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Afghanistan Reconstruction Trust Fund

Strengthening the ARTF Governance Structure

Introduction

The ARTF was established in March 2002 as a multi-donor trust fund that could support immediate stabilization and reconstruction needs in Afghanistan, and in particular fill the operating budget's financing gap. Drawing on the lessons of its own experience, two independent evaluations and input from the Government and donors, the ARTF has since evolved to become the main vehicle for multi-donor, on-budget support for the Government's national programs, reform agenda, fiscal sustainability and the prioritization and delivery of the national development strategy.

An important characteristic of the ARTF has been its ability to adapt to changing circumstances and development priorities, within a consistent and sound framework. The donors, Government and other partners, with the support of the World Bank, acting as Trustee and Administrator of the ARTF, propose to put in place a set of measures that modify the way in which the ARTF governance framework functions. This package of reforms aims to strengthen ARTF governance arrangements and enhance the delivery of development assistance in Afghanistan.

Since the publication of the last independent evaluation of ARTF in August 2008[1], the Administrator, working closely with Government and donor partners, has put into practice some of the evaluation's key recommendations. The core objective of these refinements has been to position ARTF more strategically in the Afghan development context and to further engage donors in the strategic management of the ARTF. The two major changes introduced following the 2008 review were:

- Through the ARTF recurrent cost window, the Incentive Program (IP) was established as a mechanism to support Government reforms through a series of annual incentive payments in exchange for completion of agreed reforms. The ARTF IP aligns the interests of donors and Government in priority areas including economic governance (such as tax policy) public sector reform (pay & grade), private sector development (corporatization & mining regulatory environment) and more transparent government.
- The ARTF investment window has expanded as donor contributions have increased year on year. At the same time, donors and Government have expressed a desire to use the ARTF as a financing vehicle for development projects. As recommended in the independent evaluation, a 3-year financing strategy was developed and agreed by the donors and Government to better align ARTF support with longer-term government priorities and to move the ARTF away from annual allocations towards more predictable multi-year financing.

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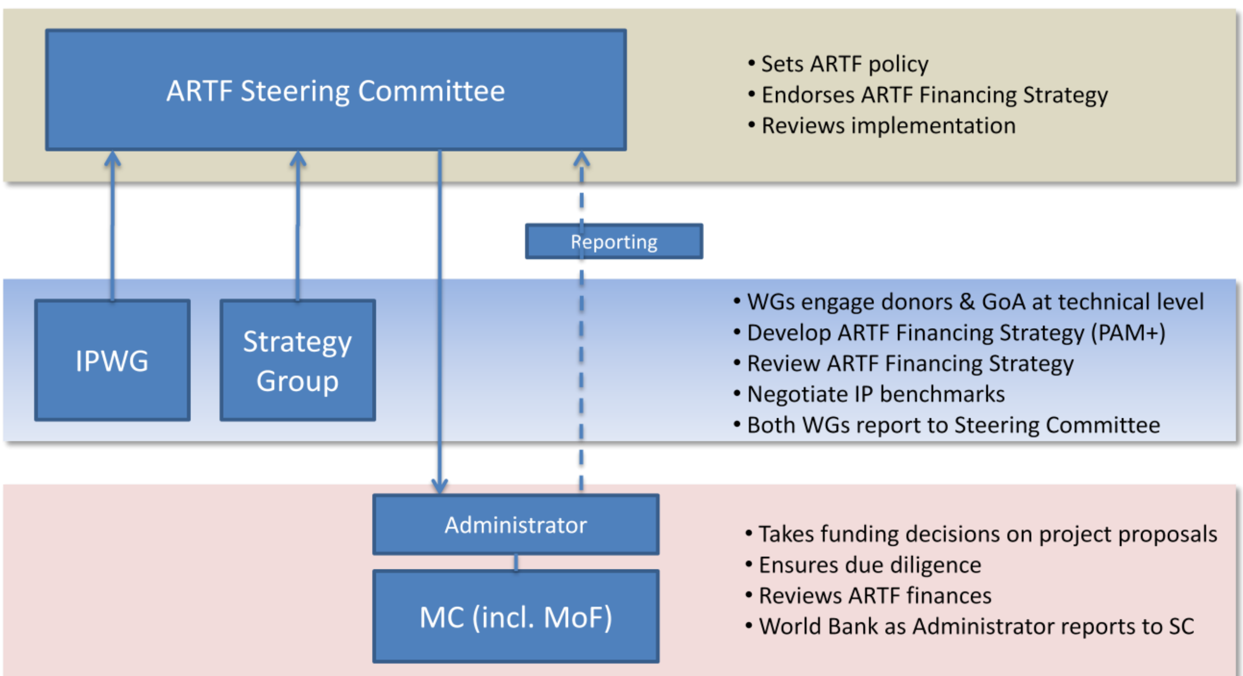
[1] Scanteam of Norway. See www.worldbank.org/artf for the full report.

Towards a more effective ARTF governance

The innovations described above have already brought fundamental improvements to ARTF operations. Nevertheless, there remains a need to consolidate and build on these operational improvements. The existing three-tier governance framework (Steering Committee, Management Committee and Administrator) will remain intact; however, the functioning of the Management Committee and Steering Committee will be strengthened (the change of name from Donor Committee to Steering Committee reflects a more strategic role). Two working groups will be formally convened under the Steering Committee to provide inputs to the Steering Committee on strategic, technical and policy matters. The Management Committee, strengthened by the formal membership of Government, will remain the body tasked with the execution of funding decisions, in line with the ARTF Financing Strategy as agreed by the Steering Committee (see figure 1 below).

Fig. 1 Supporting the effective implementation of the ARTF Financing Strategy



Clarifying roles and responsibilities:

ARTF Steering Committee: The Steering Committee sets strategy for the ARTF which is the responsibility of the Management Committee to implement. Decisions of the Steering Committee are made on a consensus basis and henceforth would be informed by the proposed working groups. The Committee meets once a quarter in Kabul and once a year – where possible – in another major donor capital. The Committee is made up of all ARTF donors, the World Bank and Ministry of Finance, with other MC members participating as observers. This arrangement was formalized through the changes in governance structure of November 2005. The Committee meets under the co-chair of the World Bank and the Minister of Finance.

Working Groups: The proposed IP working group and Strategy Group would be technical advisory bodies accountable to the Steering Committee and representing the wider group of ARTF donors. The working groups are Kabul-based bodies, chaired by the World Bank, with Government participation, and would be relatively restricted in membership based on clear criteria set out below so as to achieve a more technical and focused discussion than is possible at the Steering Committee. Accountability of these groups would be achieved by ensuring a continual feedback loop between them and the Steering Committee and also by reviewing membership of the groups regularly.

ARTF Management Committee: The ARTF Management Committee is the body that reviews and approves individual funding proposals. The Management Committee is responsible for reviewing and, if appropriate, approving funding proposals. It also reviews ARTF finances and makes recommendations to the Administrator on the management of the ARTF. Decisions are taken on a consensus basis. The Administrator is responsible for reporting on the decisions of the Management Committee to the Steering Committee.

The Administrator is also responsible for preparing all documentation for the Management Committee, for which it acts as secretariat and chair. The initial members of the Management Committee are the Asian Development Bank, the Islamic Development Bank, the United Nations Development Program and the World Bank. In 2005, the Ministry of Finance of Afghanistan was added as an observer. The paper proposes that the Ministry of Finance become a full member of the Management Committee.

Measure 1: The ARTF Strategy Working Group

It is proposed that an advisory Strategy Group that will report to the Steering Committee be formed. The Strategy Group will take ownership of the ARTF Financing Strategy.

Rationale: Following the 2008 evaluation, a three year framework and strategy for the ARTF was developed and agreed with all ARTF donors and the Government. The initiative aimed at strengthening the link between ARTF donors, ARTF decision-making and Government strategy as well as the ARTF's support to broader aid coherence in Afghanistan. The Financing Strategy puts the ARTF on a more strategic path based on donors' collective estimate of available funds over a three year period. It then sets out the broad allocation of ARTF funds to both the recurrent cost window and the investment window, and organizes financing into five priority clusters: Agriculture, Rural Development, Infrastructure, Human Development and Governance/Capacity Building, all based on Government priorities. This approach and three year framework was endorsed by the Steering Committee meeting held in London in January 2010 and has been under implementation through allocations made by the Management Committee since the start of SY1389.

As the next phase in its evolution, it is proposed that the Steering Committee should have a greater role in the ARTF's strategic direction and in ensuring that the Strategy is implemented in accordance with the realities on the ground. Therefore, it is proposed that the Steering Committee establish a strategy working group to help advise the Steering Committee. The Strategy Group would be composed of: (i) key donors with technical expertise in Kabul, (ii) the Ministry of Finance and (iii) the Administrator, acting as secretariat and facilitator. The Steering Committee would agree on strategic decisions as set out in the Financing Strategy and these decisions would be implemented by the Management Committee which would continue to approve individual funding decisions. In essence, the Strategy Group would support the Steering Committee to fulfill its mandate.

The Strategy Group would meet in Kabul at the technical level to review the Financing Strategy, review the implementation of the ARTF program and propose modifications to the Strategy for endorsement by the Steering Committee. The Administrator would prepare background documents for discussion and the ARTF Financing Strategy paper. Specifically, the Strategy Group would:

- make recommendations to the ARTF Steering Committee on the ARTF Financing Strategy at the start of each solar year as a mechanism to guide ARTF allocations during the period;
- inform the annual review (by the Steering Committee) of the implementation of the Financing Strategy to assess how well funding decisions on individual projects, recurrent cost support and the Incentive Program met the proposed strategy, and to highlight issues that arose in the course of implementation;
- hold ad-hoc review meetings during the year whenever necessary to discuss particular issues or bottlenecks;
- ensure that the Financing Strategy is coordinated with the Ministry of Finance Fiscal Policy unit (and therefore the Medium Term Fiscal Framework) as well as with the Ministry of Finance Budget Department;
- support the development of a results matrix for the Strategy: the PAM-plus.

The Strategy Group would not set sector level policies - currently handled through project design and supervision – but the Strategy Group could raise relevant matters in relation to sector level policies to the attention of the Steering Committee. In time, when sector wide approaches become an option, the Strategy Group could be expected to play a wider sectoral role. To the extent appropriate, the group could also act as a liaison to Government clusters.

In order to be effective and to avoid unnecessary layers, the Strategy Group will meet in Kabul and be comprised of the following members:

- Donors contributing more than an average of $10m per annum to the ARTF (currently about ten) and that have adequate technical expertise at the local level;
- The Ministry of Finance and sector ministries where appropriate as decided by the Strategy Group;
- The Administrator.

Measure 2: Incentive Program and the IP Working Group

It is proposed that the Incentive Program constitute the framework for setting annual ceilings for recurrent cost support. It is also proposed that the IP Working Group be recognized as the donor group that will agree the policy benchmarks with the Government which are then subsequently

incorporated into a memorandum of understanding between the ARTF Administrator and the Ministry of Finance. The Administrator will continue to undertake the technical review of benchmarks for approval by the IP Working Group. The IP Working Group (IPWG) reports and is accountable to the ARTF Steering Committee.

Rationale: The IPWG is now fully operational and has clear terms of reference agreed on an annual basis through a memorandum of understanding with the Ministry of Finance. Since December 2008, the IPWG has helped negotiate three rounds of IP benchmarks and has reviewed the outcome of two. The latest round of benchmarks has just been reviewed by the IPWG in December 2010. The IPWG is also the body responsible for recommending the level of ARTF recurrent cost support every year.

Membership of the IPWG has remained the same since donors "self-selected" the membership at inception. It is proposed that the Steering Committee should approve membership of the IPWG each year or alter it if necessary. Membership decisions should be based on the following criteria:

- In order to remain efficient, the size of the IPWG should remain at no more than 5-6 donors appointed by the Steering Committee, plus the Administrator.
- In order to ensure the necessary technical expertise, members must be able to support, in Kabul and on a full time basis, technical expertise in one of the following three key focus areas: fiscal sustainability, public sector governance and private sector development.
- Members should be regular contributors to the ARTF including through the provision of un-preferenced funding.

The link between the IPWG and the Steering Committee of the ARTF is critical to ensure that the broader donor group remains engaged with the group's policy discussions, the Government's overall reform agenda and the progress achieved under the program. It is also important that the broader ARTF donor community is aware of how their funds are being leveraged to achieve results under the ARTF recurrent cost window. As the IP evolves over the coming years, possibly also increasing the value of incentive funds available to Government, this will become increasingly important, with the IPWG taking on the main economic governance policy discussions with Government. As the IPWG deliberates a new program, the Administrator, with the members of the IPWG, will therefore ensure opportunities for those donors with a particular interest to engage with the working group. In addition, during supervision of the IP and following the undertaking of the Technical Review by the Administrator, a report on progress in meeting the benchmarks will be presented and discussed with the donors at the quarterly Steering Committee meeting.

Measure 3: ARTF, ADB and Infrastructure

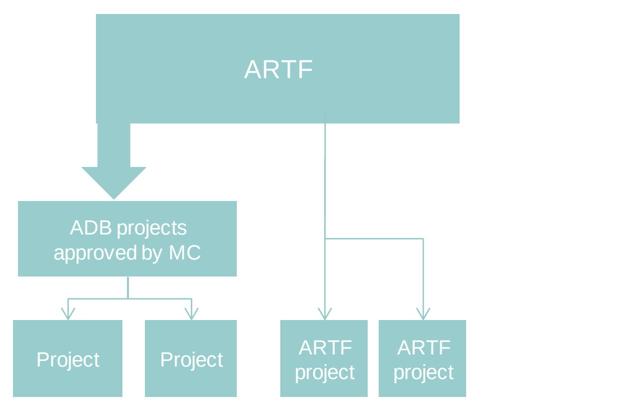
In order to increase the opportunities for the ARTF to finance larger infrastructure projects, it is proposed that the ARTF establish a Financial Intermediary Fund to channel ARTF resources to the Asian Development Bank (ADB) under terms and conditions, and in accordance with procedures, to be

agreed between ADB and the Administrator, including that (i) such resources will be channeled to ADB under "pass-through" arrangements and will co-finance ADB-financed projects, and (ii) ADB's operational policies and procedures will apply to the use of said resources. The Administrator will have no responsibility for the use of ARTF resources transferred to ADB through the Financial Intermediary Fund.

Rationale: There is considerable unmet demand for large scale infrastructure investment in Afghanistan and the desire to increase infrastructure financing is reflected in the current financing strategy. The Government has therefore asked the World Bank to establish a mechanism within the ARTF to enhance the ability of donors to the ARTF to finance priority infrastructure projects. It is proposed that this mechanism leverage the comparative advantages of both the World Bank and ADB by supporting ADB supervised projects.

The ARTF already has considerable investments in infrastructure, including in local or community infrastructure (through the NSP, National Rural Access Program and irrigation), and in medium-sized infrastructure in the energy sector and urban infrastructure including water, sanitation and roads. The World Bank provides full supervision of these projects working with counterparts in the Ministry of Energy and Water, the Ministry of Urban Development and the Kabul Municipality.

Fig 2: ADB pass through arrangement



However, to meet its national development objectives the Government, with the agreement of the donors, is looking to the ARTF to finance additional infrastructure investments (including in the irrigation and transport sectors) to be implemented through existing ARTF mechanisms. This will be accomplished by introducing this additional financing mechanism which would allow the ADB to take responsibility for the preparation and supervision of some larger infrastructure projects under ARTF financing in accordance with ADB's own policies and procedures. In basic terms, the ADB would work with Government counterparts to prepare and appraise larger infrastructure projects for implementation. These projects could be financed through a variety of means including ADB's own funds, other bilateral donors or through ADB's own Infrastructure Trust Fund which it expects to launch in the very near future. ADB projects that fit the ARTF Financing Strategy could be submitted to the Management Committee for financing – just as the World Bank currently does for all other ARTF projects. When an ADB prepared project is approved, funds would pass directly to the ADB from the ARTF, and the ADB would provide the full range of project supervision and reporting requirements following regular ADB rules and procedures. The World Bank will have no responsibility for the use of funds transferred to ADB through the Financial Intermediary Fund.

As part of this arrangement, the ADB would also agree to certain reporting requirements. Reporting would be both technical (physical progress, outputs and outcome reporting) as well as financial. Reports would be made available to donors through the regular mechanisms of the ARTF (quarterly reports and quarterly meetings). The issues of implementation and strategy which would be considered by the Strategy Group and the Steering Committee would cover all projects including those prepared/supervised by the ADB.

In order to avoid any perceptions of conflict of interest, the ADB would recuse itself from Management Committee discussions and decisions on proposals from which it stands to benefit either as executing agency or as a financier.

Measure 4: Ministry of Finance on the Management Committee

It is proposed that the Ministry of Finance become a full and formal member of the ARTF's Management Committee.

Rationale: When the ARTF was established, the Government had no official representation on the Management Committee. The main reason for this was that ARTF financing was used primarily to support the operating budget. In this context, it was felt that a streamlined and technical body, independent of Government, was appropriate. As the ARTF expanded and took on more investment financing for the core development budget, the absence of Government from formal ARTF decision-making became an anomaly.[2] In 2005, following the recommendation made by the first independent evaluation of the ARTF, the Steering Committee approved "observer" status for the Ministry of Finance. For five years, the Ministry of Finance has played a highly constructive role on, and has been engaged in the deliberations of, the Management Committee. The Ministry's engagement has also ensured that all the decisions of the Management Committee have been aligned with Government priorities.

As the ARTF has developed through the introduction of the Incentive Program and a much broader development program, the need for official Government presence on the Steering Committee has further increased.[3] The Ministry of Finance, as the World Bank's main counterpart in Government, and the Ministry responsible for the overall flow of funds through the Government's budget and for the implementation of the national development strategy, is the proper representative of the Government on the Management Committee. The Ministry's formal membership would also lock-in strong Government ownership and leadership of development efforts in Afghanistan, a key objective of the Government and donors.

[2] It should be noted that every investment financed by the Government was prepared, appraised and agreed with Government before it was submitted to the MC. Government is therefore directly involved in the decision process.
[3] The ARTF is now the single largest source of on-budget development financing in Afghanistan (nearly 30 percent in SY1388).

Measure 5: Increasing the ARTF Administrative Fee

In line with the World Bank's policy on cost recovery approved by the Executive Directors in 2007, it is proposed that the ARTF administration fee be increased from 1.5 percent to 2.0 percent to help cover the additional costs incurred by the World Bank as the ARTF's administrator.

Rationale: Currently, the World Bank charges an administration fee of 1.5 percent on all donor contributions to cover the costs of administering the ARTF. The fee is meant to cover all costs related to the delivery of the ARTF program including the mobilization of World Bank technical experts (both in country and visiting missions), housing, security and in-country logistics for supervision as well as those costs incurred through Headquarter-based functions including treasury (management of the ARTF fund balances) accounting and audit, disbursements, legal services and HR.

When the 1.5 percent fee was set, the ARTF focus was on the recurrent cost window. This operation – large and single - generated significant economies of scale which justified a fee structure below World Bank norm. Moreover, the Monitoring Agent contract, funded directly from donor contributions, was assumed at the time to provide monitoring across the recurrent and investment portfolio. The relatively standard World Bank fee of 2 percent was, therefore, waived.

These conditions no longer apply. In addition to administering the recurrent costs (and the more complex IP), the ARTF now finances 21 separate investment operations across a wide range of sectors. Moreover, the ARTF faces additional pressure to ramp up and take on more operations and find new means of supporting the Government and the international community to deliver high quality development projects, policy reform and aid coherence. Each investment operation requires separate World Bank teams for design, appraisal and supervision. Bringing these teams in-country, or housing them here full time, involves significant additional costs. The Kabul office houses one of the largest concentrations of international World Bank staff globally and is one of the most expensive to maintain given rapidly expanding security costs over the past two years. The deteriorating security conditions in country, and the uneven governance and capacity in different ARTF counterparts calls for an extraordinary effort and higher costs on the part of the World Bank team to ensure project quality, provide greater implementation support to project implementing entities during implementation and provide fiduciary due diligence.

While potential increases in donor contributions will mean additional fee income, economies of scale will not correct given the depth and variety of activities and projects. Moreover, income from contributions comes only when disbursements are made. This means that additional fee income will not be provided in the immediate term when projects are in the start-up phase.

The 2008 evaluation made the following point on the ARTF administrative fee:

> *"The donors have so far received an extremely good deal with the ARTF. For only 1.5% of their contributions, they are getting management and external quality assurance, a distributed risk sharing arrangement, access to senior government officials and policy papers that otherwise most would have difficulties arranging. The need for increased quality assurance activities may*

require additional funding, either by providing higher overhead to the Administrator, or making direct contributions in the form of staff or services, or a combination of both. But it is not likely that it will be possible to both deliver quality in a high-risk situation and continue maintaining the very low management fees."

The Administrator has therefore agreed with the donors to increase the administration fee to a level appropriate for the new challenges and the Afghanistan context, and in line with World Bank standard fee scales.

Process and Next Steps

This paper has been agreed by the Government and by all the ARTF donors. Once approval of the Executive Directors is received, donors will be sent amended Administration Agreements that reflect the above arrangements as appropriate. The Administrator will seek the agreement of the donors to the revised Administration Agreements on a no-objection basis.[4]

[4] Donors will have a chance to preview the legal agreements.