

RECONSTRUCTING AFGHANISTAN SERIES



## A Critical Assessment of Microfinance

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## **Acknowledgements**

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## **About APPRO**

The Afghanistan Public Policy Research Organization (APPRO) is an independent social research organization promoting social and policy learning to benefit development and reconstruction efforts in Afghanistan. APPRO is registered with the Ministry of Economy (Registration Number: 1212) as a non-for-profit organization and headquartered in Kabul, Afghanistan.

APPRO's mission is to measure development progress against strategic reconstruction objectives and provide insights on how to improve performance against the milestones set by the government of Afghanistan and the international donors. APPRO is staffed by personnel with many years of collective experience in various facets of development and scientific research.

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## 1. INTRODUCTION

Afghanistan has come out of a decades-long intermittent period of armed conflict which has severely limited the capacity and the ability of the state to provide services to meet even the most basic needs of the population. With an average per capita GDP of less than US \$200 Afghanistan was in 2001 one of the poorest countries in the world, with its formal institutions and infrastructure virtually destroyed. An estimated 80 percent of the population lives in rural areas with agriculture and agriculture-based employment providing income for 67 percent of the labor force. The amount of useable farmland comprises as little as 12 percent of the total land area, and land ownership is highly skewed with great regional differences. A significant portion of rural households possesses little or no land for sustenance.

Afghan households need access to credit as a coping strategy - for consumption smoothing, crises and life cycle events such as marriages and funerals. Access to credit is also purported to be key in expanding income-generating activities, investment in productive assets and improvement of livelihoods, thereby adding to local economic growth. Small, medium and large scale entrepreneurs need access to credit for capital accumulation in setting up or expanding businesses. This need has attracted new attention in a time of economic reconstruction, promotion of economic growth in the formal sector, and development of rural markets. Access to credit is considered by donors and Afghan policymakers as an important service for promoting socio-economic inclusion, countering poverty and promoting growth in rural Afghanistan. The continued commitment to microfinance at the highest levels is reflected in the Interim Afghanistan National Development Strategy (I-ANDS) which contains a rural development benchmark relating to rural credit and financial services:

To promote livelihoods and economic growth, the Government will expand access to quality financial services—especially for women and the poor—by further developing informal financial markets through the Microfinance Investment Support Facility in Afghanistan (MISFA), creating a legally independent yet regulated sector, and mobilizing resources and private institutions that will provide financial products for investment in small and medium-sized enterprises. Comprehensive rural financial services will also provide special products such as insurance that will encourage private sector investments in rural farm and non-farm enterprises. (I-ANDS 2005:148)

MISFA was established in August 2003 as the apex organization for “Microfinance Institutions” (MFIs) in Afghanistan. The number of MFIs has since grown to 15 (See Appendix A for a list and descriptions). The MISFA website recorded a total of US\$252.8m in loans disbursed to 314,208 active borrowers by May 2007. This commitment to microfinance is based on the assumption of a large unmet demand for credit in rural communities. At its inception, MISFA estimated that as many as 2 million households were in need of credit. In December 2007, the World Bank official website reported that,

The World Bank, CGAP (the Consultative Group to Assist the Poor), and the donors that followed, seized the opportunity [in 2002] to establish a model microfinance industry in this *virgin* territory - doing things right, from day one. Four years later, microfinance in Afghanistan is thriving despite deteriorating security in the country, and a new impact survey has found that the benefits to clients are real. ...Interviews with more than 1,000 households across five regions of the country in the spring of 2007 revealed that 700,000 employment opportunities have been created for women...<sup>1</sup> (emphasis added)

However, research has shown that a variety of informal credit mechanisms are commonly used across Afghanistan, pointing to the presence of highly evolved, albeit not always fair and equitable, credit markets throughout rural Afghanistan. Village level case studies of informal credit conducted in Herat, Kapisa and Ghor provinces and a pilot study in Balkh in 2006-2007 (Klijn and Pain 2007) raised a number of challenges to such assumptions on the unavailability of credit, finding that an array of credit options were available to rural households. The authors also questioned the understanding of credit mechanisms based on a preoccupation with 'formality' (Klijn and Pain, 2007, p.2):

If we look at informal credit through the lens of formal systems where money exchange is treated as simply as a commodity exchange, does this not rather ignore the context of social relations in which most Afghans lead their lives and the meaning and role that informal credit plays within these relations?

To further investigate the inconsistencies in perceptions by the international donors of the positive role of microcredit in improving rural livelihoods this research examined the interrelations between microcredit and traditional credit. Village level in-depth interviews were held with households, loan officers and key informants in villages where microfinance is being offered. Data collected from Kabul, Bamiyan, and Balkh provinces were supplemented with data from a series of shorter and less in-depth key informant interviews and focus group meetings conducted in Herat. The interviews and focus group meetings in the four provinces took place between February and August 2007.

This paper examines the interface between MFIs as introduced organizations with anticipated institutional roles in facilitating desirable socio-economic change and the pre-existing rural institutions that have traditionally governed credit transactions for generations of rural Afghans. An institutionalist framework is applied to primary and secondary data to assess the outcome to date of introducing microcredit in Afghanistan. This paper concludes with a series of recommendations for integrated policy and operational interventions to improve rural livelihoods in post-2001 Afghanistan. The remainder of this paper is organized as follows.

The next section provides a brief history of formal microcredit in Afghanistan. Section 3 outlines the objectives of this research while section 4 describes the methodology used in the analysis of the data from primary and secondary sources. Section 5 provides a detailed description of the context including a review of some of the relevant literature. Section 6 analyzes the data from primary and secondary sources, followed by Section 7 to conclude on the main findings. The paper concludes with Section 8 which outlines a series of policy and operational recommendations.

## 2. MICROCREDIT IN AFGHANISTAN

In this study, microcredit refers to small amounts of money borrowed by clients from MFIs as part of the set of services described as Microfinance.<sup>2</sup> Loans can be delivered to individuals and groups with or without collateral and may or may not contain a savings requirement. In Afghanistan, there are variations in the microfinance system across different MFIs, although they operate under the general policy guidelines as prescribed by MISFA (Microfinance Investment Support Facility in Afghanistan). These variations occur in terms of targeted groups, nature of financial services provided, and the presence of capacity building components built into the loans. For instance, PARWAZ only offers loans to urban women, while FINCA cooperates with donor organizations such as USAID to contribute to nationwide programs such as ARIES (Agriculture, Rural Investment and Enterprise Strengthening) and has established FAMA (FINCA Afghanistan Microfinance Academy) to train its employees in training its clients.<sup>3</sup>

There is an array of different regulations that govern formal credit provision through the 15 MFIs operating under MISFA. For instance, loan repayment cycle can start from 2 weeks after borrowing, such as in the case of OXUS, or 10 months, as is the case with ARMP. Each MFI has different loan cycles, with different amounts that can be borrowed after the end of a repayment cycle. Most MFIs require that savings be made before loans can be accessed. Some MFIs only give group loans, whereas others provide loans to individuals and groups. The Murahaba credit system utilized by FINCA is the world's first Sharia law compliant microcredit system. Under Sharia law, interest on loans is considered as sinful. To avoid this label, the Murahaba system charges "administrative costs" for its loans, which include interest calculated annually and payable by the borrowers as the service cost of their loan.

In traditional lending the mechanisms are rooted within local family, community, and Islamic notions and norms of social assistance and responsibility, linked in many ways to the practice of giving alms to the poor or to benefit from donating to the needy based on the

**Table 1. Inventory of Traditional Credit Practices and Terms**

TERM	DEFINITION
Murabaha	A contract of sale between a lender and a client for the sale of goods at an agreed price plus an agreed profit margin for the lender. The contract involves the purchase of goods by the lender, who then sells them to the client at an agreed mark-up. Repayment is usually in installments. Murabaha has been adopted by many banks as a means of lending that is consistent with Islamic law. However, murabaha is considered illegitimate by some Islamic scholars.
Muzarebat	A partnership between an investor and a businessman in which one provides the money and the other provides the work; profit is divided between the two, while the loss is carried only by the investor.
Qarz-i-hasana	Credit on goodwill terms with no interest
Qarz-i-khudadat	A loan given on the understanding that the debtor will repay when God provides the opportunity.
Salam	A well known form of advanced payment where credit is provided for a future harvest at an already fixed (low) price.

Source: Klijn and Pain (2007); Maimbo (2003)

Islamic notion of sawab (Table 1). They can also be bound up with local hierarchies and patronage arrangements as well as other social networks and may have a role in sustaining exploitative power relationships (Klijn and Pain 2007). An inventory of the traditional forms through which credit is transacted is listed in Table 1. Excluded from this inventory are voluntary donations such as Khairat (voluntary alms), Zakat (obligatory alms), and Hawala services (to transfer funds).

### **3. OBJECTIVES**

In this paper we examine the interface between the newly introduced MFIs and pre-existing (traditional) sources of lending and borrowing in rural areas. We pay particular attention to MFIs as organizations with intended institutional roles in relation to pre-existing institutions with key governance roles in rural livelihoods. A key assumption in our analysis is that the introduced organizations (the MFIs) with intended institutional roles can improve rural livelihoods, given the “right” interface between the new organization (the MFIs) and the pre-existing and mostly traditional institutions such as those described in Table 1. In the analysis we drew on information from secondary sources as well as primary data collected from research in 2007 in the four provinces of Balkh, Kabul, and Bamiyan, and Herat. The research was guided by the following objectives:

- Identify and inventory the traditional institutions that govern lending and borrowing credit
- Investigate the role of microcredit in rural communities
- Assess the interface between MFIs and the traditional forms of lending and borrowing
- Take stock of the changes in rural socio-economic conditions due to introduction of Microcredit

An institutionalist framework based on Hayden’s (Hayden 1982a, 1982b, 1982c) “Social Fabric Matrix” (SFM) and Parto’s (2005a, 2005b, 2008) “Typology of Institutions” is employed to analyze the data from primary and secondary sources. The next section provides a description of these two approaches to institutional analysis and the methods utilized in the collection and analysis of the data.

### **4. METHODOLOGY**

Our analysis is informed by Hayden’s “Social Fabric Matrix” (SFM) and the concept of delivery and process. Hayden (1982b) uses as examples the “components” of electric companies delivering electricity, novels delivering myths, and values delivering belief criteria. Components may deliver more than one “element”. For example, some industries can deliver goods and services as well as carcinogenic substances. Designing an SFM requires first defining the matrix components and their elements. In Table 2 the range “1...n” denotes the elements for each component.

The flows of goods, services, information, funds, and people collectively structure and maintain community relationships. Depending on the subject of study, the SFM that emerges from linking these elements may attribute more or less weight to each element. The system continues to function as long as there is delivery among its elements consistent with natural principles and social rules. A “sustainable” system has continuous delivery and receipt among its many elements. Absence of delivery-receipt relationship among elements undermines the continuance of relationships and can lead to a reconfiguration of the matrix. One main purpose of the SFM is to organize what we know as the basis to identify the key nodes or points in a given system and investigate possibilities for intervention through policy or other means toward more desirable outcomes.

**Table 2. Social Fabric Matrix**

Delivering Component	Receiving Component						
	Cultural Value 1...n	Social Belief 1...n	Pers. Attitude 1...n	Pers. Taste 1...n	Environment 1...n	Technology 1...n	Institutions 1...n
Cultural Value 1...n							
Social Belief 1...n							
Pers. Attitude 1...n							
Pers. Taste 1...n							
Environment 1...n							
Technology 1...n							
Institutions 1...n							

Source: After Hayden (1993)

The completion of the SFM for a research problem should also result in discovering linkages among the components/elements and the identification of weak and strong linkages. Placing a notation of “1” or zero in any cell in Table 2 denotes the existence or absence of a delivery / receipt relationship. If more than one relationship are of interest, each relationship can be accounted for in this binary fashion. The number of cells in the SFM depends on the research or policy problem being addressed, i.e., it is scope-dependent. The boundary for the system represented by a constructed network is thus subjective and delineated by the researcher. Links or relationships between deliveries and receipts are established on the basis of reciprocity, and/or redistribution, and/or exchange.

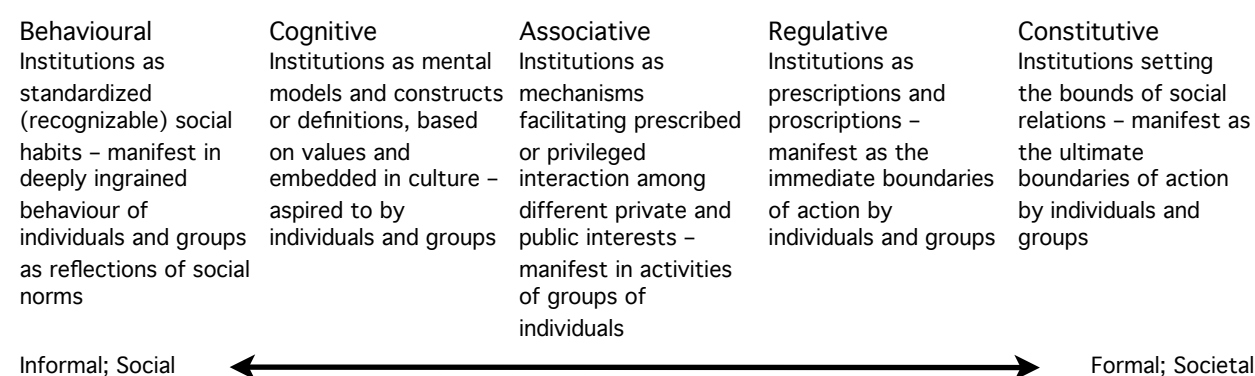
The central nodes are entities or phenomena that are involved in more overlaps, have more reachability to other entities, and generate greater levels of deliveries, in terms of flows, than other entities or phenomena. Using the SFM, it is possible to identify the relevant set of influences that shape the behaviour of a system (Hayden 1998:94). As a means to model action processes, the SFM can be used to select the most important components, or



regulatory factors, through highlighting the delivery and receipt relationships. Depending on the number and importance of the most central node(s), one might speculate about the resilience of the network or the stability of a particular institutional arrangement as a whole, were one or more of the central nodes to be eliminated or diminish in importance.

Consistent with Uphoff and Buck (2006) and Parto (2005a, 2008) this research also employed a notion of institutions as formal and informal structures which collectively organize a community. As such, institutions have relative permanency and longevity (Hodgson 1988, Parto 2005a, Uphoff and Buck 2006) and are manifest as a continuous spectrum consisting of formal, tangible entities (e.g., banks, government agencies, courts) at one end and less formal, intangible phenomena (e.g., customs, norms, and beliefs) at the other. The full spectrum may be depicted as in Figure 1.

**Figure 1. Characteristics and Manifestations of Institutions**



Source: Adapted from Parto (2008)

In this conception, institutions are viewed as reflections of learning in the broadest societal sense (Voeten and Parto 2006, Parto 2005b, 2008). However, once established, institutions structure (constrain and facilitate) further learning in a continuous and interactive auto-catalytic process (Parto et al. 2005). Institutions are thus structuring phenomena and manifest at different levels of inter-relation, scales of governance, and in different spheres of the political economy.<sup>4</sup> Applying the levels-scales-spheres perspective to institutions yields a loose but necessary typology of institutions (Figure 1).<sup>5</sup>

In our analysis we use the typology in Figure 1 in conjunction with Hayden's SFM to identify and map the formal and informal institutions as the components (and their elements) that collectively structure credit transactions in the four provinces of Balkh, Bamiyan, Herat, and Kabul. A full inventory is presented of the constitutive, regulatory, and associative institutions based on reviews of secondary data and interviews with key informants. The information on the cognitive and behavioural institutions comes from the interviews recognizing, however, that more accurate data on these two latter institution types can only come from household surveys of representative household samples, a task which was beyond the scope of this research.

It is important to distinguish between each institution type and its catalyst(s). For example, the introduction of a new regulation on borrowing is not an institution but a catalyst. The

catalyst may, or may not, result in the emergence of an institution which plays a significant role in structuring transactions and has relative permanency. If the regulation on borrowing is not enforced or complied with widely, it is not, for all intents and purposes, “instituted”. In a similar vein, an association which comprises a group of organizations or individuals determined to protect and promote common interests may or may not emerge as an associative institution. If the association persists, actively lobbies on behalf of its members, and succeeds in changing the operating environment for its members, it can be said to have become an associative institution. Sustained lobbying by the association can result in the elimination of old or the formation new regulations (in the broadest sense) to benefit the members and thus the formation and persistence of the regulative institution.

The use of this typology in analysis elsewhere has illustrated that intervention through policy succeeds only if it resonates with the pre-existing behavioural and cognitive institutions within the area of focus for the policy. An important implication of this proposition is that governing to effect systemic change, as intended through the introduction of microfinance in rural Afghanistan, requires a continuum of measures to be pursued jointly through local arrangements and supported by territorially defined levels of government. In the case of microfinance, local arrangements have included the introduction of MFIs in villages while the government and the international donors have provided structural support including funds, expertise, and regulation. The focus of this research has been to assess the compatibility of introduced change with pre-existing conditions.

A total of 32 households were interviewed in the four provinces in addition to a number of “chit-chats” on the streets with random individuals. 33 focus group meetings were organized and 19 key informant interviews conducted with shopkeepers, local government officials, farmers, teachers, mullahs, elders, widows, and MFI staff.<sup>6</sup> The MFIs active in the 4 provinces studied for this research are listed in Table 3.

This research did not focus on specific MFIs in the 4 provinces. Due to time and resource limitations, the dispersion of MFI-originated credit among the MFIs operating in each province, and to maintain confidentiality rules we use “MFIs” as the focal organization with intended institutional functions.

**Table 3. Active MFIs in case study provinces**

Location	MFIs
Kabul	AFSG (Mercy Corps), AMFI (CHF), BRAC, FINCA, MOFAD (Care Afghanistan), OXUS (ACTED), PARWAZ, WWI
Balkh	ARMP, BRAC, FINCA, FMFB, OXUS (ACTED), SUNDUQ (MADERA), WWI, WOCCU
Bamiyan	AMFI (CHF), ARMP, BRAC
Herat	ARMP, BRAC, FINCA, MADRAC

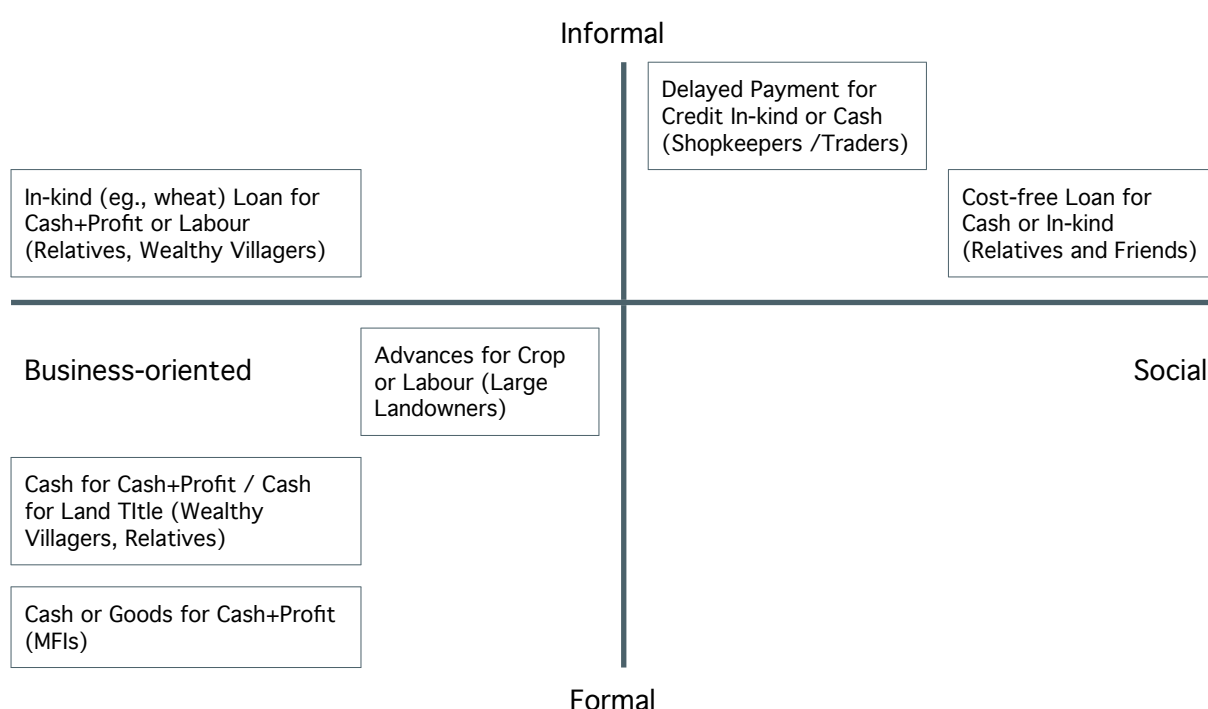
Source: MISFA

The interviews and focus group meetings in each province were organized with assistance from local officials, NGOs, and MFI personnel to examine credit transactions involving MFIs and rural borrowers in more general terms while making every attempt to distinguish between MFI-originated loan types and procedures. Some of key differences in lending arrangements among the MFIs are reported later in this paper.

## 5. DESCRIPTION OF THE CONTEXT: THE RURAL FINANCIAL LANDSCAPE

Using this data, as well as other literature, we look at the formal credit systems alongside existing local and traditional understandings of credit, assistance, repayment, and interest and notions of community/social responsibility. We examine formal and informal credit institutions that collectively structure microcredit transactions in rural Afghanistan. The spectrum of institutions examined include Government measures and organizations which organize or oversee microfinance, banks and other organizations that disburse microfinance, and the customs and norms that govern community behaviour in relation to credit from traditional sources as well as Islamic notions of money lending.

**Figure 2. Traditional Rural Financial Landscape**



Source: Based on Klijn and Pain (2007)

To varying degrees, these traditional transactions can be formal and agreed upon in strict business terms or they could be highly informal and arranged based on kinship and/or social relations.

The introduction of MFIs fits into several of the Afghan Government's key priorities and commitments from the international donors. It is seen as a means for poverty reduction, fostering economic growth and productivity, and the formalization of legitimate economic activities and financial services. Microfinance programs are bound up with the Government's commitment to gender mainstreaming through increasing the participation of women in economic life – many microfinance loans are targeted at women. According to I-ANDS (2005:44-45):

The Afghan economy is dominated by the informal sector (as it is the case in many neighboring countries, such as India), running across all areas of production, but particularly the small holder economy.... Exchange of services and products between rural households is widespread, and women perform a major part of this work.

It remains open to debate whether attempts to formalize economic activity have been successful or indeed desirable, particularly given the fact that formalized borrowing through MFIs can lead to a strengthening of traditional forms of borrowing due to pressure on borrowers to make their repayment installments, forcing them to borrow from traditional sources.<sup>7</sup> Table 4 shows the World Bank's (2007) conceptualization of the range of traditional ("informal") economic transactions that make up the largest part the Afghan economy. The range of traditional transactions considered most nefarious are grouped in the "illegal" category. The chart is highlighted here because it exemplifies the way legitimate or desirable economic activity and exchange can be perceived through the lenses of "formality" and "legality".

Table 4 is useful for categorizing the financial transactions that take place outside the formalized and registered sector. However, it does not fully capture the fact that these are social as well as financial transactions. Attempts through policy or other means to effect lasting change need to better resonate with these pre-existing conditions either by charting ways of working through social relations or by devising new institutional forms that compete with and, ultimately, replace certain traditional institutions deemed as detrimental to the emergence of a re-aligned, legitimate, accountable, transparent, and productive political economy as part of the larger agenda of post-conflict reconstruction.

Credit from traditional sources spans all of the categories in Table 4. Traditional loans may often take the form of in-kind transactions between households, placing them in the category of "in kind activities", but credit linked with the opium economy and the salaam system is also a well known form of traditional advance on a crop. Klijn and Pain (2007) point out that it is partly the informality of transactions in the opium economy that has led to a condemnatory attitude toward the traditional financial sector as a whole. This attitude is based on a lack of transparency in the hawala transaction system as well as the use of this system as a means for money laundering, largely from illicit activities centered around the opium economy. Nevertheless, a condemnatory attitude toward traditional means of transactions runs the risk of overlooking the need to work through and change the pre-existing institutional forms prevalent in rural economies and through which credit giving and borrowing have traditionally been conducted.

**Table 4. Range of Informal Activities as defined by the World Bank**

ACTIVITY	MFIs
In kind'	More or less legal. Examples: Subsistence agricultural output; sharecropping; services such as blacksmith, carpenter, thresher; non-monetized exchange of goods and services between households.
Extra-legal'	Output and production with potential for formalisation. Small scale transactions often involving casual labor. Examples: Money exchange dealers; small shops and traders; small manufacturing; agricultural production; construction; registered NGOs that are actually for-profit entities; economic activities of Kuchis.
Irregular'	Further away from legality. Production and transactions that break aspects of Afghan law. Examples: trade in illegally exploited resources, such as illegally harvested timber or illegally mined emeralds; illegal use of gravels and construction materials; smuggling; re-export of Pakistani imports back into Pakistan.
Illegal'	Output that is outright illegal. Examples: opium; bribe taking by officials; people trafficking; prostitution; forced labor; excavation and theft of archaeological artefacts; arms trafficking; land seizures. Activities encompass 'war economy' (financing war and insurgency) and 'black economy' (run for profit).

Source: World Bank (2005)

Understanding the interaction dynamics between introduced and traditional / pre-existing institutions requires extensive and in-depth knowledge of these institutions. In the case of credit, particular attention needs to be paid to social network arrangements and traditional values that govern borrowing. These aspects can be captured reasonably well through mapping the institutional landscape as illustrated later in this paper.

Our focal organization in this study, MFIs, are the operational arms of the MISFA set up in 2003 to build a system to provide flexible, timely, and affordable finance to the poor as a means to alleviate poverty throughout Afghanistan. Table 5 is a list of MFIs active in Afghanistan as well as the number of clients per MFI and the value of loans. Information is not available for a provincial breakdown of MFI loan portfolios and the number of borrowers.

**Table 5. Microfinance institutions (MFIs) in Afghanistan**

NAME	GROSS LOAN PORTFOLIO (US\$)	NO. OF ACTIVE BORROWERS
AFS	925,905	6,217
AMFI	1,178,618	3,362
ARMP	16,889,524	30,346
BRAC - AFG	20,780,335	138,625
CFA	1,743,375	10,430
FINCA - AFG	6,192,768	27,570
FMFB - AFG	17,609,421	16,955
Hope for Life	Unknown	Unknown
MADRAC	1,195,027	8,249
Monad	966,520	4,499
OXUS - AFG	805,522	5,621
Parwaz	734,834	7,138
Sundug	724,417	3,660
WOCCU - AFG	844,609	1,869
WWI - AFG	1,266,941	10,773

Source: <http://www.mixmarket.org/en/demand/demand.quick.search.asp>, accessed December 30, 2007

## 6. ANALYSIS

Traditional lending is by far the most common way of acquiring credit for rural Afghan borrowers. Many of these forms of credit are given in kind. The National Risk and Vulnerability Assessment (NRVA) 2005 which surveyed over 30,000 households found that traditional (informal) credit was an important source of income allowing households to cope with unforeseen circumstances or opportunities. Thirty-eight percent of all households interviewed reported having taken a loan from traditional sources in the year prior to the survey. Moreover, the assessment found that informal loans were more commonly taken on by rural (42 percent) than by urban (25 percent) households, concluding that “these figures are indicators of a strong social network in rural areas in comparison to urban areas” (NRVA 2005:40).

The survey also asked households to report the use to which their largest informal loan had been put. The largest portion of loans was used for food purchases, indicating the role of credit in consumption smoothing and the possible impact of food insecurity on demand for credit. The impact of food security and agricultural productivity on demand for credit was further suggested by the fact that of rural areas, households in the Paktika province had the largest number of loans (96 percent) used for purchasing food, whereas the Kunduz province, an area of agricultural surpluses, showed the lowest occurrence of loans (27 percent) used for food purchases. In the urban areas, the use of loans to purchase food was less prevalent, and more households used their loans for business purposes.

MISFA was set up in 2003 at the invitation of the Government of Afghanistan to pool diverse donor funding mechanisms and to convert funds into streamlined and flexible support to MFIs in Afghanistan.<sup>8</sup> MISFA serves as the means for the Ministry of Rural Rehabilitation and Development (MRRD) to build up the lower end of the financial sector through programs to formalize at least a significant portion of microfinance, including microcredit, in rural Afghanistan. Specifically MISFA was set up to

- Coordinate donor funding so that the conflicting donor priorities endemic in post-conflict situations do not end up duplicating effort and distorting markets,
- Help young microfinance institutions scale up rapidly, offering performance-based funding for operations and technical assistance, and
- Build systems for transparent reporting and instill a culture of accountability.

In addition, MISFA's mandate is to provide technical support to MFIs and to monitor performance against the three main goals of scaling up as rapidly as possible to serve poor people throughout Afghanistan, especially women; to use public funding to invest in institutions (MFIs) that would become sustainable and able to grow further without requiring more subsidies; and to make a transition from international organizations with microfinance expertise to Afghan organizations with local expertise. MISFA receives its funds from the Canadian Government, the British Department for International Development (DFID), the Consultative Group to Assist the Poor (CGAP) of the World Bank, the Swedish International Development Cooperation Agency (Sida), USAID, and the Dutch Oxfam N(o)vib.

As of September 2007, MFIs were active in 23 provinces (106 Districts) and had active clients totaling 405,099. The number of women clients stood at 269,743 (70% of the total). A total of 882,103 loans had been disbursed for a cumulative value of \$317,226,364. The outstanding loans total \$94,572,179, distributed as follows: Trade and Services (\$56,876,378), Household consumption – food, medical, house repair, education, etc. (\$2,629,229), Handicrafts and Manufacturing (\$12,848,158), Agriculture (\$7,846,699), Livestock (\$12,887,654), and Other (\$1,484,061).<sup>9</sup>

The performance of MFIs (and MISFA) has been evaluated as favourable by the World Bank, albeit inconclusively. A synthesis of performance by MFIs in different provinces based on a survey is expected from MISFA in late 2008. It has to be noted that performance surveys to date have focused on the financial sustainability of MISFA and its MFIs and not the livelihood impacts of MFI-originated loans in rural Afghanistan.

The rationale for the Government of Afghanistan and its international donors to promote microcredit is based on an assessment of the post-2001 period as having “a huge unmet demand” for microfinance. In December 2001, according to MISFA,

...the picture looked bleak with a non-functioning financial sector, a total absence of commercial players willing to serve the poor, and lack of delivery capacity among existing Microfinance Institutions (MFIs). [F]oreign donors were asked to step in. The issue facing everyone – foreign donors and Afghans alike – was how to meet that demand and energize the development of an entire microfinance sector that will serve the Afghan people beyond tomorrow.<sup>10</sup>

Previous research (Maimbo 2003, Hanifi 2004, Lyby 2006) suggests that the situation as described in the above quote from MISFA was not, and has not been, the case since 2001. Informal commercial financial services and credit have been operating in Afghanistan for hundreds of years. A study of cash, credit, debt and state-society relations in nineteenth century Afghanistan found that a number of social groups and financial institutions and instruments were associated with cash, credit and debt (Hanifi 2004). One of the informal financial services that has attracted most attention is the hawala system. The same historical study found that "In terms of credit, the key fiscal instruments were bills of exchange known in Afghanistan as hawalas ...that circulated widely within and moved regularly through the country" (Hanifi 2004: 200). A World Bank (Maimbo 2003: 8-9) study of hawaladars in Kabul in 2003 notes that:

Local money exchange dealers can be found in almost every community in Afghanistan. Traditionally, these dealers provide the community with numerous financial services in addition to funds transfers, for which they have attracted much attention. They also provide deposit-taking facilities for those who want to save, microfinance for informal entrepreneurs, trade and finance for wholesalers and retailers; and currency exchange services for international business and personal transactions.

There has been an assumption that credit from traditional sources is more expensive than credit from MFIs. Derogatory phrases like "money lender" and "loan shark" have been used to describe some traditional lenders. But these terms do not explain the full range of credit services available to Afghans from traditional sources or the costs involved in borrowing on traditional terms. Reportedly, the interest rates charged for formalized microcredit loans are much lower compared to the rates offered by money-lenders. In Bangladesh, where Grameen Bank charges between 15 to 35 percent on the average loan, one author described these loans as "the only alternative for the poor to local moneylenders who regularly charge 10 times that amount" (Synovitz, RFERL, March 30 2007). However, there are no estimates provided by MISFA of the average cost of MISFA loans relative to the average cost of traditional credit in the regions where MISFA partners operate. This is a significant omission since some forms of traditional credit carry no interest or time limits on repayment (see Table 1).

It is often the case that hawaladars, and other sources of credit for business and trade purposes charge effectively more interest than MFIs. But, there are also indications that even in the case of hawaladars, this may not always be the case. Maimbo (2003) notes that the degree of competition in the market may have been bringing down charges for all hawala services, including loans. He also cites one hawaladar serving mostly large organisations claiming not to charge interest on loans at all, owing to "the Islamic prohibition against charging or receiving interest on loans and deposits" (Maimbo, 2003: p11). In any case, there is little evidence on the cost of lending in the informal commercial sector in Afghanistan. There is, however, evidence presented by Klijn and Pain (2007) on informal credit suggesting that rural households have access to loans from family, friends and community trust networks on better terms than microcredit loans or, in the case of qarz-e-hasana, with no charges at all.

Although microfinance continues to be discussed as a tool to fight poverty through acting as a mechanism to include the rural poor in mainstream economic activity, it is generally not targeted at the poorest groups. A World Bank study of microfinance and gender roles in

Afghanistan in 2006 noted that loans were not reaching the “ultra poor”. The report goes on to explain that fighting “abject poverty” is not the aim of microfinance worldwide, noting that the Consultative Group for Assistance to the Poor (CGAP) changed the last word in its name from “Poorest” to “Poor” in recognition of this fact (Lyby, 2006: p 21). This is confirmed by Klijn and Pain (2007:51), who point out that whereas informal alms are accessible to the very poor, “both informal credit systems and formal micro credit will exclude the effectively destitute.” Thus, while “the village moral economy clearly provides assistance to such people; micro credit does not address this group, nor does it aim to.”

Primary data used in this research suggest that even the middle and higher income families targeted by microcredit are not necessarily drawing the intended benefits from these loans, with noted exceptions in Herat (see Klijn 2006). Knowledge of MFIs’ borrowing rules and eligibility criteria appears to be a factor in how effectively a borrower uses the money and assesses the ability to repay. A general lack of understanding of the rules by borrowers was noted during the interviews. The Bamiyan case indicates that a significant portion of the borrowers and potential borrowers are unclear about the rules on borrowing. In part, this is due to variation in the form of guarantee required to secure MFI loans as each MFI operating in Bamiyan has its own set of rules based on loan size.

MFIs in Afghanistan, as in other countries worldwide, often concentrate on loans to women as a means to increase women’s participation in economic activity beyond the household level:

In the implementation of micro-credit schemes, the Government will continue to pay particular attention to women, aiming to expand the number of female beneficiaries relative to men and encourage mechanisms for group savings. (I-ANDS 2005:94)

Some 70 percent of loans distributed in Afghanistan so far have been given to women. Women’s loans are distributed in groups of women with the aim to enhance women’s social mobility and participation in the economy. However, as we report later in this paper and as pointed out in other research, such aggregated statistics used outside their social and family contexts can exaggerate the positive impact of microcredit on women. Lyby (2006:1) states:

...Although most loans are given to women, the limitations faced by women with regard to gender roles in most regions ensures that the men continue to be actively involved when it comes to buying or selling goods in the market, even if the credit is received in the name of the woman. This has led to concerns as to whether the women merely serve as fronts or conduits of resources that effectively go to the men.

Lyby (2006) nuances this observation by suggesting that there may be, nevertheless, indirect benefits accruing to women from microfinance in terms of joining other women in borrowers’ groups and training. Benefits to women may also be a by-product of a family’s increased economic productive capacity facilitated through microcredit. Lyby (2006:36) also reports that while men more commonly made the decision on how to spend the loans distributed to the women in their families, the number of women making this decision was significant. According to this report, a high number of women reported that the decision on how to spend the loan was discussed in the family. Women interviewed by Lyby (2006)



reported improvements in their wellbeing and status in the family with one woman reporting that she felt more appreciated by the men in her home and was now consulted on financial matters, as a result of receiving microcredit.

Part of the rationale for introducing microcredit is that loan sizes can be larger and thus more likely to have an impact on economic productivity. A large number of borrowers in the Kabul, Herat and Balkh provinces, however, complained that microcredit loans were too small to invest in significant productive assets, especially given the frequency of repayments. In Bamiyan it was reported that some MFIs offer larger loans with a longer grace period before repayment. Lyby (2006:35) also reports that: "[M]any men and women said the loans were too small to really make a difference, and additional money was frequently needed from other sources in order to start a project". Some interviewees reported that small-sized loans had a corrupting effect on powerful individuals who had become loan group leaders. Some of these leaders reportedly borrow from MFIs on behalf of the group but hoard the loan for their own personal use. These findings may indicate a failure of MFIs to effectively identify and respond to the needs of the different income groups they are intended to serve.

More generally, MFIs have not displayed significant changes to their programs based on the feedback they have received from their clients or the limited research on microfinance in Afghanistan. There is incongruence between client needs and program structures, evident in client behaviour of bypassing program rules by borrowing through more than one borrowing book, as well as the seemingly high percentage of non-returnee clients, mostly due to the non-fulfillment of initial expectations from taking a loan or disqualification to borrow due to inability to repay previous MFI loans. Also, in the Bamiyan case it was reported that a number of borrowers get around borrowing rules by, for example, forming groups so that one individual secures access to a large loan. This illustrates the continued importance of social networking arrangements in credit transactions.

Research in the four provinces points to the need for a client-led approach to service delivery in credit provision. The only example that comes close to a client-led approach is the MFI in Bamiyan which developed a lending system that follows the natural cash flow of the community, based on economically active summer and non-active winter months. Another example of systemic planning from the Bamiyan case is the MFI that offers larger loans and enjoys greater client satisfaction due to its transparent program characteristics. It has to be noted, however, that the generally higher level of satisfaction with MFIs operating in Bamiyan is likely accentuated by a less severe environment of risk (see Section 6, below).

The key observation in the Bamiyan and other cases is that MFIs in general have not yet taken steps to monitor and evaluate the impact of their products, which must precede steps taken towards an adaptation of programs to local context. Indeed, a focus note published by CGAP<sup>11</sup> emphasizes the importance social performance indicators to measure microfinance success. The conceptualization of the idea is still in its infancy and actual changes in the day to day operation of MFIs may be a while in coming.

One of the main claims in promoting MFIs in rural economies is to lessen the negative livelihood impact of high interest (monetary or in kind) charged on credit from traditional

sources. While this is certainly true in some cases, and compounded by ecological factors such as droughts, a challenge faced by MFIs is the public perception that the *sudh* (interest) payable on loans is viewed as *haram* (sinful) in the Koran, even if the *sudh* is lower compared to the interest paid on loans from traditional sources. A meeting with a Mullah in Bamiyan confirmed the sinful perception of MFI loans, with the Mullah declaring that any loan over a fixed period with an interest charge was *sudh* and therefore disallowed by the Koran. Similar instances were reported in Herat. During the field visit for this research in Herat an MFI was said to have had to withdraw entirely from one village after the local Mullah posted the following message around the village condemning *sudh* charged on loans dispersed by MFIs as *haram*:

We, the ulema and elders, declare that MFI loans are *haram* because of *sudh*. We request that people refrain from taking out MFI loans. Those who already have loans are asked not to take out further loans. (Sign posted in the Pashtun Zargun District, a similar sign was sighted in the Guzara District)

This announcement was said to have been made after borrowers had reported difficulty in making their MFI loan installments, some having resorted to selling assets to make payments.

There are a variety of possible interpretations of what constitutes *sudh* according to Koranic law, and therefore what kind of credit is forbidden, and what kinds permitted. This often depends on the interpretation by individual Mullahs, rather than a locally specific feature: some Mullahs view interest on loans as *haram* while others are more tolerant of it. There is, at the same time, evidence to suggest that some MFIs have made significant attempts to come to terms with the negative public perception of MFI-originated loans. In the face of opposition from Mullahs, for example, some MFIs operating in Bamiyan and Balkh have obtained fatwas from Islamic scholars declaring their operations as being consistent with Islamic law. Also, in recognition of religious prohibitions of charging interest, some MFIs provide *murhaba* style loans whereby the MFI buys products for its clients but adds a prearranged mark up based on the accumulated interest that would have been accrued for the duration of the loan. In the case of other MFIs, however, many non-borrowing respondents identified the issue of *sudh* as the determinant for their decision not to take interest bearing loans.


MFIs frequently rely on traditional mechanisms to launch a new operation in new villages. Many loan officers reported organizing introductory meetings in local mosques to spread awareness of the MFI being introduced in their communities. Local authority figures such as the Maliks and village elders have also been noted to facilitate the establishment of MFIs. These processes can sometimes affect the flow of information to women, who are not involved in these initial meetings but who are deemed as a main group of target clients by the MFIs.

## 6.1 INSTITUTIONAL AND ORGANIZATIONAL MAPPING

Definitions of formality and informality, such as those described in Table 4, do not fully capture the full range of institutions through which the giving and receiving of credit is governed, since these transactions are structured by individual as well as collective mental models and rules. Many of the institutions with which MFIs interact are not informal at all, such as the functions of Islamic leaders and maliks, or the hawaladars, for example, but still involve the confrontation of new formalized interventions with more deeply rooted and traditional understandings of the way things are done.

Figure 3 offers a more nuanced typology of the relevant institutions affecting and being affected by credit transactions. This perspective on institutions is used to identify (Figure 4) and map (Figure 5) a fuller range of institutions that collectively govern credit transactions as follows.

**Figure 3. Typology of Credit Institutions**

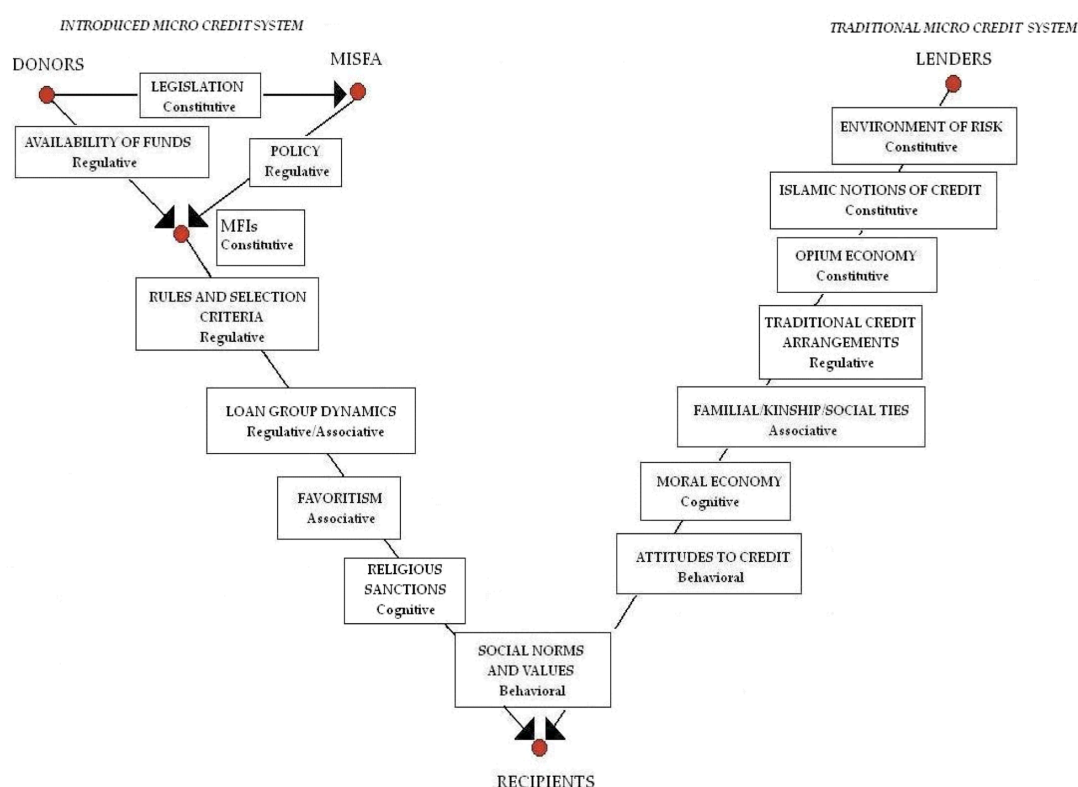
	INSTITUTION TYPE	EXAMPLES
Informal Social 	<b>Behavioural:</b> Standardized (recognizable) social habits – manifest in deeply ingrained behaviour of individuals and groups as reflections of social norms	Understandings and internalization of “how things are done” based on cultural (including religious) values such as the notions of halal (permissible) and haram (impermissible)
	<b>Cognitive:</b> Mental models / constructs or definitions, based on values and embedded in culture – (to be) aspired to by individuals and groups	Islamic notions of charity and community responsibility such as ashor (khoms in Shiaism) and zakat, both requiring that a portion of earned and accumulated wealth be given up to support the poor
	<b>Associative:</b> Mechanisms facilitating prescribed or privileged interaction among different private and public interests – manifest in activities of groups of individuals	Community and familial trust networks that facilitate interactions and transactions
	<b>Regulative:</b> Prescriptions and proscriptions setting the bounds of social relations – manifest as the immediate boundaries of action by individuals and groups	Formal regulative environment such as legislation and judicial capacity that facilitate interactions and transactions; rules and arbitration mechanisms laid out and conducted by elders, maliks or shuras to regulate transactions and interactions
Formal Societal 	<b>Constitutive:</b> Prescriptions and proscriptions setting the bounds of social relations – manifest as the ultimate boundaries of action by individuals and groups	Formal microfinance organisations and banks – formal and inflexible understandings of repayment schedules and interest; human / civil rights of individuals governed at the most fundamental level in the land

Source: Adapted from Parto (2008)

### 6.1.1 INSTITUTIONS OF MICROCREDIT

Two main sources of credit were identified: Introduced Microcredit System through MFIs and traditional forms of lending, grouped together under Traditional Microcredit System (Figure 4). Secondary data and field research data gathered through interviews and focus group meetings were used to identify the plethora of institutions that collectively govern microcredit transactions.

**Figure 4. Institutions Governing Microcredit Transactions**



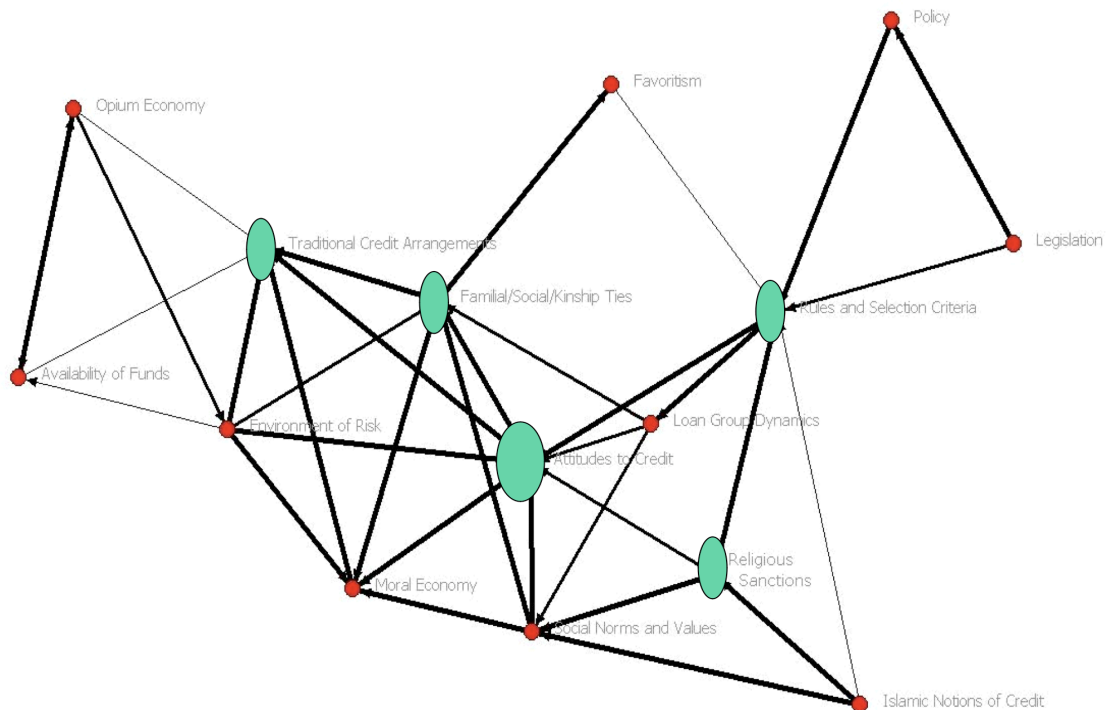
MFIs-originated credit (on the left) and credit from traditional sources (on the right) are characterized according to the typology presented in Figures 1 and 3. Using Hayden's SFM method the role(s) of each institution in relation to other institutions is mapped (Figure 5) based on three simple criteria of Strong (3), Moderate (2) or Weak (1) relation (See Table B1, Appendix B).

The main purpose of the map in Figure 5 is to highlight the institutions most instrumental in credit transactions from introduced (MFIs) and traditional sources. 15 institutions were identified and used to generate this map (Appendix C). The blank cells in Table B1 (Appendix B) indicate no relation between the listed institutions. The descriptions of the institutions used to generate Figure 5 and the assumptions underlying the numerical values given to a given relationship with other institutions are explained in Appendix C.

Based on the mapping of institutions in Figure 4 we can make the following observations:

- The behavioural institution, "Attitudes to Credit" (Figure 5) is manifest as a set of recognizable social habits based on deeply ingrained values. Attitudes to Credit occupies a central place in the institutional landscape of credit transactions. This suggests taking root in rural communities by MFIs depends very much on how they come to terms with, or overcome, the instrumental role played by Attitudes to Credit in structuring the relationship between lenders and borrowers. Deeply embedded social norms and values are at best very difficult to change. Change may be possible through introduction of systemic incentives over a long period of time, possible generations.

**Figure 5. Institutions of Microcredit**



- The cognitive institutions, "Religious Sanctions" and "Moral Economy" prescribe in ideal terms "doing the right thing" in lending and borrowing based on long-held traditions. Change in or replacement of these institutions is possible through the introduction (with incentives) of new ways of doing things. Educational and public awareness programs and campaigns can be used to promote new mental models on how things ought to be and what new ways of doing things could be aspired to. Establishing new mental models takes a long time and can conceivably happen within one generation. It may take generations for a new mental model to become a shared mental model and ultimately a behavioural institution.
- The associative institutions, "Favouritism", "Familial/Kinship/Social Ties", and "Loan Group Dynamics" are products of instrumentalism by the actors involved to facilitate prescribed or privileged interactions and pursue common interests. Because these associations are interest-based and instrumental, it is possible to introduce incentives and disincentives to constrain or enable the actors involved. Change can be effected relatively easily to discourage favouritism and redefine loan group dynamics. Changes in familial/kinship/social ties are more difficult to establish.
- The regulative institutions, "Rules and Selection Criteria", "Policy", and "Availability of Funds" are prescriptions and proscriptions setting the immediate boundaries in societal relations and are enforced through public sanctions. In microcredit transactions, these institutions are all newly introduced. Changes in these institutions are relatively easy and can happen almost immediately. The regulative

institutions, "Loan Group Dynamics" and "Traditional Credit Arrangements" are products of behavioural and cognitive institutions and, as such, are more difficult to change. Change would require the introduction of systemic incentives and disincentives.

- The constitutive institutions, "MFIs" and "Legislation" are prescriptions and proscriptions setting the ultimate bounds of societal relations in microcredit. They are promoted and enforced through political structures and measures, ecology, geography, and place-specific mental models. Change in any of these institutions is relatively easy. In contrast, "Opium Economy", "Islamic Notions of Credit", and "Environment of Risk" are generations-old fundamental structuring phenomena, established by ecology, religion, and conflict. Change in these latter constitutive institutions is highly dependent on changed material and physical conditions and likely to take generations.

Changing the properties of the network mapped out in Figure 5 requires change in the main nodes such as "Attitudes to Credit", "Opium Economy", "Islamic Notions of Credit", and "Environment of Risk". But, these institutions are arguably the hardest to change, mainly because change would require a long time, a lot of resources, and long-term commitment by those wishing to effect change, i.e., the Government and its international donors. The introduction of a modern banking sector in opposition to the traditional arrangements can violate traditional norms and values, causing tensions with powerful traditional actors such as Mullahs or opium smugglers. To overcome these tensions, innovative ways of engaging powerful traditional actors need to be devised based on an appreciation of and respect for context-specific values, norms, and local conditions. This is particularly the case with illegal poppy growing as an established and ecologically sustainable economic institution. Despite the strong international stance against poppy growing in Afghanistan, the elimination of the opium economy may simply not be an option, at least in the short term.<sup>12</sup> Some have suggested at least part-legitimization of poppy growing as a means to control it and a source of income for reconstruction efforts (Senlis Council 2007).

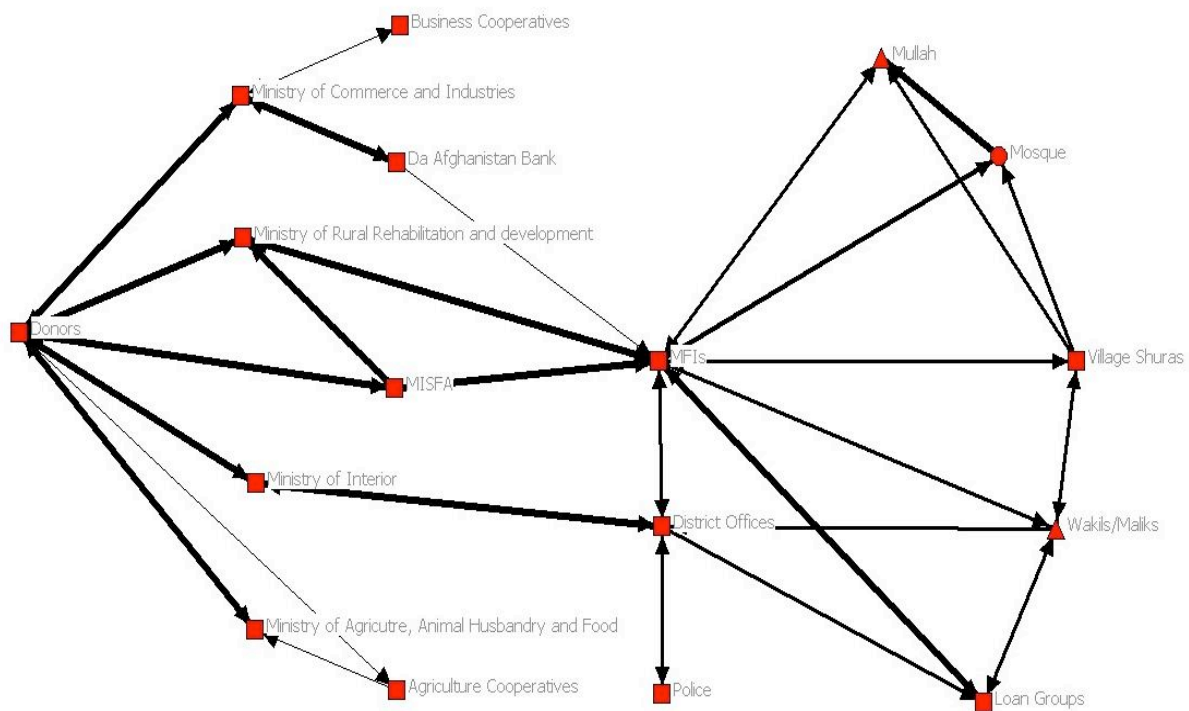
Understanding institutions of microcredit as outlined in this section also suggests that access to finance by rural Afghans is not "the solution" to rural poverty. Microfinance needs to be viewed as one of many factors including access to basic services such as health and education or adequate infrastructure, necessary to create an enabling environment for the rural communities to help themselves. The main policy lesson here is to appreciate institutional complexity and have low expectations in setting policy objectives, while persisting over the long term and work with and through traditional institutions that govern credit lending and borrowing.

### **6.1.2 ORGANIZATIONS OF MICROCREDIT**

There are some variations among the organizational entities (MFIs) involved in microfinance transactions in the four provinces. At a formal level the legislation and the rules that MFIs operate under are standardized and prescribed by MISFA. In practice, however, how the rules are enforced by individual MFIs and how the borrowers respond to these rules vary and depend on the MFI, MFI personnel, and the operating environment.

The following map (Figure 6) displays the relationship between the organizational entities dealing with microfinance in the four provinces. One key difference among the provinces is the make-up of the MFIs active in each province (see Table 3, above).

**Figure 6. Organizations of Microcredit**



The map in Figure 6 illustrates the linkages between MFIs and other local and extra local organizations and individual actors. The thickness of the linkages is based on four parameters: existence of relations (0 or 1), information exchange (0 or 1), influence (0 or 1), and resources (0 or 1) among the organizations that have a bearing on microcredit transactions (see Table B2, Appendix B). What the map cannot show is the net impact of influence and information. To illustrate, MFIs routinely make contact with the local shuras, mullahs, district offices, and so forth before starting operation in a new location. There is a connection, a flow of information, and perhaps some influence from a given MFI toward other organizations and actors as far as making a convincing case to start operations. But, as was the case in Herat, if a mullah announces taking MFI loans is against Islamic values, the mullah's influence on the affected MFI cannot be captured by this map. If there is a clash of influences from the mullah and the MFI, it is impossible to determine who benefits from the net impact.

That said, Figure 6 adequately captures the lack of co-ordination, or indeed any connection between different organizational entities, e.g., different government ministries, that could potentially and positively affect service delivery in the microfinance sector. The Ministry of

Agriculture, Animal Husbandry and Food and the Ministry of Commerce and Industries are the two most prominent ministries that should be important government organizations in the operation of MFIs. Since agriculture is the mainstay of the majority of the population that access formal credit, some coordination between these ministries would be desirable. Similarly, the Ministry of Commerce and Industries, and organizations operating under it for the promotion of business activities, such as the Afghan International Chamber of Commerce (AICC), among others, do not have any form of organizational coordination with MISFA, or any of the individual MFIs operating in the same area. Despite having offices in all of the four provinces studied, the AICC did not appear to have any contact with the MFIs operating in the area.

At the time of writing the governance of MFIs is solely under the Ministry of Rural Rehabilitation and Development (MRRD). The rules and regulations that govern MFIs are a nebulous mix of laws that apply to NGOs as well as commercial enterprises. Currently, the monitoring and evaluation of different MFIs is done via independent monitors and consultants. As commercial enterprises, the governance of MFIs should adequately fall under the Ministry of Commerce and Industries. Da Afghanistan Bank, the central bank of the state and a key implementing partner of the Ministry of Commerce and Industries, is said to be poised to take over the governance of MFIs. However, these steps had not materialized in 2007 when the research for this paper was underway. MISFA remains the premier governing body under MRRD for the operation of microfinance in Afghanistan.

The lack of coordination among line ministries is not limited to microfinance. Numerous studies on post-2001 Afghanistan have underlined a general lack of coordination among line ministries as a major impediment to reconstruction efforts.<sup>13</sup> The existence of MISFA as an apex organization and as one that has continual interactions with the ministries and the international donors can and should be used as a platform to effect more cohesion among the ministries. This would require instituting formalized lines of reporting and accountability between MISFA and the ministries.

At a lower level of analysis, the activities of individual MFIs are also largely uncoordinated. The MFIs operating in the different provinces did not appear to be related to each other in any way. Numerous borrowers claimed that while being approved for a loan, they were asked if they had taken a loan from any other MFI, but were unaware of any follow-up or corroboration of their claims. Many households interviewed in field visits stated that they were able to access loans from more than one MFI operating in their area. This leads to the conclusion that MFIs not only enter a market populated by traditional credit products as just another provider, but are also in competition with one another. This lack of coordination among MFIs is by design, however, and a product of MISFA's desire to promote open competition among MFIs so as to maximize choice in the range of credit products available to potential clients. The resultant duplication of services, however, does not necessarily result in better service delivery or an adaptive business model that takes clients' needs into account. Loans from one or more MFIs may be the last resort for a constrained borrower unable to borrow from other sources. Arguments for increasing consumer choice as the way forward must take into account the factors that constrain choice making for the more desperate borrowers.



## 6.2 DISCUSSION

In Afghanistan MFIs entered communities with the assumption that there is sizable unmet demand for microfinance. The analysis of the information from secondary sources and the from the field visits undertaken for this research suggests that MFIs entered an already sizable credit market as just another product. The establishment and sustainability of MFIs depends squarely on how MFIs as new challengers manage to find their niche and fit in with the key institutions that govern transactions in a pre-existing market dominated by traditional credit providers. To illustrate, reducing the influence of traditional credit sources as a means to capture a part of the market for microfinance requires introducing incentives to make MFI loans and other financial schemes more competitive and attractive to the prospective borrowers. In the longer term, institutionalization of MFIs is contingent on how effectively long-established social norms and values are changed in favour of borrowing from microfinance organizations. This is not a task to be left only to MFIs, but a challenge for reconstruction programs to provide other necessary elements, such as improved infrastructure and addressing the many-faceted water and land issues, conducive to increased economic activity.

Unchecked, microcredit from MFIs can become parasitic in combination with credit from traditional sources, with traditional credit being used to pay off MFI loans. There is also evidence to suggest that the reverse, with MFI loans being used to pay off loans from traditional sources, also takes place. Similar examples have been found in studies of microcredit loans provided in Bangladesh (Klijn and Pain 2007). Inter-reliance between microfinance from MFIs as a formal process and traditional systems also extends to the grass roots implementation of microfinance loans. Traditional community relations and trust networks are sometimes used to bend the rules in the implementation of microcredit, for example. Loan officers are sometimes from the same communities as borrowers, and are therefore part of the same community trust networks as the borrowers themselves. Working through these relations, some borrowers are able to take out more than one loan, or higher amounts and, through this process, reinforce the inequities evident in traditional power relations centered on gender, tribal connections, and wealth. Several loan officers interviewed in the four provinces reported that, based on trust and favouritism, they sometimes give borrowers more time to repay because of difficulties to meet repayment obligations.

Evaluations of the performance of microcredit loans appear to be preoccupied with the criteria of repayment. A recent publication (World Bank 2007) makes reference to a 95 per cent loan repayment rate, the fact that the microfinance sector as a whole is already covering 89 per cent of its costs from its own income earned from lending activities, and that some of the microfinance institutions have already reached operational self-sufficiency, suggesting that it is expected that most of the other MFIs will achieve financial sustainability by the end of 2008. Clearly, the financial sustainability of MFIs operating under MISFA is prioritized over measuring the sustainability of loans in terms of income generating gains to the borrowers. This preoccupation with repayment, coming from the highest donor and policymaking levels, is reflected in implementation by MFI staff in rural Afghanistan. All loan officers interviewed appeared to be under pressure to secure repayment, with reports in two locations that one MFI was docking loan officers' wages when clients failed to repay.

Unless microfinance leaves households with more productive assets than they had before the loan, it is difficult to conclude that there has been an overall positive impact on rural livelihoods, despite instances of microfinance being productively used in some cases such as Herat. Due to acute poverty in many rural areas, compounded by external factors such as droughts and persistent civil and military strife, households often spend microcredit loans on consumption smoothing needs. In Herat, one borrower reported that she had taken out a microfinance loan to help pay for her son to get married, a story that was echoed in research from other provinces. Some borrowers spend all of their loans on consumption, while others divert portions of the loan for this purpose. If widespread, consumption smoothing based on credit from traditional sources and MFIs results in leaving the borrowers worse off than before. Desperate borrowers would borrow from anyone willing to lend, regardless of their future ability to repay. Those in debt and under pressure to repay may be forced to liquidate livestock and other assets or marry off, in some cases, their daughters to annul their debts, an outcome diametrically countered to the rationale of institutionalizing MFI credit as a means for increased income generating capacity and livelihood betterment. To be sure, MFI-originated loans alone cannot be expected to work around the pre-existing institutions that govern credit transactions in rural Afghanistan.

Microfinance is often presented as a way of fighting poverty, but it is not aimed at the very poorest groups, since ability to repay, and to successfully invest in productive assets are often beyond the reach of the very poorest. An implicit argument for microfinance programs including microcredit is that if they succeed in improving local economies as a whole, there are likely to be benefits for the poor through the trickle down effect. This research found, however, that it is possible that the strength of the local economy might have a decisive effect on the success of microfinance loans, rather than the other way around. Microfinance may be more successful in areas with a healthy existing market for a given crop or commodity, such as amongst potato farmers in Bamiyan, than in communities with a poorly functioning local economy. This suggests that, for microfinance schemes and programs to take root locally with tangible net benefits for the borrowers and the local economy in the longer term, pre-existing economic conditions would need to be better than poor and destitute – a relatively productive local economy is less conducive to consumption smoothing practices.

Credit and assistance from traditional sources, on the other hand, have been noted to have a positive impact on the livelihoods of the very poorest households in the community. The traditional sources of credit and assistance networks that support the poorest Afghan households are important features of the resilient livelihood strategies adopted by the Afghan poor under extreme conditions. Conclusive and comparable evidence does not yet exist to suggest an overall positive impact of microcredit on borrowers or the wider village economy. There is insufficient evidence to conclude that MFI-originated microfinance has resulted in making the rural poor, as a target group, more enterprising and economically more productive. This points to a need for more studies, spanning a longer period of time and covering larger samples of the population, to more accurately establish the benefits accrued to the rural poor through availability of loans from MFIs and in conjunction with credit from traditional sources. A longitudinal study is likely to capture the dynamics of loan cycles, drop out rates by borrowers and lenders from the system, and changes in the credit system as an outcome of learning, crucial in institutionalization processes, by both lenders and borrowers.

Where loans are tied to the building, expansion, or enhancement of an enterprise, it is vital that this should be linked to training and identification of business needs and viable markets for the end products of the enterprise. In the long run, external factors such as the strength of the local economy, irrigation issues in the case of agricultural enterprises, droughts, transport and energy infrastructure, and access to markets play quite instrumental roles in the success or failure of an MFI as far as making a lasting impact on livelihoods. Unless MFIs meet their declared aim of improving sustainable income generation in conjunction with improvements in all other facets of Afghan rural political economy, there is a risk that MFI-originated loans might feed cycles of debt, instead of improving livelihoods in a sustainable fashion.

Future research and efforts to reform how MFI funds are disbursed will need to pay particular attention to the non-financial and longer term impact of credit provision and borrowing through MFIs. The design of microfinance organizations to prioritize repayment as a measure of success filters down to the loan officers and may be clouding a comprehensive view of exactly how far loans are helping livelihoods. The design of loans with very frequent and inflexible repayment schedules may also combine with small loans in initial cycles, making it hard for households to make a sufficient investment with their loan and make enough profit to both repay and end up with more assets than they started with.

Despite the many shortcomings in the introduction of microfinance in rural Afghanistan, it is too early to conclude that microfinance has been a failure. There have been, in Bamiyan and in some instances in Balkh and Herat, cases of increased participation of women in productive economic activity. There are also cases of livelihood improvements, more so in Bamiyan than in the other provinces. The introduction of microfinance in rural Afghanistan remains a work-in-progress. The future success or failure of this experiment depends on how well MISFA and its MFIs adapt to their operating environment by learning and how the many institutional gaps and obstacles highlighted in Figures 5-7 are understood and overcome.

## **7. CONCLUSIONS**

Microfinance from traditional sources in Afghanistan is subject to a complex set of institutional arrangements. Numerous forms of credit transactions are governed by generations-old traditional institutions. Interventions through the introduction of MFIs to change the pre-existing lending and borrowing patterns and arrangements are thus difficult to institute in the short term and likely to be subjected to suspicion and mistrust, particularly if a given MFI fails to effectively “resonate” with the pre-existing institutions that govern credit transactions. There is clearly a perception amongst policymakers that microfinance is working in Afghanistan, although studies of microfinance have drawn mixed conclusions.

Evidence suggests that even the middle and higher income families targeted by microfinance do not always benefit fully, due to the small sizes of loans, short grace periods and frequent repayment cycles of some loans in the first cycles. Longer grace periods, and larger loans offered by microfinance organizations in the later cycles of lending are likely to

increase the potential for long term livelihoods benefits for borrowers. While some innovation has taken place, notably the implementation of the murhaba-based loans, there is clearly much more room for similar initiatives to make formal borrowing more acceptable to the potential borrowers. Future initiatives should focus on such issues as affordability to borrow (through flexible and/or reduced interest), longer grace periods, longer term loans, and larger loans.

There appears to be a desire by the Government and international donors to regulate and supervise the variety of people involved in hawala style activities including the hawaladars grocers, merchants and a host of other individuals. If identifying, licensing and regulating the well-established system of hawala transactions is difficult because of the number of actors and the complexity of their relationships, the task will be many folds more difficult, and perhaps not very useful, for the less common but equally complex traditional forms of transaction such as alms. This calls for increased attention to and innovativeness in the development of new lending and borrowing arrangements with a capacity to replace the less transparent and difficult-to-document traditional institutions. Policy innovation in this regard is only possible through engagement of the target population to continually define and re-define community needs. As Reich (1988) has eloquently put it, policymakers' responsibility is not only to discover "objectively" what they think people want and then to devise solutions, but to provide the public with alternative visions through engaging with them so as to broaden the range of potential responses is being wanted.

Given the need for re-visioning and reexamination, the replacement and transformation of traditional institutions of credit with MFIs is at best a medium-term objective. As such, it would require on the part of MFIs competitiveness of lending terms, receptiveness to client needs and, most importantly, increased trust by the borrowers in MFIs. These requirements would only emerge over time through further adaptation by MFIs to better fit with local conditions (including what the public wants) and through positive livelihood impacts felt by the borrowers of MFI loans.

## **8. RECOMMENDATIONS**

### **8.1 POLICY RECOMMENDATIONS**

- The emphasis on the financial sustainability of MFIs must be supplemented with equal emphasis on assessments of the social sustainability of MFIs, if the introduction of microfinance is to lead to measurable, documented improvements in rural livelihoods.
- A change of thinking at policymaking levels is necessary regarding the moral framework in which traditional microfinance transactions are discussed. The discussion of "informal credit" or "moneylending" in a pejorative leads to an implicit assumption that all traditional sources of credit should wither away along with increased regulation of financial transfers and increased reach of formal financial services through, for example, MFIs.

- Policy options that recognize, respect, and work with and through the more equitable pre-existing lending and borrowing arrangements need to be more closely investigated to reduce the tension between the introduced and traditional forms of lending and borrowing. A starting point in this process is to engage the relevant community actors such as mullahs prior to introducing MFI-originated loans in rural communities.
- Introducing records or paper trails for traditional financial transactions is perhaps overambitious. However, MFIs could be regulated to perform an additional function in monitoring the debt to traditional sources.
- Ultimately, there needs to be recognition that, alongside a conceptual shift away from the negative perception of the traditional sector as something that should be replaced by formalized structures, microfinance alone will not achieve the poverty reduction and economic growth aims that it is intended to help deliver. Microfinance will need to be regarded as one component of the strategy to improve local services, employment creation, infrastructure, and market function.

## **8.2 OPERATIONAL RECOMMENDATIONS**

- The pervasiveness of microcredit (and finance) from traditional sources should be taken into account when assessing the demand for MFI-originated loans so as to avoid duplication of services that are already available locally, and sometimes equitably, and to ensure that microcredit targets the households where it can make a difference.
- The engagement of mullahs and other influential community actors needs to be sought and sustained to avoid resistance to and backlashes against MFIs and their services.
- To take root and become institutionalized, MFIs have to successfully compete with the traditional terms of lending and borrowing. Interest rates or service charges have to remain lower than those in the traditional sector.
- The size of MFI loans and repayment arrangements (commencement of repayment of installments and the lifecycle of the loan) need to be re-thought so as to minimize undue pressure on the borrowers and discourage decapitalization through selling assets or additional borrowing to meet strict repayment deadlines.
- MFIs should fully assess and monitor levels of existing indebtedness in communities where they plan to operate so as to minimize contributing to cycles of indebtedness prevalent in many of the poorer rural areas.
- MFIs should standardize their methods of recording and responding to non-payment, involving the creation of mechanisms for assessing reasons for non-payment and for protecting households who may be going through decapitalization as a result of repayment pressures.
- MFIs should adopt a standardized system of evaluating the livelihoods impact of their loans so that a general picture can be built of the types of loans and repayment schedules most appropriate in different Afghan contexts.

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## END NOTES

- 1 From: <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:21590188~pagePK:64257043~piPK:437376~theSitePK:4607,00.html>, accessed December 31, 2007.
- 2 CGAP defines Microfinance as “the supply of loans, savings, and other basic financial services to the poor ... to run their businesses, build assets, stabilize consumption, and shield themselves against risks. Financial services needed by the poor include working capital loans, consumer credit, savings, pensions, insurance, and money transfer services.” For more information see: <http://cgap.org/portal/site/CGAP/menuitem.b0c88fe7e81ddb5067808010591010a0>
- 3 See Appendix A for a list and descriptions of MFIs under the MISFA umbrella.
- 4 For an elaborate discussion of levels, scales, and systems see Parto (2005a). See, also, Philo and Parr (2000) for a discussion of scale and institutions.
- 5 This typology and the subsequent discussion are based on Parto (2005b).
- 6 We acknowledge access to data collected by teams of researchers from Afghanistan Research and Evaluation Unit (AREU) for an ongoing project on microfinance. We are also grateful for valuable comments from Erna Andersen, Floortje Klijn, Asta Olesen, and Amit Brar. All errors and omissions remain our responsibility.
- 7 See, in particular, Klijn and Pain (2007). This point was also brought up by interviewees in a number of cases during fieldwork in the Kabul, Balkh, Bamiyan, and Herat provinces.
- 8 This section is based on the official website for MISFA, available at: <http://www.misfa.org.af>
- 9 For more information see: <http://www.misfa.org.af>
- 10 From MISFA’s website, available at: [http://www.misfa.org.af/index.php?page\\_id=4](http://www.misfa.org.af/index.php?page_id=4) accessed September 6, 2007.
- 11 The Focus Note is titled “Beyond Good Intentions: Measuring the Social Performance of Micro Finance Institutions” and can be accessed in the world wide web at [http://www.cgap.org/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Documents/FocusNote\\_41.pdf](http://www.cgap.org/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Documents/FocusNote_41.pdf).
- 12 It is worth noting that in Figure 5, “Opium Economy” is off to one side as not being a key institution in microfinance. This is because the transaction sizes are far larger in opium dealings than transactions in microfinance. Figure 5 suggests that, at least initially, Opium Economy is a marginal though potentially important institution in lending and borrowing.
- 13 See, for example, Lister (2005, 2006), The World Bank (2005a, 2005b), and Asia Foundation (2007).



## **APPENDIX A:**

### **THE MICROFINANCE INSTITUTIONS (MFIs) OF AFGHANISTAN**

**AFSG:** The Ariana Financial Services Group (AFSG) was established by Mercy Corps in April 2003. AFSG uses the group lending methodology to provide credit to predominantly female clients in Kabul City who are active in a wide range of small businesses. The organization has also started an individual loan product targeted at repeat cycle clients (both males and females).

**AMFI:** CHF International's Afghanistan Microfinance Initiative (AMFI) offers credit and working capital to low-income households in Bamiyan and Ghazni provinces. The program uses solidarity group method to offer credit to business owners.

**ARMP:** The Afghanistan Rural Microcredit program (ARMP) was set up in 2003 by the Aga Khan Foundation (AKF). The organization offers a variety of loan services to individuals to improve their business activities or remedy cash flow problems.

**BRAC:** Set up by BRAC (Bangladesh) in 2003, it is the leading MFI in Afghanistan. BRAC offers individual loans to business owners in both urban and rural areas of the country.

**CFA:** Child Fund Afghanistan (CFA) was started by the international NGO, Christian Children's Fund (CCF) and currently (2007) operates in 3 provinces. CFA follows a solidarity group lending methodology and has already financial sustainability.

**FINCA:** FINCA Afghanistan was set up in 2004 by the International NGO, FINCA International. The organization has pioneered the development of shari'a law compliant lending (murabaha) in Afghanistan. FINCA operates in city and surrounding areas of Kabul, Jalalabad, Herat and Mazar-e-Sharif.

**FMFB-A:** The First MicroFinance Bank – Afghanistan was established in 2003 to lend in order to "reduce poverty, diminish the vulnerability of poor populations and alleviate economic and social exclusion." It has operations in 7 provinces.

**Hope For Life:** Affiliated with HOPE International, is a global, faith-based, non-profit organization focused on poverty alleviation through microenterprise development.

**MADRAC:** Established in June 2005 by the Danish NGO, DACAAR, with the main goal of providing microfinance services to low-income households in rural areas of Afghanistan. MADRAC uses a solidarity group lending method for its operation with group sizes of 10-20 members. MADRAC works in the Herat, Ghazni and Laghman provinces.

**MOFAD:** The Micro Finance Agency for Development (MoFAD) is a savings-based microfinance program established in Kabul by CARE Afghanistan. MoFAD uses CARE's well-known savings and credit group (SCG) methodology to set up groups of women who rotate their savings and borrow from the MFI.

OXUS: Part of the OXUS Development Network (ODN), a global network of MFIs affiliated to ACTED, the French international development NGO. OXUS Afghanistan is currently providing loans to solidarity groups of women and men for income-generating activities. The organization works in Kabul, Parwan, Balkh and Faryab provinces.

PARWAZ: The first woman-led Microfinance institution for Afghans by Afghans in Afghanistan, established 2002, to provide microcredit to male and female households in Kabul and Ghazni and the surrounding areas.

SUNDUQ: Setup by MADERA, a French NGO, in 2005. The organisation uses the village banking methodology to provide credit to rural households. MFI operations are spread across the Eastern part of the country.

WWI: Women for Women International (WWI) started a microfinance program in 2004 in Afghanistan to offer financial services to the poor and socially excluded women in rural and urban areas.

WOCCU: The apex organization of the international credit union system. Only owner-members have access to the savings and loan services provided by each credit union. WOCCU has established two credit unions in Balkh and Jowzjan.

## APPENDIX B:

### DATASETS FOR INSTITUTIONAL AND ORGANIZATIONAL MAPS IN FIGURES 6 AND 7

Table B1. Matrix for Figure 5 based on the strength of relations among institutions (3=Strong, 2=Moderate, and 1=Weak)

	A	B	C	D	E	F	G	H	I	J	K	L	M	N	O
Legislation (A)			3	2											
Availability of Funds (B)										2	1				
Policy (C)				3											
Rules and Selection Criteria (D)					3									3	
Loan Group Dynamics (E)								2				2		2	
Favoritism (F)				1											
Religious Sanctions (G)				3				3						2	
Social Norms and Values (H)												3	3	3	
Environment of Risk (I)		1									3	2	3	3	
Opium Economy (J)		3							2		1				
Traditional Credit Arrangements (K)												3		2	
Familial/Social/Kinship Ties (L)						3					3		3		
Moral Economy (M)											3				
Attitudes to Credit (N)											3	3	3		
Islamic Notions of Credit (O)				1			3	3							

Table B2. Matrix of relationships among organizations of microcredit (mapped in Figure 6) based on existence of relations (0 or 1), information exchange (0 or 1), influence (0 or 1), and resources (0 or 1)

	A	B	C	D	E	F	G	H	I	J	K	L	M	N	O	P	R
Donors (A)		1,111	1,111	1,111	1,111	1,101			1,000								
MRRD (B)	1,100						1,111										
MOI (C)	1,100							1,111									
MOAAHF (D)	1,100																
MOCI (E)	1,100									1,000							1,111
MISFA (F)	1,111	1,111					1,111										
MFIs (G)		1,100						1,000			1,100	1,100	1,100	1,100		1,111	
District Offices (H)			1,100												1,010	1,010	
Agriculture Co-ops (I)				1,000													
Business Co-ops (J)					1,000												
Village Shuras (K)							1,100					1,100	1,100	1,100			
Wakils/ Maliks (L)								1,100			1,100					1,010	
Mosque (M)							1,100							1,111			
Mullah (N)							1,010										
Police (O)								1,100									
Loan Groups (P)							1,001					1,100					
Da Afghanistan Bank (R)					1,110		1,000										

## **APPENDIX C:**

### **DESCRIPTIONS OF AND ASSUMPTIONS ABOUT INSTITUTIONS OF CREDIT TRANSACTION**

#### **LEGISLATION**

Legislation refers to laws that govern the transfer of money from the Donors to MISFA. Legislation has a direct, strong effect on the policy of the MFIs. The laws regarding the distribution, use, availability and intended effect of funds form the basis for the policies enacted by MISFA for the operation of MFIs. Legislation also has a moderate effect on the rules and selection criteria of MFIs. The laws determine the policies of MISFA, which in turn forms the basis for the rules, selection criteria, punitive measures and other operational parameters of MFIs. As such, legislation is a constitutive institution (according to the typology in Figure 3) in the introduced system because it sets the ultimate boundaries of action for MISFA and, consequently, for MFIs and their clients.

#### **AVAILABILITY OF FUNDS**

Availability of Funds to MISFA from the Donors for the operation of microfinance programs has a moderate effect on the opium economy if MFI loans replace finance available to borrowers from participation in the opium economy. However, Klijn and Pain (2007) demonstrate that traditional credit arrangements are weakly affected by the availability of funds from the formal sector. Moreover, there is some evidence of borrowers borrowing from traditional sources to pay off their formal loans. From a livelihoods perspective, this points to a conflictive, detrimental relationship between traditional forms of borrowing and finance arrangements with MFIs.

The Availability of Funds from MFIs is a regulative institution (Figure 3) in the introduced sector since it determines the immediate boundaries of action by MFIs.

#### **POLICY**

Actions by MFIs are structured through Policy as determined by MISFA. The Rules and client Selection Criteria (see below) for the MFIs are a direct result of the Policy of MISFA for the operational parameters of MFIs. Policy, therefore, is a regulative institution (Figure 3) within the introduced sector.

#### **RULES AND SELECTION CRITERIA**

The borrowing Rules and Selection Criteria used by MFIs regulate credit transactions in the introduced credit sector by setting the immediate boundaries on who receives the loans and what punitive measures may be taken against non-payment. As such, the Rules and the Selection Criteria have a direct, facilitative impact on the Dynamics of a Loan Group (see below).

Rules and Selection Criteria also affect Attitudes to Credit strongly. Traditional attitudes to credit are based on negotiable and flexible repayment arrangements while finance from MFIs tends to be more strict. The observed behaviour of borrowing from traditional sources to pay back MFI-originated loans is arguably an outcome of this relationship between Rules and Selection Criteria and the Attitude to Credit. Also, the interplay between the flexible traditional attitude to credit and the restrictive mode of behaviour imposed on the borrowers by MFIs can result in a conflictive relationship.

### **LOAN GROUP DYNAMICS**

The loan group is one of the principal forms through which MFI-originated loans are dispersed to individual borrowers. The Loan Group Dynamics represent regulative as well as associative institutions in transactions involving MFIs. An individual's relationship with the loan group and the ability to pay determine the individual's eligibility for future loans. Loan groups simultaneously serve as a means for individuals to secure MFI loans and a mechanism to exert peer pressure on borrowers (to repay) and thus shaping repayment behavioural patterns.

Loan Group Dynamics have a moderate effect on deeply ingrained social norms and values manifest as standardized habits of groups and individuals in social situations. The presence of a loan group can result in a realignment of social values associated with credit repayment and also have moderate effects on social and kinship ties. The presence of a loan group whose options to access credit are determined partly by individual action, also affects the attitude that the individual has towards credit repayment. Group Loan Dynamics can come into conflict with traditional social norms and values and attitudes to credit repayment. However, their longer term impact can be facilitative if group and individual-in-group attitudes toward credit are changed without undermining the traditional norms embedded in social, kinship and familial ties.

### **FAVORITISM**

Loan group officers can exercise favoritism toward certain borrowers. Being (largely) based on familial, kinship and social ties, Favoritism is an associative institution (Figure 3) in traditional and in introduced forms of borrowing. Evidence from interviews with borrowers in the four provinces suggests that the Rules and Selection Criteria used by MFIs can be undermined by favoritism. A weak relationship is assumed between Favoritism and MFI Rules and Selection Criteria since rules and selection criteria are not always clear to the borrowers.

### **RELIGIOUS SANCTIONS (BY MULLAHS)**

Traditionally, mullahs are interpreters of Islamic notions concerning behaviour in the community, including individual economic behaviour. The perception of *sudh* as being sinful is a cognitive institution (Figure 3) or a mental model promoted by mullahs and expected to be complied with by believers. Wealthier mullahs can also act as money lenders based on terms that could be benevolent or draconic, depending on the mullah and his scruples.

Since mullahs usually act as watchdogs in enforcing social norms and values, their influence on perceptions within the community about introduced forms of credit is likely to be significant. Some MFIs have responded to the instrumental role of mullahs by modifying their interest system based on consultation with or buy-in from the mullahs in some cases. A moderate effect from Religious Sanctions on borrowing behaviour is assumed because the power of mullahs concerning *sudh* is not conclusive to attitude change, as has been reported in this research and other literature. Depending on the role assumed by the mullah in a given context, the relationship between Religious Sanctions and the Rules and Selection Criteria of MFIs can be conflictive or facilitative.

### **SOCIAL NORMS AND VALUES**

Social norms and values are behavioural institutions (Figure 3) manifest as deeply ingrained, standardized patterns of behaviour. To a large extent, but not exclusively, Attitudes to Credit are manifest as social norms and values which in turn structure familial, kinship and social relations as well as forming a key component part of the Moral Economy (see below).

### **ENVIRONMENT OF RISK**

According to Klijn and Pain (2007), "environment of risk" is the institutional expression of inequality, inequitable class relations, exploitation, social exclusion and unaccountable power within rural Afghan society. These features cause the poor to seek protection through relations of patronage with the powerful actors and reinforce the dependency of the poor on the powerful. This relationship has a strong effect in defining traditional credit arrangements. The Environment of Risk is a constitutive institution (Figure 3) since it sets the ultimate boundaries of action by individuals entering traditional credit relations.

The Environment of Risk has a weak effect on the Availability of Funds from Donors to MISFA and a strong effect on Attitudes to Credit. An element in consideration to provide funds is the perceived scale of success in terms of improved socio-economic and political security. Higher risk areas are less likely to receive microfinance, making the relationship between Environment of Risk and Availability of Funds conflictive.

### **OPIUM ECONOMY**

The opium economy has proven to be a resilient agricultural activity and by all accounts has been a constitutive institution (Figure 3) in the Afghan rural landscape for a number of generations. The salaam system of advance payment is a widespread credit arrangement in the opium economy. The practice is far less evident in rural economic activity. A weak effect is assumed of the Opium Economy on Traditional Credit Arrangements.

Availability of Funds from donors is highly dependent on the state of the opium economy in an area. A high level of opium production generally implies low availability of funds for the area. The Opium Economy, due to the security risk element attached with opium cultivation, acts as a facilitator to the Environment of Risk in rural Afghanistan. This effect is assumed as moderate because the Environment of Risk is a pervasive aspect of rural Afghanistan, regardless of the role of the opium economy.

### **TRADITIONAL CREDIT ARRANGEMENTS**

Traditional Credit Arrangements, such as Qarz-e-hasana and Qarz-e-Khudad (Figure 1), usually arranged as advance loan on crops, play a regulative role (Figure 3) in the flow of credit from lender to borrower. These arrangements have a strong influence on Familial/Kinship/Social Ties (see below) because they facilitate the creation and reinforcement of existing ties within the community. The form of credit arrangement often corresponds to the structure of social power relations.

Traditional Credit Arrangements have a moderate influence on Attitudes to Credit. Klijn and Pain (2007) note a confidence among borrowers about their ability to access credit and repay loans, attributing this to the flexibility and negotiability of Traditional Credit Arrangements. The structures of these arrangements themselves contribute to the shaping of Attitudes to Credit.

### **FAMILIAL/SOCIAL/KINSHIP TIES**

This associative institution (Figure 3) facilitates the major interaction among the lenders and borrowers within the traditional system of credit. Familial, social and kinship ties have a strong and direct effect on Favoritism. The stronger the ties, the higher the possibility of rule-bending by the lenders and the expectation of preferential treatment by the borrowers. Moreover, traditional credit arrangements are negotiated on the basis of these ties. The Moral Economy (described below) also operates on the basis of familial, kinship and social ties.

### **THE MORAL ECONOMY**

The set of expectations and choices concerning credit relations, with the aspect of morality that legitimizes the parameters of these relations, form the basis of the Moral Economy as a cognitive institution (Figure 3) in informal credit practices. Traditional Credit Arrangements are affected strongly by the Moral Economy. Klijn and Pain (2007) refer to leniency in many cases in repayment arrangements as a product of the Moral Economy. The Moral Economy is affected by the Attitudes to Credit and reinforces Traditional Credit Arrangements.

### **ATTITUDES TO CREDIT**

Attitudes to Credit (Klijn and Pain 2007), refers to high confidence among the potential borrowers in finding loans and in repaying them. This behavioral institution (Figure 3) is a key feature in Traditional Credit Arrangements, the Moral Economy and the Familial/Kinship/Social Ties. Since rural individuals have been reported to have a high confidence in accessing as well as repaying loans, they enter into traditional credit arrangements more readily. They also utilize their familial and kinship ties frequently to access credit, thus reinforcing these ties.

### **ISLAMIC NOTIONS OF CREDIT**

Islamic Notions of Credit are both cognitive and constitutive institutions (Figure 3) which at once guide actions of individuals and set the ultimate boundaries for socio-economic activity. Islamic Notions of Credit have a weak impact on the Rules and Selection Criteria formulated by MFIs concerning microfinance. MFIs have changed their rules to better accommodate Islamic notions, but this has been the direct result of the actions of Mullahs, the purveyors of the Islamic notions of credit.