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The Kabulbank Scandal

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The Kabulbank scandal

By Warren Coats

The Kabulbank scam in Afghanistan may be the largest theft of depositor money per capita the world has ever experienced. This is the first of a three-part series chronicling the unfolding and ultimate resolution of that scandal.

On Wednesday, Sept. 1, 2010, long lines of customers formed in front of Kabulbank, Afghanistan’s largest financial institution. Da Afghanistan Bank (DAB), the country’s central bank had removed the two top executives of Kabulbank and prompted a run on the bank by worried customers rushing to withdraw their funds. One day later, Afghanistan’s President Hamid Karzai, trying to stem the tide, told concerned depositors, “Kabulbank is safe. People need not panic, need not be worried.”

Kabulbank had grown from nothing when it opened in July 2004 to the largest bank in Afghanistan in just a few years. After just five years Kabulbank had three times more deposits than the next largest bank in Afghanistan, and more than one-third of all deposits in the banking system.

In 2010, it had 68 branches serving most of the country, a large network of ATM cash machines, and a sophisticated IT and accounting infrastructure. The following Saturday was a beautiful, late summer day in Washington, DC. I was sitting in the gazebo in my back garden reading Amy’s War, about the almost two decades of civil war in Sudan, in preparation for my planned trip to Juba, southern Sudan the following week. My 30-some years of experience with the International Monetary Fund (IMF) establishing and advising central banks, including introducing new currencies, was being called upon by Deloitte/USAID to help establish a new central bank and currency in the about-to-be new country of South Sudan. While sitting there pondering how the authorities would handle the Kabulbank crisis, my blackberry rang. “Sorry to disturb you Warren,” said Luis Alberto Cortavarria-Checkley, a former banking supervisor in Peru now with the IMF on the other end. “We are sending a team to Kabul to advise DAB on the Kabulbank crisis. Are you interested in going?”

I was.

“Could you leave tonight? ... Enrique Gelbard is the mission chief and is taking the last Air France flight to Paris tonight and on to Dubai. Marcin Sasin, the Afghan desk economist will be on the same flight. In Dubai you will meet up with Melissa Tullis from the Fund’s Legal Department and you will all proceed from there on Safi Air at 3 a.m. arriving in Kabul at 6:30 a.m. Monday morning.”
“Sure,” I said, “Who is taking care of tickets and visas? They will have to arrange for me to get the visa after I arrive and I will need a letter to convince Safi Air to let me board in Dubai without a visa. I had better start packing.”

The birth and death of Kabulbank

When Afghanistan’s new, post-Taliban government introduced a new currency on Oct. 7, 2002, for all practical purposes there were no banks to help. The three state-owned commercial banks, Bank Millie, Pashtaney, and the Export Promotion Bank were zombies. They had been arms of the government—the pay masters that counted out the cash to pay government employees, handled the government’s foreign payments, and lent their depositors’ money to the government and state-owned enterprises, etc.

When I arrived in Kabul the first time in January 2002 they had not made any loans for a number of years. The branch infrastructure of these banks was not even sufficient to handle the introduction of the new currency and redemption of the old ones.

There were six issues of domestic bank notes in circulation in 2002 – all in the names of former Afghan leaders at the time of their issuance. Between October 7, 2002, and January 2, 2003, all of the old currency had to be exchanged for the new Afghani.

In the absence of functioning banks the exchange relied heavily on a centuries-old system of moneychangers known as Hawala dealers. These unregulated private entrepreneurs provided the services of exchanging one currency for another and money transfers, such as delivering cash to your profligate son backpacking around Europe.

An Afghan can take U.S. dollars to a Hawala dealer in Chicago and have an equivalent amount of dollars or Afghani delivered to a friend or relative in Kandahar within hours on the basis of a name and a password. Hawala dealers existed long before Western Union was even thought of. In 2002 the occupying U.S. military enlisted them to collect the old currencies in exchange for the new one, which required managing inventories of both all over the country.

Before he founded Kabulbank in 2004 as its chairman, Sherkhan Farnood was one of the biggest and most successful Hawala dealers. As a banker Farnood was not entirely confidence inspiring. There was some concern at the central bank at the time whether the relationship lending that moneychangers sometimes engaged in, even though legally they were not supposed to take deposits or lend money, could successfully mature into the collateralized, business plan-based, creditworthiness assessment of modern bank lending.
On top of that, Farnood was proudly a world-class gambler and poker player, hardly the image the banking industry wishes to cultivate – modern day Wall Street aside. On the face of it Kabulbank was successful. While the bank’s general and VIP savings deposits paid interest, Kabul Bank introduced a new deposit product in April 2006, the “Bakht Deposit,” which complied with Shariah requirements against paying interest – of interest to many Muslim customers in this overwhelmingly Muslim country.

Instead of receiving interest, the Bakht Depositers participated in weekly and monthly lotteries depending on the amount of their minimum balance. The new product proved extremely popular. Kabulbank’s already rapid growth exploded and it quickly became Afghanistan’s largest bank several times over. But it was less clear what was happening on the other side of Kabul Bank’s balance sheet, i.e., its loan assets. Rumors began to circulate of questionable funding of Karzai government friends.

While the young and inexperienced supervisory department at Da Afghanistan Bank raised a number of governance concerns with Kabulbank during its first six years of operation, including the repeated rejection of its proposed external auditor, no serious supervisory measures were taken. This changed when an eye-popping Washington Post article on Feb. 22, 2010, claiming insider lending abuses at Kabul Bank led former DAB governor Abdul Fitrat and the IMF to agree that a forensic audit was needed as standard prudential supervision is not well equipped to detect criminal behavior.

On March 29, 2010 the former governor requested technical assistance with such an audit from the U.S. Treasury Department and in May President Karzai affirmed his support for the audit. However, political tensions between the president and the U.S. over night raids on Afghan homes by American Special Forces resulted in a significant delay in the audit. In the end, Karzai refused to allow the U.S. to oversee the audit, which was eventually conducted by an international audit firm, Kroll, under the supervision of DAB in late 2011, well after its collapse.

Worrying that all was not right at Kabulbank, the central bank introduced a regulation on June 6, 2010, prohibiting large shareholders from holding management positions in their banks and used this regulation to force Farnood and KHALILULLAH FEROZI, respectively Kabulbank’s chairman and CEO, to resign at the end of August. The public fuss over their “resignations” helped bring Kabulbank’s problems to the public’s notice and started the depositor run on the bank on Wednesday, September 1, 2010.

Monday, September 6, 2010

I sleep well on planes, thank God. We arrived at Kabul on schedule at 6:30 a.m. The immigration official at the airport had been notified of our expected arrival and allowed us to enter the country, but kept our passports. We were met at the airport
by the IMF security officer resident at the IMF guesthouse where we always stay, and two armored cars.

We had time for a shower and breakfast at the guesthouse before proceeding to DAB and our meeting with Governor Fitrat followed by meetings with Qaseem Rahimi, head of the Financial Supervision Department, Ateeq Nosher, head of the Monetary Policy Department, and Rahim Zakir, head of the Market Operations Department. These were followed by a briefing meeting with the World Bank financial sector team headed by Nick Krafft, and a large meeting at the U.S. Embassy led by my old Baghdad office mate Bill Block, which included representatives from the U.K Embassy, the U.K. Department for International Development, some vaguely identified AML security types, as well as the World Bank team.

Our own team was six strong (Enrique, Marcin, Melissa, myself plus Borja Garcia from the IMF’s Fiscal Affairs Department and Khanjar Wabel Abdallah, the IMF’s resident representative in Kabul). The WB office is literally next door to the IMF guesthouse and the U.S. Embassy is only a few blocks away. By the time we returned to the IMF guesthouse at 5:30 pm, I collapsed in bed and slept through dinner.

**Tuesday, September 7, 2010 – The War Room**

In the first week of September Kabulbank’s deposit base of US$1.3 billion dropped by one-third. In response to the run, President Karzai announced, while we were in the air, that all depositors’ funds in Kabulbank would be protected (guaranteed somehow) and Governor Fitrat assured the public that the central bank would provide Kabulbank with all of the liquidity it needed to honor public demands for their money. The daily net deposit outflows fell from US$73 million on Aug. 31 to US$31 million on Sept. 7.

Also while we were in the air, DAB replaced Kabulbank’s management with a conservator, contrary to our advice that the bank be put into receivership. The law allowed placing a bank into conservatorship without the public announcement required for receivership and President Karzai clearly wanted as little publicity as possible.

The president is said to have been furious at the embarrassment brought to his name by his brother Mahmood Karzai,2 who owned 7 percent of Kabulbank’s shares, and the semi-public power struggle between Farnood and Ferozi. Apparently Karzai had instructed DAB governor Fitrat to fix the problem.

Bank panics, especially runs on large banks, are adrenaline-inducing events that virtually always lead governments to guarantee all deposits. This pushes the rot onto taxpayers without addressing underlying weaknesses in bank governance and/or supervision.

While the deposit guarantee was a fait accompli, and DAB did not have the expertise to implement quickly an orderly liquidation, we were determined to instill as much
resolution good practice into the process as possible. I recommended that we recruit Kat Woolford, a bank resolution expert with whom I had worked in Baghdad, and she moved to Kabul a few weeks later.

Governor Fitrat had explained to us the day before, that he had set aside space on the third floor of the central bank – in the space used by the IMF actually – for what he called a 'war room'. He wanted us to work together with the World Bank and the U.S. Treasury team to develop joint recommendations for stemming the run on Kabulbank and for its rehabilitation.

At the massive meeting at the U.S. embassy the day before, the World Bank and U.S. Treasury teams had agreed to meeting with our team in the war room at DAB at 8:30 a.m. Someone forgot to tell the IMF office manager who had the key to the room and didn't usually arrive until 9 a.m. We moved down to the room outside the governor's office and began our discussions until the war room was opened.

Working with other international organizations can be a challenge. Working against them can be a disaster. We are born with strong family/tribal instincts, which in the modern world tend to take the form of nationalism of one sort or another. Among groups working internationally each group tends out of instinct and habit to defend its turf and approach against any other organization. Even members of our own IMF team from different departments had perspectives that reflected the mandates of their departments.

The member from the IMF’s Fiscal Affairs Department argued from the perspective of the finance minister and the members from the Monetary and Capital Markets Department defended the perspective of the central bank. The interagency struggles among American advisers from different U.S. government departments in Iraq when I was working there in 2004-05 were the worst I had ever seen anywhere.

Fortunately, we on this occasion were all on the same page, which was to minimize the cost to the government and maximize market discipline of banks for the future. Our differences concerned how far it was practically and politically possible to press for these principles.

If we could make our war room collaboration work, it would greatly strengthen the power of our recommendations and assistance, which ran against the instincts of the Afghan authorities. Our first session around the war room table was an important occasion for establishing confidence that we were each honestly sharing the information we had. It was a kind of mating dance. We swapped our usual jokes with the World Bank team and they did with us.

At our meeting the day before at the U.S. embassy, our mission chief had failed to mention that we knew DAB had already extended a lender of last resort loan of $100 million to Kabulbank and I worried that this oversight would sour the confidence
building among the groups that was needed. Fortunately it did not and a genuine rapport and cooperation quickly developed.

My day ended with dinner in the Canadian Embassy two doors down from the IMF guesthouse with my friend, Canadian Ambassador to Afghanistan Bill Crosbie.

September 8 – 11, 2010

We expected Wednesday to mark the end of Ramadan and the beginning of the feast of Eid ul-Fitr, the Festival of the Fast Breaking. During the three-day holiday plus normal weekend banks would be closed giving us all a chance to catch up with events and for DAB and Kabulbank branches to restock their currency inventories.

Muslim holidays follow a lunar calendar and thus fall on different dates each year. However, Eid throws in the further wrinkle that someone somewhere must actually see the new moon in order to start the celebration. Whoever that all-important person is didn’t see it as expected and Eid started a day later, something all Afghan Muslims and we learned on what we thought would be the last day of Ramadan. Because DAB was closed during this holiday period, the closest thing Muslims have to the Christian Christmas, our daily or twice-daily war room meetings with the World Bank and U.S. Treasury moved to the conference room of the IMF guesthouse where we resided.
During these days we met with Masoud Musa Ghazi, the conservator of Kabulbank the governor had appointed a few days earlier, who reviewed his plans for gaining control of the bank. He shared, in confidence, his preliminary findings on the condition of the bank, and its loans to its principal owners, which exceeded our wildest expectations. By and large all the deposits raised by Kabulbank had been “lent” to its owners and friends of the Karzai government. The scale was truly staggering and shocking.

As prudential regulations limit the amounts that can be lent to single or connected parties, the amounts going to the owners and their friends were disguised as loans to other unrelated parties and dummy companies. The owners invested the bank’s money lent to them in various companies and properties – the most frequently cited being $160 million worth of luxury villas in Palm Jumeirah, Dubai, purchased by Farnood and his wife. With the bursting of the global real estate bubble and the associated recession, the value of these properties and other business investments of Kabulbank’s borrowers fell as well. This was not a bank that lost money from mismanagement and excessive risk taking. It was a bank that had been a criminal enterprise for stealing depositor money from the beginning, covering its tracks with bribery and skill.

In a meeting at the IMF guesthouse Kabulbank's internal auditor Raja Gopalakrishnan gave what would have been an Academy Award-winning performance. He bragged about the skill with which he had designed the fraud and covered up the bank’s crimes and he provided us with a number of detailed examples. We nicknamed him “the liar” for short because his last name was unpronounceable and because he told us a number of things that we knew were not true.

He ended by almost threatening us. “This is Afghanistan, Kabulbank will never be put into conservatorship. Never! Not as long as we are alive.” He marched out leaving us shocked and speechless.

His sentiment was echoed by ousted Kabulbank CEO ... Ferozi who told the Washington Post “if there is no Kabulbank, there will be no Karzai, no government.” Equally telling was his statement that the bank’s loan system wasn’t perfect, but that was to be expected “in a country like Afghanistan,” where personal relationships carry more weight than “being a professional” in the field.

On Saturday morning at about 1 a.m. I was dragged out of bed to join a teleconference with IMF headquarters in Washington in which we discussed our recommendations. A first draft of our joint note and recommendations to the governor was prepared and discussed with our World Bank and U.S. embassy colleagues. Everyone checked back with their head offices for guidance and approval.
That evening, Wabel, the IMF resident representative, and I had dinner, again for me, with the Canadian ambassador. Thank God for Wabel to keep the conversation going as I literally nodded off over and over again at the dinner table.

My departure was booked for Sunday so that I could arrive in Juba, South Sudan on Monday the 13th. Enrique asked if I could delay by two days and I agreed. Our war room team was working in remarkable harmony. We knew that the American team had intelligence that they didn’t always share, such as the movements of the Kabulbank principals, but trusted that they were sharing everything relevant to our joint work. We began round after round of revisions to our joint report to the governor and minister.

Everyone would review the latest draft electronically and each of the three teams would consolidate their edits and send them to Enrique to merge into the next draft that we would then discuss in the war room. Our goal was to send the finished document to the governor and minister on Sunday for discussion with them on Monday when banks reopened. Saturday evening each group sent the “final” draft to our respective headquarters.

**September 12 – 14, 2010**

Sunday morning following additional teleconferences with our headquarters, with the same presumably going on with the World Bank and U.S. Treasury, it was obvious that we would have trouble sticking to our timetable. Our HQ pressed some good suggestions for strengthening our recommendations. The World Bank accepted them and the U.S. Treasury very reluctantly accepted them.

We all recognized that there was great value in having a joint report, and that would require compromises here and there. The U.S. Treasury came back with its own changes requested by its head office. The “final” report was sent to the governor and minister on Monday morning and discussed with them later in the day. Following those discussions a few more changes were agreed to and the “final, final” report was issued Tuesday, my departure day. The first banking day following the holiday saw continued net deposit drains from Kabulbank but at the more modest rate of $19 million.

Given Kabulbank’s size – one-third of all deposits in the economy – and the government’s demand that it be saved, we agreed with the government’s strategy of guaranteeing deposits and of DAB providing all of the liquidity support to Kabulbank needed to allow depositors to withdraw their funds if they wanted. However, we thought that the governor should provide the public with more information on the measures being taken to clean up the bank.

The removal of Kabulbank’s chairman and CEO had been announced, but it had not been announced that the bank had been placed under the control of a DAB-appointed conservator who could act with all of the powers of the shareholders.
Deposits of the owners had been frozen, as were their real estate assets in Kabul. The more difficult recommendations dealt with how to clean up the bank and its governance and what to do with the politically well-connected owners. President Karzai wanted as little publicity as possible.

We made a new lending program with the IMF contingent on, among other things, a forensic audit of Kabulbank, an independent public review of the Kabulbank crisis, putting the bank under receivership and its controlled liquidation by selling off its good assets, a serious effort at asset recovery from “borrowers,” and prosecuting wrongdoers if criminal activity at Kabulbank were found.

Achievement of these benchmarks came slowly and the approval of a new program with the IMF was significantly delayed. Kabulbank was not put into receivership until April 20, 2011, at which time it was split into a good bank and bad bank – Kabulbank in liquidation and a successor New Kabul Bank. While Karzai commissioned a quick and dirty report by an Investigative Commission Evaluation of Kabulbank submitted six weeks later, it was not acceptable to the IMF. A proper internationally conducted forensic audit, the Kroll report, was not completed until March 14, 2012. A Special Tribunal established by President Karzai to hear Kabulbank-related cases convicted the two main architects of the fraud of a range of relatively minor charges on March 5, 2013.

At 5:15 a.m. Tuesday the security officer at the IMF guesthouse helped me put my suitcase and computer bag in the IMF’s armored car and we drove to the airport. As it happened, the Afghan First Vice President Mohammad Qasim Fahim, the brother of Haseen Fahim, a major benefactor of Kabulbank, was arriving from his hospital stay in Germany and the main access to the airport was closed. We were directed to parking area C, which is further from the entrance than are areas A and B. I said good-bye to Wahid, our driver and the security officer and I started the trip to the terminal and the airline check-in counter.

At the first of many security check points I marveled that the guy in front of me received a full body search while his bulging back pack went unexamined. My security officer, who was kindly pulling along my bag, was stopped and not permitted to proceed because he was not a passenger. He presented his case for accompanying me to the guard, “but Sir, I need to carry his bag. He is old.” Another bubble deflated, and I flew off to Juba, South Sudan.

To be continued....

ENDNOTES

2 I met Mahmoud Karzai the first time in his Baltimore restaurant in January 2002 just before leaving for my first of many visits to Kabul. He was surprised and happy to meet someone on their way to his country and I was
eager to learn as much from him as possible before going. But during that first January no one knew much of anything.

Warren Coats in his office at DAB in October 2005.

The Kabulbank Scandal: Part II

By Warren Coats
Cayman Financial Review, April 22, 2015

The Kabulbank scam in Afghanistan may be the largest theft of depositor money per capita the world has ever experienced. This is the second of a three-part series chronicling the unfolding and ultimate resolution of that scandal.

Kabulbank, intervened in September 2010, was finally put into receivership on April 20, 2011. New Kabul Bank (NKB) was established the same day by transferring to it the good assets of Kabulbank and by assuming its remaining deposit liabilities – what is known as a good bank-bad bank split. This allows for a smooth continuation of the banking services provided by the old bank while the old bank is liquidated.

The conservatorship team that took charge of Kabulbank in September 2010
consisted largely of central bank staff seconded to Kabulbank headed by Masood Khan Musa Ghazi, the highly respected chief accountant at the central bank. Ghazi was made CEO of New Kabul Bank taking his conservatorship team with him. While highly motivated and intelligent, the team naturally lacked experience with running a commercial bank.

Bankruptcy receivership experience was also in short supply in Afghanistan, but some experience had been gained liquidating a small bankrupt Russian-owned bank the year before. An energetic local team was appointed to represent creditors in the liquidation of Kabulbank in receivership (KBR). But Kabulbank was a bank unlike anything anyone had ever seen before.

Kat Woolford, an IMF consultant with years of American bank liquidation and supervision experience, gave invaluable assistance to both the KBR and NKB. I had worked with her earlier in Iraq.

Each morning one of our armored cars would take her from the IMF guesthouse to either the KBR or NKB and in the afternoon she would switch. The rest of us would generally head to the central bank or the finance ministry, but we would occasionally meet with the staff at KBR, NKB, the Justice Ministry or the Financial Disputes Resolution Committee (FDRC) headed by the highly respected Abdullah Dowrani. The KBR was supervised by the FDRC.

Our guesthouse street, which also included the World Bank offices and the Canadian Embassy, had seven security checkpoints in our block. When returning to the guesthouse the final checkpoint included mirror checks under our van and a once-around by a dog sniffing for explosives. We flashed our passports to the familiar guards, Kat would slip the dog a treat, and we were off to the fortified entrance of our compound. We stopped grumbling about these checks after a suicide bomber attack on the convenience store at the end of the block.

From deposits of $1.3 billion dollars equivalent eight months earlier, Kabulbank’s deposits had dropped to less than $0.6 billion by the time of its good bank-bad bank split (see Part I of this series). This deposit outflow and NKB’s remaining deposit liabilities were largely financed by two lender of last resort (LLR) loans from Da Afghanistan Bank (DAB), Afghanistan’s central bank.

For all practical purposes Kabulbank had no good assets to transfer to NKB other than the proceeds of the two LLR loans, which became assets of NKB and claims on the old Kabulbank in bankruptcy. Even its extensive branch network was housed in rented offices.

The IMF’s Kabulbank-related conditions for a new lending program were to sell the temporarily state-owned new bank to reputable new owners, recover all of the stolen assets possible and prosecute the wrongdoers. This seemingly simple resolution suffered from innumerable, complex challenges. Every aspect of the
resolution was complicated by President Hamid Karzai’s determination to protect his name and the interests of his family and friends.

**Privatization/liquidation of NKB**

Simply liquidating the bank by selling off its good assets (an extensive branch network, large number of depositors, modern IT infrastructure), which was initially our first choice, was not possible because no other bank was able to take over the essential government payroll function it performed.

The government was well advanced in computerizing its personal records and replacing cash salary payments with direct deposits to employee bank accounts. This was saving the government a lot of money by eliminating ghost workers and paymaster skimming. Given the lack of payment systems development, it was not possible to allow individual employees to open an account with any bank of their choice at which to receive an electronic salary deposit. All employees of a ministry had to have accounts with the same bank with the capacity to accept such payments.

To a very large extent Kabulbank was the only bank with this capacity and World Bank funded projects to modernize payment systems that would overcome this limitation were years from implementation (now targeted for late 2015). This made it almost impossible to force depositors and/or individual branch offices of Kabulbank into other banks.

Normally a good bank-bad bank split is made by moving clearly identified assets to the new, good bank, which then assumes the remaining deposit liabilities, a so-called purchase and assumption transaction. The books of Kabulbank were so complicated, because of attempts to hide the true state of affairs, that it was not possible to quickly identify good assets and proper liabilities.

Most of the transaction records were maintained in Dubai. As a result, NKB was established by moving almost the entire book to the new bank and clawing back bad assets and fraudulent liabilities to the old bank in bankruptcy as they were identified. This process was greatly assisted by a forensic audit by Kroll International. However this audit that gave NBK a clean and definitive balance sheet – a prerequisite to privatize the government-owned bank – was only completed two years later in April 2012.

In the interim, NKB was forbidden to make new loans and focused on providing payment services such as government salary payments. Though Ghazi, the CEO of NKB, was under the mandate to cut costs, close unprofitable branches and reduce employment, counter-political pressures kept staffing at much higher levels per branch or per deposit than at competitor banks. NKB ran an operating loss of $1 million to $2 million a month.

The IMF insisted that the bank be privatized or liquidated. Afghanistan already had
two bloated state banks it needed to get rid of. But politicians were reluctant to give up these cash cows for their families and friends. In a questionable decision, the Ministry of Finance decided to postpone the further staff and branch trimming, leaving it for the new private owners to undertake.

Selling a bank in a place like Afghanistan is no easy task. We preferred foreign buyers and some powerful Afghans preferred local buyers. There were rumors that Kabulbank’s founders would try to buy it back through proxies.

Considerable effort was made by the Finance Ministry, with the help of foreign privatization advisors, to prepare NKB for sale and to organize a transparent bidding process with clear terms and qualifications for bidders. While several potential bidders expressed interest by the Nov. 27, 2012, deadline, only one actually bid by the mid-January 2013 deadline. This bid from an Afghan with earlier connections with the Kabulbank founder was rejected.

After the IMF rejected suggestions that the government permanently retain ownership of NKB, a second offering with somewhat more flexible terms was undertaken in May 2013 with bidder due diligence access to NKB books from June to August and a bid deadline at the end of August.

Of the three bids received, two of which were potentially acceptable, the bid evaluation committee selected one to recommend to the President’s Cabinet in December. Before we were able to pop the cork on the Champagne bottle to celebrate the successful conclusion of an important and long battle, which promised to significantly strengthen Afghanistan’s banking sector going forward, the Cabinet rejected the bid as inadequate. Those wanting to keep NKB as a state-owned bank had won.

DAB capital

When President Karzai announced the government’s guarantee of all legitimate deposits with Kabulbank, then Governor Abdul Qadeer Fitrat and Finance Minister Omar Zakhilwal jointly signed an agreement for a lender of last resort loan to Kabulbank sufficient to cover any deposit withdrawals (US$ 400 million). The minister’s approval was required by the “exceptional circumstances” provision of the central bank law.

When Kabulbank was put into receivership (KBR) its remaining deposits were transferred to a new bridge bank, New Kabul Bank, along with sufficient good assets, including the proceeds of a second LLR loan from DAB of US$425 million, to cover its deposit liabilities and expected operating losses – i.e. a good bank-bad bank split.

The MOF later replaced DAB’s LLR loans to Kabulbank totaling an equivalent of US$825 million with an eight-year promissory note paid off in equal quarterly
installments. This required annual appropriations by parliament and took DAB’s place among the creditors of the bankrupt bank. Thus any asset recoveries from KBR’s liquidation would go to the Ministry of Finance as the only remaining creditor of significance.

The entire Kabulbank affair raised concerns in the ministry about DAB’s financial condition and its operations. It also revealed some issues with regard to the calculation of DAB’s capital. At the time of the Kabulbank crisis, before it issued its LLR loans to Kabulbank, DAB had a strong positive equity position (assets exceeded liabilities) but negative capital as determined by its accounting principles.

The MOF wanted to know why it wasn’t receiving the net profit of DAB it thought it was entitled to and DAB wanted to know why the MOF wasn’t recapitalizing it as required by the law. My IMF colleague, Marcin Sasin, and I convened several meetings between the MOF and DAB and were eventually able to achieve agreement between the two on amendments to the capital provisions of the DAB law and what was owed between the two.

The policy goal of most central banks, which we thought appropriate in this case as well, is to account for net income in accordance with International Financial Reporting Standards (IFRS) but to exclude unrealized valuation gains from any resulting distributions of profits to the government. Most central bank assets are foreign, and changes in the exchange rate between the domestic currency and the currency of its foreign assets change the domestic value of those assets. The income from DAB’s gold assets, which had appreciated in value considerably, was put in a special reserve that protected it from inclusion in capital and profits payable to the government. But DAB had incurred losses on the revaluation (realized and unrealized) of its foreign currency assets that were not netted against its gains from gold. Thus gold’s appreciated value was reflected in DAB’s equity but not as part of net income added to capital.

The proposed amendments worked their way through the approval process (DAB’s board, the Department of Justice, Cabinet) and still sit awaiting action in the parliament two years later.

**Asset recovery**

Efforts to recover Kabulbank assets “lent” to its owners and their friends were complicated by President Karzai’s desire to minimize publicity and protect his family and friends, as well as the authorities’ lack of experience with the established protocols for international cooperation in asset recovery.

Based on the Kroll audit and subsequent discoveries by the Kabulbank receiver (KBR), the receivership had US$1,011 million in potentially recoverable assets of which US$896 million where claims on shareholders and related parties. Of this amount as of Aug. 1, 2013, US$151 million had been recovered in cash and an
estimated US$179 million in non-cash assets available for sale.

The receiverships claims on the 17 shareholders and their friends were very difficult to document as many of them were held through intermediate companies such as Gas Group, Pamir Airways, Kabul Neft Co, etc. Only $52 million of Kabulbank’s loans were what we called normal: legally contracted with repayment schedules.

Initially, Governor Fitrat sought voluntary repayments, then legally binding agreements for repayment from the shareholder group. But the group contested half of the $896 million in claims made against it. Under IMF pressure to increase asset recovery, President Karzai issued decrees excepting all but the two founders from accrued interest and prosecution if their debts were repaid in full (within one month of the first decree issued April 11, 2011, and again within two months of the second decree issued April 4, 2012). This was reported to the public, under IMF pressure for greater transparency, in the “Report on Kabul Bank Asset Recovery.”

Although the asset recovery process recovered cash, seized and sold, and normal loans were repaid, total recoveries amount to only about $200 million out of US$935 million identified assets. Mahmood Karzai, the president’s brother and a holder of 7.41 percent of Kabulbank’s shares, repaid $3.9 million of what he had “borrowed” claiming that he did not need to repay the remaining balance of $8.8 million because that had been lent to him to buy his shares (a violation of banking regulations) and his shares were now worthless. Thus he had complied with his brother’s conditions for amnesty both in his view and in his brother’s view.

The seizure of assets belonging to Kabulbank founder Sherkhan Farnood and ex-CEO Khalilullah Ferozi abroad was very limited because Afghan officials were not familiar with the required international protocols and because the two were never convicted of money laundering, a prerequisite for many of the international asset-recovery tools, largely because the attorney general did not wish to press charges.

Justice

President Karzai managed to keep the public in the dark about what had happened until Governor Fitrat lost patience and disclosed the names of shareholders who had received loans in testimony to parliament on April 27, 2011. He soon thereafter resigned and fled the country and now lives in the United States where he had also lived during the Taliban reign from September 1996 until December 2001. During Governor Fitrat’s first stay in the U.S. he sold Afghan carpets. He helped me buy (i.e. bargain for) one of the several Afghan carpets in my home during my first visit to Kabul in January 2002.

One of the IMF conditions for lending to Afghanistan was an independent and public investigation and report on the Kabulbank fraud. This was fulfilled by the Independent Joint Anti-Corruption Monitoring And Evaluation Committee. In its
Report Of The Public Inquiry Into The Kabul Bank Crisis, issued November 15, 2012, the committee found that:

- “Kabul Bank’s controlling shareholders, key supervisors and managers led a sophisticated operation of fraudulent lending and embezzlement predominantly through a loan-book scheme.... The loan-book scheme provided funds through proxy borrowers without repayment; fabricated company documents and financial statements; and used information technology systems that allowed Kabul Bank to maintain one set of financial records to satisfy regulators, and another to keep track of the real distribution of bank funds. Shareholders, related individuals and companies, and politically exposed people were the ultimate beneficiaries of this arrangement. Over 92 percent of Kabul Bank’s loan-book was for the benefit of 19 related parties (companies and individuals). Except for the initial investment of $5 million, all shareholder acquisitions and transfers were ultimately funded by money from Kabul Bank.

- “Kabul Bank’s Credit Department opened loan accounts for proxy borrowers on instruction from senior management, and forged supporting documents including applications, financial statements, and registrations, and employed fake business stamps to lend authenticity to the documents. Many financial statements were forged by Afghan accounting firms, seemingly established for the sole purpose of producing fraudulent documents to support loan files....

- “Electronic transfers had the appearance of being transferred to overseas suppliers or for other legitimate purposes. Some cash was transferred through the Kabul Airport using Pamir Airways, which was owned by shareholders related to Kabul Bank. Repayment of loans was rare, and most often new loans were created to provide the appearance of repayment.” (IMEC report)

The normal Afghan courts had no understanding of and thus competence to evaluate the financial crimes at issue and are notoriously corrupt. A Special Tribunal established by President Karzai to hear Kabulbank-related cases convicted the two main architects of the fraud of a range of charges (but not money laundering). Nine DAB staff and management, including former governor Fitrat, were also convicted of failing to detect or prevent the fraud.

These convictions have been appealed. No further progress was made during the remainder of Karzai’s presidency.

*The conclusion of the story (maybe) will be presented in the next issue.*
The village of Istalif in North Western Afghanistan.
The Kabulbank Scandal: Part III

By Warren Coats and Gary A. Gegenheimer
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The Kabulbank scam may be the largest theft of depositor money per capita the world has ever experienced. Kabulbank was Afghanistan’s largest bank when the central bank intervened on September 2010. It was put into receivership on April 20, 2011. New Kabul Bank (NKB) was established the same day by transferring old Kabulbank’s remaining deposit liabilities covered by an equivalent amount of claims on the central bank, Da Afghanistan Bank (DAB). Kabulbank’s deposits had dropped from $1.3 billion eight months earlier to under $0.6 billion by the time of its good bank/bad bank split.
The establishment of NKB allowed the continuation of the newly developed direct deposits of a large share of government salary payments to employee bank accounts, a function other banks were not yet able to perform (see Part I).

The Afghan authorities (and the conditions of IMF loans) have focused on justice for those involved, the recovery of stolen assets, and the future of NKB and the banking sector more broadly (see Part II). This is the third of a three-part series chronicling the unfolding and ultimate resolution of that scandal.

The new Ghani/Abdullah coalition government of Afghanistan that took office on Sept. 29, 2014 had both campaigned on the promise that fighting corruption would be one of their highest priorities. The very next day, President Mohammad Ashraf Ghani held a press conference in which he stated that the Kabulbank case would be retried and expanded to all potentially guilty parties.

The original trial had given the real crooks, Sherkhan Farnood, the founder of the bank, and Khalilullah Ferozi, its CEO, relatively light sentences. They were never imprisoned. Instead, nine DAB staff members were convicted of the bogus crime of failing in their supervisory duties to detect the real crime.

One of those watching the press conference on TV that day was the 33-year-old Comptroller General of DAB, Muhammad Qaseem Rahimi, who was one of the nine
DAB staff convicted in the first trial. Qaseem had joined DAB’s staff in May 2004 as Portfolio & FX Manager in its Market Operation Department. He was one of a group of young Afghan university graduates hired by BearingPoint, a USAID contractor, as part of a USAID mentoring program. Those hired in this program received special training and mentoring from BearingPoint experts and many went on to become middle management of the central bank and the Finance Ministry.

Qaseem is a natural leader. When I visited DAB’s Market Operations Department in 2005 and 2006, I would often find him standing in the center of a group of his colleagues. At 5 feet, 11 inches, he was at least a half a foot taller than those who usually surrounded him so he was easy to spot.

Though he was earning a master’s degree in finance from the International Islamic University, Kuala Lumpur, Malaysia, when Kabulbank was established and licensed by DAB, he had risen to the head (director general) of the Financial Supervision Department by the time DAB intervened in 2010. His conviction and those of his DAB colleagues were bogus and were meant to convince the public that the government was acting to punish the Kabulbank bad guys, who had cost taxpayers (someone’s, somewhere) almost a billion dollars.

Qaseem’s first encounter with rough play by the Attorney General’s Office (AGO) came in 2011 when he and 25 other DAB staff were rounded up from their offices at DAB and detained in the basement of the AGO’s building for questioning and mug shots. They were held there for over 12 hours. Qaseem’s anger at such crude intimidation was palpable as he relayed his experience to Kat Woolford and me during one of our regular lunches with him in his office after the event.

Thus Qaseem greeted the President Ghani’s promise of a new trial with relief. But this is Afghanistan and when the president’s order, “On resolving Kabul Bank Crisis and reimbursement of embezzled properties,” was issued the next day on Oct. 1, 2014, it differed significantly from his press conference promise of a new trial. Instead of a new trial, it called for a speedy conclusion of the appeals of the earlier convictions and stated that the “Attorney General Office shall oversee the implementation of preliminary court ruling and arrest suspected individuals within three days after issuance of this order and keep them in custody until the issuance of the courts final verdict.”

That was Wednesday, the last working day of the week before Eid holidays. On Thursday, Qaseem met with fellow DAB convictees, Mohibullah Safi, the former first deputy governor, and Mustafa Massoudi, former head of the Financial Intelligence Unit, and drafted a letter to the president requesting him not to cancel their bail as they were government employees and willing to appear in court whenever required. They attempted to send their letter to the president via Ateeq Nosher, Ghani’s deputy for Policy and Strategic Planning and former head of DAB’s Monetary Policy Department, but he had left, along with others in the president’s office, for Dubai for the Eid holidays.
Their letter never reached the president. On Tuesday Oct. 7, the first workday following Eid holidays, Bismillah, a DAB bank examiner who was also convicted in the Kabulbank trial, was arrested in his office. Knowing that he would be arrested, Qaseem left home for his office on Wednesday, kissing his 10-day-old daughter Yusra and his 4-year-old son Yusuf goodbye. Indeed, he was arrested that day along with DAB bank examiners M. Arif Salik, and Sher Aqa.

The convictions of the latter two young men were upheld but their sentences were reduced from six to three months imprisonment, which they have now served. Qaseem’s conviction was overturned but not until he had remained in jail for five weeks. Due to bureaucratic incompetence or vindictiveness (it is often difficult to tell which in Afghanistan), he was not actually released for another week.

At the same time, Nov. 11, 2014, the court increased the penalties for the real criminals. Shekhan Farnood, Kabulbank's founder, was sentenced to 10 years in jail, increasing the previous sentence of five years, and required to repay the US$334,256,079 that had been taken from the bank, plus a fine of US$237,384,668. Khalillullah Ferozi, the bank's CEO, was also sentenced to 10 years in jail, increased from five years and required to repay the US$196,632,892 he had taken, plus a fine of US$137,174,981. And this time these two are actually in jail.

The convictions of three other Kabulbank staff were upheld — one year each in jail — but Raja Gopalakrishnan, Kabulbank's internal auditor and the brains behind the accounting design of the fraud and his Indian sidekick Ram Chandaran (chief credit officer) remained safely in India to which they were allowed to flee under questionable arrangements with the AGO. My lawyer counsels me against stating the obvious.

For the rest of the DAB scapegoats, Mustafa Massoudi was fined AFS24,000 (about US$400), Mohiullah Safi still sits in jail waiting for a judgment on his appeal, Masood Khan Musa Ghazi, former chief accountant of DAB appointed as Conservator of Kabulbank, then CEO of New Kabul Bank, fled the country to places unknown, and former Governor Abdul Fitrat resigned and fled the country after revealing to the Afghan Parliament all that DAB knew about the Kabulbank swindle (including the participation of then President Karzai’s brother Mahmood) and is now living in Virginia. So far, the Attorney General’s Office has made no progress in the investigation and arrest of a list of other real participants in the crime called for by President Ghani.

What is the explanation for this bizarre mix of results? Most observers accept the sincerity of President Ghani’s and CEO Abdullah Abdullah’s desires to fight the entrenched corruption of Afghan political and administrative structures. Skeptics claim that Ghani allowed innocent people to go to jail just to demonstrate that he was doing something. Genuine change is a step-by-step process that will take a very long time. The president's powers are limited.
He can’t even easily appoint his own government. His first choice for finance minister, Jailani Popal, withdrew because, according to the New York Times, ”he did not have enough money and jobs to bribe Parliament into approving him.” Ghani’s nomination for governor of DAB, Khalil Sediq, a former governor of the central bank, was rejected by Parliament because of his dual citizenship (American and Afghan). According to former DAB governor Fitrat, the Attorney General, Muhammad Ishaq Aloko, is the most corrupt person in the country, which may explain some of what we are seeing.

People lined up to collect their salary

The new government put all existing ministers, including Attorney General Aloko, in acting status and Aloko resigned but has not yet been replaced. Long-established ways of doing business will take a long time to squeeze out of the system and the culture, but honest and determined leadership from the top is essential.

Asset recovery

By the end of the Karzai government, US$216.5 million had been recovered of total recoverable assets of US$896 million (taking account of allowed write-offs). Of that amount US$157 million was in cash and the rest in property. Since then, total recoveries increased to US$229 million, an increase of only US$12.5 million.
A large part of the problem of recovery of the stolen assets stems from the fact that so much Kabulbank money was transferred abroad to related parties of the bank, or entities controlled by them. The recovery of these assets depends critically on mutual legal assistance requests and the cooperation of the countries where those assets are located.

Considerable insight into this issue can be found in reports of the Independent Joint Monitoring and Evaluation Anti-Corruption Committee (MEC), which was established at the invitation of the Afghan government following the London and Kabul conferences of 2010. The MEC’s October 2014 report on KB provides the most thorough public accounting of where the money went and who absconded with it.

The report, which is available in its entirety on the committee’s website, notes that, according to the Kabulbank receivership, between March 2007 and April 2011 $873 million of licit and illicit funds were sent to 28 countries for the benefit of bank-related parties via SWIFT transactions. The largest of the 28 recipient countries were the United Arab Emirates, Latvia and China. In a number of cases, transfers were made for the purchase of products and services from trading companies, oil and gas-related companies, and for the purchase of products and services related to Pamir Airways, which was owned by Farnood.

Between 2011 to 2013, the AGO sent requests for mutual legal assistance to seven jurisdictions in 2011 (United Arab Emirates, France, United Kingdom, India, Switzerland, Germany and the United States). In some cases, such as the UAE, Afghanistan has mutual legal assistance treaties. In others, such as the U.K., there is no standing treaty governing such matters, thus any requests for assistance must be handled on an ad-hoc basis.

Unfortunately, these requests have proceeded slowly due to a variety of factors, including technical deficiencies with some requests and the lack of prioritization by receiving countries. Key points regarding these requests are illustrated for the UAE, the most important of the jurisdictions involved:

- **United Arab Emirates**
  - Afghanistan and the UAE have had an agreement of mutual legal assistance in criminal matters since October 2008. The agreement provides for best efforts in providing documents and records, locating and identifying persons or items, executing requests for searches and seizures, and assisting in the proceedings related to the immobilization and forfeiture of assets.
  - The Afghan government submitted an urgent request for legal assistance to the UAE in May 2012 seeking records, documents, and other information related to Farnood and Ferozi. It also sought to freeze assets related to specifically mentioned bank accounts in anticipation of a confiscation order. The UAE Ministry of Justice initially returned the document on the grounds...
that it was sent without the signature and stamp of higher judicial authorities of the Afghan government. Afghan officials sent additional requests in July and September 2013, and a subsequent letter in October 2013. This request met with no response from the UAE.

- In December 2013, MEC members brought the UAE’s lack of cooperation to the attention of the Organization for Economic Cooperation and Development (OECD). The MEC requested that the OECD add the UAE to a list of countries that do not enforce anti-money laundering laws.

The OECD’s secretary-general forwarded the request to the Financial Action Task Force (FATF), which focuses on high-risk and non-cooperative jurisdictions. In April 2014, the FATF president committed to bring the MEC’s concerns to the attention of the Asia/Pacific Group and the Middle East and North Africa Financial Action Task Force for them to consider during the next compliance evaluations for Afghanistan and the UAE.

As the above brief MEC summary demonstrates, there is plenty of blame to go around for the lack of progress on international recovery of Kabulbank assets. Some of the requests from the Afghan authorities have lacked the information necessary for the recipient country to respond in a meaningful fashion. In particular, critical information regarding specific individuals, transactions and/or accounts often has not been included.

When requests have been sufficiently detailed and specific, they have typically only been submitted to the foreign authorities in Dari, despite assurances of translation into the receiving countries’ official languages. In addition, technical assistance has been available from the international community to support criminal asset recovery to assist with further international letters of request and analysis of data provided through mutual legal assistance, but this avenue has not been vigorously pursued by the AGO.

On the other hand, in some cases, requests have been delayed in the recipient countries for reasons that have not been readily apparent.

Clearly, renewed and vigorous efforts are needed, both on the Afghan side and from the international community. Afghan authorities need to frame requests in the language of the recipient country and with sufficient clarity and specificity, and adherence to any relevant procedural requirements, so that the recipient countries can actually understand the request and respond in a meaningful manner. It remains to be seen whether the new government can improve on the efforts of its predecessor.

Even if this can be accomplished, however, it is very much a two-way street: recipient countries also need to prioritize properly framed requests and respond to them in a timely fashion. Only then can there be any hope of recovering the millions of dollars of Kabulbank funds that were spirited out of the country.
It is noteworthy that Afghanistan is a party to the U.N. Convention Against Corruption and the U.N. Convention Against Transnational Organized Crime (the Palermo Convention), both of which contain mutual legal assistance provisions. Hopefully, the new Afghan government, as well as other parties to these and similar conventions, will take these obligations very seriously.

**New Kabul Bank**

The IMF’s position was that New Kabul Bank (NKB), which is temporarily owned by the Finance Ministry, should be privatized to reputable owners in a transparent auction or liquidated rather than remaining a state-owned bank and thus joining the other two overstaffed and inefficient state banks. Liquidation had been put off as a last resort because of the important role played by NKB in the electronic payment of government salaries. Over 90 percent of such payments are made through NKB and until the completion of upgrades in payment infrastructure financed by the World Bank making it possible for employees to designate their own bank, there was no option to continuing the service except through NKB.

These upgrades and new, more integrated payment systems will not be completed until the end of 2016, though the growth of mobile banking is extending the possibility of electronic salary payments to remote areas as well. Though most of these salary deposits are withdrawn in cash immediately, the electronic salary payment program has significantly reduced payments to ghost workers and skimming by paymasters. Sixty percent of government employees are now paid electronically, over 90 percent of which are through NKB.

In a tragic terrorist attack on NKB in Jalalabad on April 18, 34 bank customers waiting to withdraw their government salaries were killed and 125 were injured. It was the first suicide bombing by Daesh (also known as the Islamic State or ISIS) in Afghanistan.

The first effort to privatize NKB in early 2013 failed because the only bid received did not meet the technical requirements of the tender. The most important requirement was that the new owners must be fit and proper. A second tender was held in the autumn of 2013 and two bidders submitted bids that met the tender’s technical requirements.

The Evaluation Committee recommended that the Afghan Cabinet accept the better of the two bids, but the Cabinet rejected it as insufficient. The real reason was more likely that those wanting to keep the bank under government ownership prevailed. Government banks, like Afghanistan’s existing two (Bank Millie and Pashtany Bank), are invariably overstaffed, poorly run and, in general, sources of patronage and corruption.

The story of Kabulbank is a sad and tragic one. The struggle to build a strong and efficient banking sector in Afghanistan has been and will be long and hard.
Hopefully, the headwinds of corruption that have produced this story are receding but we will only know many years in the future.

1 The MEC is an independent agency consisting of six senior anti-corruption experts selected through a nomination process overseen by the international community and the Afghan government. It is not subject to direction from either the Afghan government or from the international community. The MEC focuses on developing anti-corruption recommendations, monitoring and evaluating the anti-corruption efforts of the Afghan government and the international community, and reporting on a regular basis to the president, Parliament, the people of Afghanistan, and the international community, about the state of the fight against corruption in Afghanistan.