Donor Approaches to Risk

in Fragile and Conflict Affected States

Mini Case Study

Afghanistan

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Introduction

This is a mini case study on Afghanistan to inform the OECD/INCAF study on Donor Approaches to Risk in Fragile and Conflict Affected States. It focuses on the Afghanistan Reconstruction Trust Fund (ARTF) and the intentions expressed in the Tokyo Mutual Accountability Framework as examples of how donors have approached risk assessment and management of fiduciary risks. Broader conflict and security risks are not considered, nor are other trust funds or approaches discussed.

Security support and development aid for Afghanistan

Since the September 2001 attacks donors have shown a strong engagement in Afghanistan against a background of continued internal armed conflict. The International Security Assistance Force (ISAF) was set up in 2001 to assist the Afghan government to secure control over the territory and some 60 countries have provided troops.[1] Responsibility for security will be handed over to the Afghan forces in 2014, but a strategic partnership with the United States ensures that some US troops will remain in the country after the withdrawal of most foreign military units.

Total net ODA to Afghanistan has risen over time from below US$ 3 billion in 2005 and 2006 to US$ 6.7 billion in 2011, which brought aid levels up to US$ 190 per capita in 2011.[2] According to the World Bank, once spending on the Afghan security forces is included in the calculation, total foreign spending was as high as 15.7 billion USD in 2010/11, and thus about the same as GDP.[3] Foreign aid is likely to continue at a high level following the end of the military presence. At the 2012 Tokyo conference, donors pledged some US$ 16 billion for the 'Transformation Decade' of the 2010s.[4]

At present donor engagement is framed by the *Kabul Process* and is steered through a series of conferences among Afghan stakeholders (the Consultative Peace Jirga 2010) and the international community and the Afghan Government (2010 London and Kabul, 2011 Bonn, 2012 Chicago and Tokyo Conferences). The Kabul process has turned international engagement into an Afghan lead and owned process supported by an international partnership. It succeeded the 2006-2011 Afghanistan Compact and the 2002-2005 *Agreement on Provisional Arrangements in Afghanistan Pending the Re-Establishment of Permanent Government Institutions* (the 'Bonn Agreement' of 2001). While the first agreement identified and supported the Afghan state institutions to be set up, the Compact integrated the security, governance and development components and set targets in all three fields. The compact set up a Joint Coordinating and Monitoring Board (JCMB) and associated sectoral working groups, which are co-chaired by the Government of Afghanistan and the UN as a mechanism for the Afghan government and international community to hold each other mutually accountable for their commitments.

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[1] http://www.isaf.nato.int/subordinate-commands/isaf-joint-command/index.php#Contributing%20Nations

[2] OECD DAC figures for net ODA

[3] http://siteresources.worldbank.org/INTAFGHANISTAN/Resources/Vol1Overview8Maypm.pdf, p. 1

[4] http://www.guardian.co.uk/world/2012/jul/08/afghanistan-donors-16bn-development-aid

The Kabul Process has generated some key commitments related to aid effectiveness and risk management. During the Kabul Conference (2010) donors made the commitment to channel at least 50% of aid through government systems and to align at least 80% of aid spending to national priorities (NPPs). The Tokyo Conference produced the 'Tokyo Mutual Accountability Framework', which sets out mutual expectations and highlighted responsibilities of the Afghan government and reaffirmed donor commitments to align support with national priorities. Besides commitments from the Afghan government for elections, rule of law, economic reforms, the framework also contains specific commitments on revenue collection and locally accountable budget execution, as well as the integrity of public finance. Donors on their part pledged to continue budget support through the 'Transformation Decade', and specifically to increase the share of aid spent through the Afghanistan Reconstruction Trust Fund (ARTF) Incentive Program to 10 percent by 2014 (increasing to 20% by 2024). Commitments are expressed as general goals for each objective area, and are supported by a list of indicators of how progress towards the goal will be measured and judged.[5]

The Tokyo Conference established a performance monitoring mechanism, which reviews the progress in achieving defined objectives.[6] It centres on the use of three monitoring structures to review progress on a regular basis. A Standing Committees and Joint Coordination and Monitoring Board (JCMB) monitors progress. A Senior Officials Meeting to be held in 2013 and every second year subsequently reviews progress and updates indicators where needed. A Ministerial-level Meeting is planned for 2014 to oversee progress at the highest level and to update indicators, assess resource requirements and renew international commitments.

Approaches to managing fiduciary risks in Afghanistan

Donors have identified four key fiduciary risks in Afghanistan, with corruption being related to all four areas: (1) use of funds is not reported (i.e. funds drawn but never accounted for); (2) use of funds not for the purposes intended by the Grant (i.e., used for non-budget expenses or security/military expenses); (3) use of funds without due consideration for economy (i.e., agreed procurement guidelines not followed); and (4) use of funds for unsubstantiated expenditures (i.e., expenditures that do not meet the agreed fiduciary standards). Procurement corruption and financial leakages are seen as the highest risk for donor funds (World Bank, 2012)[7], as indicated by the problems experienced by the UNDP administered LOFTA fund.[8]

Low financial management capacities within the Afghan Government contribute to fiduciary risks. Of particular concern are the absence of effective internal audits across government, low

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[5] Note that the framework is presented only in general terms, and does not prescribe the sequencing of commitments or explicitly relate particular donor commitments to the observance of government commitments.

[6] http://www.ausaid.gov.au/countries/southasia/afghanistan/Documents/tokyo-declaration-and-mutual-accountability-framework.pdf

[7] http://siteresources.worldbank.org/AFGHANISTANEXTN/Resources/305984-1326909014678/8376871-1337730954926/Fiduciary-Framework-ARTF_15-may-2012.pdf p. 1

[8] The UNDP administered LOFTA is used to channel support for the Afghan Police. In 2012, the deputy project manager and finance officer of the trust fund were removed from their posts following a Wall Street Journal report on donor's concerns about possible abuses at the fund. The non-public UNDP report of December 2012 found that administrators had colluded with suppliers to inflate the cost of contracts over several years, and that this had been possible due to wider management problems within the office (February 2013). http://online.wsj.com/article/SB10001424127887323478304578330280263422940.html

standards in external audit practices, and frequent lack of compliance with public finance and procurement rules.

Donors use the World Bank administered Afghanistan Reconstruction Trust Fund (ARTF) as the principle instrument for fiduciary risk mitigation. In addition, there are various programmes, many run by the World Bank and UNDP, aimed at government capacity building for enhanced budget management.

2.1 The Afghanistan Reconstruction Trust Fund

According to donors' assessment, the Afghanistan Reconstruction Trust Fund (ARTF) is the 'most reliable and lowest-risk vehicle for delivering international assistance through Afghan systems.''[9] (Australian Government). It provides funding for the key areas of the 22 Afghan national priorities under five priority sectors, which correspond to the Government's Development Clusters: agriculture, rural development, human development, and governance/public sector capacity. Five of the portfolios are managed by the World Bank and the security sector related areas by UNDP. This division of responsibility was necessary as the Bank's Articles preclude it from funding police activities. In addition, there is the NATO-ANA trust fund for support for the armed forces.

The ARTF is a mechanism for predictable on-budget financing for government priorities. Grants are made available in the form of investment projects and some recurrent costs following the ARTF decision-making procedures described below. All payments through the World Bank administered portfolios are subject to World Bank financial management and procurement rules including individual transaction review by the Bank (see details below).

Since its establishment in 2002 the Afghanistan Reconstruction Trust Fund (ARTF) has been used by 33 different donors who channeled 6.1 billion over a 10 year period (As of January 2013)[10] with the US being the most important single donor followed by the UK, Canada, Netherlands, Germany, EU, Norway and Australia.

The latest financing strategy (2012-2014) foresees an important increase in contributions to the fund from 1.8 billion spent during the last three year period (2009-2011) to around 3 billion for the next three year period.[11]

ARTF structure and management

The Trust Fund operates as a single account, held by the World Bank in the US. The World Bank management proposes allocations at its monthly meeting. Decisions are translated into Grant Agreements signed by the World Bank and the Government of Afghanistan.

The ARTF has a three-tier governance framework (Steering Committee, Management Committee and Administrator), as well as two working groups. The Steering Committee sets the strategy for the ARTF which the Management Committee (MC) is responsible for implementing. Decisions of

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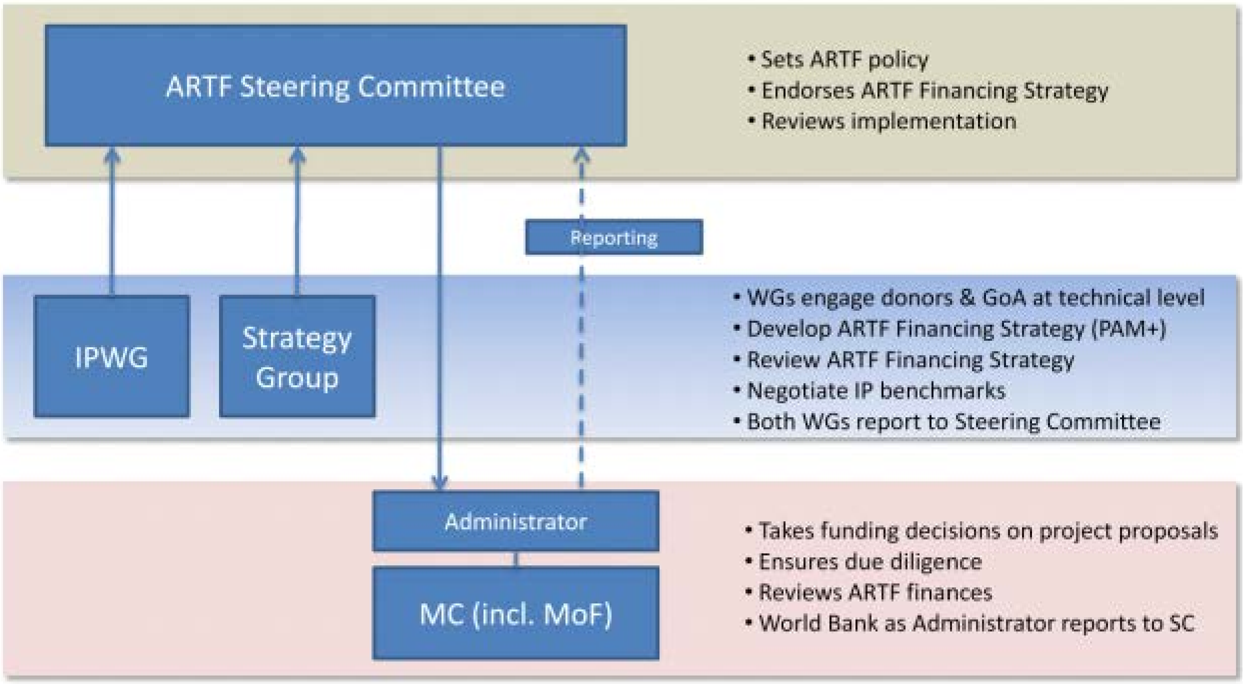
[9] Australian Government http://ausaid.gov.au/countries/southasia/afghanistan/Documents/artf-delivery-strategy.pdf

[10] http://ausaid.gov.au/countries/southasia/afghanistan/Documents/artf-cross-roads.pdf p.7

[11] http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/0,,contentMDK:23236940~pagePK:146736~piPK:146830~theSitePK:223547,00.html#ida What is the ARTF's financing strategy.

the Steering Committee are made on a consensus basis and informed by the working groups. The Committee is made up of all ARTF donors, the World Bank and Afghan Ministry of Finance, with other MC members participating as observers. The Committee meets under the co-chair of the World Bank and the Minister of Finance. This set-up has enabled the ARTF to adapt to changing circumstances and development priorities, with consistency and consensus.



To mitigate the fiduciary risks the ARTF has established internal control procedures over financial reporting of trust fund activities. The Bank applies its rules on investment operations for all ARTF grants. Receipt, cash management and disbursement are subject to the Bank's Treasury and Accounting rules, and transactions are subject to review by Bank staff (World Bank 2012). For the recurrent costs (mainly salaries), staff caps and pay scales are managed using the *tashkeels* system (an organizational chart detailing the number of staff and their position within a government body, which have to be approved by a competent body at the beginning of each budget year). Salary payments pass through a monitoring agent. The risk of procurement corruption is mitigated through transparency rules and external oversight. The ARTF financed Afghanistan Reconstruction and Development Service Procurment Unit (ARDS-PU) is located within the Ministry of Economy and provides Procurement Facilitation Services to most of the Afghan line ministries and agencies for procurement above a certain threshold to ensure compliance with the procurement guidelines and transparency. Only some certified procurement entities are exempt from the obligation to pass through the ARDS-PU. The risk of financial leakages is mitigated through World Bank Treasury Department wide controls. All donor receipts flow through the WB Treasury and remain there until they are disbursed to the beneficiary either as an advance to a Special Account or as direct payments against contracts reviewed by the WB. In addition, controls are carried out by the monitoring agent. 2220 supervisory agent site visits are planned for the period 2012-14.

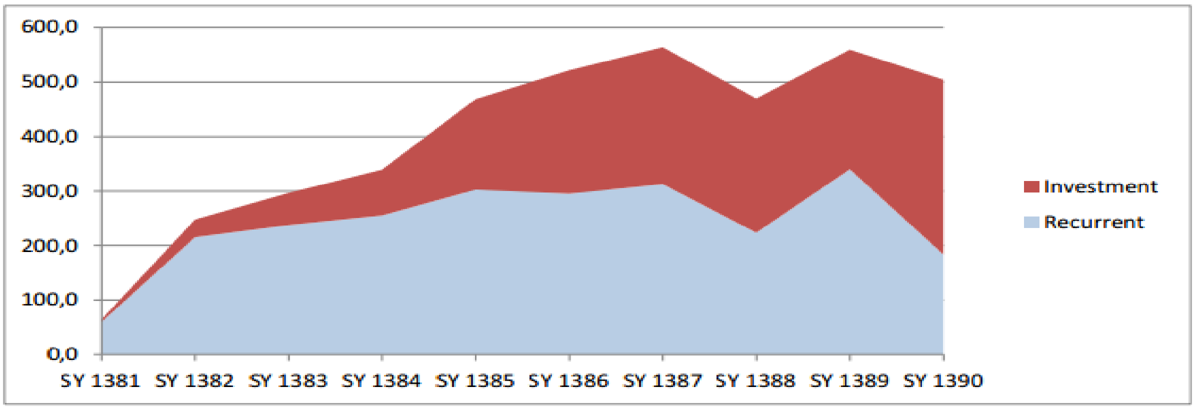
The Kabul Bank Scandal

The 2010 Kabul Bank scandal destabilised Afghanistan, eroded public trust in the newly established banking system and slowed down transfer of donor funds. Kabul Bank handled wage payments for the security sector (some 1.5 million USD per annum) which were partly funded by donors. These payments were interrupted following the discovery that top executives at the Kabul Bank had diverted close to 1 billion USD of bank deposits. Many of these executives had close relationships with high government officials and the fraud was only full investigated following the IMF's decision to link the renewal of the Extended Credit Facility Program to a forensic audit, receivership and independent review of Kabul Bank. As this IMF programme is used by donors to benchmark financial support, several donors started to withhold payments, including through the ARTF. The bank bailout cost the Government over 5 percent of GDP (Monitoring report).[12]

Investment and recurrent cost payments through the ARTF

The ARTF is divided into recurrent and investment funding. The Recurrent Cost Window reimburses the government for a certain portion of eligible and non-security related operating expenditure every year. The Investment Window provides grant financing for national development programs in the development budget. Overall spending under the ARTF has grown significantly, and the latest financing strategy (2012-2014) provides a large boost to investment funding. As indicated in the chart below, recurrent spending was particularly important in the early years of the ARTF, and since then its relative importance has fallen slightly. There was an overall dip in spending in 2008/09 due to the transition from the second to the third NSP. A second drop in ARTF spending in 2010/11 coincided with the Kabul Bank fraud.

Fig 3.1: Total disbursements by window, USD mill/solar year



Source: ARTF Annual Report SY 1390, table 7.

The ARTF Incentive Programme

The Incentive Program (IP) within the ARTF is one of the key instruments to motivate the Afghan Government to work towards the goals of the Tokyo Mutual Accountability objectives of increased revenue collection. The IP was set up in 2008 as an annual programme within the ARTF's

[12] http://www.mec.af/files/knpir-final.pdf

Recurrent Cost Window to support the Government's reform agenda, with a focus on fiscal sustainability and economic governance. In 2012 the IP was reformed to focus specifically on fiscal sustainability through increased domestic revenue mobilization and strengthened expenditure management (2012-24). It was changed to allow for a more programmatic, multi-year approach and more frequent technical reviews and disbursements.

The IP provides for an annual automatic decline in baseline ARTF Recurrent Cost Window financing and offers an offsetting incentive package, based on concrete progress in the Tokyo reform agenda. The IP seeks to provide the Afghan Government with more flexible, on-budget funding in conjunction with progress on specific economic development achievements.[13]

Conclusions on risk management practices in Afghanistan

Fiduciary risks due to high levels of corruption are a serious concern in Afghanistan, which the Kabul Bank scandal and the LOTFA procurement fraud highlight. Finding adequate mechanisms to mitigate fiduciary risk are therefore essential. The World Bank administered ARTF within the framework of the Tokyo Mutually Accountability Framework is an example of good practice in this respect.

The ARTF's approach to risk management is to combine stringent fiduciary controls with a development and reform agenda for the financial management system that enables a progressive increase in the use of country systems. Tight controls from external agencies are gradually reduced once government units are certified to carry out for example procurement procedures.

One limitation of the ARTF is that World Bank rules prevent it from supporting the crucial security sector, which absorbs some 10 percent of GDP and is likely to increase in the coming years to some 18 percent of GDP. Suitable arrangements to manage the substantial fiduciary and programmatic risks of supporting the security sector will need to be found.

13

http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/0,,contentMDK:22156917~pagePK:146736~piPK:146830~theSitePK:223547,00.html

http://siteresources.worldbank.org/AFGHANISTANEXTN/Resources/305984-1326909014678/8376871-1337730954926/Fiduciary-Framework-ARTF_15-may-2012.pdf