HOW THEY ROBBED KABUL BANK

by
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June 12, 2012
www.USpolicyinaBigWorld.com
Acronyms, Codes, and Terms

AGO       Attorney Generals Office
AISA  Afghanistan Investment Support Agency
BioFin   Biographical and Financial Report
DAB      Da Afghanistan Bank
ECF      Extended Credit Facility
IMF      International Monetary Fund
LLL      legal lending limit
MoC      Ministry of Commerce
Q        a former Kabul Bank senior official
         tazkira the Afghan ID card
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Foreword

My interest in the Kabul Bank scandal goes back to early 2011. I read the media reports in September 2010 when the scandal broke but it was only later that I realized the significance of the scandal - that it went all the way to the Parliament and to the president, and that it provided a unique glimpse into high corruption in Afghanistan.

In September 2011, I completed “The Kabul Bank Scandal and the Crisis that Followed” and then updated the same paper that December. However, as I wrote the paper, there was always a sense that I did not have a significant part of the story.

In January 2012, a former senior Kabul Bank official, whom I will refer to as ‘Q’ in order to protect his identity, contacted me via email. Q read my paper and thanked me for giving a “fair account” of Kabul Bank, but added that “certain facts” presented in the paper “were distorted” because they relied on media reporting, which did not have all of the facts.

What followed from that initial contact was a flurry of emails back and forth with Q, which included him sending me certain Kabul Bank documents to prove key aspects of the fraud as he recounted it. Q also sent me photos of the fraud’s main characters.

This paper is truly the product of a collaborative effort that would not have been possible without the Internet and email. Q combed through the first draft, made several corrections, added extra details, and then sent it back. I did the same and then resent it to Q. The process repeated itself three more times before posting the finished product.

“How They Robbed Kabul Bank” differs from my previous paper in that this one focuses on the mechanism of the scam and several of the key actors in the fraud. Apart from the bank’s two top leaders, Sherkhan Farnood and Khaliullah Fruzi, Q identifies four additional actors in the fraud: the fraud’s leading architect, Johnson MallaiKal Rappai, the one who forged the loan documents, Amitava Basu, and two other senior staffers, Shokrullah Shokran and Esmatullah Baig, whose job it was to document the illegal (“fictitious”) loans and email that information to the Shaheen Exchange in Dubai.

The paper concludes with a revisiting of the September 2010 deposit run through an analysis of the balance sheets. The central bank’s monetary assistance (the bailout) is identified and shown to exceed what was actually needed to survive the crisis.

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How They Robbed Kabul Bank

Kabul Bank (now “New Kabul Bank”) was Afghanistan’s largest private bank. It opened on June 24, 2004, and by August 2010 had 75 branches with at least one bank in each of Afghanistan’s 34 provinces.¹ At the end of August 2010, Kabul Bank had received $1.3 billion in deposits from the Afghan public.² Kabul Bank also managed a $1.5 billion annual contract to pay the salaries of about 80% of Afghanistan’s government workers.³

Kabul Bank’s two leading shareholders, Chairman of the Board of Supervisors Sherkhan Farnood and Chief Executive Officer Khaliullah Fruzí, were fired for mismanagement on August 30, 2010. Their dismissals triggered a deposit run on September 1, which led to a government bailout.

Lending Restrictions

Sherkhan is a businessman to the core. Even his humor is infused with a deep sense of business calculation. Sherkhan’s guiding business philosophy is that one must “spend money to make money.” He used to repeat the phrase frequently among Kabul Bank’s staff, and others, as a sort of punch line.

Establishing a bank offered Sherkhan the possibility of making profits by charging people for a variety of financial services. However, the primary reason for starting Kabul Bank was to “spend [other people’s] money to make money.” Sherkhan could use the bank’s deposits to finance his own businesses.

Two banking laws, however, limited Sherkhan’s ability to lend Kabul Bank’s money as he desired: *restrictions on large exposure loans* and *related party lending*. Afghan banking law limits banks from engaging in both of these practices in order to protect banks—and thereby the depositors—from taking excessive risk by exposing the bank through lending to a single borrower or a group of related borrowers for huge sums of money.

The first of these laws prevents a bank from large exposures, or issuing loans too large in relation to its available “unimpaired capital and reserves,” which form a part of so-called “regulatory capital.”⁴ In lay terms, banks have lending limits. Afghan banking law

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¹ For more factual information about New Kabul Bank, visit its website at http://www.kabulbank.af/html/AboutUs.html. Retrieved on December 1, 2011. The “68” branches’ figure on the website is outdated.
³ This money is foreign aid. Kabul Bank made money for managing the contract and earned about $3 million a year (not $10 million as has been reported) in interest for holding the money at the central bank. New Kabul Bank retained the contract.
⁴ “Law of Banking.” Article 35/4. Regulatory capital is the sum of equity capital, non-specific reserves, and profit for the current year (previous year’s undistributed profits is accounted in reserves) and provision for standard quality assets (subject to a maximum of 1.25% of Risk-weighted assets or actual, whichever is lower). Put another way, regulatory capital includes equity capital and other items, which may qualify as capital as there are no strings attached to it in the form of liabilities or any other conditions.
stipulates that a single loan’s size per borrower cannot exceed 15% of a bank’s regulatory capital.\textsuperscript{5} The 15% figure is called the legal lending limit (LLL).\textsuperscript{6}

In addition, the aggregate sum of all large exposures cannot exceed 200% of regulatory capital, whether the loans are intended for individual borrowers or a group of borrowers. Kabul Bank internally kept the LLL at 10% of regulatory capital so that it would not attract the provisions of the central bank’s large exposure regulations.\textsuperscript{7} Afghanistan’s central bank is called “Da Afghanistan Bank” (DAB) and is the main banking regulatory body in the country.

In real terms, the LLL meant that in 2005 and 2006 Kabul Bank could not grant a loan to a single borrower whose size exceeded about $2 to $3.5 million. The lending threshold increased as Kabul Bank’s profit accrued and reserves rose due to the increase in business and deposits. In 2007, the LLL jumped to about $6 million and in 2008 it was $8 million. In 2009, the LLL was $10 million and, in 2010, the LLL was about $12.5 million.

Group lending occurs when a holding company (a parent company) and its subsidiaries apply for loans at the same bank. There is a concern that these companies might transfer money to one another in order to manipulate the financial health of the company that applies for a loan. For example, company A has two subsidiaries, or companies B and C. Suppose company C applied for a loan and companies A and B transferred money to company C in order to make company C’s financial health appear better than it actually is. Group lending regulations are designed to protect banks from the negative impact of such accounting trickery by limiting what holding companies and their subsidiaries can borrow.

The second law that restricted Kabul Bank’s lending ability, or related party lending, made it difficult, but not impossible, for Kabul Bank to issue loans to people or

\textsuperscript{5} Ibid.  
\textsuperscript{6} Any loan, whose size is greater than 10% of regulatory capital, but under the LLL, is classified as a large exposure.  
\textsuperscript{7} This measure enabled Kabul Bank to concern itself only with related party lending regulation and other regulations, which did not disturb its lending practices.
businesses with whom Kabul Bank’s shareholders or administrators were related. The law is very specific that a “related party” includes those who either have an equity stake in a company (a shareholder) or those who influence the decision-making process in a company by virtue of their senior authority (an administrator).

Related party lending restrictions would apply to the following cases: a Kabul Bank shareholder seeks a Kabul Bank loan for a company in which he is also the CEO, or a non-shareholding Kabul Bank director seeks a Kabul Bank loan for a company in which he is a shareholder. In both cases, the Kabul Bank shareholder or administrator is connected to the company that desires a Kabul Bank loan. Related party lending restrictions limit such loans because it is thought that the Kabul Bank shareholder or administrator might use his influence to obtain a loan under terms that would be favorable to him, but not to the bank.

In the absence of independent verifying mechanisms, the identification of related parties is difficult in Afghanistan. The Afghan central bank tries to identify related parties by having bank shareholders and administrators complete the “Biographical and Financial Report,” commonly referred to as the BioFin. Under “Schedule D - Property Interests,” shareholders and administrators are asked to identify all business enterprises in which they hold a beneficiary interest.

However, the experience at Kabul Bank suggests that the central bank does not scrutinize or verify BioFins. The central bank merely acknowledges having received the BioFins and then files them away. The identification of related parties in Afghanistan is a daunting task for internal and external auditors as well, and voluntary declarations are the only feasible option available today.

Sherkhan and the other Kabul Bank shareholders owned additional businesses. According to related party lending restrictions, Kabul Bank was legally permitted to lend to these businesses only if it followed certain procedures. First, Kabul Bank had to demonstrate that the related party in question had not influenced the loan decision process. Second, no favorable terms could be extended to the related party loan, such as a lower than normal interest rate. And, third, following loan approval, the bank was obliged to

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9 Proving that a related party did not influence a loan decision is a difficult condition to satisfy because it is subjective in nature. In fact, many times a bank cannot satisfy this condition.
rigorously monitor the performance of the loan, which required the borrower to make adequate disclosures throughout the life of the loan.

A good example of legal related party lending was when Kabul Bank issued a loan to Pamir Airways for the purchase of a Boeing 737-400. Kabul Bank was permitted to lend to Pamir Airways, even though Sherkhan was both a Kabul Bank and a Pamir Airways shareholder, provided that the loan did not exceed the LLL. As a first step, Pamir Airways was asked to provide a long list of documents. Had Pamir not been able to stand up to such rigorous scrutiny, it would have been obliged to borrow from a different bank.

The Shell Company and Loan-Splitting Scheme

However, since Sherkhan wanted to lend Kabul Bank’s money however he saw fit, the above lending restrictions posed a problem. Q says that Sherkhan’s other businesses probably could not have withstood the additional scrutiny that Pamir Airways was able to endure. Moreover, Sherkhan wanted to engage in large scale lending of many tens of millions of dollars or more to individual businesses, and to permit his associates, many of whom were politically connected, to be able to borrow freely from Kabul Bank without the need to keep their books in order or to run their businesses legitimately.¹⁰

¹⁰ By “legitimately” it is meant the strict following of whatever laws and regulations that may apply to a business as opposed to non-compliance and bribing one’s way through instead.
The challenge Sherkan confronted was how to bypass the above lending restrictions without getting caught by Kabul Bank’s own internal auditing department, its independent external auditor (a non-affiliated private auditing firm), and the central bank’s annual audits. Sherkan was not a banker by education or experience. He was a money exchanger, a businessman, and a professional gambler, but banking requires a complex understanding of accounting and finance.

Sherkan looked to Johnson Mallaikkal Rappai, a professional banker from India whom he hired as Kabul Bank’s general manager two months after the bank opened. Before coming to Kabul Bank, Johnson was fired from the Federal Bank of India in Kerala, for forgery and for taking bribes in exchange for approving loans.

Johnson held three different positions during his six years at Kabul Bank: general manager, acting CEO, and chief advisor. Johnson accepted his advisory position after the central bank refused to approve his appointment as CEO in 2006. Johnson was shifted to Dubai in 2008 due to differences between him and Fruzi. Johnson provided advice to Sherkan in Dubai on all his businesses, and left Dubai in November 2010, after the Kabul Bank crisis erupted.

In order to bypass legal lending limits and to circumvent the extra scrutiny associated with reaching the LLL, Johnson advised Sherkan to split large loans into smaller ones and to create shell companies — referred to as “fictitious” companies in the media- that would receive the loans. Shell companies are legal entities, since they exist on paper, but have no actual business operations, except perhaps to serve as a conduit for money transfers. The shell companies hid the true borrower’s identity.

This is how Johnson’s illegal loan scheme worked. Suppose a business wanted to borrow $45 million from Kabul Bank. Since this sum exceeded legal lending limits, Johnson advised Sherkan to split up this vast amount of money into many smaller loans.

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12 Johnson is usually referred to as “Johnson M.R.” in Kabul Bank’s documents.
13 A confidential inquiry to the Federal Bank of India in Kerala will confirm Johnson’s record as such information is generally not made public. Q discovered it through contact with Indian bankers.
14 Q says that the central bank did not approve Johnson as CEO because Delawari, then the central bank’s governor, thought Johnson was arrogant and caused Sherkan to be arrogant. Also, Deloitte’s lead advisor at the time, Larry Boren, did not support Johnson’s candidacy either, and strongly advised Delawari against approving him. Deloitte was the accounting firm that served in an advisory role to the Afghan central bank under a USAID contract.
Each of these smaller loans would be issued to separate shell companies. In practice, however, Sherkhan and Johnson preferred splitting up loans that fell far short of the legal lending limit, because larger loans attracted attention from audits due to their financial importance to a bank.

**Diagram 1: Johnson’s Loan-Splitting and Shell Company Scheme**

Johnson’s scheme also was helpful in bypassing related party lending restrictions. For example, whenever Sherkhan or the other Kabul Bank shareholders needed money for their businesses, lavish living, gifts, and bribes, they would simply create shell companies and take out as many smaller loans as desired.

**Working Capital Loans**

Johnson’s shell company and loan-splitting scheme was effective in part because Kabul Bank mainly issued business loans, and most of these were in the form of “working capital” loans. Until 2009, 95% of Kabul Bank’s loans were business loans. Afterwards, business loans slowly dropped to about 80% of Kabul Bank’s loan portfolio. Moreover, about 90% of Kabul Bank’s business loans were issued in the form of “working capital loans.”

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15 “Report of Examination: Kabul Bank,” Da Afghanistan Bank, 2007, p. 10. This was the central bank’s third annual audit of Kabul Bank. Q says that the 95% figure continued through 2009, and then slowly dropped to 80% by the time of the crisis.
loans.” Learning how this type of loan works helps to explain how and why the Kabul Bank fraud unfolded as it did.

Working capital loans are aptly named because businesses need “working capital” to begin operations and to grow as a company. They are both similar to and different from credit card debt. Working capital loans are similar to credit cards in that there is an approved credit limit, and the borrower is charged interest only on what is used. For example, suppose Kabul Bank approves a $1 million working capital loan. If the borrower chooses to withdraw $500,000 and no more during the life of the loan, then interest is applied to just the $500,000 (not the $1 million).

Working capital loans differ from credit cards in the way in which the money is used. With credit cards, the credit card holder chooses for what, when, and where to charge the card, and multiple charges may be made in a single day. For example, the cardholder may buy movie tickets or furniture at any time, and the card issuer does not bother how the card is used.

However, for working capital loans the borrower has to declare the purpose for which the money is withdrawn, which must be consistent with the purpose of the loan. For example, one cannot obtain a working capital loan for developing an electronics store and then divert the money for use in an oil business. So every time the borrower wishes to make a withdrawal, he or she has to visit the bank and provide some documentary proof for which the money is needed.

Moreover, as per Kabul Bank’s credit policy, the money is supposed to be sent to the intended recipient via check or wire transfer to safeguard against the money’s misuse. A similar principle exists in the U.S. when someone buys an automobile. The money for the automobile is not deposited into the borrower’s checking account. To guarantee that the seller gets the money, the bank will issue a check in the seller’s name.

Consequently, withdrawing money from Kabul Bank’s working capital loans was cumbersome by design, and the borrower had to visit Kabul Bank’s designated loan disburser to get approval from him. For example, borrower A withdrawals money from his working capital loan. He or she was supposed to produce an invoice showing that such and item or such and such service needed to be purchased. Kabul Bank’s loan disburser was supposed to issue a check or wire the money to the appropriate party, but never give the money directly to borrower A. Borrower A may wait another week, a month, or several months before making a second withdrawal.

Fruzi was the loan disburser when he was Deputy CEO, and he permitted borrowers to withdraw cash directly from the cash counters. It was a blatant violation of the bank’s internal credit policy and international banking norms. Permitting borrowers to walk out of Kabul Bank with cash drawn from their working capital loans opened the door for borrowers to spend their loan money for other purposes.
Repaying working capital loans also is different from repaying credit card debt. Credit card users have a mandatory monthly payment, which includes principal (the amount spent on the card) and interest. In contrast, Kabul Bank’s working capital loans had one-year terms. Before loan approval, Kabul Bank carefully communicated to the borrower that the sale proceeds from his or her business had to be routed into his or her bank account, which was linked to their loan account. Consequently, a borrower might make numerous deposits into his or her loan account each week in order to pay down their working capital loan.

While working capital loan recipients did not have a mandatory monthly payment, they were expected to show reasonable turnover of their inventory consistent with their business plan, and to make reasonable deposits and withdrawals within the 12-month term, otherwise the working capital loan had to be converted to a term loan.

An example will illustrate the borrowing and repaying of working capital loans. Borrower A is approved for a $500,000 working capital loan for his electronics business. He makes a one-time withdrawal for $200,000 in order to travel to Dubai and to purchase radios and televisions to sell in Afghanistan. The $200,000 covers all related costs for the trip and for the purchase of the radios and televisions. The borrower returns to Afghanistan with the merchandise and, upon reentry, pays a customs tax to the Afghan government. Next, the borrower sells the radios and televisions and returns the sale proceeds to his Kabul Bank account, which is linked to his working capital loan account. He may make three, four, five or more deposits per week depending upon his sale volume.

Paying the interest on a working capital loan (or “servicing the interest”) also differs from paying credit card interest. With credit cards, interest is rolled into the mandatory monthly payment. In contrast, while working capital loans do not have a fixed repayment schedule, the interest must be serviced on a fixed pattern.

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16 Kabul Bank’s credit policy, Section 86.
At Kabul Bank, borrowers had to pay the interest on each withdrawal within 90 days.\textsuperscript{17} For example, borrower A makes a withdrawal on his working capital loan on January 1. He has until March 30 to pay the interest on that withdrawal.\textsuperscript{18} During this period, the principal payment will happen by way of routing the sale proceeds into his Kabul Bank account as described above. The borrower makes a second withdrawal from the same loan some time after January 1 and the process repeats itself for the second withdrawal.

Under certain circumstances, Kabul Bank granted borrowers a moratorium on repayments, although interest still accumulated during that period. The nature of some business investments require months, even years, before being able to bring a product to the market. For example, in the case of acquiring a used aircraft, a buyer places an order and may wait six months or longer until the plane is delivered. For new aircrafts, the waiting period may run a few years. In such cases, Kabul Bank suspended repayments, which is a standard practice across all banks, until the borrower’s investment could be brought to the market, money could be made, and repayment made possible.

Moratoriums are not granted in working capital loans because of the nature of these loans. Moratoriums are used only for term loans, which have a fixed repayment where the

\textsuperscript{17} The banking regulation states 60 days since it assumes application of interest on monthly rests. However, since Kabul bank applied interest on daily rests, an additional 30 days were added.

\textsuperscript{18} Kabul Bank charged interest on “daily rests” rather than “monthly rests.” These terms refer to the compounding frequency. Daily rests mean that the interest on the outstanding amount is calculated and applied on a daily basis. However, Afghan banking regulations assume the interest frequency to be on monthly rests.
principal and interest are bundled. In addition, a moratorium only delays the commencement of the repayment, since the bank continues to charge interest from the day that the loan is issued (the repayment schedule will take this into account).

It should be noted that after the Kabul Bank deposit run began in September 2010, media reporting mistakenly alleged that Kabul Bank’s illegal loans were issued interest free and with no repayment requirement. Q says that the misunderstanding was caused due to the failure to grasp both the repayment character of working capital loans and the concept of moratorium for certain term loans.

The true borrowers’ list, which will be described shortly, as well as Q’s testimony, indicate that interest was being charged and the loans were expected to be repaid. The vast majority of the illegal loans ranged from 14% to 20% interest and a few were considerably higher. The problem was that many of the borrowers refused to repay their loans and Sherkhan was slow to act against them since he owned shares in their businesses, an unofficial collateral for the bank.

Kabul Bank’s loans could not be interest free for the simple fact that the auditors and the central bank would not have allowed it. After the scandal, Kabul Bank’s internal audit department analyzed the true borrowers’ list and found that about 35% of the illegal loans (in terms of the number of loans, not the monetary amount) were being faithfully repaid. Most of the loans that were not being repaid, not surprisingly, belonged to Sherkhan, Fruzi, and their associates.

**Applying for a Kabul Bank Business Loan**

While the concepts of splitting larger loans into smaller ones and creating shell companies seem simple enough, in practice they are technical and tricky as the loan application process illustrates. Even with the illegal loans, Kabul Bank still needed the required documentation on file. If Kabul Bank did not have the documents, it risked criticism from audits and eventually getting caught by the same.

For the illegal loans, with the exception of requiring the business license (to be discussed shortly), Q says that Sherkhan did not bother collecting the other documents until mid-2006, and even then the effort was half-hearted. It was not until late 2007 that Kabul Bank made a serious attempt to collect all loan documents. Such was the brazenness of the fraud during Kabul Bank’s early period.

To understand the fraud that occurred in Kabul Bank’s credit department, which was the body that worked with loan approval, it is necessary to understand how a bank’s loan approval process works. Suppose that an electronics business needs extra capital to open a new branch and contacts a bank for a loan.

From the bank’s perspective, the loan is an opportunity to make money from the interest it charges to the electronics business. The bank’s concern in approving the loan is
whether or not the electronics business will be able to repay. If the financial status of the business is solid and the loan amount is within the electronic business’s repayment ability, then assuming other aspects of the broader economy are acceptable, the risk of default is low and the bank may approve the loan.

The challenge confronting the bank is how to know if the electronics business is in fact financially solid and able to repay what it borrows. To solve this mystery, a bank establishes a credit policy, which outlines what a borrower will need for a loan approval.

Kabul Bank’s credit policy, which reads like a banking law, was approved by the central bank in 2006. It states that a borrower, in this case the electronics business, must complete a loan application and provide certain financial and statutory documents. The loan application establishes the identity of the borrower, states the desired loan amount, and identifies collateral in case of default. The financial documents that Kabul Bank required from businesses were:

- a business license,
- tax returns for the last two years (if applicable),
- independently audited balance sheets (lists all assets, liabilities, income, cash flow, and various schedules) for the last two years (if applicable),

As per the Law of Banking, if a bank submits a policy to the central bank and does not receive a reply within 30 days from the central bank, the submitting bank may assume that the policy is approved. Kabul Bank’s credit policy was approved in this way.
• the documents that prove these assets and liabilities exist and truly belong to the business (invoices, receipts, titles, etc.), and
• a business plan.

Statutory documents include the memorandum and articles of association and byelaws, which identify the shareholding and the legal structure of the company. The business plan is significant because it shows how much funding is required and explains step-by-step how the business will turn a profit with the new funding. Business plans are usually prepared with a consultant’s assistance and worked out from audited balance sheets. Start-up businesses do not have balance sheets to work from.

Once a bank receives these documents, it investigates to confirm their legitimacy, and after understanding the business plan, tries to determine if the loan amount is sufficient and its purpose will in fact make profit for the business. While the loan application process may sound tedious, it is designed to protect the bank’s money. Sherkhan and the others at Kabul Bank who facilitated the fraudulent loans, held the bank’s credit policy in contempt.

As noted above, the only document that Sherkhan required for the illegal loans was a valid business license. In contrast, Kabul Bank’s legal loans were held to the letter of the law. Applicants had to fill out a loan application and to supply all the documents noted above. In Afghanistan, all businesses must obtain a business license (also called a trade license) before beginning operations. The Afghan Ministry of Commerce (MoC) and the Afghanistan Investment Support Agency (AISA) issue the licenses. The process is easy and takes only a few days.

Sherkhan never budged on the business license requirement because it offered Kabul Bank deniability. If caught for issuing a loan to a shell company, Kabul Bank could say, “We didn’t know that such and such loan was intended for another purpose. Talk to the MoC or AISA who gave the company its license.”

The business license application requires the following information: the company’s name, the name of the president and vice president (if applicable) of the company along with their addresses and photos, the company’s initial capital amount, and the license’s ID number. Business licenses are given for a period of one year subject to renewal, provided the licensee gets clearance from the Afghan Ministry of Finance’s Income Tax Department, vouching that he or she submitted tax returns and paid whatever taxes were due.

The applicant’s identity is proved by his or her tazkira, which is the Afghan ID card. The tazkira contains the holder’s name, date and place of birth, age, and photo. An Afghan-owned business cannot obtain a business license without tazkiras of the president and vice-president (if applicable). Also, the MoC and AISA require applicants to personally appear.
The true borrowers of Kabul Bank’s illegal loans did not put their own names on the shell company licenses, nor did they appear at the MoC or AISA. They circumvented these requirements through the presence of middlemen: their own middlemen and the MoC and AISA’s unofficial middlemen, who work in part under the auspices of helping illiterate applicants complete the business license application correctly, but Q says that they also act as conduits for the MoC and AISA officials who take bribes.

The true borrowers used a trusted middleman, such as a relative or an employee, to represent them. The borrower would discuss with the middleman beforehand what to put on the business license application, and then supply the middleman with the names, photos, and tazkiras of two of his (the borrower’s) unsuspecting employees, who would be registered as the shell company’s president and vice president. The borrower would get his employees’ tazkiras under the pretext of creating records, updating a file, or any other invented scenario. In some cases, the employee may have given their tazkira willingly in exchange for a bribe.

![Image of the renewed business license for the “Afghan Investment Company” (AIC), dated May 7, 2007](image-url)

Pictured above is the renewed business license for the “Afghan Investment Company” (AIC), dated May 7, 2007 (shrunk to about 40% of its actual size). Afghan business licenses expire after one year. The photos are of Haseen Fahim (left) and a very young Sher Khan Farnood. The back of the license identifies AIC’s shareholding as $45 million.

After the Kabul Bank scandal surfaced, many of the bank’s leading shareholders denied that they took out illegal loans using “fictitious names,” which as just explained were in fact the names of real people. However, as the business license application process makes clear, the shareholders knew that they were using other people’s names. According to Q, the business licenses are one aspect of the scandal that the Attorney General’s Office (AGO) and the central bank never investigated.
Had the AGO visited the MoC and AISA and pulled up the business license files of the shell companies, it would have seen the names and photos of the real life employees of Sherkhan and his associates, as well as the names of the middlemen that filled out the applications, and the brokers who serviced them. Moreover, Q notes that the bank statements for the illegal loans that Kabul Bank issued to the true borrowers each month had the “fictitious” names recorded on them.

There was even another means to identify the true borrowers and that was through Kabul Bank’s books. Banks use double entry accounting, which means that for every credit or debit there is a corresponding debit or credit. In addition, banks use another accounting feature called narration, or particulars, which tell for what purpose a particular transaction occurred and what was the actual transaction. The narration is located in the account statement. Transaction information is easier to obtain for wire transfers. However, Q says that neither the AGO nor the central bank decided on this course.

Shell Company and Illegal Loan Maneuvers

Johnson’s illegal loan scheme used a complex series of money transfers to hide itself from the auditors and the central bank’s inspection team. The transfers reflected the links between the illegal loans, the business licenses, and the shell companies. The illegal loans made to those borrowers who were repaying on a regular basis (the 35% figure noted earlier) followed an expected path. The borrowers created shell companies using their employees and relatives as presidents and vice presidents, then received their loan money from Kabul Bank, and repaid it with interest.

However, the Kabul Bank shareholders and other Sherkhan associates used more complex maneuvers because they were not repaying. They allowed business licenses to expire after one year, then new shell companies were created, and new loans associated with the new companies were taken out. The following example illustrates the practice.

Suppose a Kabul Bank shareholder decided he needed $1 million for his business. He obtained a business license for shell company A, say on January 1, 2009. He got the license following the steps described above. The $1 million was received and spent as he wished. Some of the money would go to his business and another part for luxurious living. When shell company A’s business license expires, the shareholder would not renew it, otherwise he would have to pay taxes on a company that existed only on paper.

As already noted, there was interest attached to the loan for shell company A, and to service the interest within the 90-day limit required another maneuver: the Kabul Bank shareholder created shell company B and took out a second loan for $1.5 million. (Alternatively, he might have taken out two smaller loans through two more shell companies.) He used the money from the second loan to service the interest on the first loan. Eventually, he would even pay off the first loan with the money from the second loan. If the money from the second loan was insufficient to pay off the first loan, the shareholder would create additional shell companies and take out more loans. This
process repeated itself until there was a web of loans and shell companies created in the shareholder’s wake, none of which had the true borrower’s name attached to them.

The auditors did not uncover Johnson’s illegal loan scheme in part because of how they conduct their work. Generally speaking, auditors tend to focus wherever a bank is losing money. They look for red flags, such as unserviced interest or loans that go unpaid, which was not occurring at Kabul Bank. In Kabul Bank’s case, its books appeared in order since the illegal loans were being paid off and the interest was being serviced –through the creation of ever more illegal loans.

**Tracking the Illegal Loans**

How did Sherkhan keep track of the true borrowers and what they owed? Kabul Bank recorded the names of the shell companies while two Kabul Bank employees documented the true borrowers in a Microsoft Excel spreadsheet. The two employees were: Deputy CEO Shokrullah Shokran (Sherkhan’s cousin) and Deputy Chief Credit Officer Esmatullah Baig.

Both men had worked with Sherkhan at the Shaheen Exchange in Dubai, and transferred to Kabul Bank when it opened. Apart from Royal Pamir, a travel agency noted in the last chapter, Sherkhan also owned two other Dubai-based businesses: Shaheen Exchange, his money exchange business (also called a “hawala”) and Sherkhan Farnood General Trading, a real estate business.

Shokrullah and Baig worked with loan approval and the posting of loan activity at Kabul Bank. They documented the major details of the illegal loans (the account number, the fictitious name as in Kabul Bank’s records, the true borrower’s name, the loan limit, interest rate, etc.) on one Excel spreadsheet and emailed it to Shaheen Exchange. The file was updated as needed, as new loans were created and old loans were paid off, and emailed out each time.

Shaheen Exchange, at its computer system in Dubai, used the Excel file to open accounts for the loan holders so that the accounts mirrored the ones at Kabul Bank, except that Shaheen Exchange used both the true borrowers’ names and fictitious names, while Kabul Bank recorded just the fictitious names. This same Excel file was the true borrowers’ list.

The true borrowers’ list contained a wealth of information dispersed across 22 columns. Included in the columns were: the true borrower’s name, the shell company name, the
address, phone number, loan account number, loan limit, the shell company president’s name, his father’s name, and the name of the shell company vice-president and his father’s name, and what product or service the business allegedly offered. Other columns included the loan’s interest rate, the issue date, renewal date, current balance, the type of collateral if any, the status of the business license, and other information.

Shokrullah and Baig also followed a separate track of activity. They copied (extracted through a query) in a separate Excel file, all of the illegal loans’ deposit and withdrawal activity, and emailed the data to Shaheen Exchange at the end of each business day (every day but Friday). Shaheen Exchange then uploaded the loan activity histories into its system.

The practice of daily emailing Excel spreadsheets to Shaheen Exchange enabled the latter to fully mirror the illegal loan accounts at Kabul Bank. Consequently, Sherkhan knew at any given time the precise status of each of Kabul Bank’s illegal loans. He merely took a loan account number from the true borrowers’ list, entered it into Shaheen Exchange’s system, and then instantly accessed the activity history of any loan he wanted to.

**The Shaheen Exchange Money Spout**

In addition to Shaheen Exchange’s role in storing the illegal loan data, it also was the spout where the money came out. Q explains that Kabul Bank and Shaheen Exchange were unofficially merged. Not only did Sherkhan own Shaheen Exchange but also the manager of the Dubai branch, Dr. Ahmad Jawid, was also a Kabul Bank shareholder and a member of Kabul Bank’s Board of Directors. Shaheen Exchange staff worked in Kabul Bank. Shaheen branch managers were repeatedly selected to manage new Kabul Bank branches. Shaheen Exchange effectively functioned as a Kabul Bank department of money transfer.

To understand how Kabul Bank’s money was channeled to the Shaheen Exchange’s Dubai branch, a technical explanation will be given first, followed by one in lay terms. Banks have accounts with each other for clearing and money transfer purposes. Banks identify these accounts by the names “NOSTRO” or “VOSTRO”. NOSTRO means “ours” and VOSTRO means “yours”.

For example, Bank A in New York holds an account at Bank B in London. From Bank A’s perspective, it refers to its London account as a NOSTRO (ours) account. However, from Bank B’s perspective, the New York account is called a VOSTRO (yours) account.
because it belongs to the New York bank. These terms would be reversed for Bank B’s account in New York.

Bank A’s NOSTRO account in London will always be in debit balance and reflected in the asset side of its balance sheet. Conversely, from Bank B’s perspective, it will have Bank A’s VOSTRO account listed in credit balance and reflected in the liabilities side of its balance sheet.

Suppose that Mr. X who is a customer of Bank A, wishes to send money to Bank C, which also happens to be in London. The money transfer is called a “wire transfer.” Bank A will debit Mr. X’s account in New York and then instruct Bank B to debit its NOSTRO account and will also instruct Bank B to credit such and such account at Bank C. The instructions for the wire transfer are normally routed through the SWIFT network, which is a message transmitting service that sends banking instructions from one bank to another (not the actual money). From Bank B’s perspective, it will debit the VOSTRO account of Bank A held in its books and process the wire instruction (or pay Bank C). Similarly, when someone wants to send money from London to New York, the same process will be repeated but in the opposite direction.

From the above example, it is evident that certain actions have to hold for this interbank money transfer system to work. For example, what if there was no balance in Bank A’s NOSTRO account with Bank B? If Bank B continues to process the wire instructions sent by Bank A, then the account of Bank A will be overdrawn. In lay terms, Bank B will be paying out of its own pocket to cover Bank A’s transfers. This latter scenario is precisely what was occurring between Kabul Bank and the Shaheen Exchange.

Kabul Bank opened an account for Shaheen Exchange (viewed as a VOSTRO account by Kabul Bank but a NOSTRO account by Shaheen Exchange), which enabled the latter to handle Kabul Bank’s transfers to Dubai, as well as transfers from Dubai to Kabul Bank.

This is how the transfers worked. Someone transferred $1 million from Kabul Bank to Shaheen Exchange in Dubai. Kabul Bank credited the Shaheen Exchange’s account with itself at Kabul for $1 million and then sent wiring instructions to Shaheen Exchange in Dubai. Next, Kabul Bank transferred the money to Shaheen Exchange via its correspondent banks, which are international banking partners. The crediting of Shaheen’s account at Kabul Bank and the transfer through correspondent banks is a legal and normal transfer.

The siphoning of money occurred through the reverse transfers. For example, suppose someone wanted to transfer $1 million from Shaheen Exchange to Kabul Bank. Shaheen Exchange took the money and instructed Kabul Bank to debit its Shaheen account, and then to credit the money to the beneficiary. Normally, Shaheen should have transferred the $1 million to its account with Kabul Bank via its correspondent banks, but it did not do it. The result was that Shaheen’s account with Kabul Bank was overdrawn and the
shell companies were used to adjust the overdrawn amount.\textsuperscript{20} Kabul Bank was funding all of Shaheen Exchange’s transfers to Afghanistan without getting reimbursed. Sherkhan squandered the $1 million he received at Dubai, or passed it to one of Kabul Bank’s illegal borrowers (his associates).

Stealing the cash from Dubai worked well for Sherkhan since most of Kabul Bank’s business loans went to people who were doing business in Dubai. Kabul Bank would have needed to transfer most of the money to Dubai anyway. Due to Afghanistan’s high country risk status, Afghan businessmen are unable to purchase goods in Dubai on credit. Everything must be paid in full in cash before it can be flown to Afghanistan. Simply put, Kabul Bank’s business loans were needed primarily in Dubai, not Afghanistan.

**The Loan Document Forgery Scheme**

At the end of 2007, a major change occurred in the way that Sherkhan handled the illegal loan documentation at Kabul Bank. The change was occasioned by repeated criticisms of Kabul Bank’s credit department by Kabul Bank’s internal audit department and the central bank’s auditing team.

Kabul Bank’s audit department opened in April 2006, or two years after Kabul Bank began operations, and it completed its first audit that fall. The audit department noted that many loans lacked proper documentation. The central bank’s first annual audit of Kabul Bank occurred in November 2007. The central bank’s audit team asked for the audit department’s reporting, which was standard practice, and picking up on its non-documentation theme, also criticized Kabul Bank’s credit department for non-documentation of loans. Sherkhan, Fruzti, Johnson, and the other facilitators of Kabul Bank’s fraud, never took the internal audit department’s criticism seriously, but the central bank’s rebuke caused a panic among the shareholders and directors.

The central bank found that Kabul Bank’s loan files did not have active business licenses, memorandum and articles of association, audited balance sheets, or proof of invoices for purchased goods.\textsuperscript{21} The audit endangered Kabul Bank’s banking license, which if revoked by the central bank, would close down the bank.

What to do? Kabul Bank was under pressure to get its loan files in order. In mid-2007, Amitava Basu, the credit department’s manager, was promoted to Chief Credit Officer. The appointment put Basu on Kabul Bank’s Management Board. He came to Kabul Bank in 2006 after retiring from the central bank of India.

Basu devised a plan to forge the borrower’s loan documents -all of them- the financial and statutory documents, and even the business plans. Sherkhan’s only requirement

\textsuperscript{20} Usually, when a bank decides to give an overdraft limit to a foreign financial institution, the central bank’s of both countries get involved and the process is a tedious one.

\textsuperscript{21} The business licenses for the shell companies were expiring after one year and were not being renewed in order to avoid paying taxes.
remained, that borrowers had to obtain their own business licenses. Over the next several years, at least eight accounting companies helped to forge the needed documents.  

Q says that Basu was instrumental in forming at least one of these accounting companies. Basu had developed an acquaintance with one of Fruzi’s relatives named Rabbani Yousufi. Basu convinced Yousufi to start an accounting company to forge the documents that Kabul Bank needed. Yousufi obtained the business license for Naweed Sahar Accounting Company.

Here is how Basu’s scheme worked. A borrower would approach Sherkhan or Fruzi and ask for a loan. Sherkhan or Fruzi would tell Shokrullah and Baig the loan amount. Shokrullah and Baig would transmit this information to Naweed Sahar Accounting Company, which would work with Basu to forge the necessary documents.

Naweed Sahar printed the financial statements on its letterhead, and then sent them to Kabul Bank as officially audited financial statements. However, the statutory documents and the business plan were sent to the borrower, who would submit them to Kabul Bank. Q notes that since Basu worked on the documents, he charged his services to the borrowers’ loan accounts.

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By the second half of 2009, the internal audit department suspected fraud with Naweed Sahar’s financial statements and recommended banning the company’s work at Kabul Bank. Yousufi complained to Fruzi who overturned the audit department’s recommendation. Naweed Sahar’s work continued to be accepted at Kabul Bank, although soon many other accounting firms also began forging documents for the illegal loans.

Diagram 2: How to Obtain an Illegal Loan from Kabul Bank

A borrower has informal discussions with Sherkhan or Fruzi regarding a loan, and the decision to sanction or reject the loan is taken either by Sherkhan or Fruzi or by both.

Sherkhan and Fruzi instruct the borrower to meet with Shokrullah or Baig. The fictitious loan process is explained to the borrower.

The borrower floats a fictitious company and obtains a business license from the MoC or AISA, naming his employees or relatives as president and vice-president.

The borrower, through Shokrullah or Baig, contacts Basu to prepare the financial statements required by the borrower in keeping with Kabul Bank’s credit policy.

The borrower submits the loan application in the shell company’s name, along with the required documents, to Kabul Bank’s credit department, which recommends sanctioning the loan.

What prompted the audit department’s suspicion against Naweed Sahar? There were four factors. First, the vast majority of Kabul Bank’s borrowers were using Naweed Sahar’s accounting services. The odds were beyond belief that such a high rate of borrowers was coincidentally hiring the same accounting firm. Realistically, the financials from Kabul Bank’s borrowers should have been coming from many different firms.

Second, the formatting from balance sheet to balance sheet was the same. A balance sheet’s style presentation varies depending on the type of business that is audited; however, this was not the case with Naweed Sahar’s work. Third, the balance sheet calculations were the same for similar loan disbursements. For example, if one randomly pulled two separate $5 million dollar loans from Kabul Bank’s loan portfolio, which were
both audited by Naweed Sahar, one would discover that the figures were identical with the exception of one or two minor alterations.

The reason for the same calculations being used in multiple balance sheets suggested that Basu used the same balance sheets repeatedly as a sort of template, changing only names, addresses, a figure here, and a figure there. This enabled Basu to reduce his forgery workload. It also helped keep the various accounting ratios within acceptable limits, because once balance sheet figures are altered significantly, then the ratios, which banks rely on to make their loan approval decisions, also fluctuate.

Kabul Bank’s 2009 internal audit report, which extended to December 31, 2009, addressed the problem of same calculations (“same values”). Under the subheading “Credit Appraisal Forms Having the Same Values for Different Customer,” the report observed, “During the course of our credit review, we observed that Credit Appraisal Forms and Business Plans, for different customers, have had the same values for: current ratio, debt to equity ratio, receivable days, profit, [and] revenue.” The report coolly concluded, “Documentation just for the purpose of completing forms may not yield the desired results.” It was an incredulous statement. Kabul Bank’s own audit department was reporting that loan documents were being forged.

Fourth, Naweed Sahar was also providing the same document forgery services to Kabul Bank’s archrival, Azizi Bank. On several occasions, Naweed Sahar mistakenly faxed the financial statements intended for Azizi Bank to Kabul Bank. These documents were identical to the ones (same format, same figures) that Naweed Sahar was sending to Kabul Bank. An employee of Kabul Bank’s credit department privately alerted the audit department, which subsequently recommended banning Naweed Sahar.

The corruption in Afghanistan’s other private banks has been reported by the media, and subsequently denied by the Karzai administration. According to Q, all of the Afghan-owned private banks in Afghanistan are mimicking Kabul Bank’s illegal lending practices. (The Afghan-owned private banks are distinguished from the foreign-owned private banks.) They are splitting large exposure loans into smaller loans, issuing them to shell companies, and forging the required loan documents.

Q notes that the founders of Azizi Bank and Ghazanfar Bank were former Kabul Bank borrowers, while the founder of Maiwand Bank was a former shareholder and Deputy CEO of Kabul Bank. All three men took out illegal loans from Kabul Bank and eventually started their own banks for the same purpose as Sherkhan did: to fund their own businesses.

Such is the level of contempt that Afghanistan’s private banks hold for their own policies, laws, and regulations. Q is concerned that when the international community pulls out of

Afghanistan, Afghanistan’s financial sector may collapse since a substantial portion of the deposits in the banking sector have been squandered.

How successful were Basu and Naweed Sahar Accounting Company at addressing Kabul Bank’s loan documentation problem? The results were mixed. On the one hand, the central bank recognized Kabul Bank’s efforts in its 2008 annual audit of Kabul Bank. Basu received a pay raise and became popular at Kabul Bank for his job performance. He was even promoted to the Board of Directors, the only foreign national ever placed on the board.

However, the internal audit department was unimpressed and continued to criticize the credit department’s documentation problems. In the 2009 audit, the audit department still discovered numerous problems with loan documentation. In addition to the forgery noted above, loans continued to be approved without:

- memorandum and articles of associations,
- the borrower’s credit report from other banks where applicable,
- tax returns for two years,
- audited balance sheets for two years,
- enough collateral to cover 100% of the loan,
- meeting the minimum limit in certain accounting ratios,
- routing the borrower’s sale proceeds to the loan account,
- the required Board of Director’s signatures for loans over $2 million,
- the repayment schedule for term loans (not working capital loans),
- business licenses (despite Sherkan’s insistence),
- a valid ID to confirm the borrower’s identity, and even
- the borrower’s signature and stamp on the loan application.  

Why the differing views? It was due to the subjectivity applied by auditors. The central bank saw the credit department’s effort to improve the loan documentation problem and commended it for the progress, while the audit department examined the quality of the documentation changes and found them lacking.

The Deposit Run

In the summer of 2010, a power struggle for ownership of Kabul Bank emerged among its leading shareholders. On one side was Sherkhan Farnood, and on the other side were Khaliullah Fruzi, Mahmoud Karzai, and Haseen Fahim. Quite unexpectedly in July, Sherkhan visited the U.S. Embassy in Dubai and shared with U.S. officials his version of the bank’s leadership and fiscal troubles. Sherkan had ties to the U.S. Treasury

25 The list is most, but not all, of the problems identified in the 2009 internal audit report.
26 Andrew Higgins, “Kabul Bank Crisis Followed U.S. Push for Cleanup,” Washington Post, September 17, 2010. While U.S. officials might have believed that Sherkhan came clean with everything, Q thinks that Sherkhan gave only a slanted version of the scandal, as Sherkhan was unlikely to reveal Johnson’s or Basu’s fraud schemes.
Department and went to the embassy for help as a sort of last resort. He was on the verge of losing Kabul Bank and he did not trust any Afghan officials to help him keep the bank.

While Sherkhan intended for his visit to secure U.S. help in his struggle to hold on to Kabul Bank, his revelations had the opposite effect because they permanently damaged his reputation and relationship with the U.S. In particular, American officials were surprised to learn that Sherkhan owed a lot of money to Kabul Bank, more than what was recorded in the bank’s books. Q says that as a result of a loss of confidence in Sherkhan, U.S. officials turned to central bank Governor Fitrat to get the true picture about Kabul Bank.

Also in July, U.S. General David Petraeus met with Fitrat and President Karzai to discuss Kabul Bank. Petraeus had arrived in Afghanistan earlier that month to take command over U.S. and international forces in Afghanistan from outgoing U.S. commander General Stanley McChrystal. Petraeus believed that Afghanistan’s corruption problem was working against the military’s goal of bringing an end to the insurgency by delegitimizing the Karzai administration.

In his first three weeks on the job, Petraeus held over 20 meetings with President Karzai and corruption was a “regular topic.” At the meeting, Fitrat and Petraeus presented Karzai with evidence of Kabul Bank fraud, and Petraeus urged the president to take action.

On August 29, Fitrat met with the Kabul Bank shareholders in a meeting whose tone is described as having “little sense of urgency.” Sherkhan and Fruzi agreed to resign “at some unspecified time in the near future.” However, the following day, Monday, August 30, President Karzai summoned his brother, Mahmoud, to the presidential palace and “berated him over the state of affairs at Kabul Bank” because the infighting risked further damaging the president’s already poor reputation in fighting corruption.

On the same day, Fitrat went to Kabul Bank and demanded the immediate resignation of both Sherkhan and Fruzi under the threat of imprisonment. While Fitrat was the administration official that fired the two men, given the Afghan political context, it is likely that Fitrat acted under President Karzai’s orders. As a general rule, influential Afghan business and political figures that are connected to President Karzai cannot be

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30 Andrew Higgins, “Kabul Bank Crisis Followed U.S. Push for Cleanup,” Washington Post, September 17, 2010. Assuming this was the same event, then previously it was reported to be a “stormy and inconclusive meeting.” See: Joshua Partlow and Andrew Higgins, “Afghan Authorities Take Over Largest Bank to Avoid Meltdown,” Washington Post, August 31, 2010.
32 Ibid. Q provided the reason for the berating.
33 Fitrat’s flip flop from August 29 to 30 appears to be related to President Karzai’s anger expressed on the 30th. After laying into his brother, President Karzai likely ordered Fitrat to immediately fire Sherkhan and Fruzi.
fired, arrested, or prosecuted without the president’s approval. Sherkh an later recalled, “It was an easy choice. I resigned.”

In their place, the central bank installed its own chief financial officer, Masood Ghazi, as acting CEO of Kabul Bank. Ghazi was Fitrat’s most trusted aide at the central bank, and his appointment as CEO stemmed from the central bank’s broad enforcement powers in the Afghan banking sector. The limited intervention signaled Fitrat’s understanding of Kabul Bank: the bank was not in danger of collapsing despite the widespread fraud. However, later into the crisis, Q says that Fitrat placed Kabul Bank into conservatorship because the International Monetary Fund (IMF) questioned the logic of his limited intervention.

Conservatorship is a banking corrective process where a central bank installs a “conservator” to take over a troubled bank and to “conserve” its assets. Under Afghan banking law, the legal ground for placing a bank in conservatorship (the reason why it is done) is bankruptcy or criminal activity. Ghazi’s title was subsequently changed from acting CEO to conservator, and his new job was not without perks. Q says that Ghazi charged Kabul Bank $25,000 in October to decorate his home.

On August 31, the day after Sherkhan and Fruzi were fired, Kabul Bank wired $4.9 million to three accounts in Dubai—all registered in Sherkhan’s name. This is the first time that this story has been reported. The money did not leave Kabul Bank through a loan account. It was transferred to Dubai by debiting Kabul Bank’s “fixed assets.” Q says that there were no transfer application forms or supporting documents of any kind for these transfers.

The $4.9 million transfer was so brazen that in Kabul Bank’s daily balance sheets the transfers are identified by the villas’ street addresses: “Villa F-74,” “Villa D-79,” and

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37 “Law of Banking,” Articles 46–52. The central bank has the power “to remove an administrator, officer or employee” of a bank. The central bank may exercise these powers outside of the conservatorship and receivership context.
38 “Law of Banking,” Articles 53 through 60.
41 The charge appeared as an expense in Kabul Bank’s balance sheets in October 2010.
42 The precise amount in the August 31, 2010 balance sheet is $4,866,306.02. Note that this transfer is separate from the reported $1.3 million transfer that Sherkhan received from the Kabul Bank’s Laskkar Gah branch in 2011. See: Alissa J. Rubin and James Risen, “Losses at Afghan Bank Could be $900 Million,” New York Times, January 30, 2011.
43 The three loans were actually mortgage loans. If the villas already had an active mortgage loan then Sherkhan’s loans against the villas would have been similar to what in America is referred to as a “home equity loan.” However, since Sherkhan owned the villas free and clear, his three loans were mortgage loans.
44 This is Q’s astute observation.
“Villa Shore Line PH-01.” Also, by accounting for the transfers under “fixed assets” it was implied that Kabul Bank owned the villas, but Afghan banking law forbids banks from owning residential real estate.\textsuperscript{45}

The Kabul Bank employees that were associated with the wire transfers were later questioned, and they said that Shokrullah Shokran authorized the transfers. Shokrullah was questioned and he said that Masood Ghazi and Governor Fitrat knew about the transfers because he informed them afterwards.

The $4.9 million transfer is significant because neither Ghazi nor Fitrat took action against it. However, on September 16, Kabul Bank’s audit department reported the illegal transfers to the Board of Directors, then acting CEO Ghazi, and the heads of the Audit Committee and the credit and finance departments, but no official banking action was taken as a result.\textsuperscript{46}

After business hours on August 31, Sherkhan and Fruzi’s dismissal from Kabul Bank leaked out and caused a panic. The two men were the public faces of Kabul Bank and frequently appeared in the media and other public forums, so their firing shook the confidence of Kabul Bank depositors. Beginning on September 1, and lasting for the next seven business days, or to September 8, a stampede of angry Kabul Bank depositors withdrew their money as quickly as possible.\textsuperscript{47}

One depositor declared, “If they do not listen to us we will break all the windows of Kabul Bank, we will loot all the branches and even … the presidential palace.”\textsuperscript{48} Another irate member asserted, “I used to trust the bank but not anymore. You put your money in, you don’t know if you’ll get it out.”\textsuperscript{49}

Abdullah Abdullah, who ran against President Karzai in the 2009 election, wondered if Kabul Bank was receiving state funds and stated emphatically that the government and the Kabul Bank shareholders were responsible for the bank’s failure.\textsuperscript{50} Abdullah said, “The government of Afghanistan and the shareholders are responsible for this issue. …If the bank was acting illegally for five years, why didn’t the central bank take any action against it?”\textsuperscript{51} On September 13, calm returned to Kabul Bank following back-to-back holidays that extended from September 9-12.

\textsuperscript{44} For a map of Palm Jumeirah, where you can see the locations of the villas, see: http://www.dreampropertydubai.com/Palm-Jumeirah/. Note that the villas make up the branches/leaves and the apartments are in the trunk.

\textsuperscript{45} “Law of Banking,” Articles 33 and 34. Banking law does not forbid banks from offering mortgage loans.

\textsuperscript{46} The incident was reported through an internal audit department memo on September 16, 2010.

\textsuperscript{47} The seven days were: September 1, 2, 4, 5, 6, 7, and 8. September 3 was a Friday and Kabul Bank is always closed on Fridays. It was opened on Saturdays and Sundays. Kabul Bank’s main branch in Kabul was the only branch to open on September 8, and it was opened for half a day. All of Kabul Bank’s branches were closed on September 9-12 for the memorial of Ahmad Shah’s Massoud’s death and the end of Ramadan.


\textsuperscript{49} Ibid.


\textsuperscript{51} Ibid.
As noted earlier, on September 4, Governor Fitrat was given the true borrowers’ list of Kabul Bank. The significance of Fitrat obtaining Kabul Bank’s true borrowers’ list is that it indicates that, shortly after the crisis broke, the central bank knew the identities of everyone that illegally borrowed Kabul Bank’s money.

Q thinks that Fitrat kept it a secret from the Afghan government that he had a copy of the true borrowers’ list, and instead used the true borrowers’ list as political insurance. In the event that the central bank were ever implicated in the scandal, Fitrat could threaten to publicize the names on the true borrowers’ list, which included many Afghan politicians. It is worth noting that in April 2011, after Fitrat got wind that the AGO was going to arrest him, he took preemptive action before Parliament and used the list to expose ten of Kabul Bank’s biggest borrowers of illegal loans.52

Whatever Fitrat’s intentions, he did keep his possession of the true borrowers’ list a secret from the Afghan public, and in fact pretended not to know who the recipients were, as was evidenced by the need for the later forensic audit that Fitrat and the IMF insisted upon to supposedly locate Kabul Bank’s missing money. Keeping the list a secret also protected the shareholders, and others, who illegally took the bank’s money.

Kabul Bank’s True Fiscal Position

According to Kabul Bank’s August 31, 2010 balance sheet (Table 1), or the day before the deposit run, the bank had received $1.3 billion in deposits.53 From this amount, the total in loans and advances amounted to $912.8 million: $909.4 million was lent to the public and $3.4 million was given as loans to Kabul Bank’s staff in the form of credit cards and personal loans, which were secured by salary and cash collaterals (Table 2).

Kabul Bank’s $912.8 million loan portfolio figure contradicts the wildly understated loan figures issued by the Karzai administration after the crisis, which erroneously estimated Kabul Bank’s total loan portfolio at only $587 million, of which $538 million was supposedly loaned illegally.54

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53 The author has a copy of the balance sheet. Table 1 is a summary only. There was an accounting error in the original balance sheet for August 31, 2010 that had to do with the exchange rate. Kabul Bank’s Oracle accounting software treats the Afghani as the functional currency (not the dollar). So all end of day figures are actually given in AFN and then converted to dollars. The first balance sheet on August 31 showed a deposit total of $1.336 billion (based on an exchange rate of 45.51 AFN per $1). Later, the balance sheet was corrected with the new exchange rate (or 46.58 AFN per $1), which adjusted the deposits downward to $1.3 billion.

### Table 1: Balance Sheet of Kabul Bank as on August 31, 2010

<table>
<thead>
<tr>
<th>ASSETS</th>
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<th></th>
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<td>Cash on Hand</td>
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<td>Balance Maintained with Inland Banks</td>
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<td>Balance Maintained with Foreign Banks -NOSTRO Accounts</td>
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<td>Investments</td>
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<td>Loans and Advances</td>
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<td>Other Assets</td>
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<td>Other Suspense Accounts</td>
<td>$378,446,165.41</td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL ASSETS</strong></td>
<td><strong>$1,806,372,634.89</strong></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>LIABILITIES</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital and Reserves</td>
<td>$116,415,331.42</td>
<td></td>
</tr>
<tr>
<td>Demand Deposit</td>
<td>$1,242,860,290.24</td>
<td></td>
</tr>
<tr>
<td>Time Deposit</td>
<td>$57,824,052.94</td>
<td></td>
</tr>
<tr>
<td>Payable Accounts</td>
<td>$366,393,467.79</td>
<td></td>
</tr>
<tr>
<td>HOC Accounts</td>
<td>$-3,146,676.72</td>
<td></td>
</tr>
<tr>
<td>Currency Suspense Account</td>
<td>$-12,667.71</td>
<td></td>
</tr>
<tr>
<td>Other Liabilities</td>
<td>$-86,288.11</td>
<td></td>
</tr>
<tr>
<td>Current Years Profit</td>
<td>$19,036,855.08</td>
<td></td>
</tr>
<tr>
<td>Revaluation Loss</td>
<td>$7,088,269.96</td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL LIABILITIES</strong></td>
<td><strong>$1,806,372,634.89</strong></td>
<td></td>
</tr>
</tbody>
</table>

### Table 2: Loan Portfolio Details as of August 31, 2010

<table>
<thead>
<tr>
<th></th>
<th>All figures in USD</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overdraft Accounts</td>
<td>$551,813,129.04</td>
</tr>
<tr>
<td>Term Loans</td>
<td>$353,812,048.23</td>
</tr>
<tr>
<td>Interest Accrued on Term Loans</td>
<td>$6,817,872.63</td>
</tr>
<tr>
<td><strong>GROSS LOANS</strong></td>
<td><strong>$912,443,049.90</strong></td>
</tr>
<tr>
<td>Interest Receivable NPA USD</td>
<td>$-23,56,725.89</td>
</tr>
<tr>
<td>Interest Receivable NPA USD (Term Loan)</td>
<td>$-668,531.65</td>
</tr>
<tr>
<td><strong>NET LOANS</strong></td>
<td><strong>$909,417,792.36</strong></td>
</tr>
<tr>
<td>Debit Balance in Credit Card (Platinum)</td>
<td>$190,639.36</td>
</tr>
<tr>
<td>Debit Balance in Gold Credit Card</td>
<td>$7,351.11</td>
</tr>
<tr>
<td>Loans Given to Kabul Bank Staff</td>
<td>$3,155,850.51</td>
</tr>
<tr>
<td>Interest Accrued in Staff Loans</td>
<td>$-8,478.00</td>
</tr>
<tr>
<td>Debit Balance in Savings Accounts</td>
<td>$44,824.92</td>
</tr>
<tr>
<td>Debit Balance in Current Accounts</td>
<td>$13,526.68</td>
</tr>
<tr>
<td><strong>TOTAL OTHER LOANS</strong></td>
<td><strong>$3,403,714.58</strong></td>
</tr>
</tbody>
</table>
Of the $1.3 billion, a sum of $458.7 million was retained as “liquid assets,” or cash-equivalent assets, commonly referred to as “cash” (Graph 1). Kabul Bank’s liquid assets were dispersed among four different categories most of which paid interest. $234 million was kept with “inland banks,” in this case the central bank. $152.6 million was located in foreign banks, in NOSTRO accounts. $67.7 million was in “cash on hand,” or actual cash located in Kabul Bank’s branches and ATM machines spread across Afghanistan, and an additional $4.3 million was held under “investments” with the central bank.

Kabul Bank’s unusually high cash holding of $458.7 million, or 35.26% of its deposits, was actually reported by the Washington Post on September 1, 2010. The reason for the high level of liquid assets was because some of Kabul Bank’s management officials advised Fruzi in the last quarter of 2009 to limit new lending by funding new loans with only the profit made available from the interest paid on current loans. In lay terms, Kabul Bank stockpiled all new deposits from the end of 2009 through August 2010.

Due to the central bank’s 8% rule, which states that a bank must hold on to at least 8% of its deposits in cash-equivalent form, Kabul Bank was not permitted to release all of its $458 million during the run. At the end of September 8, or the last day of the run, Kabul Bank depositors had withdrawn $418 million, leaving the bank with $882 million in deposits. The central bank’s 8% rule forced Kabul Bank to retain at least $70 million of its own cash, which meant that Kabul Bank released to the public $388 million of its own

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cash during the run. The central bank made up the $30 million difference. Kabul Bank’s massive reserves almost covered the deposit run without government assistance.

The central bank intervened with money from Afghanistan’s reserves when Kabul Bank’s cash was exhausted. It gave Kabul Bank money as needed on a day-to-day basis. The way this worked was that at the end of each day during the run, Kabul Bank gave its daily report on withdrawals, deposits, and liquid asset totals to the central bank, which transferred money to Kabul Bank as needed.

At the end of September 8, or the final day of the deposit run, the central bank had given Kabul Bank $170.3 million, and $140.8 million of that amount was still with the bank. About $75 million was located at Kabul Bank’s branches all over Afghanistan, $61.5 million was in the NOSTRO accounts, and another $4.3 million was in investments with the central bank (Graph 2).

Ghazi and Fitrat used a dubious accounting technique to account for the central bank’s lending to Kabul Bank in the latter’s balance sheets. Normally, Fitrat and Ghazi should have created a new entry on the liability side of the balance sheet entitled something like “borrowings from the central bank.” Instead, they accounted for the central bank’s lending on the asset side of the balance sheet by letting Kabul Bank’s “balance maintained with inland banks” (one of the liquid asset categories), go into negative numbers (Graph 2).

Ghazi and Fitrat also failed to properly document Kabul Bank’s remaining $70 in liquid assets. It also appears to be a part of the negative balance in “balance maintained with inland banks” (Graph 2). According to Q, the erroneous accounting method was the result of either incompetence or an attempt to hide the central bank’s lending. Since analysis of
the “balance maintained with inland bank” still indicates how much the central bank lent to Kabul Bank, the former explanation is likely.

While the official end of the deposit run was September 8, the balance sheets show that the bleeding of Kabul Bank’s deposits continued through the end of September, in large part because of the cancelation of the Bakht Deposit, which further lowered deposits by an additional $180 million, leaving total deposits at $702 million on October 1, 2010 (Graph 3). The central bank completely financed these latter withdrawals since Kabul Bank did not have the available cash.

![Graph 3: Deposit Run at Kabul Bank](image)

At the end of September 2010, the central bank’s total cash assistance to Kabul Bank was about $350 million, of which $149.9 million still remained with Kabul Bank. Specifically, $77 million in cash was spread across Kabul Bank’s many branches and ATMs, and $72.9 million was located in NOSTRO accounts (Graph 2).

Put another way, not including the $149.9 million given to Kabul Bank that was still with Kabul Bank, by the end of September, about $200 million of the central bank’s money was used to reimburse Kabul Bank’s depositors. Kabul Bank shed an additional $50 million over the next couple of months, and the central bank provided the cash for these later withdrawals as well. Deposits hovered around $650 million well into the middle of 2011.

**The Shareholder and Central Bank Coup**

The September 2010 Kabul Bank scandal triggered a crisis with the International Monetary Fund (IMF), which demanded that the Karzai administration bring the scandal to a successful resolution before the IMF would renew its $120 million Extended Credit
Facility (ECF) program with the Afghan government. Instead, the government stumbled along for many months, unwilling to prosecute the shareholders or to seize their assets.

Kabul Bank remained in conservatorship until April 2011, when the Karzai administration placed Kabul Bank into receivership following intense IMF pressure, because conservatorship failed to retrieve the bank’s money. Receivership meant salvaging the good part of the bank by letting it continue under a new name, or “New Kabul Bank,” and grouping the bad loans in another entity that would get shut down after as much money as possible was recovered. New Kabul Bank began as a legal entity on April 18, 2011, and the Kabul Bank shareholders were not associated with it.

However, receivership triggered another IMF demand: the Afghan government needed to propose a plan for how to recapitalize the government’s reserves in the event that receivership failed to fully reimburse the government bailout, which in June 2011 was estimated at a staggering $820 million. The sheer size of the bailout at this time was mindboggling because Kabul Bank did not need that much lending. All it needed was about $350 million: $200 million to cover September 2010’s withdrawals, $50 million to handle the later withdrawals, and perhaps another $100 million to strengthen the bank’s forward fiscal position.

By the public not having all the facts, it was inferred that the $820 million was used to pay Kabul Bank’s depositors during the deposit run. Q does not know why the central bank unnecessarily injected an additional $470 million into Kabul Bank. He only says that Fitrat and Ghazi know the answer to this question.

Q believes that the central bank conspired with Kabul Bank’s shareholders to absorb most of the bad loans from Kabul Bank’s books. In lay terms, the $820 million bailout had the effect of the central bank purchasing most of Kabul Bank’s bad loans so that Kabul Bank could start over with a clean lending slate. The bailout effectively transferred the collection responsibility for the bad loans to the central bank.

However, since the central bank refused to force the politically connected borrowers to repay, the central bank transferred the responsibility for repayment to the Afghan taxpayers through the budget supplemental that was passed by the Afghan Parliament in October 2011.

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58 Ibid. The date is courtesy of Thomas Ruttig of the Afghanistan Analysts Network in an email.


60 For a blistering editorial on the $73 million supplemental, see: “Parliament Rejects Budget Again!,” Outlook Afghanistan, April 30, 2011. The Parliament struggled to pass Afghanistan’s current budget (SY1390). The $73 million
It is likely that the central bank and Governor Fitrat knowingly bailed out the shareholders. The central bank had Kabul Bank’s balance sheets and, therefore, knew that the bank’s cash position was strong before the deposit run. It also had the true borrowers’ list and knew that about 35% of the bad loans were being repaid regularly. Moreover, the central bank was aware of the substantial shareholder assets.

The larger question is “What did President Karzai know?” Fitrat would have needed Karzai’s approval for the massive bailout, but how did Fitrat justify it? Q thinks that Fitrat told the president that all of Kabul Bank’s loans were bad and that the bank had no available liquid assets. If this did not happen, then perhaps President Karzai simply ordered Fitrat to pay off most of Kabul Bank’s bad loans -perhaps after consultation with the two first brothers.

The excessive bailout also raises questions in regards to the IMF and Deloitte, the USAID-contracted advisors at the central bank. What did they know about Kabul Bank’s liquidity before the run? Q says that the IMF had one of their experts in “winding up banks” at Kabul Bank from the start of the crisis, a Ms. Cat (Kat?). She was still there after the bank was split in April 2011. Q argues that had the IMF examined Kabul Bank’s balance sheets it would have known that the bank’s liquidity was strong and that the bailout was excessive and used for purposes other than paying the depositors. Only the IMF expert knows whether or not she looked at Kabul Bank’s balance sheets.

Q does not think that the IMF knew the details of Kabul Bank’s balance sheets or else it would not have insisted on splitting the bank. After all, Kabul Bank’s fiscal position fundamentally changed once the central bank pumped the additional $470 million into it.

As strange as it may seem, thanks to the central bank’s $820 bailout, Kabul Bank had been restored to health, its bad debt (most of it) being transferred to the central bank. Q thinks that the IMF relied exclusively on whatever the central bank told it without checking Kabul Bank’s figures for themselves. However, he also adds that the IMF could have cross-verified with the Deloitte advisors at the central bank, unless the latter were in the dark too.

Conclusion

While several unanswered questions remain regarding the Kabul Bank scandal, the basics of the scandal are clear. There was a massive theft at Kabul Bank and the mechanism was

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an illegal loan network. Sherkhan used illegal loans to spend Kabul Bank’s money in any way that he wanted and with impunity.

There was also an excessive bailout and a cover up as to how that money was spent. The bailout money was used to help Kabul Bank during the deposit run and to pay off much of Kabul Bank’s illegal loans. The responsibility of reimbursing the bailout was dumped on the Afghan people.
About the Author

Michael (“Mike”) Huffman holds a Master of Science in International Relations with a National Security emphasis from Troy University, and a Bachelor of Arts in Government with an International Affairs emphasis from Oral Roberts University. Mike has been to many countries including South Korea, Japan, Britain, France, Russia, Honduras, Ghana, Cameroon, and Chad. Mike lives in Virginia.