**International Monetary Fund**

Islamic Republic of Afghanistan and the IMF

**Press Release**:
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November 15, 2011

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# **Islamic Republic of Afghanistan:** Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

November 1, 2011

The following item is a Letter of Intent of the government of Afghanistan, which describes the policies that Afghanistan intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Afghanistan, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

## LETTER OF INTENT

November 1, 2011

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Ms. Lagarde:

We would like to thank the International Monetary Fund (IMF) for its advice and support over the last year as the government of Afghanistan and Da Afghanistan Bank dealt with the crisis at Kabul Bank that came to the fore in September 2010 and its consequences. In response to the crisis, we have taken important steps to mitigate its adverse effects, minimize the fiscal costs, and safeguard good governance and the rule of law over the last 12 months.

Against this background, we entered into discussions with IMF staff on a new program that could be supported under the Extended Credit Facility (ECF). The three-year program through 2013/14 establishes a macroeconomic framework that will support our efforts at economic stabilization and implementation of structural reforms. In particular, the ECF arrangement will help us make significant progress toward a stable and sustainable macroeconomic position, while managing the challenges of the withdrawal of the international presence in Afghanistan, as well as strengthening the financial sector. These are key pillars of our development strategy that aims at sustained poverty reduction. Given our large dependence on donor support, we require external assistance to build a more resilient and self-sustaining economic structure as well as reinforce our balance of payments position.

We hereby kindly request the approval by the Executive Board of a three- year ECF arrangement in an amount equivalent to SDR 85 million (52.5 percent of Afghanistan's quota). To monitor progress in implementing our reform agenda, the program includes a set of prior actions, quantitative performance criteria, indicative targets, and structural benchmarks, outlined in the attached Memorandum of Economic and Financial Policies (MEFP) and the Technical Memorandum of Understanding (TMU).

The government believes that the policies set forth in the attached MEFP are adequate to achieve the objectives of its program, but it will take any further measures that may become appropriate for this purpose. We will consult with the Fund on the adoption of these measures and in advance of any revision to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation. We intend to remain in close consultation with Fund staff and provide timely information necessary for monitoring economic developments and implementation of policies under the ECF-supported program. In addition, the government stands ready to take any further measures that might be required to ensure that the overall objectives of the program are attained.

In line with our commitment to transparency, we hereby request that the staff report, this letter of intent, and the attached MEFP and TMU (including all annexes and attachments), as well as all other ECF-related documents, be published on the IMF website.

Sincerely yours,

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|---|---|
| /s/ | /s/ |
| Omar Zakhilwal<br>Minister of Finance | Mohibullah Safi<br>Acting Governor<br>Da Afghanistan Bank |

Attachments:

Memorandum of Economic and Financial Policies
Technical Memorandum of Understanding

## MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

1. This memorandum reviews recent economic developments and summarizes the government's economic objectives and policy framework for 2011–14, for which we are seeking support under a new three-year arrangement with the IMF.

2. **The government of Afghanistan and Da Afghanistan Bank (DAB) have made a number of important achievements under our economic program for 2006–10.** In January 2010, we fulfilled the conditions for reaching the completion point under the Enhanced Heavily Indebted Poor Countries (HIPC) initiative, bringing together four years of important and successful efforts despite an increasingly challenging security situation. We strengthened basic economic institutions, made strong progress in restoring fiscal control and improving public financial management, fostered trade and growth, and managed inflation well. Tax collection, which was relatively weak during the first two years of the program, has improved significantly since early-2009. We also improved the monitoring of the four largest public enterprises, although the problems at Kabul Bank that came to the fore in the fall of 2010 highlighted the costs of weak corporate governance and the need to tackle vulnerabilities and prevent abuse in the financial system.

3. **Looking ahead, much remains to be done.** In particular, we will focus our efforts on safeguarding financial stability, strengthening the banking system, promoting responsible lending for investment and growth, improving the business environment for the private sector, moving decisively toward fiscal sustainability, and improving fiscal planning and expenditure management. We believe this will complement commitments by donors to channel additional support through the budget and allow us to raise spending in line with our development objectives.

## I. RECENT DEVELOPMENTS

4. **Growth and inflation.** Economic activity remains robust, with projected real GDP growth of about 6 percent in 2011/12, following a growth of 8 percent in 2010/11. While agriculture has suffered from fluctuations, growth outside agriculture has been strong due to increased security spending and expansion of construction and trade. Inflation has increased again owing to rising international food prices, adverse conditions in neighboring countries, and an accommodative monetary policy. The 12-month rate of inflation peaked at 18 percent in January-April 2011, rising from 2 percent in June 2010. It has since moderated again to 11 percent in August. During the same period, core inflation (which excludes cereals, fats, and transportation) rose from 5 percent to 13 percent.

5. **Fiscal performance.** Fiscal performance in 2010/11 remained strong. The overall fiscal deficit including grants fell from 1.6 percent of GDP in 2009/10 to about balance in 2010/11. The improvement came mainly from a decline in development spending and a tight control over nonsecurity spending, but also from improved domestic revenue collection

which was up by about 1 percent of GDP in 2010/11. Revenues in 2011/12 remain buoyant, with a 25 percent increase in the first half over the same period in 2010/11. We continued implementing pay and grade reforms, and recruited almost 60,000 personnel in the security sector leading to an increase in security spending of 1.5 percent of GDP in 2010/11.

6. **Development spending.** Development spending fell by 1.7 percent of GDP in 2010/11, the third year of consecutive decline. This was a result of the combined effect of earmarked donor funding that could not be reallocated, worsening security that prevented the execution of projects in some regions and capacity constraints at line ministries. Other problems include ambitious multi-year spending plans (with large carry-overs), incentives for the donors and line ministries to "front-load" the budget, difficulties with procurement planning and execution, slow approval processes, and poor contract management. We are addressing these issues through the Public Financial Management Road Map, which was prepared in consultation with IMF staff. In addition, we are working closely with line ministries to enhance their budget execution capacity and we will continue to engage with donors to increase flexibility of funding according to their bilateral and multilateral commitments.

7. **Fiscal reforms.** We have made progress with structural reforms in the fiscal area. First, the Medium and Large Taxpayer Offices now report directly to headquarters in Kabul instead of to the Ministry of Finance's provincial offices, an important measure in our goal to create a national tax administration organized along functional lines. Second, we simplified the chart of accounts to reduce risks associated with the implementation of program budgeting reform. Third, with the implementation of the Afghanistan Financial Management Information System (AFMIS) in Nuristan in 2010, we completed the AFMIS roll-out across the country. This is a significant achievement, which provides timely information on budget expenditures and subjects them to a high degree of fiduciary control. Fourth, the implementation of the Automated System of Customs Data at the Nimroz customs post has begun. A business model for border controls in line with best practice (a critical measure to fight corruption at customs) was introduced in September 2011 at the Hairatan Border Crossing Post. The model envisages the presence of only two ministries at the border (Interior and Finance). Following successful implementation of the pilot, the model will be rolled out to additional border crossing posts by end-March 2012.[1]

8. **Public enterprises.** Financial reviews and business plans by four key public enterprises—Ariana (an airline), Da Afghanistan Breshna Sherkat (DABS, a power utility),

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[1] In addition, we had the largest positive increase in Public Expenditure and Financial Accountability (PEFA) scores of any country with two assessments. We remain committed to increases in budget transparency. Although still low in absolute terms, we had a 160 percent increase in our Open Budget Index score from 8 to 21 percent and have committed to at least 30 percent in the next review.

Afghan Telecom, and The Afghanistan Fuel and Liquid Gas Enterprise (FLGE)—were finalized in 2010. The financial reviews revealed a number of shortcomings, such as a lack of management and financial reporting systems in the companies, over-staffing (Ariana), lack of competitiveness (Ariana, Afghan Telecom, FLGE), collection problems (DABS), and serious corporate governance issues (FLGE). The business and restructuring plans that are now being implemented address these deficiencies.[2]

9. **Financial sector and Kabul Bank**. Over the past four years, the central bank has strengthened its capacity for banking supervision. Still, the rapid growth of the banking sector proved challenging as illustrated by the Kabul Bank crisis that came to the fore in the fall of 2010. In August/September 2010, due to concerns over operation of Kabul Bank, the largest commercial bank, we removed the two major shareholders from management, put the bank into conservatorship and suspended shareholder rights. However, public concern over its stability caused a run on the bank. With one-third of the system's assets of US$4 billion, the run threatened the stability of the whole banking system. In order to prevent further instability we promptly announced that its deposits would be guaranteed. This action contained the run and prevented contagion. Nonetheless, Kabul Bank lost about one-half of its deposits and the central bank had to extend a lender-of-last-resort (LoLR) facility for US$825 million. Subsequently, Kabul Bank was put into receivership, revoking shareholders' rights altogether. Its deposits and good assets were transferred to a bridgebank—New Kabul Bank—which is being prepared for sale. It was established that about US$865 million (principal and interest) in the asset portfolio of the bank are questionable.

10. **Monetary developments.** We responded to the initial run at Kabul Bank in September 2010 with sufficient cash notes to repay depositors. At the same time, by sterilizing the impact of the LoLR loan to Kabul Bank with a fraction of our foreign reserves, we prevented the bank's crisis from destabilizing the exchange rate. The interest rate on 28-day capital notes remained at around 3 percent. However, monetary aggregates grew by more than envisaged, mainly reflecting the increased preference for cash by the public in the aftermath of the Kabul Bank crisis, but also high aid inflows.

11. **External current account**. The external current account balance was favorable, facilitating a further buildup of international reserves to about 7 months of imports. After reaching the HIPC completion point in 2010, we are following up with Paris Club creditors on

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[2] At Ariana, the ministry of finance-appointed implementation team has installed a new chief financial officer, the amendments of the charter of the company is in process, and an advisor was recruited to work on maintenance, safety, and quality assurance. In the past year, DABS has improved revenue collection and introduced a procurement manual and new human resources' procedures. Afghan Telecom has been expanding its capacity. As for FLGE, the company no longer enjoys an effective monopoly on fuel storage.

their debt relief commitments, and carrying out negotiations with other creditors on comparable terms.[3]

12. **Structural reforms.** While there were delays in the implementation of the structural measures agreed under the previous program for implementation by March 2010, all but one of those measures have been implemented (Table 1). The pending benchmark on the protocol for border controls is being carried over to the new program.

## II. THE ECONOMIC PROGRAM FOR 2012–14

13. **The program.** Our three-year economic program is a key component of the government's development strategy going forward. It is an integral part of the comprehensive framework for security, development, and governance presented at the Kabul Conference in July 2010 and it establishes the economic parameters for Afghanistan's transition, which is to be agreed at the Bonn Conference in December 2011. Within this broader development agenda, the program aims at consolidating the gains achieved so far and invigorating reforms to foster growth and poverty reduction. To this end, the key objectives of the program will be to: (i) make significant progress toward a stable and sustainable macroeconomic position while managing the challenges of the withdrawal of the international presence in Afghanistan; (ii) strengthen the banking system and address the governance and accountability issues highlighted by the Kabul Bank crisis; (iii) move toward fiscal sustainability; and (iv) improve the transparency and efficiency of public spending and services to protect the poor. We will pursue policies to keep inflation low, improve banking supervision and financial integrity, amend the banking law, and strengthen the framework to deal with financial crime. In addition, we intend to achieve sustained increases in domestic revenues (with proper focus on the extractive industries sector), prioritize public spending and improve expenditure management, and reduce fiscal risks from public enterprises.

14. **Macroeconomic outlook**. Despite an expected decline in overall donor assistance, our goal is to sustain annual real GDP growth at about 6–7 percent over the next three years, supported by an expansion in the nonagricultural sector and mining investment. Cognizant of the negative effects of inflation, particularly on the poor, and in line with our goal to protect vulnerable segments of our population, we will strive to bring inflation down. Sustained donor funding and a stable economy will support the balance of payments. We intend to keep international reserves at around 7 months of imports.

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[3] A 100 percent debt forgiveness agreement with the United States in the amount of US$109 million came into effect in September 2010, and we signed a final debt forgiveness agreement with Germany in the amount of US$17 million in January 2011. Saudi Arabia, Iraq, and Croatia also provided 100 percent debt relief. We are still discussing debt restructuring and relief with Non-Paris Club creditors, namely Bulgaria, Iran, Kuwait and OPEC.

15. **Prioritizing development spending.** In early 2010, we developed the cluster approach to better prioritize the Afghanistan National Development Strategy (ANDS) and improve coordination and implementation.[4] We grouped line ministries in six clusters (security, governance, infrastructure, agriculture and rural development, human resource development and private sector development) that focus on the delivery of selected large-scale national priority programs which, combined, account for over 80 percent of the development budget through 2013/14. We are also taking steps to address bottlenecks in the execution of the development budget. The objective is twofold: for the government to improve the delivery of services; and for donors to align development assistance with our national priorities and channel more resources through the budget. The government believes that improvements in governance will give donors the confidence to increase the proportion of these funds channel through the budget, and we have steadily implemented Kabul conference commitments on governance and corruption and maintain a matrix of achievements.

16. **Poverty reduction.** Our policies are guided by the ANDS and based on low inflation, propoor budgeting, and economic growth. Although it will be necessary to allocate increasing amounts of spending to security, we will also allocate adequate resources to help the poor. To monitor results, we will improve the collection and analysis of poverty indicators. In 2011/12, we will update the ANDS poverty profile using the 2007/08 National Risk and Vulnerability Assessment as a baseline, and integrate the allocation and tracking of propoor outlays into the budget process. Based on the existing poverty profile, propoor operating spending in the 2011/12 budget is programmed to be about Af 16.3 billion (25 percent of nonsecurity operating spending) compared with Af 13.6 billion in 2010/11 (25 percent of nonsecurity operating spending) (indicative target).[5]

## A. Monetary and Exchange Rate Policy

17. **Low inflation, an exchange rate regime capable of absorbing shocks to the economy, and effective coordination of monetary and fiscal policies are key ingredients for macroeconomic stability.** To this end, we will continue to promote price stability, strengthen monetary policy operations, and improve coordination between the central bank and the ministry of finance.

18. **Monetary and exchange rate policies**. Monetary policy will aim to lower core inflation to about 4 to 6 percent, while still recognizing that many drivers of inflation are

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[4] The cluster process is not a new strategy for development nor does it substitute the budget process. It is a way to better prioritize activities for the purposes of budget planning, with an emphasis on improving governance, job creation and the delivery of public services.

[5] Separately, we also estimate that around 45 percent of the development budget is propoor spending, but this will not be yet included in the program because of uncertain execution rates.

external and beyond our control. To this end, we will regularly monitor leading indicators of inflation, including monetary aggregates and headline inflation, to steer monetary policy. We will maintain a floating exchange rate system that will allow the rate to reflect market fundamentals, while intervention will aim at smoothing out volatility and achieving our international reserves targets. We remain committed to an independent central bank that sets monetary policy with a view to maintaining low inflation and managing shocks or persistent changes in foreign exchange inflows without overburdening fiscal policy.

19. **Monetary program.** In line with improved operational capacity at the central bank, we switched in 2010 to reserve money targeting. Given our estimate for money demand growth and the recent rise in inflation, we target reserve money growth of 19 percent during 2011/12. We also intend to slow the growth of currency in circulation from 34 percent in 2010/11 to 18 percent in 2011/12.

20. **Foreign exchange risk**. We will adopt measures to reduce the central bank's exposure to foreign exchange risk. Currently, large foreign currency inflows from coalition forces are converted to Afghanis by the central bank. These inflows remain in a dollar account, except for an appropriate working balance in Afghanis. We will move towards a system in which foreign currency will be exchanged on an open market, with sales to the central bank as a last recourse. To this end, the central bank has been reducing its role in providing currency through foreign exchange auctions by raising minimum bid amounts in these auctions and charging service fees for cash transactions.

21. **Monetary operations**. By January 2012, we will restore the averaging of required reserves that was in effect before the introduction of the blocked account system. This will facilitate banks' liquidity management, stabilize interbank rates, and foster the development of the interbank market. We will also increase the stock of the central bank's capital notes to facilitate monetary policy implementation and to enable open market operations. To prevent the capital note market from being dominated by a few participants, we have introduced a percentage ceiling on the amount of capital notes that a successful bidder can obtain.

22. **Ministry of finance and central bank coordination**. The cost of monetary policy over the past few years has negatively affected the equity of the central bank. This has highlighted the need to implement the framework for central bank capitalization in a manner that ensures autonomy of the central bank, safeguards its resources, adheres to international accounting standards and best practices, and is fiscally sustainable. To this end, the ministry of finance and the central bank will reach agreement by December 2011 on the central bank's capital requirements and its calculations, possible amendments to the central bank law, and modalities for addressing the central bank's capital shortfalls or surpluses. Subsequently, the ministry of finance will recapitalize the central bank as required. To strengthen the conduct of monetary policy, facilitate public fiscal cash management, and promote market development we will finalize legislation—with timely IMF assistance—to set up a sukuk

(Sharia compliant treasury bill) market with a view to submit the bill for parliamentary approval by September 2012.

## B. Financial Sector

23. **We have designed and started implementing a comprehensive strategy to strengthen the banking system, to lower fiscal costs associated with Kabul Bank's failure, and to address governance issues (Table 3).** This strategy, outlined in the attached action plan, includes resolving Kabul Bank, drawing lessons from its failure, promoting transparency, governance and the framework for protecting the financial system from economic crime, as well as addressing moral hazard, and strengthening banking supervision, and safeguarding a financial system based on integrity and the rule of law.

24. **Resolution of Kabul Bank.** We are proceeding to resolve Kabul Bank to lower fiscal costs and protect the banking system. The bank has been put under receivership and its license has been revoked. Shareholders' rights, including ownership rights, have been extinguished. Moreover, shareholders that have been found not fit and proper according to the banking law and central bank regulations will be banned from future ownership of any bank in Afghanistan. The bad assets of Kabul Bank (along with the US$825 million LoLR liability) remain with the receiver, which, with the help of an asset management specialist, will continue to effectively pursue their recovery domestically and internationally through all available legal, regulatory, and administrative means, in accordance with Afghan law and relevant international treaties. A bridge bank was established by transferring to it Kabul Bank's remaining deposit liabilities of US$633 million, remaining good assets of about US$208 million (consisting of physical assets and the remainder from the first LoLR loan) as well as US$425 million of new financing (funded by a second LoLR loan of that amount extended to Kabul Bank before its receivership). The bridge bank, New Kabul Bank, will be put up for sale by June 2012. The sale will be conducted in a fully transparent manner, and only "fit and proper" qualified applicants will be considered. If the sale does not materialize, the bank will be downsized and merged into other financial institutions or liquidated by March 2013. A share of salary and other payment services will be migrated to other banks to allow government employees a choice of bank starting in 2012. In case privatization fails, the migration would be accelerated in line with the objective of merging or liquidating the bank by March 2013. The receiver and New Kabul Bank will produce monthly reports including management accounts to allow the ministry of finance and the supervisor to monitor their financial performance.

25. **Financing of Kabul Bank's insolvency.** To compensate the central bank for the costs of resolving Kabul Bank, the ministry of finance issued a zero-coupon government bond with net present value of Af 37.6 billion (equivalent to US$825 million), taking over DAB's lender of last resort claim on Kabul Bank. The bond has an 8-year maturity and a quarterly increasing amortization schedule. It will yield a regular flow of payments to the central bank and allow the government to honor this obligation with fiscal resources. The

characteristics of this zero-coupon bond are equivalent to a financial instrument with a two percent yield. The first amortization installment will be paid immediately after the financing has been approved by parliament. In addition, over time, the amounts recovered from Kabul Bank's impaired assets will be paid to the central bank and reduce the outstanding amount of the bond. Request for payment of the first year's installment of US$73 million through the national budget was initially rejected by parliament because parliamentarians wanted to better understand the issue. After a period of engaging with parliament, a bill was resubmitted to parliament for a payment of US$51 million, with the remaining US$22 million having been transferred to the central bank from the receiver out of asset recoveries. The bill was approved by parliament on October 15, 2011, and the government made the payment on October 24, 2011.

26. **Moral hazard.** Governance problems and fraud are the causes of Kabul Bank's failure. The government is investigating and will prosecute any criminal acts related to the bank's failure and will pursue maximum asset recovery using all appropriate legal and regulatory mechanisms. To this end, we have implemented a strategy for prosecution of crimes committed at Kabul Bank and a prosecutorial team has been formed in the Attorney General's Office, equipped with the necessary mandate, expertise and resources. Evidence of wrongdoing at Kabul Bank has been and continues to be referred to law enforcement authorities according to the Afghan law. Lastly, in order to promote stability in the financial sector, in cooperation with development partners, we will prepare by March 2012 a roadmap with a medium-term strategy to build capacity and strengthen the institutional framework to deal promptly and effectively with economic crime.

27. **Asset Recovery.** An audit is expected to be completed by end-March 2012 to establish the financial liabilities of the shareholders and provide the basis maximum asset recovery (below); the auditor has requested some additional time compared to our earlier understandings because the analysis of the group loans is taking longer than expected. We received the interim report for Kabul Bank on September 20, 2011 and shared it subsequently with IMF staff. The interim report for Azizi Bank is expected for November and will also be shared with staff. As criminal investigations into Kabul Bank have commenced, the legal system will be used to facilitate asset recovery domestically and internationally, including through the use of relevant international treaties and mutual legal assistance provisions. To date, asset recovery efforts resulted in US$75 million recovered in cash—including from performing loans, under legally binding agreements with cooperating shareholders and related parties, and outside such agreements—along with physical assets available for sale valued at about US$153 million, and we are working to make further progress on asset recovery in the coming weeks. We have also initiated legal proceedings, including in the field of asset recovery, where appropriate and where shareholders were not cooperating. We have requested training in asset recovery and are tasking an audit firm currently working in Kabul to advise on how to make asset recovery more effective, both domestically and internationally.

28. **Transparency and accountability.** DAB issued a written public statement explaining the events leading to the collapse of Kabul Bank, the action taken, and the envisaged resolution strategy; the statement was posted on DAB's website (http://www.centralbank.gov.af/) in May 2011. In addition, to draw on the lessons from the collapse of Kabul Bank, the ministry of finance and DAB have referred the case to the independent Monitoring and Evaluation Committee (which was set up as part of the Kabul Process) to conduct an in-depth public inquiry. This inquiry will examine the events leading to the Kabul Bank crisis, starting with the inception of the bank, and look into the operations of the bank, activities of its shareholders, the role of supervisory and auditing bodies, and the subsequent effectiveness of the government and the criminal justice system in dealing with any crimes committed. The final report will be published by September 2012.

29. **Identifying vulnerabilities.** We have started audits by internationally reputable audit firms of all banks in the system with a CAMEL (Capital, Asset Quality, Management, Profitability, and Liquidity) rating of 3 or worse, beginning with systemically important banks. The terms of reference for the audits of Kabul Bank and Azizi Bank have been agreed with the IMF. For Kabul Bank, the aim is to document accounting irregularities and possible crimes, such as fraud and money laundering – the results will also serve to support prosecution and asset recovery. For Azizi Bank, the audit is expected to identify potential problem areas and help develop additional corrective measures if needed—ultimately contributing to strengthening banking supervision. We are committed to having the audits finalized by end-March 2012.

30. **Banking supervision.** To improve banking soundness, the central bank is stepping up monitoring of banks and enforcing previous supervisory orders. Our approach to strengthening supervision began with a detailed "lessons learned from Kabul Bank" operational strategy to strengthen supervision. In addition, the central bank established an interdepartmental committee to review compliance with regulations by banks and issued supervisory orders to all banks with weak CAMEL ratings regarding corrective actions previously recommended. The committee is responsible for monitoring enforcement orders and imposing sanctions for noncompliance (e.g., fines, suspension of profit distribution, restriction on bank branching or lending, conservatorship, and bankruptcy), and monitoring enforcement orders and supervisory measures, including on AML/CFT recommendations. We are also working to improve capacity for off-site supervision that has been lagging. We also seek to restore the capacity and effectiveness of the banking supervision department that have been weakened, including because some staff moved to the receiver.

31. **Regulatory framework.** We have reinforced the governance framework for banks. The central bank has published a circular clarifying the criteria that banks' shareholders and managers must meet in order to be "fit and proper." In addition, we have fully enforced a

circular meant to prevent conflict of interests and governance issues that arise when shareholders hold management positions.

32. **Legal framework.** We intend to improve governance in the banking system by strengthening the banking law and encouraging consolidation through higher capital requirements. We will finalize a replacement or amendments to the banking law by end-March 2012 with a view to strengthening provisions on corporate governance, capital, large exposures, related parties, consolidated supervision, early intervention, enforcement, and bank resolution.[6] We will submit the law or the amendments to parliament by September 2012. We have already started reviewing the existing central bank regulation in light of these changes to speed up their implementation once they become law. To strengthen the banking system's capacity to absorb losses and encourage consolidation of small banks, we have doubled the minimum capital requirement to US$20 million and the central bank will request a recapitalization plan for the banks that have not been able to increase their capital to the new ratio by September 2012 while encouraging them to consider merging with another bank. In addition, a moratorium on increasing the number of banking licenses is in place.

33. **AML/CFT**. Cognizant of the threat that corruption, drug trafficking, and the financing of terrorism poses to our financial system and our security, we will strengthen our AML/CFT regime by implementing an action plan based on the recommendations of the February 2011 assessment. To this end we will submit to parliament amendments to our AML/CFT legislation as necessary, strengthen the capacity of the financial intelligence unit (FinTRACA), publish its annual report, implement (by enforcement where there is electricity and security and by encouragement in areas where there is not) the reporting arrangements for money service providers (MSPs) via dedicated software. This year we have strengthened our AML/CFT regime by increasing the intensity of the training FinTRACA gives to financial sector compliance officers, we have completed the registration of roughly 80 percent of the MSPs outside of Helmand and Kandahar, we have encouraged the use of dedicated reporting software for all MSPs, and we have issued terms of references for AML/CFT interagency coordinating bodies (at the working and high level).[7]

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[6] Corporate governance and consolidated supervision amendments are intended to address weaknesses that leave the banking sector vulnerable, including risks from mismanagement and bad accounting. Amendments related to the enforcement of supervision orders are being put forward to increase the efficacy of bank supervision and legal implementation, while amendments regarding problem bank resolution are designed to limit the costs to the government and damage to the financial sector in the event of bank failure.

[7] The financial intelligence unit of the central bank will also continue training counterpart institutions in AML/CFT regime implementation, including the filing of suspicious transaction reports.

## C. Fiscal Policy and Governance

34. **Going forward, our objectives in the fiscal area are to achieve sustained increases in revenue collection, a gradual takeover of externally-financed operating spending, and an expenditure allocation consistent with ANDS priorities in line with improvements in public expenditure management, fiscal policy formulation, and accountability in public enterprises.** To this end, the program envisages actions to broaden the tax base, deepen tax and customs reforms, strengthen budget processes, program budgeting, and the Medium-Term Fiscal Framework, and increase transparency, governance and efficiency in public enterprises (Table 2).

35. **We will take further steps to move toward fiscal sustainability**. Fiscal sustainability will depend on sustained increases in revenues together with prioritized spending reflecting development and security priorities. The program envisages an increase in domestic revenues of 0.6 percent of GDP in the next three years. Looking beyond the program period, the planned introduction of a VAT in March 2014 is expected to raise an additional 2 percent of GDP, and we are aiming for a revenue-to-GDP ratio of about 16 percent of GDP by 2017/18.

36. **Expenditures.** On the spending side, the baseline scenario projects an increase in the size of security forces (national army and police) from 275,000 in March 2011 to a planned maximum of 400,000 by April 2014. In 2011/12, wages will increase by 1.4 percent of GDP, of which security accounts for 1 percent of GDP.[8] We plan to continue reforms in education, the civil service and other ANDS priorities. Other spending pressures, emanating from the security transition and the gradual takeover of operations and maintenance of capital projects, will lead to an increase of 0.8 percent of GDP in nonsecurity spending as a share of GDP. Development spending is projected to increase by 0.3 percent of GDP. Given the agreement with donors to gradually phase out ARTF grants to the operating budget by US$25 million per year, we will increase the domestic financing of the operating budget accordingly. The large increase in security spending in nominal terms means that the share of operating spending financed by domestic revenues is expected to first increase and then fall in the third year.

37. **Tax administration.** Our goal is to further increase the efficiency and equity of tax collection. To this end, we intend to implement additional measures to strengthen the medium and large taxpayers' offices (MTOs and LTOs) including the consistent application of these offices' selection criteria. In addition, the Standard Integrated Government Tax Administration System was implemented in July in the LTO, allowing for automated collection systems. Lastly, specialized units will be created in the Revenue and Customs departments to use

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[8] Security forces will increase by 60,000 in 2011/12

budgets strategically and in a manner consistent with reform plans. These units will report directly to the Directors of Revenue and Customs and will be in charge of budgeting, procurement, personnel planning, and monitoring budget execution.

38. **Customs administration**. In September we started implementing a new business model of border control at the Hairatan customs post in line with best practice. The new model envisages only two agencies at the border (Afghan Customs Department and Afghan Border Police), streamlining the number of agencies involved to improve collections and reduce opportunities for corruption. We will roll out this new business model to two additional border posts March 2012—three if the security situation permits. In addition, we will move forward with post-clearance audits and set up risk management approaches to cargo verification by June 2012. These two reforms will limit interaction between taxpayers and customs officials thus facilitating trade, improving efficiency, and reducing opportunities for corruption.

39. **Tax policy.** We will initiate a major tax policy reform centered on the introduction of a VAT by March 2014, with the aim of broadening the tax base significantly and achieving our long-term goal of raising revenue-to-GDP ratio to levels comparable with similar countries. We will move forward with the VAT legislation by preparing an implementation plan with support by IMF staff, sending a draft law to the Ministry of Justice ("Taqnin") for review by end-December 2011, and submitting the law for parliamentary approval by end-December 2012. Lastly, we will set up an effective and transparent fiscal regime for mining, and seek full compliance with the Extractive Industries Transparencies Initiative (EITI) by September 2012.[9]

40. **Public financial management**. We plan to strengthen our public financial management systems with a view to ensuring that (i) policies reflect social needs; (ii) the budget is used to assign responsibilities for development outcomes, (iii) resources are allocated in an efficient manner; and (iv) officials are accountable and services are delivered with a focus on helping the poor. In this connection, donors signaled their willingness to increase the share of development aid delivered through the budget over the next few years, including through multi-donor trust funds. For our part, we will implement the Public Financial Management Road Map with priority reforms in budget preparation, budget execution, and transparency and accountability.

41. **Budget presentation and execution.** We will improve the capacity and involvement of provincial authorities in budget planning and project implementation, reduce procurement

[9] Afghanistan became an EITI candidate country in February 2010. In addition to the four sign-up criteria that were met to achieve EITI candidate status, the Afghanistan EITI (AEITI) Multi-Stakeholders Group and National Secretariat have been established to run and oversee EITI implementation. Currently AEITI stakeholders are undertaking EITI training and capacity building activities.

delays by ensuring that key line ministries adhere to the revised legal framework, and incorporate financial and nonfinancial performance targets in budget submissions. We will also improve financial planning and reporting, including reports on the financial operations of the general government (extra-budgetary agencies, municipalities, and estimated disbursements by donors through the "external" budget).

42. **Transparency and accountability.** To increase the transparency and accountability of public spending, we will continue to implement Article 61 of the Public Finance Expenditure Management Law. The Internal Audit Department of the Ministry of Finance performed audits on four key line ministries in the past year. We will audit 10 additional line ministries in 2011/12. External audits will be enhanced by strengthening the independence of the Control and Audit Office under a new audit law which was submitted to parliament on May 10, 2011.

43. **Governance.** To improve governance and strengthen anti-corruption measures, we have established an Anti-Corruption Unit in the Attorney General's Office and the Anti-Corruption Court within the Supreme Court, enhancing our ability to investigate and prosecute corruption-related offenses. We also adopted a detailed "strategy and policy for anti-corruption and administrative reform," and have ratified the United Nations Convention against Corruption in August 2008. In July 2008, the President issued a Decree establishing a High Office for Oversight and Anti-Corruption (HOO) as the highest office for the coordination and monitoring of the implementation of Afghanistan's anti-corruption strategy and for the implementation of administrative procedural reform in the country. Despite delays including some beyond government control, an independent Monitoring and Evaluation Committee was inaugurated on May 11, 2011.

44. **Program budgeting.** We will continue the program budgeting reform by creating a simple results framework directly linked to line ministries' performance indicators, as defined in the ministries' budget submissions. This will allow linking public spending to intended results and increasing the efficiency and effectiveness of spending (particularly propoor spending). Furthermore, we have introduced in the 2011/12 budget a common presentation of the operating and development budgets across all budgetary units. Parliamentary appropriations on a program basis will take place in subsequent years after sufficient progress is achieved. During this year, we will also develop and implement a communication strategy to explain this reform to key stakeholders.

45. **Medium-Term Fiscal Framework.** We have been strengthening our medium-term fiscal framework by preparing short- and medium-term policy trade-offs and financing constraints to make it a more effective tool for fiscal policy formulation. Going forward, we plan to (i) improve revenue projections through sensitivity analysis and plausible macroeconomic assumptions; (ii) incorporate line ministries' estimates of future spending; and (iii) improve the analysis of security spending. Ultimately, our objective is to move toward a

medium-term budget framework including projections of spending by line ministries in line with the priorities of a multi-year framework.

46. **Public enterprises.** We are taking steps to strengthen the financial oversight of public enterprises to contain fiscal risks, reduce opportunities for corruption, and foster reforms; and will seek donor assistance to build capacity. We are ensuring the implementation of the restructuring and business plans of the four large public enterprises. Specific actions include finalizing HR reforms at Ariana by June2012, ensuring a continued reduction of subsidies for DABS, and developing a timebound plan by June 2012 for the reform and rationalization of FLGE into a commercial entity—including an asset inventory and audited financial statements—that does not require any subsidies or special treatment, and discontinue its current monopoly and unauthorized collection of fees. Finally, we will strengthen capacity at the Department of State-Owned Enterprises and, by end March 2012, submit to the Ministry of Justice changes to the legal framework governing public enterprises that will bring such entities under ownership and effective control of the Ministry of Finance.

## D. Program Modalities and Monitoring

47. **We will continue monitoring our reform agenda through our Technical Coordination Committee (TCC).** The first year of the new three-year economic program to be supported by the ECF arrangement will be monitored through quantitative performance criteria for March and September 2012, indicative targets for December 2011 and June 2012; as well as selected structural benchmarks. The first and second reviews of the program could be completed in May 31, 2012 and November 30, 2012, respectively. The central bank will work with IMF staff to ensure timely completion of the update safeguards assessment and is committed to implementing its recommendations thereafter. Quantitative targets and structural measures are specified in Tables 4–5 and defined as needed in the attached Technical Memorandum of Understanding (TMU).

48. **During the program period, we will not impose or intensify restrictions on the making of payments and transfers for current international transactions, or introduce or modify multiple currency practices, or conclude bilateral payments agreements inconsistent with Article VIII, or impose or intensify restrictions for balance of payments purposes.**

## Table 1. Islamic Republic of Afghanistan: Structural Benchmarks for the Seventh Review of the ECF Arrangement, December 2009-March 2010

| | Target Date | Status as of September 25, 2010 |
|---|---|---|
| Begin publication of four-month reports and forecasts for financial flows and other key variables for Da Afghanistan Breshna Moassessa/Sherkat (DABM/S). | Dec. 31, 2009 | Delayed. Implemented in July 2010. Most data were provided in March 2010 and the remaining data were submitted in July 2010. |
| Finalize a comprehensive review of the financial situation of Afghan Telecom, ARIANA, DABS, and the Liquid Fuel and Gas Enterprise (FLGE) and their fiscal relations with the government in terms of tax owed, subsidies (if applicable), and other payables or receivables. The review will include regularization of tax payments and other cross debts and reduction of subsidies (if applicable); closure of unauthorized bank accounts; review of corporate governance procedures; business plans; and plans for divestiture, restructuring, of privatization for these enterprises. | Mar. 30, 2010 | Partially delayed. Review of all SOEs (except FLGE) was implemented by March 2010. The review of FLGE was completed in October 2010. |
| Transfer the directorate responsible for monitoring and managing public enterprises in the MOF from the Administration Department to the Finance Department or the Office of the Minister. | Feb. 28, 2010 | Delayed. Implemented in April 2010. |
| Adopt and implement the business model of border controls clarifying the role of each ministry at the border consistent with internationally accepted best practices in consultation with other stakeholders (Ministry of Commerce and Industry and Ministry of the Interior) for better customs controls at the border. | Feb. 28, 2010 | Not implemented. The delay is due to difficulties in clarifying the roles of various ministries and ensuring good governance. Measure has been reformulated and included in the program to be supported under the new ECF arrangement. |
| Implement the Automated System for Customs Data (ASYCUDA) transit module along Zaranj-Nimroz axis and declaration processing module at Nimroz. | Mar. 30, 2010 | Delayed. Implemented in June 2010. |

## Table 2. Islamic Republic of Afghanistan: Fiscal Measures

| Measure | Timing |
|---|---|
| 1. Tax Policy | |
| *VAT* | |
| a) Finalize a VAT implementation plan; | End-December 2011 |
| b) Submit VAT legislation to Ministry of Justice's Taqnin; | End-December 2011 |
| c) Submit VAT legislation to Parliament following Cabinet approval; | End- December 2012 |
| d) Begin implementation of VAT. | End-March 2014 |
| *Mining* | |
| a) Review the consistency of mining and tax laws; | End-November 2011 |
| b) Develop MoF's capacity for medium-term projections of mining-related revenue; | End-March 2012 |
| c) Ensure a transparent mechanism for licensing, contracting, and collecting taxes, royalties, and fees; | End-March 2012 |
| d) Prepare a medium- to long-term strategy to restructure and corporatize public enterprises in the mining sector. | End-March 2012 |
| 2. Tax and Customs Administration | |
| *Resourcing* | |
| Specialized units will be created at ARD and ACD to enhance their capacity to use budgets strategically and consistently with reform plans. These units will report directly to the Director General of Revenue and the Director General of Customs and will be in charge of budgeting, procurement, personnel planning, and monitoring budget execution. | End-March 2012 |
| Implement SIGTAS in the LTO | Completed |
| Establish pilot of a Border Management Model at Hairatan Border Crossing Point (BCP), based on a 'two-agency' approach which restricts border presence to the Afghan Border Police (ABP) and the Afghan Customs Department (ACD). Under this model, the ABP will continue to fulfill immigration and security responsibilities, with ACD fulfilling all other commercial and trade-related duties. | Completed |
| Border Management Model to be rolled out to at least two additional Border Crossing Points—three if the security situation permits. | End-March 2012 |
| Improve post-clearance audits by improving the unit resources and introducing risk management. | End-March 2012 |

**Table 2. Islamic Republic of Afghanistan: Fiscal Measures**

| Measure | Timing |
|---|---|
| Finalize (End-September 2011) and approve (End-December 2011) the new organizational structure of ACD along best international practices in consultation with IMF staff. | End-December 2011 |
| Introduce risk management to cargo verification. | End-June 2012 |
| 3. Budget and Treasury Departments – PFM Roadmap | |
| *Program budgeting* | |
| Prepare a single common program-based budget presentation integrating the operating and development budgets across all budgetary units. For Budget Statement purposes, submit to the Cabinet and Parliament a program-based presentation, along with the traditional line-budget basis presentation until such time as appropriations are done on a program basis (not to happen until, at least, 1392). | Completed |
| MoF develops and implements a communication strategy consistent with commitments under the PFM roadmap. | Implementation underway. |
| Conduct a full review before a decision is made to transition to program based appropriations, which is unlikely before the 1392 Budget at the earliest. | End-September 2012 |
| *FPU* | |
| Start developing a tax policy capacity at the FPU in line with IMF staff recommendations. | End-December 2011 |
| Enhance the MTFF and other budget documents by: | |
| *a.* Analyzing explicitly the medium-term security related operating spending, including various assumptions, to assess the impact on the resource envelope available for non-security spending; | End-December 2011 |
| *b.* Including robust extractive industry revenue projections; | End-March 2012 |
| *c.* Updating projections of existing and new major fiscal pressures; | Ongoing |
| *d.* Costing fiscal pressures of new reforms. | Ongoing |
| *Budget execution and fiscal reporting* | |
| Enhance AFMIS functionality to meet the requirement for commitment control of all commitments approved by the Special Procurement Committee based on allotments issued. | Completed |
| Prepare financial plans for the Ministries of Interior and Defense taking into account their procurement plans. Annual allotments with monthly breakdown based on these financial plans will be issued on a pilot basis for operating budget expenditures for the rest of the year. Based on a successful implementation for these two ministries, we intend to extend this pilot to as many ministries as possible during the next fiscal year, 2012/13. | End-November 2011 |

**Table 2. Islamic Republic of Afghanistan: Fiscal Measures (Concluded)**

| Measure | Timing |
|---|---|
| Issue 2001 GFSM-based biannual reports on the financial operations of the general government, including extra-budgetary agencies, and estimated disbursements by donors through the External Budget (based on information provided by donors). For municipalities, the reports will be annual. The reports will be quarterly for the centre after a year and remain biannual for the remainder. | TBD |
| 4. Audit | |
| *Internal audit* | |
| The Internal Audit Department of the Ministry of Finance will perform internal audits in accordance with Article 61 of the PFEM law and strengthen the internal audit departments in four line ministries (Ministry of Public Health, MoTCA, MRRD, and Ministry of Energy and Water) by reviewing their institutional arrangements, methodologies, procedures and staff capacity. | Completed |
| The Internal Audit Department of the Ministry of Finance will perform internal audits in accordance with Article 61 of the PFEM law and strengthen the internal audit departments in an extra ten line ministries. | End-March 2012 |
| The Internal Audit Department of the Ministry of Finance will perform internal audits in accordance with Article 61 of the PFEM law and strengthen the internal audit departments in all remaining line ministries. | End-March 2013 |
| *External audit* | |
| Submit to parliament the new audit law. | Completed |

## Table 3. Islamic Republic of Afghanistan: Banking System Action Plan

| Objective | Measures | Target Date |
|---|---|---|
| Minimize fiscal costs and protect the banking system | 1. Kabul Bank will be placed in receivership and its banking license revoked. All shareholder share ownership and related rights and interests will be extinguished. The receiver will split assets and liabilities into a good bank and the remaining Kabul Bank estate. The good assets, the legitimate deposits, the DAB current account liability, and the salary payments services will be transferred to a bridge bank, aka the good bank, which will be a newly incorporated entity with a new banking license. | Done in April 2011 |
| | 2. The central bank will issue a banking license for the bridge bank and its shares will be temporarily owned by the Ministry of Finance. The FDRC will approve an asset/liability split from the balance sheet of the receivership, which will include the transfer of a current account position with the central bank held by the former Kabul Bank and the assumption of its legitimate deposit liabilities. This current account balance will include the proceeds of a lender-of-last-resort facility agreed upon by the conservator prior to the decision of receivership. | Done in April 2011 |
| | 3. Enforce the regularization and repayments of Kabul Bank loans extended to shareholders and major borrowers via legally binding agreements for the full amounts attributed to them as of date. Agreements should identify collaterals, including real estate title deeds or physical assets – and cash repayments. Agreements will not preclude collection of additional debt, should such debt be identified during subsequent audits, nor will they preclude prosecution in case of violation of the Afghan law. Registration and perfection of security interests in all identified collateral will occur within a reasonable period from the date of the agreements. Those failing to comply with the attributed amounts will be pursued through the legal system. | See Table 5. |
| | 4. Finalize an 18-month fully-funded business plan for the bridge bank, focused on its rapid downsizing. The plan, together with related official documentation, will contain the following elements: (i) preparation for sale within 5 months and, if the sale fails, a provision that the bank will be liquidated no later than September 2012; (ii) quarterly budgets; (iii) strict limits on operations with no new lending; (iv) semi-annual targets for the reduction of staff and branches and shedding of business products, including credit card business to reduce costs and the systemic importance of the bank; (v) migration of Kabul Bank's salary payments activities to other banks capable of performing the service, beginning with the allocation of some salary payments contracts to other banks in an open bidding to be conducted as soon as possible. Request for proposals for the bidding will be aligned with sound practice to ensure that banks that are not sufficiently qualified to perform the service will not be included; (vi) to ensure legitimate remaining deposits will be honored, deposits affiliated with shareholders and related interests will be excluded and deposits larger than $500,000 will be reviewed; (vii) prepare monthly activity reports including management accounts; and (viii) impose service charges and reduce interest rates on deposits effective May 1, 2011. The plan will also mention a commitment to have the bank audited on an annual basis by an external audit firm. | Done in April 2011 |

**Table 3. Islamic Republic of Afghanistan: Banking System Action Plan**

| Objective | Measures | Target Date |
|---|---|---|
| | 5. The authorities will publicly announce the government's overall strategy to enforce the laws of Afghanistan with respect to ensuring accountability for economic crimes, including any crimes found to have been committed at Kabul Bank or associated with the Kabul Bank crisis that are prosecuted by the authorities. Among other things, the strategy will outline key steps to be taken and establish a timeframe for these steps. The Government will include reference to the approach and timeline that will be taken by this team in the public statement issued by DAB. Any crimes committed at Kabul Bank or associated with the Kabul Bank crisis that are prosecuted by the authorities, will be handled by a prosecution task force/team within the Anti Corruption Unit of the AGO appointed by the attorney general. The team will operate according to its defined work procedures and timelines, and shall have the roles, powers and independence given to its office under the relevant Afghan law; documentation describing this shall be provided to the IMF. The team will be supported by members who possess knowledge and expertise on financial issues. | Pending (prior action) |
| | 6. The receivership management team, supported by an asset management specialist, will work on the recovery of the receivership's assets and other assets collected from shareholders and non-performing loans with the primary purpose of realizing maximum recoverable value for claimants. All related parties' loans even if restructured or collateralized will be included in the assets to be recovered by the asset management team. The receiver will produce monthly activity reports, including management accounts, and be audited on an annual basis by an external audit firm. | Ongoing |
| | 7. The authorities will pursue through mutual legal assistance the possibility of identifying, freezing, seizing and confiscating laundered property and proceeds used or intended for use in money laundering and other offenses related to Kabul Bank. The authorities will seek advice from the audit firm on the format of the requests. | Ongoing |
| | 8. A legally binding agreement between the Ministry of Finance and the central bank will be executed to capitalize the central bank for the amount of the lender of last resort (LOLR) loans needed to finance Kabul Bank resolution. Under the agreement, the Ministry of Finance will issue a debt instrument to the central bank with net present value of 37.6 billion Afghani, equivalent to $825 million, with an eight year maturity and quarterly payments totaling 3.4 billion Afghani in the first year ($73 million), which will increase over time as required to fulfill the commitment. Annual payments will be explicitly recorded in the budget and the medium-term fiscal framework, beginning with an approved attachment to the 2011/12 budget, to be passed during the current fiscal year. The agreement will specify that its purpose is to fund the deposit guarantee extended to Kabul Bank depositors, explain the exceptional nature of such support, and commit the Ministry of Finance to make amortization payments to the central bank as required in the future. | Done in October 2011 |

**Table 3. Islamic Republic of Afghanistan: Banking System Action Plan**

| Objective | Measures | Target Date |
|---|---|---|
| | 9. Final resolution. | |
| | i. The bridge bank will be offered for sale in a transparent way, involving a pre-qualification process to ensure that controlling shareholders, beneficial owners, directors and management of intending bidders are fit and proper (which implies, inter alia, that an intending bidder is subject to a high standard of corporate governance, including risk management and internal controls, and that an intending bidder is in a sound financial and risk management state), and that the intending bidder controls adequate resources and has the necessary capacity and capability to ensure the ongoing provision of the relevant salary payments services. There will be a request for expressions of interest locally and internationally for the sale of the bridge bank. Interested parties will be given four weeks to respond with intention to participate in the bid. Once the central bank has vetted potential buyers, it will give them a deadline for sealed bids. | End-June 2012 |
| | ii. If there is no interest from a suitable buyer or the sale fails, salary and other payment services will migrate to other banks as a part of branch closings and deposit migrations. Unwanted branches will be offered at negative prices or be closed. By end-March 2013, all remaining deposits will be transferred to other banks and the bridge banks' license will be revoked. | July 2012 to End-March 2013 |
| | 10. In consultations with Fund staff, the Ministry of Finance and the central bank shall agree on the interpretation to be accorded to the framework for central bank's capital requirements and on the possible amendments to the central bank law in this regard, in a manner that ensures the financial autonomy of the central bank in conducting monetary policy, safeguards central bank's resources (including the use international reserves and the provision of the lender of last resort facility), adheres to international accounting standards and best practices, and is fiscally sustainable. The Ministry of Finance and the central bank shall sign a memorandum of understanding that will, accordingly, spell out the modalities of and procedures for the ministry's interventions in addressing potential central bank's capital shortfalls. Subsequently, the Ministry of Finance will recapitalize the central bank as required. | End-December 2011 |
| Promote transparency, reduce moral hazard, and address banking system vulnerabilities | 11. Issue a detailed public statement describing (i) key events leading to the run at Kabul Bank; (ii) actions taken and to be taken to protect depositors and the financial system; (iii) the condition of the bank; (iv) actions taken and to be taken to address suspicions or evidence of fraud, misreporting, money laundering, and corruption; (v) the envisaged resolution strategy, and (vi) the way in which the insolvency will be funded (including the responsibility of the Ministry of Finance and the intention to pay with government revenue) and efforts to recover the bank's assets. | Done in April 2011 |

**Table 3. Islamic Republic of Afghanistan: Banking System Action Plan**

| Objective | Measures | Target Date |
|---|---|---|
| | 12. Initiate an audit of Kabul Bank and Azizi Bank to be carried out by a reputable international audit firm. The work will focus on investigations aimed at determining the presence of accounting or other irregularities, as well as compliance with prudential and other regulations and laws. In relation to ECF conditionality, the firm chosen to conduct the audit (the "Auditor") and the terms of reference will be agreed with IMF staff and all communications and reports including management letters will be shared promptly with IMF staff. The Auditor will have unrestricted access to the banks, their records, their shareholders, management, and staff. The Auditor will also be authorized to communicate with third parties to gather information on matters related to the audit and the central bank will authorize the Auditor to communicate with IMF staff. The Auditor will issue interim reports within 30 days of commencing work. The audits will include, but not be restricted to, an assessment of (i) the banks' management; (ii) the quality of the banks' assets, (iii) the completeness of liabilities, including off-balance sheet commitments; (iv) liquidity position and use of the lender of last resort facility from the central bank (if any); (v) the accuracy of reports and information submitted to the central bank since 2005; (vi) compliance with prudential regulations; and (vii) any illegal activity, including, but not exclusive to, related party lending, fraud and compliance with AML/CFT law and regulations. | Done in August 2011 |
| | 13. Audit company issues inception reports. | Done in September 2011 |
| | 14. An independent in-depth public inquiry into the Kabul Bank crisis will be launched, with terms of reference to be agreed with IMF staff. The inquiry will cover the period from the licensing of Kabul Bank to February 2012 and will focus on the appropriateness, effectiveness, and timeliness of the response of the government, the central bank, and the justice system for the purposes of safeguarding the financial sector, deal with governance issues, and implement Afghan law. The independence of the body conducting the inquiry will be described and guaranteed in the terms of reference, and the budget for the inquiry, including salaries, should be independently administered. The body conducting the inquiry will have the right to determine its own agenda and the powers to enquire under Afghan law. The goal is to increase awareness, transparency and draw lessons that could be used to protect the financial sector and prevent similar events in the future. | End-September 2012 |
| | 15. In line with the authorities' desire to protect the financial system from abuse, the government will produce a roadmap with a strategy to build capacity and improve the institutional framework to respond promptly to economic crime. This roadmap will address issues related to the prosecution system to reinforce its independence to ensure accountability for economic crimes and build capacity for investigation and prosecution of these crimes as well as determine the most appropriate institutional framework going forward. | End-March 2012 |

**Table 3. Islamic Republic of Afghanistan: Banking System Action Plan**

| Objective | Measures | Target Date |
|---|---|---|
| | 16. Reputable international firm/s will initiate financial audits of 10 additional banks. | End-October 2011 |
| | 17. Audit reports are finalized and issued. | End-March 2012 |
| | 18. The report of the public inquiry will be published. | End-September 2012 |
| Strengthen banking supervision | 19. Drawing on the February 2010 on-site inspection of Kabul Bank and on the experience of central bank staff involved in Kabul Bank's conservatorship, the central bank will prepare an operational note, including a summary of lessons learned and a checklist of key procedures for use during future on-site inspections of banks. | Done in December 2010 |
| | 20. The central bank's enforcement committee will | |
| | i. review all banks' compliance with previous enforcement measures and issue supervisory orders with timetables for compliance and sanctions for failure to comply with the key corrective actions previously recommended; | Done in September 2011 |
| | ii. after that, the committee will review on a monthly basis progress with compliance and impose sanctions in line with the Enforcement Regulation (e.g., fines, suspension of profit distribution, restriction on bank branching or lending, conservatorship, and bankruptcy). | Ongoing |
| | 21. The central bank will enforce in full banking regulations and circulars by | |
| | i. removing shareholders from serving as Chairman and CEO of the bank they own; | Done in October 2011 |
| | ii. continuing the evaluation of the qualifications of shareholders and management and removing those who are not "fit and proper" as they become apparent. | Ongoing |
| | 22. The central bank will issue an enforcement letter to Azizi Bank based on an ongoing on-site examination with a strict timetable and enforcement actions for non compliance. The actions will include i) specific capitalization requirement; ii) budget and business plan requirements for improvement in profitability; and iii) detailed plan for reduction of overlimit business lines. | Done in August 2011 |
| | 23. As part of off-site supervision, the central bank will compile quarterly reports based on the data submissions from banks, including Financial Stability Indicators, including banks' prudential ratios, capital adequacy ratio, liquidity ratio, concentration ratio, related loan ratio, and other relevant information statistics, such as loan and deposit amounts for largest borrowers and depositors for each bank. | Throughout, beginning June 2011 |

**Table 3. Islamic Republic of Afghanistan: Banking System Action Plan (Concluded)**

| Objective | Measures | Target Date |
| --- | --- | --- |
| | 24. The central bank will review the existing Enforcement Regulation in light of amendments to the Banking Law as submitted to Parliament (supervisory warnings, orders, plans to take corrective action, and orders to take prompt corrective action by commercial banks). The central bank will prepare revisions of the Enforcement Regulation so as to be ready for implementation of the revised Banking Law when enacted. | End-April 2012 |
| Improve legal and regulatory framework | 25. Submit to Parliament the amended or new banking law, prepared in consultation with the Fund, that will strengthen provisions on corporate governance, capital, large exposures, related parties, consolidated supervision, early intervention, enforcement, and bank resolution, where appropriate in line with the Basel Core Principles. Specifically, the law should enable the authorities to enforce upon a bank—going concern—all necessary resolution measures and strengthen corporate governance requirements for banks (including fit and proper requirements as set by the FATF standards). | End-September 2012 |
| Accounting standards, insolvency and creditors' rights, AML/CFT | 26. Implement plan to address bulk cash movement at Kabul airport (all passengers including VIP to complete serialized inbound/outbound currency declaration forms and space for the central bank to process forms and conduct identifications and checks) with a view to deterring transfers of proceeds of crime and fraud. | End-December 2012 |
| | 27. Request an insolvency and creditor rights assessment (ICR ROSC) from the World Bank to identify remaining weaknesses and design action plan to resolve them, including legislative proposals for foreclosure of collateral and loan recovery. | End-June 2012 |
| | 28. Following IMF assessment of the AML/CFT regime in 2011 and presentation to and adoption by the Asia Pacific Group, the central bank will devise and begin implementing an action plan with a timeframe (involving relevant authorities), to address the findings and recommendations of the assessment. | End-September 2012 |
| | 29. The central bank will prepare and distribute guidance and training materials to financial institutions along with a schedule of on-site training for 2011/2012, with a view to ensuring that key money laundering and terrorist finance risk and lessons learned from Kabul Bank are properly reflected in those materials. | End-March 2012 |
| | 30. Establish a government-led National Steering Committee (NSC) to coordinate, supervise and direct financial reporting and auditing reforms. The NSC will develop an action plan (including short, medium and long-term measures) to develop accounting and auditing capacity in Afghanistan in line with the recommendations of the 2009 ROSC. | End-May 2012 |

Table 4. Islamic Republic of Afghanistan: Quantitative Targets, 2011-13 1/
(on a cumulative basis from the beginning of the respective fiscal year, unless otherwise indicated)

| | Mar. 20, 2011 Stocks | FY 2011/12 June 21, 2011 Actual | FY 2011/12 Sep. 22, 2011 Actual | FY 2011/12 Dec. 21, 2011 Indicative targets | FY 2011/12 Mar. 19, 2012 Performance criteria | FY 2012/13 June 20, 2012 Indicative targets | FY 2012/13 Sep. 21, 2012 Performance criteria | FY 2012/13 Dec. 20, 2012 Projection | FY 2012/13 Mar. 20, 2013 Projection |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | (In billions of Afghanis) | | | | |
| Floor on revenues of the central government | … | 22.2 | 46.7 | 71.6 | 98.8 | 23.8 | 50.4 | 78.2 | 109.0 |
| Indicative target (ceiling) on currency in circulation | 132.4 | 1.3 | 11.3 | 16.6 | 23.6 | 1.5 | 12.7 | 18.3 | 26.2 |
| Ceiling on net central bank credit to the central government | -48.9 | 29.3 | 25.0 | 17.8 | 24.8 | -9.5 | -4.4 | -11.2 | 1.9 |
| Indicative target (ceiling) on the operating budget deficit of the government, excluding grants | … | 0.5 | 12.0 | 33.8 | 52.6 | 10.1 | 29.2 | 44.7 | 71.3 |
| Indicative target (floor) on social and other priority spending | … | 4.5 | 9.0 | 13.5 | 18.0 | 4.8 | 9.7 | 14.5 | 19.4 |
| Ceiling on reserve money | 151.0 | 15.4 | 16.7 | 15.0 | 28.4 | -4.0 | 6.5 | 15.7 | 30.6 |
| | | | | | (In millions of U.S. dollars) | | | | |
| Floor on net international reserves of DAB | 5,017 | 450 | 514 | 572 | 630 | 117 | 234 | 351 | 468 |
| Ceiling on contracting or guaranteeing new medium- and long-term nonconcessional external debt by the public sector 2/ | … | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Ceiling on short-term external debt owed or guaranteed by the public sector 2/ | … | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| New external payments arrears, excluding interest on preexisting arrears 2/ | … | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Ceiling on lending from state-owned banks or the central bank to public enterprises in need of restructuring or government guaranteeing borrowing by these enterprises 2/ | … | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Memorandum items: | | | | | (In billions of Afghanis) | | | | |
| Operating budget balance of the government, including grants | … | 17.1 | 19.3 | 18.4 | 13.4 | 5.1 | 4.8 | 9.8 | 3.6 |
| Reference projections for the adjustors | | | | | | | | | |
| Core budget development spending | … | 5.3 | 16.7 | 33.5 | 53.4 | 4.2 | 23.9 | 41.7 | 64.1 |
| External financing of the core budget and sale or transfers of nonfinancial assets | … | 21.1 | 43.6 | 85.4 | 115.3 | 22.8 | 55.7 | 94.7 | 129.8 |
| Asset recovery from banking sector institutions in liquidation | … | 0.0 | 0.9 | 1.8 | 3.5 | 0.9 | 1.9 | 2.8 | 3.7 |
| Recapitalization, profit distribution and revaluation of MoF securities at DAB | ... | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Externally financed expenditures transferred to the core operating budget | … | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |

Source: Afghan authorities

1/ The performance criteria and indicative targets under the program, and their adjustors, are defined in the Technical Memorandum of Understanding.
2/ These targets apply on a continuous basis.

## Table 5. Islamic Republic of Afghanistan: Prior Actions and Structural Benchmarks

| Prior Actions | Status |
|---|---|
| Kabul Bank will be put under receivership and its banking license revoked. All shareholder ownership and related rights and interests will be extinguished. The receiver will split assets and liabilities into a good bank (bridge bank) and the remaining Kabul Bank estate. | Done in April 2011 |
| Finalize an 18-month business plan for the bridge bank. | Done in April 2011 |
| Issue detailed public statement about the events leading to the collapse of Kabul Bank and the actions taken and to be taken to deal with the crisis. | Done in April 2011 |
| Finalize legally binding agreements with cooperating Kabul Bank shareholders for the repayment of the full amounts attributed to them as of date. Agreements should identify collaterals, including real estate title deeds or physical assets—and cash repayments. | As of October 30th, we estimate the assets sought for recovery at US$935 million, including US$80 million in regular loans to parties other than the shareholders and related parties. Legally binding agreements for US$270 million have been signed so far with cooperating shareholders and related parties, pledging collateral of US$232 million. Under these legally binding agreements, US$36 million in cash has been collected. In addition, US$153 million in ceded assets are available for sale by the receiver. Including the regular loans, payment plans and ceded assets indicate a recovery of US$483 million is possible—US$350 million from legally binding agreements and performing loans plus assets ceded to the receiver not covered by the legally binding agreements. Of this, total cash receipts since August 31, 2010 amount to US$75 million taking together payments under the legally binding agreements, payments made outside an agreement framework and from the performing loans. The Government acknowledges that complexity of the fraud has slowed recovery effort; however, based on improved cooperation by bank executives and the work of the forensic auditors, it is confident that legally binding agreements for additional recoveries will be reached. In parallel, formal charges have been brought against 2 shareholders representing over 50 percent of assets sought for recovery and 7 officers of the bank. Negotiations over additional legally binding agreements are ongoing. |

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| Ministry of Finance to issue 8-year bond to capitalize the central bank to cover the cost of Kabul Bank's resolution ($825 million) and obtain parliamentary approval for a budget appropriation to service the bond. | Done. An US$825 million promissory note was issued on April 10, 2011, and Parliament approved the budget appropriation for FY2011/12 on October 15, 2011. |
| Formulate and announce strategy to enforce Afghan laws in relation to any financial crimes committed at Kabul Bank. The strategy will include steps and a timetable as well as documentation on the roles, powers, qualifications, and independence of the prosecution team. | Authorities have shared draft strategy with staff. |
| Complete inception report for audits of Kabul Bank and Azizi Bank. | Done. Report for Kabul Bank completed in July 2011, for Azizi Bank—in September 2011. |
| The central bank will issue an enforcement letter for Azizi Bank (in consultation with Fund staff) based on a recent on-site examination listing key actions to be undertaken, a timetable, and penalties and sanctions for non-compliance. | Done in August 2011. |
| The central bank will issue supervisory orders to selected banks with timetables for compliance and sanctions for failure to comply with key corrective actions previously recommended. | Done in September 2011. |
| The central bank will enforce in full conflict-of-interest regulations and circulars in the banking sector by removing shareholders from serving as Chairman and CEO of the bank they own. | Done as of October 31, 2011. |

| **Structural Benchmarks for the First Review** | **Rationale** | **Status/Comments** |
|---|---|---|
| In consultations with Fund staff, the Ministry of Finance and the central bank will agree, in a memorandum of understanding, on the central bank's capitalization needs and a schedule for recapitalizing the central bank as needed. | Financial sector stability, central bank independence and ability to conduct monetary policy | End-December 2011 |
| Submit VAT law—consistent with IMF advice—aimed at raising the revenue to GDP ratio to the Ministry of Justice ("Taqnin") for review with a view to submitting it to parliament by end-December 2012. | Support fiscal sustainability | End-December 2011 |
| Submit to the Ministry of Justice ("Taqnin") legislation bringing public enterprises under effective monitoring and oversight of the Ministry of Finance. | Support fiscal sustainability and macroeconomic stability by enhancing controls and reducing fiscal risks | End- March 2012 |

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|---|---|---|
| Roll out to at least two additional Border Crossing Points the new Border Management Model piloted at Hairatan Border Crossing Point. The model is based on a 'two-agency' approach which restricts border presence to the Afghan Border Police and the Afghan Customs Department. Under this model, the ABP will continue to fulfill immigration and security responsibilities, with ACD fulfilling all other commercial and trade-related duties. | Improve efficiency and lower corruption | End-March 2012 |
| Reduce number of branches at bridge bank (New Kabul Bank) by 20 according to the updated business plan. | Minimize fiscal costs | End-March 2012 |
| In line with our desire to protect the financial system from abuse, the government will produce a roadmap with a strategy to build capacity and improve the institutional framework to respond promptly to economic crime. This roadmap will address issues related to the prosecution system to reinforce its independence to ensure accountability for economic crimes and build capacity for investigation and prosecution of these crimes as well as determine the most appropriate institutional framework going forward | Financial sector stability and integrity, reduce moral hazard | End-March 2012 |
| **Structural Benchmarks for the Second Review** | **Rationale** | **Status/Comments** |
| The bridge bank (New Kabul Bank) will be offered for sale in a transparent way, involving a pre-qualification process to ensure that controlling shareholders, beneficial owners, directors and management of intending bidders are fit and proper (which implies, inter alia, that an intending bidder is subject to a high standard of corporate governance, including risk management and internal controls, and that an intending bidder is in a sound financial and risk management state), and that the intending bidder controls adequate resources and has the necessary capacity and capability to ensure the ongoing provision of the relevant salary payments services. There will be a request for expressions of interest locally and internationally for the sale of the bridge bank. Interested parties will be given four weeks to respond with intention to participate in the bid. Once the central bank has vetted potential buyers, it will give them a deadline for sealed bids. | Advance Kabul Bank resolution | End-June 2012 |
| The independent Monitoring and Evaluation Commission will conduct an in-depth public inquiry to examine the events leading to the Kabul Bank crisis, starting with the inception of the bank, and look into the operations of the bank, activities of its shareholders, the role of supervisory and auditing bodies, and the subsequent effectiveness of the government and the criminal justice system in dealing with any crimes committed. | Strengthen financial sector stability, transparency | End-September 2012 |

| | | |
|---|---|---|
| Submit to Parliament the amended or new banking law, prepared in consultation with the Fund that will strengthen provisions on corporate governance, capital, large exposures, related parties, consolidated supervision, early intervention, enforcement, and bank resolution, where appropriate in line with the Basel Core Principles. Specifically, the law should enable us to enforce upon a bank - going concern - all necessary resolution measures and strengthen corporate governance requirements for banks (including fit and proper requirements as set by the FATF standards). | Promote financial sector stability by strengthening independence of bank regulators, reducing risks from bank lending, and ensuring swift processes for bank resolution | End-September 2012 |
| Strengthen our AML/CFT regime by implementing an action plan based on the recommendations of the February 2011 assessment by: (i) submitting amendments to the AML/CFT law to parliament as necessary; (ii) increasing the capacity of FinTRACA, including by hiring additional staff as needed; (iii) expanding MSP registration and implementation of reporting to MSPs in areas currently inaccessible for security reasons if and when the security situation allows; and (iv) enforcing MSP reporting by dedicated software in all reporting areas where it is technically and logistically feasible.. | Promote financial sector stability and integrity and strengthen AML/CFT framework | End-September 2012 |
| Submit legislation to Parliament for the introduction of marketable debt instruments by the Ministry of Finance. | Develop financial markets | End-September 2012 |

## TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This memorandum reflects understandings between the Afghan authorities and Fund staff in relation to the monitoring of the ECF-supported program during 2011–12. It specifies valuation for monitoring quantitative targets under the program (Section I), quantitative performance criteria and indicative targets (Section II), adjustors (Section III), and data reporting (Section IV).

### I. PROGRAM EXCHANGE RATES AND GOLD VALUATION

2. Program exchange rates are used for formulating and monitoring quantitative targets. All foreign assets and liabilities denominated in U.S. dollars will be converted into Afghanis at a program exchange rate of 45.3740 Afghanis per U.S. dollar, which corresponds to the cash rate of March 20, 2011. Gold holdings will be valued at US$1,418.90 per troy ounce, the price as of March 20, 2011. Assets and liabilities denominated in SDRs and in foreign currencies other than the U.S. dollar will be converted into U.S. dollars at their respective exchange rates of March 20, 2011, as reported in the following table.

| Exchange Rate | Program Rate |
|---|---|
| U.S. dollars / Canadian dollar | 1.016000 |
| U.S. dollars / U.A.E. dirham | 0.272300 |
| U.S. dollars / Egyptian pound | 0.168600 |
| U.S. dollars / euro | 1.418200 |
| U.S. dollars / Hong Kong dollar | 0.128200 |
| U.S. dollars / Indian rupee | 0.022160 |
| U.S. dollars / Pakistani rupee | 0.011715 |
| U.S. dollars / Polish zloty | 0.348800 |
| U.S. dollars / Iranian rial | 0.000097 |
| U.S. dollars / Saudi Arabian riyal | 0.266600 |
| U.S. dollars / Russian ruble | 0.035180 |
| U.S. dollars / Swiss franc | 1.109800 |
| U.S. dollars / pounds sterling | 1.623400 |
| U.S. dollars / SDR | 1.585700 |

### II. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

3. **The quantitative performance criteria for March and September 2012 specified in Table 4 of the MEFP are:**

- Floors on revenue of the central government and net international reserves (NIR); and
- Ceilings on reserve money; net central bank credit to the central government (NCG); contracting and/or guaranteeing new medium- and long-term nonconcessional external debt by the public sector, (continuous); short-term external debt owed or guaranteed by the public sector (continuous); accumulation of external payment arrears, excluding interest on preexisting arrears (continuous); lending from state-

owned banks or the central bank to, or government guaranteed borrowing by, public enterprises in need of restructuring (continuous).

4. **The above variables also constitute indicative targets for December 2011 and June 2012.** In addition, the program includes the following indicative targets for the four above-mentioned dates:

- Ceilings on currency in circulation and on the operating budget deficit of the central government excluding grants; and

- Floor on social and other priority spending.

5. The **central government** consists of the Office of the President, the ministries and other state administrations and governmental agencies, including the Attorney General's Office; the National Assembly; and the judiciary, including the Supreme Court.

6. **Reserve money** is defined as currency in circulation plus Afghani-denominated commercial bank deposits at the central bank, including balances maintained by the commercial banks in the DAB's overnight facility.

7. **Currency in circulation** is defined as total currency issued by the DAB. It excludes currency held in the presidential palace vault, in the DAB main vault, and in the vaults of all provincial and district branches of the DAB.

8. **Net central bank credit to the government** is defined as the difference between the central bank's claims on the government and government deposits at the DAB. These deposits exclude deposits held at the DAB's branches because of the unavailability of reliable and timely data from the DAB's branches.

9. **Net international reserves** (NIR) are defined as reserve assets minus reserve liabilities of the DAB, both of which are expressed in U.S. dollars.

- Reserve assets of the DAB, as defined in the fifth edition of the Balance of Payments Manual (BPM5), are claims on nonresidents denominated in foreign convertible currencies controlled by DAB, and are readily and unconditionally available for DAB to meet balance of payments financing needs, intervention in exchange markets, and other purposes. They include DAB holdings of monetary gold, SDRs, Afghanistan's reserve position in the IMF, foreign currency cash (including foreign exchange banknotes in the vaults of the DAB, but excluding cash held in the DAB's branches), and deposits abroad (including balances on accounts maintained with overseas correspondent banks). Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered; claims on residents; precious metals other than monetary gold; assets in nonconvertible currencies; illiquid assets; and claims on foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options).

- Reserve liabilities are defined as short-term (original maturity) foreign exchange liabilities of DAB to nonresidents (held at DAB headquarters); all credit outstanding from the IMF; foreign currency reserves of commercial banks held at DAB headquarters; commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options); and all arrears on principal or interest payments to commercial banks, suppliers, or official export credit agencies.

10. **Revenues** of the central government are defined in line with the Government Financial Statistics Manual (GFSM 2001) but on a cash accounting basis, excluding grants. Revenue is an increase in net worth of the central government (including its units in the provinces and agencies) resulting from a transaction.

- Revenues of the central government include taxes and other compulsory transfers imposed by central government units, property income derived from the ownership of assets, sales of goods and services, social contributions, interest, fines, penalties and forfeits and voluntary transfers received from nongovernment other than grants. The definition for program monitoring excludes grants and other noncompulsory contributions received from foreign governments and international organizations; such transfers between central government units would be eliminated in the consolidation of the fiscal reports and not recorded as revenue. Receipts collected by central government on behalf of noncentral government units should not be counted as revenue (e.g., Red Crescent fees). Receipts from the sale of nonfinancial assets, such as privatization, and transactions in financial assets and liabilities, such as borrowing but excepting interest payments, are also excluded from the definition of revenue.

- Revenues should be recognized on a cash basis and flows should be recorded when cash is received. The official Afghanistan Government Financial Management Information System (AFMIS) reports will be used as the basis for program monitoring. Exceptional advanced payments will be treated as if received on the normal due date. All revenue must be supported by the relevant documentation and revenue receivables, where a cash sum has been recorded but the revenue item has not yet been accounted for, and revenues payable, where the revenue has been reported but the cash has yet to be recorded should be separately reported on a gross basis.

11. **Social and other priority spending** is defined as the sum of pro-poor spending identified in accordance with the ANDS poverty profile by the Ministry of Education, Ministry of Public Health, and Ministry of Labor, Social Affairs, Martyrs, and Disabled within the central government's operating budget for a particular fiscal year.

12. For program purposes, the definition of **external debt** is set out in Executive Board Decision No. 12274, as revised on August 31, 2009 (Decision No. 14416-(09/91)).

(a) The term "debt" will be understood to mean a current (i.e., not contingent) liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract. Debts can take a number of forms, the primary ones being as follows:

(i) loans (i.e., advances of money) to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);

(ii) suppliers' credits (i.e., contracts where the supplier permits the obligor to defer payments until sometime after the date on which the goods are delivered or services are provided); and

(iii) leases (i.e., arrangements under which property is provided which the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property), while the lessor retains the title to the property. For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair or maintenance of the property.

(b) Under the definition of debt set out in paragraph 12 (a) above, arrears, penalties, and judicially awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.

13. **Long term and medium term external debt.** A ceiling applies to the contracting and guaranteeing by the public sector of new nonconcessional borrowing debt with nonresidents with original maturities of one year or more. The ceiling applies to debt and commitments contracted or guaranteed for which value has not yet been received. This applies to private debt for which official guarantees have been extended and which, therefore, constitute a contingent liability of the public sector. Excluded from the limits are refinancing credits and rescheduling operations, credits extended by the IMF, and credits on concessional terms as defined below. Consistent with the Public Finance and Expenditure

Management (PFEM) Law, the MOF should have sole responsibility for the contracting and guaranteeing of external debt on behalf of the government.

- The definition of "government" includes the central government (including government departments), as well as official agencies that do not seek profit and whose budgets are issued independent of the annual operational or development budgets. The public sector comprises the government as defined above, the DAB, and nonfinancial public enterprises. Public enterprises are defined below in paragraph 16.

- For program purposes, the guarantee of a debt arises from any explicit legal obligation of the public sector to service a debt in the event of nonpayment by the debtor (involving payments in cash or in kind), or from any implicit legal or contractual obligation of the public sector to finance partially or in full any a shortfall incurred by the debtor.

- For program purposes, a debt is concessional if it includes a grant element of at least 60 percent, calculated as follows: the grant element of a debt is the difference between the present value (PV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt. The PV of debt at the time of its contracting is calculated by discounting the future stream of payments of debt service due on this debt.[1] The discount rates used for this purpose are the currency specific commercial interest reference rates (CIRRs), published by the Organization for Economic Cooperation and Development (OECD). For debt with a maturity of at least 15 years, the ten-year-average CIRR will be used to calculate the PV of debt and, hence, its grant element. For debt with a maturity of less than 15 years, the six-month average CIRR will be used. To both the ten-year and six-month averages, the same margins for differing repayment periods as those used by the OECD need to be added (0.75 percent for repayment periods of less than 15 years, 1 percent for 15 to 19 years, 1.15 percent for 20 to 29 years, and 1.25 percent for 30 years or more).

14. The zero ceiling on **short-term external debt** applies on a continuous basis to the stock of short-term external debt owed or guaranteed by the public sector (as defined in paragraph 13 of this memorandum), with an original maturity of up to and including one year.

- It applies to debt as defined in paragraph 12 of this memorandum.

- Excluded from the limit are rescheduling operations (including the deferral of interest on commercial debt) and normal import-related credits.

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[1] The calculation of concessionality will take into account all aspects of the loan agreement, including maturity, grace period, payment schedule, upfront commissions, and management fees.

- Debt falling within the limit shall be valued in US dollars at the exchange rate prevailing at the time the contract or guarantee becomes effective.

15. A continuous performance criterion applies to the **nonaccumulation of new external payments arrears** on external debt contracted or guaranteed by the central government or the DAB. External payment arrears consist of external debt service obligations (principal and interest) falling due after March 20, 2011 and that have not been paid at the time they are due, as specified in the contractual agreements. Excluded from the prohibition on the accumulation of new arrears are (i) arrears arising from interest on the stock of arrears outstanding as of March 20, 2011 and (ii) external arrears that are subject to debt rescheduling agreements or negotiations.

16. **Lending to, or guaranteeing borrowing by, public enterprises.** The zero ceiling on new lending from state-owned banks or the central bank to, or government guaranteed domestic borrowing by public enterprises in need of restructuring applies on a continuous basis.

- For the purposes of this performance criterion (i) "state-owned banks" refers to those banks that are wholly or majority owned by the government (as defined in paragraph 13 of this memorandum), including Bank Millie, Bank Pashtany and New Kabul Bank; (ii) "public enterprises in need of restructuring" refers to enterprises that meet either of the following: (a) public enterprises that have not had an audited balance sheet in the past two fiscal years, (b) public enterprises that have been identified by the Ministry of Finance for liquidation, or (c) public enterprises that do not have cabinet-approved restructuring plans; and (iii) "public enterprises" refers to enterprises wholly or majority owned by the government, including those covered by the State-Owned Enterprise (Tassady) Law, and all state-owned corporations and any other public entities and government agencies engaged in commercial activities but not covered by the Tassady Law.

- It applies to any new loans (or financial contributions) extended directly from the central bank or state-owned banks to public enterprises in need of restructuring, and also to any explicit government guarantees for borrowing undertaken by these public enterprises (including loan agreements and guarantees for which value has not been received).

17. **Operating budget deficit of the central government** excluding grants is defined as revenues of the central government minus operating budget expenditure recorded in AFMIS.

## III. ADJUSTORS

18. The floor on NIR and the ceiling on the NCG are consistent with the assumption that **core budget development spending** will amount, on a cumulative basis from March 20, 2011, to:

| | |
|---|---|
| December 21, 2011 | Af 33.5 billion |
| March 19, 2012 | Af 53.4 billion |
| June 20, 2012 | Af 4.2 billion |
| September 21, 2012 | Af 23.9 billion |

Should core budget development spending exceed these projections, the NIR floor will be adjusted downward and the NCG ceiling will be adjusted upward by the difference between the actual level (up to the appropriated amount) and the projected level of development spending.

19. The NIR floor and NCG ceiling are defined consistent with the assumption that the **external financing of the core budget and receipts from the sale or transfer of nonfinancial assets** will amount, on a cumulative basis from March 20, 2011, to:

| | |
|---|---|
| December 21, 2011 | Af 85.4 billion |
| March 19, 2012 | Af 115.3 billion |
| June 20, 2012 | Af 22.8 billion |
| September 21, 2012 | Af 55.7 billion |

Should external financing of the core budget (including that associated with off-budgetary spending coming on budget) and the receipts from the sale or transfer of nonfinancial assets collectively exceed (fall short of) these projections, the NIR floor will be adjusted upward (downward) and the NCG ceiling will be adjusted downward (upward) by the difference between their actual level and the projected level. The overall downward adjustment to the NIR floor will be capped at $500 million and the overall upward adjustment to the NCG ceiling will be capped at Af 25 billion.

20. The NIR floor and NCG ceiling are defined consistent with the assumption that the **asset recovery** from banking sector institutions in liquidation applied towards MoF assets or liabilities at DAB will amount, on a cumulative basis from March 20, 2011, to:

| | |
|---|---|
| December 21, 2011 | Af 1.8 billion |
| March 19, 2012 | Af 3.5 billion |
| June 20, 2012 | Af 0.9 billion |
| September 21, 2012 | Af 1.9 billion |

Should such asset recovery exceed (fall short of) these projections, the NIR floor will be adjusted upward (downward) and the NCG ceiling will be adjusted downward (upward) by the difference between the actual recovery and its projected level.

21. Should **DAB be recapitalized by the MoF**, the NCG ceiling will be adjusted upward by the amount of this recapitalization.

22. Should **MoF receive profit distribution from DAB**, the NCG ceiling will be adjusted downward by the amount of this profit distribution.

23. Should some **expenditure currently financed directly by donors outside the budget** be moved on to the operating budget, the NIR floor will be adjusted downward, and the NCG ceiling and the indicative targets (ceilings) for the operating budget deficits of the central government, excluding grants, will be adjusted upward, by the actual amount of these expenditures on the conditions that (i) the moving on budget of these expenditures is justified by a statement from donors indicating their decision to stop financing them outside the budget and (ii) they are subject to a supplementary appropriation approved by parliament. The overall downward adjustment to the NIR floors will be capped at $300 million.

## IV. Provision of Information to the Fund

24. To facilitate monitoring of program implementation, the government of Afghanistan will provide the Fund through the office of the Resident Representative of the IMF in Afghanistan, the information specified below and summarized in the list of reporting tables provided to the Technical Coordination Committee.

25. Actual outcomes will be provided with the frequencies and lags indicated below.

- DAB net international reserves: weekly, no later than two weeks after the end of each week.

- Monetary statistics, including exchange rates, government accounts with the DAB, currency in circulation, reserve money, and a monetary survey: monthly and no later than three weeks after the end of the month. The monetary survey will include the balance sheet of the DAB and a consolidated balance sheet of the commercial banking sector.

- Core budget operations and their financing: monthly and no later than four weeks after the end of the month. The official reports for program monitoring will be the monthly financial statements from the Afghanistan Financial Management Information System. The structure of financing (grants and loans should be separately identified) and expenditure data should be on a consistent cash basis. Core operating expenditures should be reported on a monthly basis using the budget appropriation economic (object) and administrative classification in addition to the program and functional classification as reported in the budget documents. Core development expenditures should also be reported separately on a monthly basis using the budget program classification in addition to the economic (object), administrative and functional classification consistent with the operating budget. All the data should also compare outturns against the approved budget. Core operating and development revenues and expenditures should also be reported by province, separately on the same monthly basis.

- External budget operations and their financing (i.e., donor funded spending outside the core budget treasury systems): semiannually (more frequently if possible) and no later than eight weeks after the end of the period. External development expenditures should be reported on a disbursement basis (as currently defined in budget documents) using the budget program classification (and an administrative, functional and provincial classification where possible).

- External debt data: quarterly and no later than six weeks after the end of the quarter. These will include: (i) details of new loans contracted or guaranteed during the quarter, including the terms of each new loan; (ii) the stock of debt at the end the quarter, including short-term debt, and medium- and long-term debt; (iii) loan disbursements and debt service payments (interest and amortization) during the quarter; (iv) debt relief received during the quarter; (v) information on all overdue payments on short-term debt, and on medium- and long-term debt, including new external arrears (if any); and (vi) total outstanding amount of arrears.

- National accounts data: annually and no later than eight weeks after the end of the year. Merchandise trade data should be reported quarterly and no later than eight weeks after the end of the quarter.

- Monthly consumer price indexes (CPIs) for Kabul and other major cities ("national" CPI) with a lag of four weeks after the end of each month.

- Four-monthly and with a three-month lag, financial flows and other key variables of the state electricity company (DABS), aggregated as well as disaggregated by regional hubs, for the preceding 12 months and (in the last four-monthly period of the year) a forecast for the following fiscal year. The report will use the template agreed with Fund staff, with all lines filled in, but excluding the disaggregation of loses into technical and nontechnical for regions outside Kabul, which is expected by March 20, 2013.

- Financial Stability Indicators for each commercial bank: quarterly and with a one-month lag after the end of each quarter. These indicators will include banks' prudential ratios, capital adequacy ratio, liquidity ratio, portfolio quality indicators (e.g., nonperforming loans, provisions as percentage of classified loans), concentration ratio, related loan ratio, information on open foreign exchange positions, large loan and deposits statistics and other relevant information.

- Lending to public enterprises from each commercial bank: quarterly with a one-month lag after the end of each quarter share a report on the following balance sheet items and operations for each bank: (i) aggregate value of outstanding loans to all public enterprises; (ii) disaggregated value of outstanding loans by public enterprise for each bank's top 10 borrowers; (iii) indicators of the quality of these loans. For this reporting requirement, public enterprises refer to those defined in point (iii) in the first bullet of paragraph 16.

- Monthly activity and cost reports from the Kabul Bank receiver, including the status and financial details of asset recovery.

- Monthly progress reports, interim reports, and final reports by the auditor conducting the forensic audits of Kabul Bank and Azizi Bank.

- Monthly detailed balance sheet and income statement for the bridge bank (with a two weeks lag) as well as quarterly reports on bridge bank's progress against its business and financial plans (staffing, branches, etc.)

- Quarterly, details on the amortization payments for the promissory note issued by the Ministry of Finance to recapitalize the central bank.

- Monthly details of the discretionary cash balances held in the Ministry's Afghani and U.S. dollar treasury single accounts (TSA), and the discretionary development 27232 account. In addition, an update of the monthly summary report of funds under operating budget, summaries of expenditure for both the operating budget and discretionary development budgets, and the updated cash projections for the current and following fiscal years.

26. The Technical Coordination Committee (TCC) will send to the IMF reports by the end of each quarter documenting progress in implementing structural benchmarks under the program. These reports will include appropriate documentation and explain any deviations relative to the initial reform timetable, specifying expected revised completion date. Other details on major economic and social measures taken by the government that are expected to have an impact on program sequencing (such as changes in legislation, regulations, or any other pertinent document) will be sent in a timely manner to IMF staff for consultation or information.