

ISLAMIC FINANCE IN AFGHANISTAN



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CHALLENGES AND RECOMMENDATIONS

A Study by Credit Solutions Financial Consultancy Services
(CS Financial)

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WE TALK NUMBERS, NOT WORDS

About CS Financial

CS Financial is a financial advisory led by qualified and dedicated senior bankers and finance experts with a wide range of expertise in financial regulatory requirements, commercial banking, Shariah advisory, insurance (Takaful), international trade, real estate, debt capital market (Sukuk), microfinance, Zakat, and Waqf sectors. Our experts are based in Kuala Lumpur, Dubai, and Kabul.

It is a one-stop banking, finance, and insurance/Takaful solution provider. It offers its services to banks, insurance and Takaful companies, microfinance companies and money exchangers, regulators, educational institutions, governments and corporates.

CS Financial supports its customers with the development of commercial and financial regulations, advising regulators on strengthening financial supervision, advising banks and finance companies on regulatory compliance, audit, banking and finance product development, trade finance solutions, asset management, arranging best IT and core banking solutions, conversion of conventional banks to Islamic, and Shariah advisory.

Its Shariah Advisory covers a broad-spectrum of services. Supporting regulators with Islamic finance legislations, regulations, and policies/procedures are an essential part of its support to the public sector. It also covers supporting private sector (commercial banks, development banks, microfinance banks and companies, insurance/takaful providers, finance companies, and traders) with all types of Shariah compliant solutions and products with innovative structures, product manual and implementation guidelines.

To maintain ongoing Shariah compliance and increase market credibility, CS Financial supports its clients with Shariah review and certification upon successful review. The review is undertaken by qualified experts well versed in Shariah and finance.

Shall it be establishing a new financial institutions or company, Islamic window in a conventional bank, or the conversion of an existing conventional bank or insurance company to Islamic, CS Financial is here to help. It develops retail, corporate banking, trade finance, asset management, insurance (Takaful) products as well as structures capital market Sukuk and syndicated banking transactions. Its solutions are reviewed by world renowned scholars who have decades of expertise in the Islamic banking and finance industry since its inception.

It supports financial institutions (banks and insurance companies) with governance framework, audit and regulatory compliance, meeting AML and various global sanction requirements and other international standards, and undertaking compliant CSR activities.

Given its strong financial and Islamic knowledge and expertise, CS Financial provides capacity building and talent development for regulatory bodies, banks, insurance companies, and educational institutions worldwide.

Introduction & Summary

Afghanistan has the potential of becoming a notable economy that basis its financial system on the principles of Islam. Its rich Islamic heritage, a state of the art constitution that nullifies any regulation that opposes the rules of Islam, and its people's strong Islamic sentiment have already pushed policy makers to embrace Islamic banking and finance. On 12th August 2015, the President of the Islamic Republic of Afghanistan has signed a revised banking act that introduces a dual banking system including a chapter on Islamic banking. Da Afghanistan Bank "DAB" has subsequently spent good effort to have 46 regulations, manuals, and guidelines in place for addressing a wide range of matters specific to Islamic banking.

The country now has the required regulations to license Islamic Financial Institutions "IFIs", impose a proper Shariah and corporate governance, monitor Islamic banking liquidity management, capital adequacy, asset classification, and profit distribution. For the sake of good order, DAB has provided guidelines and manuals for Shariah review, compliance, audit, product development, and financial reporting. In addition to guidelines on agriculture financing-based products, financial institutions shall follow very well crafted guidelines for developing Murabaha, Ijarah, Istisna, Salam, Qard, Musharakah, and Mudharabah based products.

However, the adequate implementation of these regulations and guidelines by the 7 IFIs remains a challenge for both regulators and financial institutions. Developing products by financial institutions that will fulfill the Shariah compliant funding and investment needs of their customers and developing liquidity management tools and strategies that will adhere to sound and sustainable banking practices are also challenges they face. All this adds to the existing efforts of both the regulatory authorities and the financial institutions to improve the overall banking sector of the country to a level positively viewed and accepted by the international banking counterparts.

This report sheds light on these challenges and recommends solutions to properly address them so Afghanistan lays a strong foundation for a sound Islamic banking and finance sector. Given that a financial system goes beyond banking, the report briefly covers the improvement of or the need for other financial institutions such as insurance and debt capital markets.

This report finds that Afghanistan not only has the potentials to base its banking sector entirely on Shariah, it also has the potential to become a hub and source for Islamic finance human capital for the region and beyond.

The report is based on meetings with government authorities regulating various economic sectors of the country including the banking and insurance sectors, the Afghanistan Banks Association, individual experts and representatives of many financial institutions with interest in Islamic banking and finance. The author would like to express its deep gratitude and utmost appreciation to all of them for their generosity in sharing ideas and information.

1

Establishing Parliamentary Consensus Around the Proposed Afghanistan Banking Law

The revised banking act signed by the President in August 2015 is currently being discussed with the Parliament for adoption to become a “Parliament approved law”. The Parliament refuses to enact the law as it argues that the proposed law allows for conventional banking (in addition to Islamic banking). Since *riba* (interest), *gharar* (uncertainty or ambiguity in transactions), and speculation is prohibited by the Islamic law (*Shariah*), the Parliament argues that conventional banking will allow such prohibited practices and hence is not compatible with requirements of the Afghanistan Constitution that considers null and void any law that contradicts the rules of Islamic *Shariah*.

The Parliament therefore requires a law that only adopts Islamic banking. Complying with Parliament’s requirement will jeopardize the existing banking practice in Afghanistan for sure which almost entirely is based on conventional practice from its inception. Islamic banking is new to the country; DAB is new to its supervision and the market is new to its practicing. In its efforts to ensure the stability of the banking sector, DAB has proposed to the Parliament to adopt the conventional banking for a period of time (e.g., 10 years) along Islamic banking. DAB then will work gradually converting the existing conventional banking system to be Islamic within the agreed time frame. The Parliament has not accepted this proposal insisting that the entire law shall be for Islamic banking.

Although the banking sector is regulated based on laws enacted by the Presidents through presidential decrees for more than a decade, it is still a requirement that the Parliament approves the law. In order to bring a greater awareness in the Parliament about a temporary dual system and a consensus amongst its members around the need for adopting the same in Afghanistan until the country is made ready for Islamic banking, it is proposed to arrange a trip for the relevant committee of the Parliament with a number of Afghan *Shariah* scholars, including the DAB *Shariah* Board members, to one or two Islamic countries that apply dual banking system. The Afghan delegate will meet the following experts:

1. Central bank officials in the host country(s) including legal counsels.
2. Leading Islamic banking experts (both bankers and lawyers).
3. Leading *Shariah* scholars exerts in Islamic Banking and finance.

Our general recommendations are that Afghanistan temporarily applies a dual banking system and gradually moves towards fully fledged Islamic banking within a clear time linked framework in order to comply with the constitutional requirements. A rapid change towards Islamic banking without overcoming the challenges and being ready will disrupt the financial system in the country and may cause a financial collapse:

1. DAB agrees the timeline for a gradual conversion with the Parliament.
2. DAB further educate members of the Parliament committee on dual system through:
3. Arranging meetings with Afghan international bankers with experience in Islamic banking;

4. Arranging a field trip for the relevant parliament members, the DAB Shariah Supervisory Board members, and a selective number of Afghan Shariah scholars to one or two Islamic countries that apply dual banking system. The objective of the trip will be that through meetings with regulators, Islamic banking experts, and Shariah scholars the Afghan side will obtain a better understanding of a dual system, its implications for the financial system in the country, and its Shariah compliance for temporary period of time from a public interest (maslahat) perspective. Hopefully this will help Afghan lawmakers to make a better judgment in regards to the constitutionality of a dual system. UAE and Bahrain are good destinations for such a trip due to their application of dual system. Saudi Arabia also applies a dual banking system in practice, but does not have dual banking regulations so a trip to Saudi Arabia might prove counterproductive. If due to some constraints a trip to Bahrain could not be arranged, Bahraini experts together with experts from Saudi Arabia (particularly scholars) can be invited to the UAE for meetings.

2

Updating Islamic Banking Guidelines

DAB aims to update some of its Islamic finance guidelines as some may not strictly adhere to the Hanafi Fiqh that prevails in Afghanistan. It may also do so to streamline certain guidelines and make them better compliant by the banks.

It is recommended that DAB:

1. Update regulations, guidelines, and manuals after a thorough study by an expert panel. The current regulations, guidelines, and manuals are very well crafted.
2. Keep its prospective on Fiqhi school of thoughts broad as a single school of thought may not have solutions for all needs of modern banking practices. The Fiqhi school of thoughts however are very close to each other on majority of the issues and may differ on some minor details.
3. Does not make the AAOIFI Shariah standards mandatory to follow, but may recommend to the banks to use them as a guideline. This will enable banks to have freedom to innovate in applying Islamic finance concepts.
4. Prepare its own guidelines for some of the Hanafi Fiqh concepts such as Bai Alwafa that may not be seen favorable by AAOIFI or other international standard setting bodies.

3

Expert Human Capital and Islamic Finance Expertise

DAB has required all 7 IFIs in February 2016 to comply with its regulations and guidelines within three months. The deadline has passed and most of them fall behind on their compliance until now. This is mainly due to lack of experience in Islamic finance at market level.

Islamic finance businesses at financial institutions as well as the Islamic finance supervision function at DAB are led by competent personnel with the necessary educational background. They however are short on experienced supporting staff to ensure swift compliance with regulations. Most banks also fall short on experienced staff for developing required policies and procedures. Usually bank's strategy or business planning departments will have dedicated resources to develop policies and procedure required for

compliance, control, operation, and products through collaboration with the relevant departments. This is however a gap exists in most Afghan banks.

The market overall is deficient on Islamic product development expertise. Banks have not yet developed strong Islamic-product-development-departments and most find it difficult to train their staff on Islamic banking and finance inside Afghanistan. Some banks have organized training for their staff abroad. Training abroad however is expensive and at times obtaining visa for Afghan staff is challenging.

In addition to Islamic banking staff, most Shariah compliance departments' staff as well as banks' Shariah Board members require Islamic banking and finance knowledge enhancement. Specialized trainings for them do not exist in Afghanistan at the moment. It is worth mentioning that some banks also struggle to enhance their overall ratings due to their failure to enhance controls for compliance, audit, and meeting regulatory deadlines. Some of them are regularly fined by DAB for not being able to comply with its requirements.

It is recommended that:

1. A third party infrastructure is used for developing a cost effective Islamic finance product development, policies and procedures, specialized quality Islamic banking and finance education for bank management, business and control departments, marketing teams, internal Shariah departments, and Shariah board members. The Third party to develop specific short term specialized certificate programs in the area of retail banking, corporate banking, transactional banking (trade finance, payments, cash management), Shariah controls (review, compliance, and audit), Takaful (Islamic insurance), and a specialized program in banking for Shariah Board members and staff of internal Shariah departments.
1. DAB to adopt a 2 and a 5 years strategy for its own staff capacity building on Islamic finance and shall seek third party assistance for planning and delivering such staff capacity enhancement.
2. Banks to adopt a 3 and 6 years strategy for capacity building and seek third party assistance for planning it staff capacity enhancement. It is recommended that DAB includes Islamic capacity building in its rating mechanism and award banks according to their capacity building strategy progress.
3. DAB to make the relevant certificate-training program mandatory for its staff and banks' relevant staff.
4. DAB to require banks to undergo annual external Shariah audit until it develops its own Shariah audit and review functions and staff capability. This will help DAB to understand the level of banks' compliance with its regulations and guidelines.
5. DAB to extend its cooperation with experienced regulators in the Islamic world such as Malaysia, Indonesia, Bahrain, Saudi Arabia, UAE, and Qatar for training its staff at their premises and benefiting from their accumulated experience in supervision, Shariah compliance, Shariah Board best practices, and Islamic finance education.
6. Shariah scholars to have a forum (regular gathering such as conference, symposium) where they exchange ideas about new developments in Afghanistan Islamic banking and finance sector as well as internationally developed Shariah standard and new Islamic banking and finance practices.

4

Liquidity Management Instruments

Commercial banks, insurance companies, Pensions, and DAB lack liquidity management tools and products. Afghanistan does not have its own capital market authority or a market, its banks and insurance companies do not have access to debt capital market instruments abroad to invest in. DAB has a conventional capital note program for the purpose of commercial bank liquidity management which is not available in Islamic format.

The country lacks Sukuk regulations and a framework for special purpose vehicle (SPV) needed for Sukuk issuance as well as the trust laws.

It is recommended that:

1. DAB considers issuing its capital notes in Islamic format (Sukuk) to enable liquidity management for Islamic banks and windows.
2. DAB and Finance ministry consider issuing short term (1 to 5 years) and long term (5 to 10 years) Sukuk for budget purposes enabling banks to take the government risk.
3. Government bodies issue Sukuk for short term government project (1 to 5 years). This will help the government to raise liquidity from domestic market as well as the banks to invest its liquidity in government risk.
4. Banks get access to Sukuk market outside of Afghanistan for investing its excess liquidity.
5. Banks establish interbank relationship with foreign banks and place short term (1, 3, 6, and 12 months) deposits.
6. The capital market and asset management sectors are developed along proper Sukuk regulations addressing the special purpose vehicle and trust laws points for Sukuk issuance.

5

Banking & Insurance Products and Platforms

Banks in Afghanistan offer basic products. Home finance is still not developed, investment products for wealth management such as funds and Shariah compliant saving/term deposit accounts are not offered. Trade finance solutions are at early stage.

The industry needs to be developed further to cater for the need of individuals and business. In addition to Shariah compliant banking products, other infrastructure such as proper IT system and access to commodity Murabaha platforms with international brokers is needed for banks to offer Shariah compliant cash products such as personal finance or working capital.

In addition to this, Afghanistan is yet develop the Islamic version of insurance i.e., Takaful which is growing industry in the Islamic world and is needed in Afghanistan to offer financial inclusion to a wider audience.

6

Banking, Islamic Finance Training and Public Awareness

The country is lacking proper banking and Islamic finance training. Currently banking training is mainly provided by Afghanistan Institute of Banking and Finance which is a government body. Given the banking sector and Islamic finance within it is set to grow further, there is need for third party training providers. Public awareness about banking sector overall and Islamic finance in particular requires enhancement.

Ministry of justice and the judiciary personnel are not properly trained on banking and applied Islamic finance products and operation. It will be challenge for banks, customers, and judiciary branches will struggle to properly address banking and finance lawsuits in the courts due to the lack of such knowledge in the mentioned institutes.

It is recommended that private sector develops professional banking training certificates (including Islamic finance) and universities/colleges make banking and finance (including Islamic finance) part of its teaching curriculum.

7

Islamic Finance Hub

While security and stability will be key to Afghanistan's financial sector development, the same applies if Afghanistan decides to become an Islamic finance hub for Central Asia. If Afghanistan develops sound Islamic finance regulations and trains its thousands of Shariah experts to understand and be able to opine on Islamic finance, similar to Malaysia, it can make a tremendous contribution to making itself a hub and a source of Islamic finance human capital for the country, nearby Central Asia, and the remaining Islamic world.

This will help employ a large number of Shariah students for jobs that earns them decent income.

8

Islamic Finance Development Steering Committee

To oversee and coordinate the initiatives undertaken by various government agencies and private sector and to identify the initiatives required for developing the Islamic finance industry in Afghanistan, it is recommended to form a steering committee comprising the representatives of those government bodies (ministries, banking and insurance regulators, religious, and political bodies) that engage in country's economic decision making process. This will help coordinate the efforts of different government agencies to speed up the legal and financial infrastructure of Islamic finance in the country, and will help to respond to the donors on time by meeting the deadlines agreed with them.

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