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# SPECIAL REPORT

2301 Constitution Ave., NW • Washington, DC 20037 • 202.457.1700 • fax 202.429.6063

## ABOUT THE REPORT

The collapse of Kabul Bank in 2010 struck a blow at Afghanistan's banking system. From its inception, the National Unity Government made the resolution of the Kabul Bank crisis the centerpiece of its fight against corruption. This report updates the government's progress in recovering stolen assets, charging individuals, and addressing the regulatory deficits that enabled the fraud, then provides recommendations for strengthening the regulatory and judicial climate in which banking operates.

## ABOUT THE AUTHOR

Grant McLeod is principal consultant at Global Development Advisors LLC, where he mainly focuses on governance, anticorruption, and the justice sector in Afghanistan. Formerly he was the senior policy and legal adviser for the Independent Joint Anti-Corruption Monitoring and Evaluation Committee, which monitors and evaluates anticorruption efforts in Afghanistan.

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*Grant McLeod*

## Responding to Corruption and the Kabul Bank Collapse

### Summary

- The September 2010 collapse of Kabul Bank as a result of fraud and embezzlement involving the political elite continues to resonate strongly in Afghanistan, epitomizing the proposition that impunity exists for powerful people.
- The symbolic importance of Kabul Bank was recognized by President Ashraf Ghani, who made it a cornerstone of his anticorruption campaign. But inadequate investigations, questionable legal proceedings, political expediency, obstruction, intimidation, and regulatory weaknesses are still apparent.
- Criminal court procedures were done hastily to satisfy President Ghani's interest in demonstrating tangible progress before the London Conference of international donors and Afghan government officials in December 2014. Political constraints and capacity issues at the Attorney General's Office have also resulted in the absence of any further meaningful investigations into beneficiaries and participants.
- The Ghani government has focused on recovering stolen assets while paying less attention to the criminal and punitive elements of the case. Although efforts to recover the hundreds of millions of dollars missing from Kabul Bank continue, there has been limited success since the National Unity Government came to power in September 2014. Powerful people are refusing to make timely repayments, and formal requests for legal assistance from other countries have failed to progress sufficiently because of the government's failure to address technical deficiencies in the documents of request.
- Progress has been made in the regulatory reforms needed to secure the financial sector, but implementation continues to be problematic, and oversight of some money laundering channels is weak. The Afghan government should focus on strengthening oversight of money service providers and the reporting and investigation of large cash transfers and suspicious transactions.

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## Introduction

In September 2010, Kabul Bank, a systemic bank critically important to Afghanistan's economic viability, collapsed after losing a large amount to theft and fraudulent lending, and was placed into conservatorship.<sup>1</sup> The crisis severely stressed the Afghan financial system. At the time of its collapse, the bank held the savings of nearly one million Afghans, totaling more than \$1.3 billion.<sup>2</sup> The realization that depositors' money had been stolen led to a run on the bank, resulting in \$500 million being withdrawn within just a few days.<sup>3</sup> Complete failure was averted only when the Afghan government stepped in to provide \$825 million from the central bank's reserves to cover deposits.

The aftermath of the Kabul Bank scandal revealed a complex fraud and money laundering operation headed by the bank's administrators, including its founder and chairman, Sher Khan Farnood, and his head of security turned chief executive officer, Khalilullah Ferozi. The fraud was perpetrated by the bank's maintaining two sets of accounting systems, one the real one and the other to satisfy regulators, and creating loan files in the names of fake companies. In addition, millions of dollars' worth of falsified asset purchases were set up to embezzle funds. Other money was laundered by paying for oil and gas products from outside the country or by paying inflated prices for goods and services. Much of the money was laundered to Dubai through the Shaheen Exchange, which was owned and operated by Farnood.<sup>4</sup>

Six years later the Kabul Bank crisis continues to symbolize the pervasive corruption and impunity that have threatened the legitimacy of the Afghan government. The crisis has shaken confidence in the banking system<sup>5</sup> and trust in justice. The involvement of powerful people, among them the brother of the former president Hamid Karzai and the brother of the former first vice president, immediately drew accusations of corruption and nepotism that have never been adequately answered. The response to the Kabul Bank crisis under the Karzai administration was colored by false promises, deceptive actions, illegal orders, and dubious criminal proceedings. The recovery effort, though it made significant progress, underperformed because of inability to compel repayment from some of the largest and most powerful debtors.

The inauguration of President Ashraf Ghani, a former senior official at the World Bank, and the installation of the National Unity Government (NUG) in September 2014 brought hope that the perpetrators and beneficiaries of the Kabul Bank fraud would finally be brought to justice. The NUG labeled action on the fraud a "top signaling priority" and indicated that it would be a "bellwether of [the NUG's] credibility on fighting corruption."<sup>6</sup> President Ghani wasted no time moving forward. Two days after he was sworn into office he issued a presidential decree aimed at comprehensively dealing with all remaining aspects of the case. The decree directed the Supreme Court to resolve the case and ordered the Attorney General's Office (AGO) to detain and prosecute all suspects and to pursue requests from foreign countries to trace and recover funds that had been transferred abroad. The Kabul Bank receivership, responsible for managing the bad assets of Kabul Bank, was ordered by President Ghani to summon debtors, and the Ministry of Finance was directed to pursue the privatization of the state-run New Kabul Bank which contained the "good assets" remaining from Kabul Bank.<sup>7</sup>

President Ghani's decree on cleaning up Kabul Bank and subsequent actions had the intended effect of buying credibility in the short run. The December 4, 2014, London Conference communiqué called his actions "decisive" and an "important immediate step on corruption,"<sup>8</sup> and President Ghani proudly stated that his actions "broke the aura of impunity" surrounding Kabul Bank.<sup>9</sup>

But on closer inspection, it is apparent that most of the progress toward accountability for the Kabul Bank collapse under the NUG has been illusory. Despite the appearance of early and decisive action, the Kabul Bank case has proceeded much as it did under the Karzai administration. Criminal proceedings have been superficial, and many politically connected actors who appeared to be involved have not been investigated. Sincere efforts to recover funds continue to be impeded by intimidation of those attempting to do their jobs. Structural reform has been stymied by a lack of institutional capacity and donor support. Altogether, the challenges facing the resolution of Kabul Bank continue to epitomize the serious challenges that face Afghanistan, such as nepotism, a weak rule of law, an ineffective judicial system, and low regulatory capacity.

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## **The Path to Fraud**

When Kabul Bank was first established in 2004 its founder, Sher Khan Farnood, initially held tight control of its lending portfolio while delegating the technology and deposit products to professionals. From mid-2008 Farnood relinquished operational control to Ferozi and started concentrating on various other business endeavors, including Pamir Airlines, real estate transactions in Dubai, importing oil from Uzbekistan, and acquiring building materials from China.<sup>10</sup> Under Ferozi's tenure, Kabul Bank increasingly spread money around to powerful and influential people in Afghanistan. Hundreds of thousands of dollars went to President Karzai's reelection campaign in 2009,<sup>11</sup> and other donations reportedly were provided to Karzai's chief campaign fundraiser, the former minister of finance Omar Zakhilwal.<sup>12</sup> The bank's fraudulent activities were fueled by the deposit funds of everyday Afghans, many of whom had government salary accounts at the bank. The bank's administrators had also devised a scheme offering weekly prize draws to depositors, which generated large additional deposits.<sup>13</sup>

Farnood began to lose control of the bank as a result of his focus on other activities and his absence from Kabul. In 2009, Ferozi reportedly attempted to remove Farnood with the support of Mahmood Karzai and Qasim Fahim, brothers of Afghanistan's former president and first vice president, respectively, who were both Kabul Bank shareholders.<sup>14</sup> When Farnood realized that he would not be able to retain control of the bank, he sought to expose the illegal activities of the bank by requesting an interview with the *Washington Post* and made an appearance at the U.S. embassy, which set in motion the events that led to the detection of the fraud.<sup>15</sup> Kabul Bank was put into conservatorship at the end of August 2010 and into receivership in April 2011, resulting in the assignment of bad assets to the Kabul Bank receivership and the establishment of New Kabul Bank which was created as the state-run successor to Kabul Bank to carry on banking operations with the assets that were not associated with fraud. A forensic audit conducted at this time provided details regarding the mechanics and beneficiaries of the fraud, which read like a who's who of the Afghan elite.<sup>16</sup>

## **Criminal Justice: Prosecutions without Challenging the Elite**

### ***Criminal Proceedings under Karzai***

The criminal investigation and prosecution of those involved in the Kabul Bank fraud under the Karzai administration was widely criticized. Although the main perpetrators, Farnood and Ferozi, were eventually prosecuted and sentenced, the failure to investigate politically connected people and other powerful individuals among Afghanistan's elite added to the perception of impunity.

Those who were charged fall into three categories, none of which include the beneficiaries of the fraudulent loans other than Farnood and Ferozi. In the first category are the main perpetrators, Farnood and Ferozi, whose charges included embezzlement, money laundering, and forgery. In the second category are Kabul Bank employees, who were charged as accomplices and with a variety of other offenses, including forgery. The third category includes Da Afghanistan Bank (DAB, Afghanistan's central bank) and Financial Transactions and Reports Analysis Center of Afghanistan (FINTRACA) officials, who were charged with using their official authority to impede the implementation of the law. The former DAB governor, deputy governor, and the Kabul Bank conservator were additionally charged with embezzlement.<sup>17</sup>

The Kabul Bank Special Tribunal issued its judgment in March 2013 after a number of extrajudicial meetings and a short trial. Despite the charges of embezzlement and money laundering, the tribunal convicted Farnood and Ferozi only of breach of trust and sentenced them to five years in prison, with an order to repay the amounts stolen. Kabul Bank and central bank officials were convicted under Section 130 of the 2004 constitution, a provision that allows a court to apply Hanafi jurisprudence, and sentenced to four years and two years in prison, respectively. The Kabul Bank conservator was sentenced to three years for breach of trust, and the DAB governor and deputy governor were convicted of using their official authority to impede the implementation of the law and sentenced to two years and one year, respectively.<sup>18</sup>

The special tribunal judgment was criticized for its procedural and substantive deficiencies. There were no witnesses, the sentences were disproportionate—in some cases very light and in others overly heavy—and, most important, the tribunal neglected to register convictions for money laundering, which would have enabled Afghan authorities to pursue millions of dollars being held in offshore accounts.<sup>19</sup> One of the defendants attributed the leniency of his sentence to his relations with one of the judges and within the AGO.<sup>20</sup>

### ***Criminal Proceedings under Ghani***

On October 12, 2014, eleven days after Ghani's Kabul Bank presidential decree, the AGO transferred thirty-one files to the Appeals Court.<sup>21</sup> A panel of five judges held two hearings on November 10–11, lasting four or five hours each day.<sup>22</sup> After the second day the judges deliberated for less than an hour and returned with six handwritten pages of judgment, raising questions as to whether the judgment may have been written before the hearings took place.<sup>23</sup> There were no witnesses other than the international forensic auditor, who was hastily called to testify.<sup>24</sup>

Ultimately, the Appeals Court returned a conviction against Farnood and Ferozi for money laundering and embezzlement, sentencing them to ten years' imprisonment. Farnood was ordered to repay \$334.3 million and fined \$237.4 million, while Ferozi was ordered to repay \$196.6 million and fined \$137.2 million. The court showed some compassion for the Kabul Bank and DAB officials, who were convicted of intentionally abstaining from their duty to report the crimes; Kabul Bank officials received one-year prison sentences and DAB officials received six months. The former head of FINTRACA was convicted of the same charge and was fined Afs 24,000 (approximately \$360 USD), while the head of the Financial Supervision Department of the central bank, who was responsible for regulatory oversight of Kabul Bank, was found not guilty of any wrongdoing, despite his employees being found culpable. Those who were accused but had fled the country, including the former governor of DAB and some employees of Kabul Bank, did not have convictions registered because of their absence.<sup>25</sup>

The court ordered the AGO to identify, locate, and freeze the assets of people who had "looted" Kabul Bank, including Mahmood Karzai, Qasim Fahim, and Abdul Ghafar Dawi, who is the husband of a powerful former member of parliament and current ambassador to Nor-

way, until their liabilities were cleared. The court also ordered the AGO to investigate 227 individuals identified by Farnood as beneficiaries of Kabul Bank loans.<sup>26</sup>

The Kabul Bank case was sent to the Supreme Court on November 26, 2014. Because of the symbolic importance attached to the case by President Ghani, there was a push to have the Supreme Court issue its final judgment before the London Conference in December 2014.<sup>27</sup> The Supreme Court completed its judgment within five days of receiving the case<sup>28</sup> and announced its decision on December 4, 2014, the same day on which the London Conference took place.<sup>29</sup>

The Supreme Court's decision confirmed the conviction and sentences against Farnood and Ferozi but reduced the sentences against Kabul Bank and DAB officials on compassionate grounds from one year to six months and from six months to three months, respectively. The court affirmed the Court of Appeals order freezing the assets of the "looters" of Kabul Bank and the investigation of the 227 beneficiaries identified by Farnood,<sup>30</sup> representing nearly \$250 million owed.<sup>31</sup> The list includes the former first vice presidents Marshal Fahim and Yunus Qanooni, current first vice president Abdul Rasheed Dostum, former president Karzai's nephew Yama Karzai, former minister of finance Omar Zakhilwal, former minister of foreign affairs Zalmai Rasool, First Deputy Governor of DAB Khan Afzal Hadawal, the grandson of Afghanistan's last shah, Prince Mustafa Zahir, and the former head of the Independent Commission for Overseeing Implementation of the Constitution Gul Rahman Qazi.<sup>32</sup>

After the final judgment of the Supreme Court the relevant government agencies undertook an effort to address the list of 227 beneficiaries, but the discussions devolved into officials attempting to arbitrarily remove various names from the list without considering whether the individuals owed the amount or not, according to officials who participated in the process.<sup>33</sup> Subsequently, sixty-two people whose names were on the list acknowledged and repaid their debt, representing over \$20 million owed. This group included former minister Rasool, Prince Mustafa Zahir, and the former head of the Independent Commission for Overseeing Implementation of the Constitution Gul Rahman Qazi.<sup>34</sup> Another twenty-four people on the list, owing in total \$12,597,398, were referred to the AGO for investigation, including Yama Karzai and former first vice president Qanooni.<sup>35</sup> The AGO did not undertake a serious investigation of these or any others on the list, having done nothing more than send letters of inquiry to some.<sup>36</sup>

## Recovery of the Missing Money

### *Reserve Repayments: Paying Back the Central Bank*

In September 2010, Kabul Bank depositors rushed to get their money out of the bank when it became public knowledge that there was massive fraud. Kabul Bank was insolvent at the time and had a loan to deposit ratio of 70 percent, which meant that more than \$900 million of its deposits were committed to mostly fraudulent loans.<sup>37</sup> The Afghan government stepped in with a lender of last resort facility totaling \$825 million to secure deposits and avoid a larger crisis. The facility was funded from Afghanistan's central bank reserves with repayment terms agreed to between the Ministry of Finance and DAB, according to a promissory note executed by both parties. According to the agreement, repayment was to take place over eight years, ending in 2019.<sup>38</sup>

More than half of the money borrowed from the reserve has been repaid since 2010, with DAB reporting \$388 million outstanding as of October 20, 2016.<sup>39</sup> The amount repaid comprised \$205.2 million from cash recoveries<sup>40</sup> and the rest from the Afghan government's budget. Repayments from both sources have fallen considerably under the Ghani adminis-

tration, which has seen only \$30 million recovered since Ghani took office,<sup>41</sup> while budget repayments were reduced to none in 2015 and only \$11.4 million in 2016, compared to \$66.7 million in 2014 before Ghani took office.<sup>42</sup> The Ghani government has recommitted itself to eliminating the lender of last resort balance by the end of 2019.<sup>43</sup> The 2017 budget currently under review in the National Assembly includes approximately \$145 million for repayment, which is close to the amount necessary over the next three years to meet the goal of paying it off by 2019.<sup>44</sup>

### ***Current Recoveries***

The Supreme Court endorsed the final liabilities of Kabul Bank debtors in a February 2015 directive.<sup>45</sup> The final assessment had Farnood with \$418.2 million in liabilities, Ferozi \$259.2 million, Mahmood Karzai \$17.4 million, Qasim Fahim \$46.7 million, and Abdul Ghaffar Dawi \$37.8 million, along with other, smaller debtors. Normal customers, those who had received legal loans but had not repaid them, were assessed \$52.7 million, and Kabul Bank employees who had received advance salaries were assessed \$1.5 million.<sup>46</sup>

As of early November 2016, the Kabul Bank receivership reported recovering \$447 million, an amount that included cash recoveries of \$205.2 million and a number of other monetary items, among them \$50 million in assets that had been transferred to the Afghan government but were not yet paid for, \$32.5 million in loans that debtors had provided collateral for but that had not been repaid, \$98.2 million representing loan interest that was waived under President Karzai, \$14.1 million in loan interest waived under the current government, and \$47 million of Dubai real estate that is currently tied up in litigation.<sup>47</sup> The assets transferred to the government included an oil storage complex, vehicles, apartments in Gulbahar Center and Esteqlal Township in Kabul, and assets from Pamir Airlines.<sup>48</sup> However, the government had not budgeted any amount for the public entities that had purchased these assets to pay for them.<sup>49</sup> According to a July 2016 report from the International Monetary Fund (IMF), the Afghan government has committed to including an allocation for purchasing these assets in the 2017 budget.<sup>50</sup>

### ***The Incentive Procedure***

President Ghani reportedly entered office believing that a lot more could be done to recover the stolen assets of Kabul Bank.<sup>51</sup> He therefore established the Committee on Accelerating Recovery of Kabul Bank Assets, which began work in early 2015.<sup>52</sup> The committee consists of relevant government agencies, including the receivership, the Financial Disputes Resolution Commission, the AGO, DAB, and New Kabul Bank. The focus of the committee first was on enforcing the Supreme Court's decision. However, this was viewed as difficult because of the powerful people involved and because many assets were not held in the names of the debtors. The president approved an incentive procedure in March 2015 to overcome these challenges.<sup>53</sup> Under this procedure, debtors who acknowledged their debts and made regular payments would be assessed a reduced rate of interest. Debtors were required to make an advance payment of 20 percent of their total debt and to repay the total outstanding amount in one to five years. Debtors who did not agree to pay off their debt would have their assets seized according to a court order.<sup>54</sup>

The incentive procedure did motivate several debtors to come forward and sign repayment agreements. Currently, there are thirty-five agreements signed, representing \$46.6 million to be repaid and \$9.2 million of forgiven interest. Of the \$46.6 million, \$14.1 million has been repaid and \$32.5 million subject to repayment according to an agreed-upon repayment schedule.<sup>55</sup> Mahmood Karzai reportedly paid all the outstanding amount of his assessed liabilities at once, except for a \$585,000 loan that he claimed to have paid

already.<sup>56</sup> Karzai filed a case in the Commercial Court to challenge the amount outstanding, but as of November 2016 the court had not yet issued a judgment.<sup>57</sup>

Most of the thirty-five agreements are with relatively small debtors, including seventeen Kabul Bank employees who received salary advances and collectively still owe \$186,226. Six agreements are with larger debtors who owe more than \$1 million, such as the brother of former first vice president Fahim, who still owes \$3.4 million; Gulbahar Habibi, a well-established businessman in Afghanistan, who owes \$16.3 million; and Mohammad Zahir Tahir, who owes \$7.7 million.<sup>58</sup> Of the people who signed agreements, many have not paid according to their agreed-upon schedule, including several of the major debtors.<sup>59</sup> There are suspicions that high-ranking officials at the Kabul Bank receivership are facilitating the delays in repayment without proper justification, and there are reports that the collateral, such as deeds to property, have disappeared from some debtor's files.<sup>60</sup>

On June 22, 2015, after the expiration of the three-month incentive period, President Ghani set a one-week deadline for debtors to settle their accounts, after which they would be referred to the AGO for prosecution.<sup>61</sup> Of those who did not sign an agreement, fourteen were major debtors, who collectively owed \$626.9 million; forty were small borrowers, owing \$21 million; and sixty-four were advance salary recipients, owing just over \$400,000.<sup>62</sup> The fourteen major debtors were mostly shareholders of the bank who had previously acknowledged their debts in legally binding agreements signed in late 2010. In addition to Farnood and Ferozi, the list included the largest other net debtor, Abdul Ghafar Dawi, who had assessed liabilities of \$34.8 million; Khalid Noor, the son of Balkh governor Atta Noor, who owes \$4.5 million; and Mahmood Karzai, for his disputed amount of \$585,000.<sup>63</sup> None of the fourteen other than Mahmood Karzai have made any substantial payments. The cases were referred to the AGO, who then reportedly issued arrest warrants, to be executed by the Ministry of Interior. However, most of the persons are outside the country, and the Ministry of Interior has not moved to arrest those still in Afghanistan, such as Dawi.<sup>64</sup>

### ***International Recovery of Funds***

Between 2007 and 2011, at least \$873 million of licit and illicit funds were sent from Kabul Bank to recipients in twenty-eight countries for the benefit of related persons, including bank management personnel, shareholders, and their close relatives. The largest of the recipient countries were the United Arab Emirates (UAE) (\$410.1 million), Latvia (\$130.7 million), and China (\$117.9 million), where Farnood reportedly owned a money exchange. The transfers included \$53.2 million for related-party bank accounts; \$334 million for Shaheen Exchange bank accounts; \$204.6 million for purchase of oil and gas products and services from Turkmenistan and Kazakhstan; \$65.7 million for Pamir Airlines expenses; \$99 million for general trading, construction materials, tobacco, and other oil- and gas-related transfers by related parties; and \$116.4 million sent to China by the Shaheen Exchange. The largest transfer to China, \$93 million, went to Xinjiang Qitai Xilu Company Limited, which appears to be related to a holding company owned by Farnood.<sup>65</sup>

The recovery of funds held outside Afghanistan relies on the cooperation of other jurisdictions if the debtors refuse to cooperate. The Afghan Ministry of Justice must make a formal request for mutual legal assistance to the foreign country, which is to be delivered through diplomatic channels. Prior to the NUG coming to power, Afghanistan had requested assistance from a number of countries, including the United Kingdom, Germany, the UAE, and Switzerland.<sup>66</sup> However, the requests suffered from technical deficiencies and were not executed.<sup>67</sup> In addition, they were not based on a final order of the Afghan courts for convictions related to money laundering, which is a prerequisite.

***Between 2007 and 2011, at least \$873 million of licit and illicit funds were sent from Kabul Bank to recipients in twenty-eight countries for the benefit of related persons, including bank management personnel, shareholders, and their close relatives.***

After the Supreme Court's decision of December 2014, Afghan government officials sent a list of the debtors to embassies around the world, requesting that they identify and freeze these individuals' assets.<sup>68</sup> However, these requests were also deficient. For example, the Afghan embassy in Abu Dhabi received a letter in August 2015, but the request listed only names and bank accounts, without any context to satisfy the mutual legal assistance agreement between the two countries.<sup>69</sup> It was not until August 2016 that a compliant mutual legal assistance request was submitted to the UAE; however, the UAE advised that it could not read the copy, and the original documents were resubmitted on September 25, 2016. As of November 2016, there had been no update regarding the UAE's execution of the request.<sup>70</sup>

The United States received a technically deficient request in May 2015 and went so far as to identify the remedial steps that were required, but no additional request was received.<sup>71</sup> President Ghani decided to pursue international recoveries outside the established international legal framework for requesting legal assistance. In February 2016 the president announced that he had sought the cooperation of the Special Inspector General for Afghanistan Reconstruction (SIGAR) for international recoveries,<sup>72</sup> indicating that SIGAR would have full access to banking and financial records<sup>73</sup> and ordering Afghan entities to provide such documents to SIGAR.<sup>74</sup>

## **Political Complications: Resolving the Kabul Bank under Ghani**

### ***Investigation of Kabul Bank Beneficiaries: An Impossible Task***

Shortly after President Ghani reopened the Kabul Bank case, the AGO announced that it had arrested seven people, issued warrants for twenty-one others, and claimed that it was "chasing" others through Interpol.<sup>75</sup> The AGO also claimed to have frozen the assets of Mahmood Karzai, Fahim, and Dawi following the verdict of the Court of Appeals.<sup>76</sup> Despite the appearance of action, however, little was achieved. The people arrested represented the low-hanging fruit of Kabul Bank and DAB employees.<sup>77</sup> The "chasing" of people through Interpol amounted to adding the former governor of DAB—and favorite scapegoat—to the Interpol list.<sup>78</sup> In addition, a letter was sent to UAE officials requesting that they arrest eight low-level individuals that Afghan authorities believed were in Dubai, but this was rejected by the UAE because such requests need to be submitted through Interpol, which was not done by Afghan authorities.<sup>79</sup> In a similar vein, the attempt to freeze and seize assets amounted to writing letters to a number of government entities without sufficient detail on the individuals or the assets, with the result being that no assets were frozen, despite public claims to the contrary.<sup>80</sup>

One of the themes common to both the Karzai and Ghani administrations is the lack of further criminal investigation into a number of suspected individuals, particularly Mahmood Karzai, Qasim Fahim, and the 227 beneficiaries whom the court had ordered to be investigated.<sup>81</sup> Whether guilty or not, high-profile individuals have been immune from investigation because of political sensitivities.

### ***Challenges Facing the Receivership: The Perils of Doing Your Job***

The Kabul Bank receivership faces many of the same challenges that it did under the Karzai administration, with officials continuing to receive threats and pressure from some of the large debtors.<sup>82</sup> As one official stated, "You can only go so far, but cannot push. If there are no recoveries, there is no problem."<sup>83</sup>



These threats have already had very real consequences. For example, Dawi was reportedly threatening to undermine the Kabul Bank receivership after coming under pressure to repay his \$34.8 million liability. Dawi reportedly had his wife, an influential former member of parliament, reach the president with allegations that the receiver and deputy receiver were threatening to add another \$5 million to Dawi's liabilities if he did not pay \$200,000 in bribes.<sup>84</sup> The president authorized the National Directorate of Security to conduct a sting operation, which was executed by an official who was reportedly a former employee of Dawi's at Aria Television.<sup>85</sup> The deputy receiver claims that he was induced to meet Dawi to collect collateral for a repayment agreement that Dawi was negotiating. At this meeting, \$100,000 in marked bills was provided to the deputy, and he was arrested for taking bribes.<sup>86</sup>

The deputy identified the receiver as an accomplice in the initial interrogation but later retracted his statement, claiming that he had been physically coerced into making it.<sup>87</sup> The receiver and his deputy denied all allegations, pointing out that it would have been impossible for them to alter the court's determination of Dawi's liability even if they had wanted to.<sup>88</sup> During the investigation the AGO sought evidence from Dawi, but nothing more than a statement was provided.<sup>89</sup> Despite the lack of evidence, the Primary Court convicted the receiver and the deputy in August 2015 of receiving bribes and sentenced them each to two years and four months of imprisonment and a fine of \$50,000. The Supreme Court made a final judgment on December 8, 2015, and increased the punishment to five years' imprisonment and a \$50,000 fine.<sup>90</sup> Ultimately, the former receiver was released in October 2016 when the president issued a decree that reduced the sentences of a number of prisoners, to mark Eid al-Adha.<sup>91</sup>

### ***The (Not So) Smart City Fiasco***

Shortly after the incentive procedure was approved, the legal adviser to President Ghani and the chairman of the Financial Disputes Resolution Commission visited Bagram prison to speak to Ferozi and Farnood at the president's direction.<sup>92</sup> Farnood reportedly indicated that he "would not repay a penny" of the amount he owed.<sup>93</sup> Meanwhile, Ferozi agreed to repay on the condition that he be allowed to access his property. He argued that it would be impossible for the government to identify his assets because they were hidden in the names of other people.<sup>94</sup> Initially the government was not willing to agree, but in July 2015 Ferozi's family petitioned the president to transfer him from Bagram to Pul-e-Charkhi Prison in Kabul. The request was based on Ferozi's health condition and the lack of medical facilities in the Bagram area.<sup>95</sup> On July 25, 2015, a directive from the president stated that a decision to transfer Ferozi would be taken after he had established a timetable for repayment and made a first payment. He further directed that immediate measures would be taken to release Ferozi if guarantees were given to ensure that the amount he owed was paid back.<sup>96</sup> This directive was issued despite the legal requirement that the AGO or the head of the prison, based on the recommendation of the doctor-in-charge, order the transfer of ill prisoners to medical centers outside the prison.<sup>97</sup>

Subsequently Ferozi prepared a plan for the repayment of his debts and provided collateral in the form of 58,000 precious stones.<sup>98</sup> The repayment plan included revenues from Gas Group, in which Ferozi was a shareholder, and identified several properties that he owned under different names in Kabul and Mazar-e-Sharif.<sup>99</sup> Afghanistan's business licensing agency was requested to cooperate with respect to the renewal of Gas Group's trade license,<sup>100</sup> and the president's former legal adviser requested that the minister of finance require government entities to make contracts with Gas Group for their winter needs.<sup>101</sup>

Ferozi negotiated a deal with the Nabizada Wardak Construction Company<sup>102</sup> to build a township on his land, with 50 percent of the profits to be used to pay off Kabul Bank

debts.<sup>103</sup> Ferozi and the construction company petitioned the president to obtain permission to build the township, and the president's legal adviser sent letters to the Ministry of Urban Development, with copies to the AGO, stating that "it is hoped that in accordance with relevant rules and regulations [you] cooperate and give permission." The same letter instructed the AGO to take necessary measures to unfreeze the land according to the regulations.<sup>104</sup> The president's legal adviser wrote to the National Directorate of Security seeking cooperation in allowing Ferozi to serve his sentence while in the directorate's custody in Kabul because he had met the president's preconditions.<sup>105</sup>

On November 4, 2015, Ferozi and high-level government officials presided over a stone-laying ceremony for the development of 8,800 homes in Kabul, otherwise known as Smart City.<sup>106</sup> The Smart City deal demonstrated the government's focus on recoveries. The sentiment among government officials was that it was better to secure cooperation and have the money returned than never to recover the money.<sup>107</sup> However, public outrage soon emerged as photographs and a video of Ferozi surrounded by a number of high-ranking government officials at a press conference strikingly depicted the impunity and nepotism associated with Kabul Bank.

President Ghani claimed he was not aware of the Smart City deal and nullified the agreement shortly after the public's negative response.<sup>108</sup> The president suspended his legal adviser and directed a review of the circumstances leading to the project. The review found that the agreement was made in a good faith effort to recover funds and laid much of the blame on the president's former legal adviser and the AGO for allowing activities contrary to the law.<sup>109</sup> Although the review was silent on Ghani's knowledge of the agreement, the former legal adviser attested to the president's participation in committee meetings and specific instances in which he had provided progress reports to the president and had sought direction on the handling of Ferozi.<sup>110</sup>

## **Banking and Financial Oversight: Privatization of New Kabul Bank**

After Kabul Bank was put into receivership in 2011, it was required to separate its assets into bad and good assets, with the latter moved to New Kabul Bank. New Kabul Bank is fully owned by the Afghan government, and its disposition has been one of the major outstanding issues related to the Kabul Bank crisis. As of this writing the government is engaged in its third attempt to privatize the bank. It was originally put up for sale in September 2013, but the resulting bids were rejected by the Council of Ministers as too low. Subsequently a successful bidder was identified, but the bid was not approved before the NUG came to power. After the Ghani administration took office, the Ministry of Finance announced plans to combine New Kabul Bank with the other two government-owned banks,<sup>111</sup> but it backed off when the IMF asked them to reconsider.<sup>112</sup>

The latest sale of New Kabul Bank was initiated on October 28, 2015.<sup>113</sup> There were two qualified tenders, one from an Afghan company called the Joint Stock Company and the second from the Muslim Commercial Bank of Pakistan.<sup>114</sup> It was announced that the Joint Stock Company was the successful bidder with an offer of \$31 million for the bank.<sup>115</sup> The Ministry of Finance has completed the bidding process and handed the file off to DAB for its due diligence assessment. If DAB approves, the offer will go to the Council of Ministers.<sup>116</sup>

New Kabul Bank will be transferred with a clean balance sheet, with net assets equaling net liabilities. This means that it must transfer any outstanding bad assets to the receivership, and the government must cover all outstanding losses. New Kabul Bank's 2015 financial statements indicate that the bad assets to be transferred to the receivership amounted to \$41.4 million and the bank's accumulated loss stood at \$50.4 million.<sup>117</sup> Recently, Afghan

authorities committed to recapitalizing New Kabul Bank by the end of 2016.<sup>118</sup> To this end, \$106 million was budgeted in the midterm budget review to cover past accumulated losses, reconcile accounts with receivership, and inject \$15 million for the shares of New Kabul Bank, which had never been paid for.<sup>119</sup>

New Kabul Bank currently has seventy-nine branches, deposits of approximately \$298 million, and a net income of \$20.5 million, mostly from fees and commissions because of a moratorium on lending.<sup>120</sup> Since October 2014, New Kabul Bank has taken a number of actions to reduce its operational losses. These steps have included the renegotiation of rent at branches down from \$9 million to \$5.9 million to reflect lower market rates and the renegotiation of insurance payments from \$952,000 to \$195,000 because of the lack of a lending portfolio. In addition, approximately 130 underperforming staff members were removed, international training was reduced, and three branches were closed.<sup>121</sup> These efforts have resulted in a significant reduction in the bank's operating expenses from \$25.7 million to \$21 million and its operating losses from \$4.2 million to \$525,000.<sup>122</sup> In September 2016, New Kabul Bank posted a profit of \$334,663 for the year, likely marking the first time in its history that it is profitable.<sup>123</sup>

***In September 2016, New Kabul Bank posted a profit of \$334,663 for the year, likely marking the first time in its history that it is profitable.***

## Recommendations for Remedial Action

Several regulatory and operational issues in the banking and financial sector bear remediation. The following steps suggest actions that can be taken.

### ***Improve Banking Sector Health***

Although the primary responsibility for the Kabul Bank fraud lies with the perpetrators, there were a number of opportunities to detect it sooner. A former internal audit official at the bank blamed the lack of capacity at oversight agencies such as the Financial Supervision Department of DAB and FINTRACA as one of the main reasons why the bank collapsed. In addition, FINTRACA reportedly failed to pursue large cash transfers or to question why imported goods were routed through the Shaheen Exchange instead of through the corresponding banks.<sup>124</sup>

The NUG has made several commitments to strengthen financial sector oversight and anti-money laundering efforts, including implementation of anti-money laundering laws, improving supervisory capacity, approving a new banking law and regulations, and implementing the IMF's Staff-Monitored Program and Financial Action Task Force (FATF) recommendations.<sup>125</sup>

The IMF became involved in Afghanistan in 2002 to, in part, provide technical assistance to strengthen the central bank. Its first Extended Credit Facility (ECF) program ran from 2006 to 2010 and focused on macroeconomic stability. The second ECF program was approved in November 2011 and was heavily focused on safeguarding the financial sector, strengthening the banking law and central bank supervision, and seeking resolution of outstanding Kabul Bank issues.<sup>126</sup> The second program was not successfully implemented,<sup>127</sup> however, and many of the reforms contemplated did not progress significantly, thereby leaving the financial sector at risk.

The inauguration of the Ghani administration presented an opportunity to complete the reforms necessary to secure the financial sector. In May 2015 the IMF approved a Staff-Monitored Program as an incremental program to establish credibility and build a track record for a future ECF program.<sup>128</sup> In May 2016 the IMF concluded that the program had been successfully implemented, "taking into account" the "challenging circumstances" that Afghan officials faced.<sup>129</sup> The IMF also highlighted positively the 71 percent liquidity ratio and 28

percent capitalization rate of Afghan banks.<sup>130</sup> However, New Kabul Bank's liquidity ratio fell to 59 percent at the end of 2015, and the Afghan government had not capitalized it.<sup>131</sup>

Despite the apparent success, implementation challenges exist, and the financial sector is "fragile," according to a May 2016 IMF review.<sup>132</sup> According to the IMF, seven of Afghanistan's commercial banks are weak, and two important banks are in hazardous condition.<sup>133</sup> In addition, nonperforming loans in the banking sector increased to 12.3 percent in 2015 from 7.8 percent in 2014.<sup>134</sup>

### ***Implement an Anti-Money Laundering Regime***

The FATF has consistently raised concerns about the strength of Afghanistan's anti-money laundering regime.<sup>135</sup> Afghanistan has had an action plan for FATF compliance in place since 2011, but Afghanistan was noted as a jurisdiction not making sufficient progress and was at risk of being moved to the list of countries that required countermeasures.<sup>136</sup> In response, a new anti-money laundering law was hastily enacted in late June 2014 to avoid the country being put on the blacklist.<sup>137</sup> In February 2016 the FATF recognized that Afghanistan had taken steps toward improving its anti-money laundering regime but still had strategic deficiencies. The FATF called on Afghanistan to implement its legal framework and to implement effective controls for cross-border cash transactions.<sup>138</sup>

### ***Regulate and Educate Money Service Providers***

More than nine hundred money service providers are operating in Afghanistan.<sup>139</sup> Money service providers are the principal mechanisms for engaging in financial activity. It is estimated that 90 percent of financial transactions run through them, with unregulated money service providers accounting for "a substantial portion of the illicit proceeds being moved in the financial system."<sup>140</sup> Money service providers must be licensed, must be owned by fit and proper persons,<sup>141</sup> must meet operational requirements, and must take measures to prevent money laundering. Although the DAB may conduct inspections and revoke licenses, so far it has focused only on registration, and examinations have been limited to a review of the qualifications of key personnel.<sup>142</sup>

The education of money service providers is an important area of deficit. These individuals are required to submit suspicious transaction reports to FINTRACA, but many do not fulfill their reporting requirements. According to an Afghan official in the DAB Financial Supervision Department, money service providers have demonstrated little knowledge of their regulatory obligations and have difficulty complying with regulations.<sup>143</sup>

### ***Improve Reporting of Large Cash Transfers and Suspicious Transactions***

The large cash transfer and suspicious transaction reporting regime is meant to ensure that transactions are appropriately flagged, reviewed, and investigated. This is the front line in the fight against money laundering. Although banks are consistently reporting large cash transfers, there is vulnerability in the lack of suspicious transactions being reported.<sup>144</sup> A further vulnerability appears in the verification process, which requires dissemination of suspicious transaction reports to the appropriate authorities for investigation if validated by FINTRACA; the authorities are then supposed to investigate and report back to FINTRACA, but this is not happening consistently. There is a sense that all participants in the system, including government agencies, money service providers, banks, and oversight agencies, require additional training and technical support.<sup>145</sup>

Another vulnerability in the large cash and suspicious transaction system is the reporting at national borders. A revised regulation governing the reporting of currency and other

valuable instruments at borders, broadly in line with FATF requirements, came into force in February 2016,<sup>146</sup> but implementation is incomplete. Currently reports are only being made from the international airports of Kabul, Mazar, and Kandahar, though there are plans to bring Herat and land borders on-line in the future, based on the readiness of the Afghan Customs Department. Reporting is currently being done in hard copy while an electronic customs system is being designed.<sup>147</sup> The reporting gap is compounded by the absence of reporting from the “Very Very Important Person” procedure at Kabul airport, which would include high-ranking officials.<sup>148</sup>

### ***Improve Regulatory Capacity and Oversight***

The Financial Supervision Department of DAB continues to implement its five-year strategic plan and reportedly is committed to making the transition to risk-based bank supervision. The department has stepped up supervision efforts, with full scope examinations happening annually and special-scope examinations being conducted as required. The Supervision Department reportedly has taken enforcement action against weak and vulnerable banks, with corrective action being monitored by the Special Supervision section to ensure compliance.<sup>149</sup> Although the Financial Supervision Department has increased its organizational structure, turnover remains high, and there is a need for specific technical training.<sup>150</sup> For its part, although FINTRACA has analysts and representatives spread across the country, its analytical capacity is low because many staff members do not have technical backgrounds and the system is not computerized.<sup>151</sup>

Overall, there has been little support for financial oversight since the Kabul Bank crisis and the removal of international advisers from DAB in 2010.<sup>152</sup> The World Bank had a Financial Sector Strengthening Project that included a component for capacity building that was not implemented.<sup>153</sup> The program was restructured to implement a capacity development plan, review the banking regulation framework, and implement action plans for commercial banks.<sup>154</sup> More recently, Afghan authorities and the IMF have agreed on an ECF program to help address financial sector vulnerabilities and governance gaps.<sup>155</sup> On July 20, 2016, the IMF approved a three-year \$44.9 million ECF arrangement. The program sets out a structural reform agenda that focuses on institution building, fiscal and financial reforms, and measures to combat corruption.<sup>156</sup> Meeting the structural benchmarks focusing on fiscal and financial reform have been included as a SMART deliverable under the Self-Reliance through Mutual Accountability Framework agreed to at the Brussels Conference on Afghanistan in October 2016.<sup>157</sup>

## **Conclusion**

Despite the enthusiasm and the hope that the NUG would handle the Kabul Bank case differently from how it had been handled in the past, this has proved not to be the case. The number of high-ranking Afghan officials and power brokers who benefited from the fraud is so large that fully pursuing all potential cases could threaten significant parts of Afghanistan’s governing class. The beneficiaries include vice presidents, ministers, provincial governors, senior central bank regulators, and other powerful people. The political will necessary to seriously review the involvement of these individuals is unlikely to emerge, and even where the political will does exist, there is a lack of capacity to execute. The expectation that Afghanistan, with all its political and capacity challenges, could complete complex criminal investigations and prosecutions that involve hundreds of millions of dollars laundered to numerous countries in the framework of a complex fraud is unrealistic.

Nonetheless, there is room for meaningful action to resolve some of the lingering issues related to Kabul Bank. The international recovery effort offers some promise, if the government takes the relatively simple but essential steps necessary to pursue legal assistance requests. In addition, the implementation of a new IMF ECF program should address the most pressing issues related to weaknesses in the financial sector and financial sector oversight. The technical assistance offered under the IMF program, in addition to the World Bank's program, should help build the missing capacity needed to secure the financial sector. There is also hope that USAID's mission to Afghanistan's five-year Afghanistan Financial Sector Development program, announced in August 2016, can also address some of the underlying issues. Enhanced oversight of the financial sector and the plugging of porous money laundering channels would contribute significantly to fulfilling the NUG's commitments, benefiting Afghans well into the future.

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