Afghanistan's Islamic/Sharia Banking Sector for Improved Economic Growth, Development, Trade & Investment

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Please read the Full AACC Report for extended analysis and more detailed discussions of the Key Challenges and AACC Recommendations for moving forward. This report was published on 9/29/20.

[CLICK HERE FOR: FULL AACC REPORT ON ISLAMIC BANKING AND FINANCE PUBLISHED SEPTEMBER 29, 2020]

Background:

Globally it is estimated that *Islamic* banking and finance represents about $500 billion to $1 trillion (USD) out of a global economy representing a GNP of $250 trillion (USD). *Islamic* banking is still a nascent yet developing industry inside Afghanistan and across Central and South Asia. Since the modernization of Afghanistan's banking sector began in 2003, early stage *Islamic* banking has played only a small role and the first ever "*Islamic Banking Window*" received a license in 2007 from *Da Afghanistan Bank (DAB)*, which serves as Afghanistan's "Central Bank."

In those early years, many bankers expected much stronger growth in this unique banking sector. The reasons were manifold:

- The vast majority of Afghan's are followers of Islam and the *Riba* ("usury interest") is considered amongst the gravest sins in *Sharia* (*i.e., Islamic Law*);
- In addition, many expected that the rumored wave of "*Islamic* financing" may strongly contribute to improved financial inclusion and perhaps foster greater economic growth -- which are among the main challenges facing the Afghan banking industry and economy; and lastly, and,
- Many also felt that the establishment of "*Islamic Banking Windows*" would launch a surge of deposits providing depositors and/or borrowers a unique banking vehicle for intra- and extra-Afghanistan bank transfers.

In 2015, *DAB* issued a regulatory framework for *Islamic* banking attempting to strengthen *Islamic* banking by setting clearer legal standards with rules based on standards established by the Bahrain-based *Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)* (https://aaoifi.com) and with advisory assistance also from Malaysia. *AAOIFI* is a non-profit organization that was established to maintain and promote Sharia standards for *Islamic* financial institutions, participants, and the overall industry. *AAOIFI* was created on February 26, 1990, to ensure that participants conform to the regulations set out in *Islamic* finance. It serves as Afghanistan's major standard-setting institution for Islamic finance and the banking industry. The *AAOIFI* established a regulatory framework that has helped six (6) banks to establish *Islamic* windows and it also paved the way for *DAB* to issue the first full-fledged Islamic bank to a private bank that adheres to all *AAOIFI* principles for *Sharia* banking.

As of November 2019, the banking sector consisted of one fully fledged *Islamic* bank and six Islamic banking windows with total assets of US$471.8 million, customer deposits of US$349.6 million and a total investment and financing portfolio of US$154.3 million. As of Quarter 2, 2019, the Afghan *Islamic* banking sector constitutes approximately 10.68% shares in assets, 27.92% shares in gross loans and 10.30% share in deposits of the overall banking sector. As *Islamic* finance makes its way towards mainstream banking in Afghanistan, expectations are high that *Sharia*-compliant banking will provide much-needed momentum for the country's economy, whose 99% Muslim population highly demand for interest free bearing banking services.

Currently, *Islamic* banking in Afghanistan represents only 12.21% of total banking industry assets (as of 2020). There are only six (6) *Islamic* banking windows and one full-fledged *Islamic Bank* that has received a license to operate in the Afghan marketplace (according to *The Economic & Statistics Bulletin, DAB, 2019*).

In spite of establishing clear regulatory standards, the *Islamic* banking and finance industry has not fared well developmentally and is clearly struggling. The *Afghan-American Chamber of Commerce's (AACC) Banking & Finance Working Group* has determined that the entire Islamic banking and finance sector needs a new impetus of support from international donors and international financial institutions (IFIs) like the *World Bank* and its private sector arm, the *International Development Finance Corporation (IFC)*. In addition, we believe the sector is ripe for new *"Public-Private Partnerships"* and technical support from successful *Islamic* Banking institutions in the Central and South Asia regions – including the United Arab Emirates (UAE), Bahrain and Malaysia, the preeminent *Islamic* finance nation in the world.

The AACC and its Banking & Finance Working Group have consulted many Afghan and international banking industry practitioners of *Islamic* finance to better understand the main reasons behind the slow growth and passive presence of *Islamic* banking in Afghanistan. The following report provides the six main challenges faced by Islamic banking and finance in Afghanistan today. We then offer seven strategic recommendations and a number of individual solutions for improved performance and innovation within this sector. As this was a group effort, not everyone agreed on all prescriptions but we were unified in our belief that something needed to be done urgently to improve this sector – especially its ability to provide unique access to capital for the poor, internally displaced persons (IDPs) and small and medium-sized enterprises (SMEs). The AACC remains fully responsible for its content and please send any reactions or comments to: info@a-acc.org.

***CHALLENGE ONE:* Islamic Banking Instruments Offer a Different Finance Model or Different Shared Risk Perspective that Has Not Yet Been Adequately Explained to Customers or Afghan Bank Staff:**

Afghanistan conventional bank counterparts are raising debt-based portfolios to remain competitive and secure within the Afghan banking marketplace. Many Afghanistan bankers believe that in *Islamic* finance, the spirit and structure of transaction is to share the business risk between fund providers and fund users. The risks involved in the operations of these more participatory financing vehicles are high, they say, for the banking sector as most Afghan businesses are still running on the traditional basis of bricks-and-mortar. They note this is because few businesses have turned to a modern system of recording their cash-inflow and outflow through information technology (IT)-based systems. Therefore, due to the low level of transparency and higher than normal project risk, Afghan banks have not been interested in utilizing these types of financial products/services.

However, experienced Islamic banking experts working regionally within Central and South Asia advise the AACC otherwise. They believe this may not be the full picture in Afghanistan. International Islamic bankers believe that if Afghanistan bankers had more experience in these transactions, they would use Ijara or other structures to own the asset versus lending or leasing against it. *(Please read full report for extended discussion here.)*

<u>AACC Recommendation #1:</u> "Main-Streaming" Islamic Banking and Finance

1. ***Increase SME and Small Transaction Volumes***:
2. ***DAB must better promote and encourage use of Islamic Banking transactions:***
3. ***More specifically, DAB and international donors should be more actively promoting unique Islamic financial instruments like Sukuk, where private banks have the opportunity of utilizing investments in or around major government projects; thereby leveraging and increasing the impact of specific developments so they help private sector development as well.***
4. ***International Donors should focus on new or proven de-risking instruments like factoring, insurance, guarantees, and vouchers:***
5. ***Help de-risk around micro-transactions in the Islamic financing space:***
6. ***Donors should seek to build specific capacities and specific customer-focused communities within the Islamic banking sector.***

CHALLENGE TWO: Lack of Full-Fledged Islamic Banks or Bank Branches:

At the beginning, the purpose of introducing *"Window-based Islamic Banking"* was to introduce this recently developed banking system within Afghanistan. It was generally agreed that once the window-based system takes root then it would be moved from a *"Window- based"* form to a full-fledged bank or bank branch. But in Afghanistan, it remained as a window-based banking vehicle since the establishment of the first *Islamic* banking window in 2007 and it was not until 2018 that a full-fledged *Islamic* bank was incorporated (*i.e., The Islamic Bank of Afghanistan*).

It is also widely believed within the Afghanistan banking community that the primary reason for *DAB* not playing a more insightful or strategic role in *Islamic* financing is because of the restrictions placed on *DAB* by the *IMF* who believes that Afghanistan cannot yet manage regulation or oversight of two simultaneous banking systems inside Afghanistan. Since the *IMF* requires a conventional banking system for Afghanistan that allows for or facilitates international financial integration for Afghanistan, the *Islamic* financing component has been largely ignored by donors thus constraining a key avenue for increased capital distribution and greater income equality since it would largely benefit increased trade and consumer-oriented transactions.

Lastly, it remains difficult for Afghan banking customers to believe in the benefits or risks associated with *Islamic* banking operations when the *Islamic* and conventional banking products are offered under the same roof and have the same paid-in capital. It is important to note here that most of the local shareholders of Afghan banks that maintain an *Islamic* banking window are trying to reduce or maintain low levels of risk. Currently, they are not interested in moving to full-fledged or bank branch status due to the increased risk factors. *(Please read full report for extended discussion here.)*

AACC Recommendation #2: Elevate Islamic Banking Windows to Full Fledged Islamic Banks

1. ***DAB must elevate Islamic Bank Windows and Seek Further Diversity in the Islamic Banking and Finance Marketplace*:**
2. ***Develop new Islamic Banking and finance capital requirements in consultation with the banking sector*.**
3. ***Banking Sector must provide more public outreach:* In addition, the *Afghan Bankers Association* should conduct broader outreach to the Afghan public explaining the value of *Islamic* banking instruments to the consumer and SME markets.**

AACC Recommendation #3: Increasing Capital Infusion and Reducing Regulatory Burdens

1. ***Increase capital and reduce regulatory burdens now:***
2. ***Must target "Small & Medium Enterprise (SME) Market***:
3. ***Create New SME Islamic Investment Funds***: