



Technical Assistance Consultant's Report

Project Number: 37164 (Technical Assistance 4615)
December 2007

Bhutan: Preparing the Financial Sector/Non bank Financial Sector Institutions Reform Programme (Financed by the ADB's TA funding program)

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Asian Development Bank



FINAL REPORT

PPTA 4615

**Preparing the Financial
Sector / Non bank
Financial Sector
Institutions Reform
Programme**

BHUTAN

**Prepared for the Asian
Development Bank and
the Royal Government
of Bhutan**

May 2007

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ABBREVIATIONS

ADB	Asian Development Bank
AGM	Assistant General Manager
AML/CFT	Anti-Money Laundering / Combating the Financing of Terrorism
AASB	Accounting and Auditing Standards Board
BDFCL	Bhutan Development Finance Corporation Limited
BNBL	Bhutan National Bank Limited
BOBL	Bank of Bhutan Limited
CAMEL	Capital, Assets, Management, Earnings, and Liquidity
CAR	Capital Adequacy Ratio
CEO	Chief Executive Officer
CDS	Central Depository System
CIB	Credit Information Bureau
CID	Credit and Investment Department
CRR	Cash Reserve Ratio
DADM	Department of Aid & Debt Management
DBMS	Data Based Management System
CD-AC	Direct Current-Alternating current
DOS	Disk Operating System
FISD	Financial Institutions Supervision Division
FIA	Financial Institution Act 1992
FSA	Financial Services Act
GAD	General Administration Department
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
GM	General Manager
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
ICIMS	Integrated Credit & Investment Management System
IFRS	International Financial Reporting Standards
IT	Information Technology
IIMS	Integrated Insurance Management System
IMF	International Monetary Fund
LAN	Local Area Networks
MIS	Management Information System
NPPF	National Pension and Provident Fund
Nu	Ngultrum
PPTA	Project Preparation Technical Assistance
RAA	Royal Audit Authority
RDBMS	Relational Database Management System
RMA	Royal Monetary Authority of Bhutan
RGoB	Royal Government of Bhutan

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RICBL	Royal Insurance Corporation of Bhutan Limited
RSEBL	Royal Securities Exchange of Bhutan Limited
R&D	Research and Development
SAARC	South Asian Association Regional Co-operation
SEDF	SouthAsia Enterprise Development Facility
SLR	Statutory Liquidity Requirement
TA	Technical Assistance
TOR	Terms of Reference
UPS	Uninterrupted Power Supply
VSAT	Very Small Aperture Terminal
Y2K	Year 2000
WAN	Wide Area Network

EXECUTIVE SUMMARY

A. BACKGROUND

In response to a request from the Royal Government of Bhutan (RGoB) in November 2004, the ADB provided a Project Preparation Technical Assistance facility designed to enhance the reform and development of the financial sector, including non-bank financial institutions (NBFIs): Preparing the Financial Sector/ Non-bank Financial Institutions Reform Programme (TA 4615 - BHU).

The ADB emphasised the importance of the Financial Sector Assessment (the mid-term report of this Project) and the Policy Matrix, as this work would determine the ADB policy loans for Bhutan in 2007.

The financial system in Bhutan consists of the Royal Monetary Authority of Bhutan (RMA); two commercial banks (one local private bank and one government joint-owned bank); two non-bank financial institutions (a development bank and an insurance company); and one national pension and provident fund. Bhutan also has a stock exchange and payments clearing mechanism as part of the financial system. A considerable amount of informal lending also takes place in Bhutan, especially in inaccessible rural areas, mainly in the form of middlemen or monasteries providing seasonal credit to rural farmers prior to harvest.

Although the formal financial system of Bhutan is very small in terms of financial assets, bank branches of the Bank of Bhutan Limited (BOBL) or Bhutan Development Finance Corporation Limited (BDFCL) and Bhutan National Bank Limited (BNBL) cover most of the accessible country where the use of banking services is widespread. However, in rural areas where there is no road network, there is little access to banking facilities or services. BOBL has an extensive network of branches (twenty-five throughout Bhutan); because of its wide branch network BOBL continues to be the fiscal agent for the government (mobilising revenues and budgetary payments) across the country. BNBL has four branches and three representative offices. BDFCL has twenty-three branches covering all districts, which enable it to make agricultural loans in some of the geographically scattered rural areas. The Royal Insurance Corporation of Bhutan Limited (RICBL) has nine branches.

The RMA was established by the Royal Monetary Authority of Bhutan Act (1982). It currently performs the standard central bank functions,

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including issuing currency, formulating and implementing monetary policy, managing foreign exchange reserves, as well as serving as the regulator and supervisor of the financial sector through the Financial Institutions Supervision Division (FISD). A new RMA Act is currently in front of the National Assembly.

The banks, insurance company and BDFCL are subject to detailed monthly, quarterly, and annual reporting requirements, with reports analysed in relation to prudential standards that are aimed at the banks. These standards, however, have yet to conform fully to international standards and, in a number of cases, are not uniformly nor consistently applied across the financial sector. This is partly due to the absence of national accounting and auditing standards and a uniform chart of accounts for financial institutions.

B. WORK UNDERTAKEN DURING THE PROJECT

Three missions were made to Bhutan during the course of this project, the primary objectives being an inception visit in April 2006, the Financial Assessment Review in June-July 2006 and a final visit for training in October-November 2006.

A key component of the June visit was a review of the Financial Assessment contained in the mid-term report, to draw-up a Policy Matrix, which formed the core of the policy loan negotiations between the RGoB and the ADB. Several of the conditionalities contained in the finally agreed Policy Matrix have been fulfilled under this project (See Appendix VII). Specifically:

- A revised and re-drafted Financial Services Act (FSA) giving RMA the powers to license, regulate, and supervise financial services providers, including banking, insurance and the securities markets, and well as covering the areas of corporate governance for financial institutions, Anti-Money Laundering (AML) and Combating the Financing of Terrorism (CFT).
- Draft regulations underlying said FSA to effect banking, insurance and securities operations.

In order to effect the implementation of the new law, the experts produced policy and procedures manuals and guidelines (for insurance and the stock exchange), as per the Terms of Reference of this project, to assist the FISD in carrying out their duties. These were backed up by proposed new formats for statutory reporting purposes.

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It was also agreed during the negotiations, in response to comments in the Inception and Mid-term Reports that, by the end of 2006:

- The Ministry of Finance (MOF) would establish an Accounting and Auditing Standards Board (AASB) Committee, with representation from involved Government offices and relevant persons from the private sector, to develop a plan to establish the national Accounting and Auditing Standards Board.
- The RICBL would give an undertaking to the MOF to prepare a rationalisation plan for its various operations, as approved by RMA. This should entail the complete separation of the general and life insurance businesses into two separate entities and the reallocation of the assets, currently held by the Investment Department, to the corresponding entities.
- The BOBL will establish a Memorandum of Understanding with the MOF and the Board of Directors to implement more effective corporate governance and pursue a strategy of increased liquidity mobilisation.

After discussions with the FISC, we designed a Familiarization Programme to introduce key aspects of financial regulation and supervision. We delivered training workshops to the RMA and the financial institutions on the principles of operations and prudential supervision in the various financial sectors of banking, insurance and securities, placing emphasis on international best practice and how the draft law and regulations adapted these for the Bhutanese situation. Familiarization Programmes were also held on accounting principles and off-site monitoring. Various procedural manuals and guidelines were produced as part of the project to provide practical background information for the FISC and these were referred to during the training sessions.

The draft FSA and underlying regulations (produced under this project) were presented and reviewed during the Familiarization Programme in October. This gave the RMA and representatives of the financial institutions an opportunity to discuss in detail and comment on the proposed legislation. Appendix I contains a list of the issues raised and subsequently included in the final legal drafts attached in the Appendices to this report. The conclusion of the discussions with beneficiaries was the RMA's endorsement of the final legal outputs under this TA project and their commitment to work on these outputs for prompt legislative passage.

Proposals for further capacity building, the requirements for which were previously identified and outlined in the Mid-term Report, were

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subsequently discussed by the RMA and the experts during the final mission. Agreement was reached with the ADB for the following to be realised under the loan programme:

- two RMA candidates to be selected for full-time professional training abroad to become certified accountants;
- six staff (for each of the loan programme's three years) from the RICBL to be sent on secondments (of around six months each) to insurance companies abroad for practical training in various aspects of insurance operations;
- four RMA staff (for each of the three years) to be sent on secondments (minimum of three months each) to well established (financial sector) supervisory authorities with reputations for good prudential governance.

In spite of the extensive Familiarization Programme, the experts on this project did not have as much time to spend with the staff of the beneficiary on a day to day working basis as they would not have liked, nor feel would have been appropriate to bed down the principles and practices that had been presenting to them. Although the staff were very pro-active with questions during the Familiarization Programme and took part in detailed discussions with the trainers and representatives of the financial institutions, it is only when they start to introduce the new concepts into their daily work that they will really be able to articulate those aspects that they may not have fully absorbed or understood sufficiently to enable them to fulfil their functions at a professional level. This applies particularly to the areas of insurance, capital markets and accounting, as the staff of the RMA have reasonable experience of applying international best practice to the regulation and supervision of banks. It is anticipated that the RMA may feel the need for a (or several) mentors who could make themselves available, say by e-mail, to respond to particular questions and help the staff work through technical issues they may have. This need would diminish over time, particularly as the staff return from their secondments and knowledge and experience gained thereby is passed on to colleagues.

C. STRENGTHENING LEGISLATION FOR THE FINANCIAL SECTOR IN BHUTAN

A draft FSA (Appendix I) has been produced that empowers the RMA to license, regulate and supervise the financial sector with appropriate facilities to conduct inspections, take remedial actions and impose penalties. Powers to set-up a Financial Intelligence Unit (initially within

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the RMA) for the combating of terrorism and money laundering and to set regulations for the observance of good corporate governance are key elements of the new draft.

Insurance Regulations, regulations for the capital markets and proposed amendments to current banking prudential regulations (Appendix II) have also been produced to enable the RMA to supervise prudentially the markets and the financial institutions, and to enable them to understand how they can implement compliance with the law.

The draft FSA and regulations were sent for review to a UK lawyer specialising in financial institutions legislation. His report (Appendix I) was given to the RMA and the ADB. His main opinion was that “the Royal Monetary Authority of Bhutan will, when the Act is passed and the Regulations promulgated, have power to licence, regulate and supervise financial services providers in various areas including, without limitation: banking; insurance; securities markets; corporate governance for financial institutions; Anti-Money Laundering (“AML”)/Combating the Financing of Terrorism (“CFT”)”. He also noted that “the Act and the Regulations are: clear; well constructed and flow making meaningful analysis as simple as possible; and achieve the objectives sought.”

The lawyer raised two specific points (besides some minor comments which were mostly incorporated into the text of the draft FSA) namely (1) the use of public inquiries, particularly in the case of failed financial institutions, and (2) that if an unlicensed provider has entered into a contract with a customer that contract is unenforceable against the customer if it is to his detriment. The first point was addressed in the text, but after discussion with the RMA, it was decided that the inclusion of public inquiries would not be appropriate in Bhutan. This was accepted by the lawyer.

Before the current Draft FSA 200_ is submitted to the National Assembly, the RMA needs to verify certain aspects of the law, as drafted:

- The amount of fines and length of prison sentences for certain violations of the Act. If these are altered, they should all be changed proportionally.
- The value of paid-up capital required. For example, should both the life company and the general company of old RICBL be required to put up Nu. 75 million each?
- Whether or not application fees and annual licensing fees should be imposed. If affirmative, previous drafts of the Act may be referred to for potential wordings.

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- Presuming, as discussed with FISD, that the BDFCL will fall under the remit of the FSA, whether or not additional specific regulations need to be drafted e.g. for the Statutory Liquidity Requirement (SLR) and incorporated into the Prudential Regulations 2002. Currently the SLR limit applies to all banks and non-banks (20% for banks and 10% for non-banks); it is a requirement under section 8.4.2 of the PR 2002.

In addition, the RMA should hold discussions with other Ministries to ensure that the division of powers and responsibilities are clarified and understood by all stakeholders. In particular:

- The Ministry of Trade and Industry and the Companies Registrar, with particular reference to licensing and to prospectus approval and related capital markets disclosure issues.
- The Royal Audit Authority (RAA), concerning the perceived duplication of annual audits by RAA with the (required) external audit by a professional auditing firm.
- The Tax Authority regarding what, if any, tax exemptions apply to securities transactions or indeed any other financial transactions.

The Prudential Regulations 2002 and the banking sections in the draft FSA were reviewed by a banking expert. These are deemed adequate and appropriate for the continuing supervision of the banking sector. Some changes to capital adequacy and the classification of loans (as per the policy matrix) have been drafted, but the Prudential Regulations 2002 should be further reviewed to ensure the regulations are specified as being applicable only to the banking sector.

The insurance sector has been suffering from the fact that the existing legislation did not take into account the operational requirements of the industry and the potential risks that insurance companies are susceptible to, resulting in inconsistent compliance with the law. The Insurance Regulations drafted under this project are fairly technical and concentrate on those areas crucial for the prudential supervision of insurance companies, specifically solvency margins and the admissibility and valuation of assets.

Regulation of securities businesses and of the securities exchange and its listing standards is currently committed to the RMA, but a company's initial securities distribution is largely governed by the Companies Act and the Ministry of Trade and Industry, although admission to trading on the securities exchange is a pre-requisite to a public distribution. All post-distribution trading of publicly offered company securities is required to be done on the securities exchange unless exempted by the exchange.

Most points of securities regulation are covered by the existing law and regulations, although there are some deficiencies as to fair and transparent procedural requirements, RMA investigative powers, and overlaps and inconsistencies in different laws. More notable is the lack of implementation of the rules and powers that currently exist. The draft FSA and associated regulations seek to clarify and improve these matters, by giving the RMA primary authority over securities distributions and prospectus approval, expanding its powers with regard to corporate governance of and related-party transactions by issuers, providing the RMA with authority to seek recovery of damages on behalf of investors, and increasing the fines available for legal and regulatory violations. The draft also gives the RMA a more direct role in exempting securities from the requirement of trading on an exchange.

D. SUMMARY OF RECOMMENDATIONS

The assessments conducted in the various financial sectors were reflected in detail in the Mid Term Report. The findings and recommendations z given therein (aside from those tackled in the review and re-drafting of relevant legislation) still stand as there are several areas that will need attention during the financial sector reform planned to take place in Bhutan over the next few years. It is worth noting, however, that after further review of the existing law, RMA enforcement capabilities under that law appear substantially more robust today than previously believed, in part due to the definition of financial institution in the Financial Institutions Act of 1992 (FI Act) to include persons engaged in activities subject to licensing whether or not actually licensed.

Banking

The key issues and constraints reported in the Mid Term Report emphasised the lack of competition in a banking system with strong government control and members of the boards being mostly civil servants lacking in banking experience.

The experts drafted minor amendments to the Prudential Regulations 2002 to accommodate specific requirements under the Policy Matrix. We recommend that the RMA undertake a further review of the regulations, and draft amendments accordingly, to ensure that they apply only to the banking sector, as specific regulations have now been drafted for the insurance sector and capital markets.

Insurance

Some of the key issues and constraints in the insurance sector relate to a lack of professional experience and staff with appropriate qualifications, which affects underwriting ability and the overall financial management of the business. The need for the RGoB's support in terms of developing national institutions for professional qualifications, and providing the incentives necessary to support the financial sector during the development stage, cannot be emphasised enough.

The key recommendation in the insurance sector is the reorganisation of the RICBL, as will be required under the new legislation.

Capital Markets

Bhutan's capital market is quite small and likely to remain so. Only half the country is literate and the level of financial sophistication is low. Nearby Nepal has a modest market, but Nepal has over twenty times Bhutan's population. The overhead costs of administering and regulating Bhutan's market outstrip substantially the revenues derived from the services it provides. Therefore initiatives to expand the market and improve operations must be appropriate for the presumed potential level of increased activity.

Our recommendations concentrate on providing the RMA with tools needed to perform proper securities regulation but at the same time giving it regulatory flexibility, in line with stated statutory objectives, to experiment with variations from the current simple but rigid system.

Accounting

Bhutan does not currently have a national accounting system or standards, and different regulatory authorities have different approaches. The establishment by the MOF of an Accounting and Auditing Standards Board (AASB) Committee, with representation from involved Government offices and relevant persons from the private sector, to develop a plan to establish the national AASB, will be a substantial step forward.

Moreover, there is an urgent need for banks and financial institutions providing credit to share a common chart of accounts and format for financial statements (in addition to requirements under the Companies Act 2000). Rules on application of common chart of accounts and content of

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financial statements should be issued by the FISD as authorised by the current draft FSA 200_.

We recommend that the Companies Act be amended to allow different audit requirements for smaller sized companies. Moreover, the role of the Royal Audit Authority (RAA) should be reviewed and clarified to ensure that financial institutions are not subject to duplicate audits. In many jurisdictions, a body such as the RAA is empowered to conduct audits of public sector bodies and, in addition, may be called upon by official institutions, such as the RMA, to carry out special audits in cases where they are concerned about the quality of a company's external audit report.

Information Technology

As expressed in the Mid Term Report, prior to considering any up-grading plans for IT systems, the institutions should assess the costs and benefits of the programme properly before making an investment. As there is rapid change in information technology, periodic re-training of IT professionals and staff will be required in order to stay abreast of new technology.

Nonetheless, it was agreed between the ADB, RMA and RSEBL that the exchange would benefit from the development of a website to enhance visibility and compliance with disclosure regulations. In addition, funds to develop an automated database for the Depository were also deemed necessary.

E. SUMMARY OF PROJECT ACHIEVEMENTS

The Terms of Reference for this project have been complied with fully. For the details of the individual items please refer to Appendix VIII.

1. STATUS OF THE LEGAL STRUCTURE OF THE FINANCIAL SECTOR

The draft Financial Services Act that was prepared under a previous project (referred to as draft 7), but never implemented, was reviewed, updated and extensively re-written under this project with the objective of creating a law that was readily understandable and implementable, as well as fulfilling the requirements of the RMA and the RGoB as a whole. Of particular concern was that sufficient powers to effect good corporate governance and AML/CFT would be incorporated into the new Act.

The draft FSA empowers the RMA to license, regulate and supervise the financial sector with appropriate powers to conduct inspections and investigations, take remedial actions and impose penalties.

It also introduces a distinction between “financial institutions” and other “licencees.” The former are defined as banks and insurance companies and such other licencees as the RMA may by regulation include for all or for limited purposes. This is in order to avoid applying to the usually tiny licenseees of the securities business the full panoply of sometimes elaborate regulatory requirements that the draft applies to “financial institutions,” such as the requirements for audit committees and various internal procedures and regulatory approvals.

The role of the RMA in seeking criminal-type penalties is more clearly defined in the draft FSA: some fines are permitted to be imposed in an RMA proceeding but larger ones and prison terms are reserved to judicial proceedings brought either by the Attorney General or by the RMA as appointee of the Attorney General. Prison terms are generally moderated under the draft (usually limited to two years unless another law provides for tougher sentences), but fines are generally much higher than the Nu. 25,000 provided for in the FI Act. Disciplinary proceedings before the RMA are explicitly subjected to due-process requirements such as notice and opportunity to be heard, and appeals are more specifically provided for.

Appendix I provides a clean copy of the draft FSA, as well as one with extensive explanatory notes. These notes highlight the fundamental changes from draft 7, as well as giving detailed explanations on why certain sections have been included and their implications as a guideline for those reviewing the Act.

The draft FSA was sent to the ADB and the RMA in early October 2006 and some changes (see list in Appendix I) were made during the course of

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the training sessions and discussions with the RMA and its licensees during the final mission, mainly to clarify some points. Further discussions took place until March 2007. The agreed changes were subsequently incorporated into the copies attached.

1.1 RMA – SUPERVISOR & REGULATOR OF BANKS AND NON BANKS**1.1.1 CORPORATE GOVERNANCE**

The principles of good corporate governance are referred to in various sections of the draft FSA, particularly with reference to related parties and control persons, and transparency and public disclosure. As Bhutan does not (yet) have formal corporate governance legislation, outside the rudimentary provisions of the Companies Act, we recommended that the RMA and the financial institutions should refer to the OECD principles on corporate governance, as well as such related sources as the Turnbull report and the Cadbury report. To allow development in this area, the RMA, under the draft FSA, have been given powers to issue further regulations on corporate governance as and when required.

1.1.2 ANTI MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM

The draft FSA requires that a Financial Intelligence Unit (FIU) be set up under the auspices of the RMA to help combat money laundering and the financing of terrorism. The powers given to the RMA under the Act in this area follow international best practice and specifically enable the RMA to co-ordinate and co-operate with other supervisory and law enforcement bodies, both nationally and abroad.

It is anticipated that, in due course, an independent FIU may be established in Bhutan although there is no specific allowance for this in the draft FSA.

1.2 BANKING

During the last week of June 2006, the Banking Expert was requested by the ADB Team to prepare and deliver various reports to supplement the current (legal) documentation pertaining to the banking sector.

1.2.1 LICENSING REGULATION

As yet, there is no licensing regulation in Bhutan that is detailed enough to minimise any possibilities of innocent omission or intended evasion on the part of the Applicant. The application to license a bank (see Appendix II) requires information such as the personal and professional background of the Applicant, an elaboration of the business intentions and plans of the Applicant, and a sensitivity analysis projecting the impact of changes in key variables (e.g., credits, deposits, interest rate spreads) on the viability of the proposed institution.

1.2.2 LIQUIDITY RISK MEASUREMENT AND MANAGEMENT GUIDELINE

Since a major source of bank income results from the transformation of shorter-term liabilities into longer-term assets, maturity matching via gap analysis has become a simple way to monitor whether liquidity problems are likely. If the institution exceeds prudent limits owing to maturity mismatches, it can experience a liquidity problem that in its mildest form would cause it to seek relatively expensive "money at call" borrowings, or in a more severe form could destabilise the institution and possibly require central bank intervention. Ensuring that bank management is effectively managing asset and liability maturity profiles has become an increasingly important supervisory task.

Aside from observing the SLR, banking companies need to monitor responsibly their liquidity positions by observing the short-term mismatches between their assets and liabilities. The institutions need a simple way to look at their maturity profiles, relating the size of any mismatches to a benchmark liquidity reserve figure, such as the SLR or Tier 1 capital. The draft guideline describes in detail the gap analysis approach and provides a reporting form with a numerical example so as to facilitate implementation by the banks as well as monitoring by FIRD.

1.2.3 INTEREST RATE RISK MEASUREMENT & MANAGEMENT GUIDELINE

Although it has continually plagued financial markets in industrialised countries, interest rate volatility has not been a problem in Bhutan. Since liberalisation in 1997, interest rates have moved slowly but steadily downward from their administered levels. However, eventually, with the development of a secondary market for securities (Government and non-

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Government), Bhutanese banks may become subject to the dangers of sudden and significant interest rate changes.

A maturity mismatch approach in the form of a gap analysis carried out by the institution is a commonly used tool to measure an institution's exposure to interest rate risk. Interest rate risk occurs when an institution is exposed to operating gains and losses that arise because the maturities or re-pricings of assets and liabilities do not match. That is, the institution has a mismatch in the Ngultrum amount of assets and liabilities that are subject to re-pricing within a given short-term time span.

With a positive mismatch, a rise in market interest rates will have a positive effect on the institution's earnings. On the other hand, a negative mismatch, where more liabilities are re-priced than assets in a given period, would mean a drop in earnings if interest rates increased. The earnings impact of an interest rate change should be related to a short-term benchmark, such as average quarterly earnings, so as to determine whether the effect would produce significant losses for the institution.

1.2.4 FOREIGN EXCHANGE RISK MEASUREMENT & MANAGEMENT GUIDELINE

Exchange rate risk is the risk of loss (or gain) owing to changes in the value of foreign currencies in terms of a banking company's domestic currency. Whether the banking company incurs a gain or loss depends on the direction of the exchange rate change (devaluation or appreciation) and whether the banking company has a net asset position (long) or net liability position (short) in the foreign currency.

A common approach is to measure and limit exchange rate risk in accordance with the size of the open positions (whether positive or negative) in each currency as of the close of business each day. Net open positions then may be expressed as a percent of the bank's core capital or some other benchmark, such as the bank's foreign exchange equalisation reserve. Limits are then established for the size of the percentage. The bank management's principal goal is to ensure that foreign exchange losses that could arise from the open positions will not substantially diminish total earnings and that the capital cushion of the bank will not be undermined.

If each foreign currency held by the banks were arranged in a balance sheet according to maturity, a gap analysis could be performed showing the net foreign currency position in each time-band. If, in the short run, the net foreign currency positions were negative, indicating that more

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liabilities were maturing than assets, the banking company's exposure to loss should be related to core capital in order to determine if the exposure is excessive. If, indeed, that were the case, the RMA would be forewarned that the bank's management needs to tighten its controls so as to limit the institution's exposure to foreign currency risk.

Banking companies should report their net open position by currency and by maturity on a daily, weekly and monthly basis to the Foreign Exchange Division, as well as to the FISC. The information should be presented in reporting forms provided by the RMA that clearly show each bank's foreign currency assets, liabilities and net open positions according to their respective currencies and maturities.

1.2.5 ENFORCEMENT GUIDELINE

A Draft Enforcement Guideline was provided that elaborates an action schedule to be taken by the FISC for banks that have been found to be non-compliant. If the actions to be taken to secure regulatory compliance are not executed or inadequately executed and the violations and/or irregularities continue beyond the time period prescribed in the Action Schedule, a set of prescribed penalties (listed in the guideline) shall apply.

1.2.6 INSERTS FOR THE OFF-SITE AND ON-SITE EXAMINATION MANUALS

The inserts pertaining to "Sensitivity to Market Risk" include ratios derived directly from the reporting forms recommended under the above Guideline on Liquidity Risk and Interest Rate Risk and the Guideline on Foreign Exchange Risk. These forms include one pertaining to the measurement of interest rate risk and one pertaining to the measurement of exchange rate risk that would enable FISC to assess the bank's exposures to loss arising from interest rate and exchange rate changes, particularly in the short run.

1.3 INSURANCE**1.3.1 INSURANCE GENERALLY**

A set of Insurance Regulations (Appendix II) have been drafted that will provide insurers with details on how to comply with the FSA. These are fairly technical as the supervisor of insurance companies has to concentrate on solvency and he/she must be able to react quickly to changes in the market or in a particular insurer's fortunes. The supervisor

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is particularly concerned with the types and proportions of assets, in contrast to the supervisor of banks, who has to follow standard rules on capital ratios.

A life company, conducting what is commonly known as long-term business, needs to diversify its assets, choosing ones which are of low risk but high quality. Capital is not such an important consideration for the supervisor and liquidity requirements are relaxed as liabilities are matched to assets, both in quality and duration.

On the other hand, the general company, accepting policies whose duration is usually of a year or less, must purchase and retain assets of a short-term nature to match its liabilities: capital is therefore more important in its risk management strategy.

The types of assets, how they are valued and under what circumstances they can form part of the solvency margin is specified in the Schedules to the Insurance Regulations. These regulations follow international best practice, but some flexibility has been introduced in appreciation of the current difficult investment market in Bhutan. For example, insurers usually invest in:

- government bonds – there are very few in Bhutan
- investment grade securities – equities in Bhutan are not liquid enough
- bank deposits – interest rates are poor in Bhutanese banks as there is an excess of liquidity

Life companies often also invest in property, but the current situation of the RICBL handing over all its premiums to the Credit and Investment Department (CID) for a general, fixed rate of return, is unsustainable. No allowances are being made for the matching of assets and liabilities, a crucial aspect of prudential insurance supervision.

Since 2005, the RICBL has separated out, on the Balance Sheet, the Life and the General business, as well as the business of the CID, but the shareholders' funds have not been segregated and the general administration expenses are combined with the general insurance business. Moreover, the CID has borrowed extensively to accommodate 'its clients', which means that, in effect, the insurance funds are at risk if the CID's 'business' gets into difficulties and they are unable to repay the loans that they have taken out.

Such a separation on the Balance Sheet only serves to give general information to any interested party, including the supervisory authority: it

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does not protect either the life business or the general business if the other gets into financial difficulties (all assets and liabilities belonging to the one company, the RICBL), let alone if the CID is unable to service its borrowing. It would also appear as if defaults on the loans it has made are continuing to rise and that the current arrangements are not sustainable.

In view of the above, and in line with a fundamental principle of the International Association of Insurance Supervisors (IAIS), a basic requirement of the draft FSA is that an insurer may only write general or life business. Therefore the RICBL will have to completely separate the life and general business into different companies. In addition, specific restrictions on the amount that an insurer may invest in loans are given in the regulations, which mean that the CID will have to be separated from the insurance business per se. As this will require a major reorganisation to be planned and executed by the RICBL, a two year transitional period has been granted under the draft FSA for compliance with said requirements.

The draft Insurance Regulations also contain formats for statutory reporting that are more applicable for effective off-site monitoring of insurance companies by the supervisor than the banking orientated reports currently being used. Specifically, additional formats have been included to measure better the movement in premiums and claims, the availability of suitable assets and the maintenance of an adequate solvency margin. These additional formats should be supplied to the RMA on a quarterly basis; more frequent reporting is not considered necessary in the normal course of events and should only be requested by the RMA on a special basis if they want to invoke some form of remedial action by the company.

1.3.2 ACTUARIAL STATUS

The life insurance products currently being marketed by the RICBL are almost identical to those being offered by Life Insurance Corporation of India (LIC). However, the policy documents and contracts between the life proposed or insured and the RICBL that specify the benefits payable and other terms and conditions, are not being formally approved or certified by the Appointed Actuary. This is considered standard industry practice and is a requirement for obtaining and continuing to hold a licence under the draft FSA, as well as being a core element of the IAIS principles. The Appointed Actuary has provided neither the RICBL nor the RMA with any information or Actuarial Certificate (certifying the rates to be adequate), in respect of any product, explaining the actuarial basis and formulas adopted in the calculation of the premium rates.

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As indicated in previous reports, we believe that the RICBL should appoint a more experienced Actuarial Consultant, to review and certify the premium rates and the contract documents of the existing life insurance products. The Actuarial Consultant should meet the qualifications required for an Appointed Actuary under the draft FSA and provide appropriate certification for all new products and the statutory reporting to the RMA.

In addition, in the last three Actuarial Valuation Reports of the life business prepared by the current Actuarial Consultant for the RICBL, the actuarial bases (assumptions as regards future mortality rates, rate of return on the life fund and management expenses) that have been used differ. (See Appendix VI for a description of the valuation methods that were used and recommendations for the future.) We recommend that Actuarial Valuations should be carried out using the Net Premium Method with minimum actuarial/valuation basis, as has been adopted by many other countries. The Reports should contain sufficient information, according to best international practice, not only to provide adequate data to the RICBL and the RMA but also to enable any other Actuarial Consultant to broadly determine the accuracy of the results. The recommended methods for producing actuarial valuations are contained in articles 20 to 28 of the draft Insurance Regulations, whilst a format for the Actuarial Report, required as part of statutory reporting, is given in Schedule 3 to said Regulations.

1.4 CAPITAL MARKETS

1.4.1 THE CURRENT STRUCTURE

What might generally be regarded as securities regulation is split between the Ministry of Trade and Industry (MTI) and its Registrar of Companies on the one hand and the RMA and Royal Securities Exchange of Bhutan, Ltd., (RSEBL) on the other.

The MTI currently administers the Companies Act, which, among other things, establishes:

- the content of a prospectus;
- liability for a misleading prospectus;
- procedures for making a public offering of securities;
- the definition of a private placement of securities;
- the content and filing deadlines for company annual reports; and
- the ground rules for a central securities depository (although the Companies Act also describes the depository as under the authority of

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the RMA) and the requirement to place public company securities in the depository.

The Companies Act and the MTI generally do not regulate securities businesses or securities trading after initial distribution, except that the Act:

- requires trading in public company securities to occur on the securities exchange unless exempted by the securities exchange;
- defines and prohibits insider trading; and
- regulates share buy-backs by issuers.

The RMA, meanwhile, under the FI Act, has been licensing and regulating brokers, the securities exchange and other securities businesses. The RSEBL, subject to RMA authority, promulgates listing standards, some of which overlap and expand the disclosure and reporting requirements of the Companies Act, and orchestrates the actual trading of securities according to its own trading and settlement rules.

There are various overlaps and inconsistencies between the Companies Act and the FI Act, noted in detail in the Mid Term Report: the most obvious example may be the differing and inconsistent definitions of insider trading contained in each. The FI Act also has prospectus provisions of unclear relation to those in the Companies Act. The Mid Term Report also expressed concern about potential corporate governance problems in companies with publicly traded securities.

Except with respect to clearing and depository institutions and certain enterprises like investment funds that do not yet exist and are not on the horizon, a relatively full set of securities regulatory provisions are in place. The main problem is that regulatory practice does not really correspond to the regulations. Thus the quality of issuer disclosure is sometimes very low, there are no real inspections of the RSEBL, no periodic reports received from it, only partial inspections of brokers, fewer periodic reports received from them than the words of the regulations require, no compliance procedures in place at the broker firms, no attempt to enforce capital standards on the brokers, no registry of individual securities broker representatives maintained by the RMA, nor any trading surveillance.

1.4.2 THE STRUCTURE UNDER THE DRAFT FSA AND REGULATIONS

The draft FSA includes supplementation of RMA powers with regard both to disclosure and corporate governance matters and replaces the MTI with the RMA as to prospectus approval and the other securities distribution

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portions of the Companies Act. See sections 20, 42(2), 44(3), 77(4)(b) and (c), 85(2), 87 and Schedule 1, Item 1(t) of the attached draft FSA.

The draft FSA also addresses the fundamental issue of disclosure-based regulation of securities offerings versus merit-based regulation, a policy choice not explicitly addressed in the existing legislative structure. It also more clearly provides RMA authority to permit and regulate trading outside the securities exchange and to broaden participation in the securities business.

In addition, under the current FI Act and its regulations, the criteria applicable to a given decision are often neither tied to any statutory criteria nor otherwise apparent. The draft FSA is somewhat more detailed in stating criteria for application of the Act, setting out general objectives in section 3 as well as licensing standards in section 10 and criteria applicable to specific securities businesses elsewhere, such as in section 69 (investment funds), 77 (securities exchanges), 81(2) (clearing houses), 82(2)(depositories). (See also the draft Securities Broker Regulation, section 1(5).)

The draft FSA addresses explicitly the RMA's authority over securities exchanges, securities clearing houses and depositories.

The current FI Act describes buying and selling securities as a bank function, whilst section 54 of the draft FSA clarifies that a bank may buy and sell securities as a broker to the extent that the RMA licenses it to do so. The draft also clarifies when it is that ownership of a security passes if the security is not certificated but instead has ownership tracked on the books of a securities depository. (Ownership will change when it is changed on such books.)

The draft FSA contains general securities fraud provisions, although somewhat more elaborated and articulated than in the FI Act. It allows the RMA to define specific deceptive practices by regulation, and amends the insider trading definition in the Companies Act to clarify that the trading prohibition extends not just to insiders but also to those to whom trading "tips" are passed.

The draft FSA also elaborates remedies for securities fraud, including private lawsuits (currently available under section 73 of the FI Act), injunctions at the suit of an injured person or the RMA, and a suit for damages by the RMA on behalf of investors. The draft also addresses questions of causality and calculation of damages not covered in the current law. However, except with respect to misleading prospectuses and

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reports, the draft does not include the administrative cease-and-desist order of the current law.

2. TRAINING FOR THE RMA AND FINANCIAL INSTITUTIONS

During the Inception Visit, we held extensive discussions with the FISC and the RICBL on training needs for the financial sector and an extensive Familiarization Programme was drawn up. A week's training was delivered to the RICBL in Phuentsholing at the end of June on specific aspects of insurance business. During the financial assessment visit, we conducted a day's training on actuarial matters for the FISC and a week's Familiarization programme on banking for the FISC and financial institutions. The third and final visit to Thimphu in late October consisted of intensive training for the FISC and selected financial institutions on the securities market, insurance and accounting principles; participation was proactive during the sessions. A list of attendees to these courses and the training material is contained in Appendix IV.

A meeting was held by the Insurance and Accounting experts with the Chief of the FISC and her deputy to discuss ideas for development of the capacity building portion of the loan programme and potential counterparties for the secondment part of the programme. Suitable companies and institutions were identified, recommended and ranked on a preliminary basis, in order to form a basis for further discussions amongst the bodies in Bhutan responsible for affecting that part of the programme.

2.1 BANKING

Based on recommendations by the ADB Team that arrived in Thimphu at the end of June 2006 as well as those of the RMA's senior management, the Banking Expert designed and gave a five-day Familiarization Programme (July 10 - 14, 2006) for the staff of FISC and all the financial institutions. The training sessions under the TA concentrated on examining and understanding the work undertaken within the Reform Programme with respect to regulation and supervision of the banks. User-friendly training materials accompanied each session.

2.2 INSURANCE

A week's programme was held in Phuentsholing at the end of June 2006 for the RICBL staff and management and a few members of the FISC. Emphasis was placed on the principles of insurance, reinsurance and the operations of insurance entities as well as looking at the supporting roles of other market players. A certain amount of detail on the technical

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aspects of insurance business was examined in order to start preparing the staff at RICBL for the removal of tariffs (instigated by India) and the planned secondments, preparatory to becoming more professional in the business. Discussions were held on the need to restructure the RICBL to comply with international best practice (and the requirements of the new draft FSA) and the potential impact that could have on their business and future in the country.

The insurance training in Thimphu held during the final mission was attended by the RMA only, as the emphasis this time was looking at the industry from a regulatory and supervisory point of view. The basics of insurance were also covered to help the RMA staff put the supervisory requirements, peculiar to the insurance industry, into context and to understand better the most effective approaches to off-site monitoring and on-site supervision. The importance of risk management, more expansive than that of banks, was discussed at length. The training was conducted with continuous reference to the principles of the IAIS, the draft FSA, its implications, and the insurance regulations that implement the law. The manuals and guidelines provided to the FIRD under this project are intended to provide an accessible aide-memoire for the supervisors in the course of fulfilling their duties and carrying out inspections.

A day's training on actuarial matters was also given to the FIRD staff in the summer to review and examine as a group the approaches of life actuarial valuations and the various aspects of the actuarial report that supervisors need to have in order to have confidence that the life company is being properly managed. It was emphasised, both by the Actuary and the Insurance Expert, that this is a highly specialised and complex area of insurance and that the supervisor is not expected to be able to make a judgement on the life business (e.g. its pricing and reserving) but that supervisors need to know under what circumstances, and to what extent, the Appointed Actuary should provide them with certified information.

2.3 CAPITAL MARKETS

Securities training were not part of the original terms of reference, but an effort was made to accommodate the wishes and needs of the beneficiary. Several informal training sessions on securities matters were held during the Inception visit and a more formal five-day programme at the RMA, with extensive outline notes, was held during the final mission. The latter sessions were attended by broker and securities exchange representatives as well as by RMA staff. While they were originally conceived and approved as a general Familiarization Programme on the markets and regulation, the opportunity was taken during these sessions to tie the

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subject matter to the draft FSA and related draft securities regulations, as well as measuring Bhutan's securities regulatory system against international standards. Discussion at these sessions and further post-training discussion with officers of the RSEBL concerning the draft law and rules resulted in a number of revisions to them (see Appendix I).

Further training on securities markets and regulatory matters would be useful, although it might be appropriate to favour training that concludes with some type of test or examination in order to concentrate the minds of those being trained. Moreover, since the market in Bhutan is so small and illiquid, training choices need to account for this with a preference for small-market oriented training wherever possible. More important than training is that the RMA staff understand the goals of their efforts: markets that are honest and well-informed, where buyers and sellers can find each other and trade easily and cheaply - not necessarily a market that looks like one somewhere else. It is important that the regulatory staff understand the market they are in.

2.4 ACCOUNTING

Training for the RMA and the financial institutions covered 5 modules over one week:

- Module 1: Key elements of financial statements
- Module 2: Comparison between IAS/IFRS and Indian and US GAAP
- Module 3: Asset and liabilities management
- Module 4: Analysis of financial statements
- Module 5: Financial Returns for banking, capital markets institutions and insurance

2.5 LEGAL

The legal expert conducted a workshop for the FIRD on the elements of the draft FSA version 7 before any amendments had been done. No additional materials were produced for this capacity building activity.

3. RECOMMENDATIONS

The Financial Sector Assessment that formed the core of the Mid Term report contained detailed recommendations for the various financial sectors in Bhutan. The findings and recommendations that related to the basic regulatory and supervisory laws for financial services have been covered in the draft FSA, regulations and guidelines attached to this report. Other recommendations described in detail in the Mid Term Report still stand and the sections below only highlight particular aspects that the experts wished to emphasise.

3.1 BANKING SECTOR

Operations are tainted by the implicit RGoB guarantees that arise from the nature of ownership and board membership. Furthermore, the boards are heavily weighted with civil servants lacking in banking experience, particularly commercial banking experience, gained in a competitive environment where interest rates and exchange rates fluctuate and can cause significant losses. Upgraded legislation, prudential regulations and guidelines, off-site reporting and on-site bank supervision will tend to have a dampened beneficial effect in a financial environment as controlled as Bhutan's.

A capital charge for market risk (as per Basel II) would currently appear to bring to bear an unnecessary regulatory burden to Bhutan's banking sector since the components of market risk – interest rate risk, foreign exchange risk, equity price risk and commodity price risk – are not actively at play in Bhutan. Volatility of interest rates and equity prices may occur in the future but so far, despite liberalisation of interest rates, the prices of debt and equity have remained quite stable. Furthermore, given that parity is maintained between the Ngultrum and the Indian rupee and that Bhutan's major trading partner is India, the effects of exchange rate movements have been minimal.

3.2 INSURANCE SECTOR

With respect to the insurance sector, our recommendations given below reinforce some of those identified in the inception visit and put forward in the mid-term report, which we consider to be key to provide the environment of a stable and sustainable insurance business in Bhutan.

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Specifically, the RMA should co-ordinate closely with the RICBL to discuss their plans for the sector, vis-à-vis regulation and supervisory requirements, and persuade the RICBL to start adopting and implementing, as far as feasible, the requirements of the insurance regulations, before they are enforced by law.

- The RMA should request the RICBL to start quarterly reporting of their gross premiums and claims, by class of business, and admissible assets with immediate effect.
- Negotiations should be opened by the RICBL with the Post Office to explore opportunities to appoint them as an agent for selected insurance products.
- The RMA and the RICBL, in consultation with those working in the other financial institutions and those experienced in this field, should review potential investment opportunities in Bhutan and abroad (see Capital Markets below). The RICBL needs to explore all avenues in their attempt to match their liabilities with adequate and appropriate assets.

For the past five years, the RICBL has appointed a qualified actuary, (Fellow of the Institute of Actuaries, London) residing in Kolkata, India, as the Appointed Actuary for the purposes of pricing life products offered by the company and to prepare the annual actuarial valuation of the total life insurance business in force, as required under the existing FI Act and the draft FSA.

There is no permanent member of the staff who is in the least familiar with any of the generally accepted actuarial principles, and no one in the company (or indeed, it has been indicated, in the country) is currently studying for any type of actuarial examinations.

Nonetheless, the volume of life business of the RICBL is not yet at a level where there is an economic justification for the appointment of a full time actuary from abroad. It is our opinion that the RICBL should continue to seek actuarial advice from an independent actuarial consultant, on a retainer basis, until such time as the volume of business increases to a reasonable level. In the meantime, the RICBL should continue to provide financial incentives to employees with relevant good class degrees to study for some basic actuarial courses, if not for a full professional qualification.

We appreciate that the appointed actuary has fulfilled his role at a very low fee, but the information contained in his reports is not sufficient to enable the RICBL to begin to understand the pricing of their product and reserving techniques applicable to the business. Moreover, the RMA can

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have no confidence as to the adequacy of premium rates and mathematical reserves and is unable to exercise prudential regulation properly. The present arrangement is low cost but could be an important factor in contributing to potential future losses..

- The RICBL should hire the services of an experienced actuary to carry out a full review of their life insurance operations, particularly to evaluate their undertakings and to certify the mathematical reserves. It is essential that this work be completed prior to the reorganisation of the company so that an accurate, up-to-date and formally recognised valuation of, and accounting for, the transfer of the life funds from the CID can be effected.
- It is also recommended that the RMA try to obtain the (ad-hoc) services of an appropriately qualified actuary to scrutinise the returns of the RICBL from time to time and to provide professional advice on development in these areas.

3.3 CAPITAL MARKETS

With respect to capital markets, our recommendations fall into the following areas.

- (1) Expanding the market - There are relatively few people and therefore few investors in Bhutan. But some increase in activity might be possible through removing the following barriers to investment:
 - An active capital market is desirable not as end in itself but expands opportunities and lower costs for employers of capital and expands opportunities and improve returns for providers of capital. Autarkic economic policy is not necessarily the best way to achieve these ends, and so we recommend relaxing restrictions on foreign investment.
 - Lack of information about securities markets may function as a barrier to market development, and so we recommend improving dissemination of market information, including the development and use of a website.
 - Most trading is restricted to those physically present in Thimphu, so we recommend exploring technical and legal possibilities for transmitting money and orders from remote locations.
 - Introducing new instruments could expand the usefulness of the market, so we recommend removing uncertainty about the use of bonds by developing a standard bond format.

- (2) Improving the operations of the securities market:
- Limited experimentation with off-exchange trading to compare results and to deal with issuers that no longer meet listing standards.
 - Various improvements to data dissemination including data on buying interest and other trading interest not reflected in submitted orders.
 - Improving market security by improving depository internal controls and back-up; obtaining explicit financial guarantees for brokers from parent organisations.
 - Reviewing operations of the Securities Exchange by tracking time, tasks, output, etc., with a view to evaluating cost efficiency of various information technology upgrades and for general supervisory purposes.
 - Adding an issuer representative to the Exchange board; insulating the RMA's supervisory role from conflicts arising from its relationship with the Exchange and its presence on the Exchange's board.
 - Establishing market surveillance procedures to identify unusual price or volume patterns.
 - Instituting a reporting requirement for large shareholders of public companies.
 - Adding corporate governance standards to listing standards.
 - Testing broker representatives on professional knowledge other than purely operational matters; have the Securities Exchange provide Exchange Advisory Notes on ethical and other matters of special concern.

3.4 ACCOUNTING AND AUDITING

Since the Generally Accepted Accounting Principles (GAAP) in Bhutan are construed to mean Indian GAAP, our review of departures from International Accounting standards (IAS) and International Financial Reporting Standards (IFRS) is based on Indian GAAP. We present the list of departures in Appendix IV. 5. In general, Indian GAAP is aligned with IAS and at present the Indian government is moving closer to IAS and IFRS. The RGoB is soon to establish an AASB that will deal with the implementation of a Bhutanese GAAP.

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In addition to this initiative that will impact on all economic sectors, we urge the RMA to issue Rules under the FSA or the current Financial Institutions Act 1992 to harmonise the use of a uniform chart of accounts for banks and other financial institutions (credit institutions) and rules on the content and format of financial statements.

3.5 INFORMATION TECHNOLOGY AND MANAGEMENT

The findings and recommendations laid down in the Mid Term Report of this project still hold. Some additional costings and suggestions for website design have been added to the summary given in Appendix V. As expressed in the Mid Term Report, prior to considering any upgrading plans for IT systems, the institutions should assess the costs and benefits of the programme properly before making any investment. Moreover, the continuing rapid change in information technology means that periodic training of IT professionals and staff would be required in order to stay abreast of technological change.