

ASIAN DEVELOPMENT BANK

TAR:BHU 35221

TECHNICAL ASSISTANCE
(Financed by the Japan Special Fund)

TO THE

KINGDOM OF BHUTAN

FOR

**STRENGTHENING THE CAPACITY OF THE ROYAL MONETARY
AUTHORITY AND ROYAL SECURITIES EXCHANGE OF BHUTAN**

August 2002

CURRENCY EQUIVALENTS

(as of 5 August 2002)

Currency Unit	–	Ngultrum (Nu)
Nu1.00	=	\$0.0206
\$1.00	=	Nu48.652

ABBREVIATIONS

ADB	–	Asian Development Bank
CBFSS	–	central bank financial sector specialist
FSRS	–	financial sector regulatory specialist
GDP	–	gross domestic product
RMA	–	Royal Monetary Authority
RSEB	–	Royal Securities Exchange of Bhutan
TA	–	technical assistance

NOTES

- (i) The fiscal year (FY) of the Government and its agencies ends on 30 June. FY before a calendar year denotes the year in which the fiscal year ends. For example, FY2002 begins on 1 July 2001 and ends on 30 June 2002.
- (ii) In this report, "\$" refers to US dollars.

I. INTRODUCTION

1. During the Country Programming Mission in April 2002, the Government of Bhutan asked the Asian Development Bank (ADB) for technical assistance (TA) to strengthen the capacity of the Royal Monetary Authority (RMA) and Royal Securities Exchange of Bhutan (RSEB). This TA is in line with the financial sector development program for 2002, as agreed between the Country Programming Mission and the Government. The Fact-Finding Mission¹ visited Bhutan during April–May 2002 and reached an understanding with the Government on the objectives, scope, cost estimates, financing plan, and implementation arrangements for the TA. The TA framework is provided in Appendix 1.²

II. ISSUES

A. The Financial Sector

2. Financial sector reforms and the management and regulation of the sector are key aspects of Bhutan's economic policy and over the past decade or so the Government has taken a number of measures to develop its financial sector. The sector's development is necessary to foster the Government's poverty reduction policy.³ Bhutan's financial sector comprises of RMA functioning as the central bank; two commercial banks, the Bank of Bhutan (local private bank) and the Bhutan National Bank (government owned); two nonbank financial institutions, the Royal Insurance Corporation of Bhutan and the Bhutan Development Finance Corporation; and one pension and provident fund, the National Pension and Provident Fund Bureau. In addition, RSEB, which was established in 1993 with ADB assistance, deals with a limited number of traded stocks, government bonds, and RMA bills, supported by four brokerage firms: Bank of Bhutan Securities Limited, Royal Insurance Corporation of Bhutan Securities Limited, Bhutan National Bank Securities Limited, and Drock Securities Limited. Limited clearing and payment mechanisms have also been established. Given the small size of the economy, RMA is responsible for supervision of the entire financial sector. The rationale for ADB's intervention in the financial sector is to promote private sector development. This is consistent with ADB's country operational strategy for Bhutan.

3. The RMA of Bhutan Act was passed in 1982; actual operations commenced from November 1983. Under the current exchange rate arrangement, the ngultrum (local currency) is pegged at par and is freely convertible with the Indian rupee in light of the strong economic links with India. Targeting the exchange rate, however, precludes an independent monetary policy in Bhutan. As part of the financial sector reforms, interest rates were deregulated in 1997. Despite the limited scope for a flexible monetary policy, RMA has an important role in Bhutan's monetary and credit control. Over the years, RMA has been in the process of building the institutional and operational framework for assuming an increasingly active central bank role. As the central bank, RMA is responsible for developing effective monetary policies, managing foreign exchange reserves, and ensuring soundness of the financial system by enforcing prudential guidelines, based on the RMA Act of 1982 and the Financial Institutions Act of 1992. The latter entrusts RMA with supervision of the two commercial banks, the operations of Bhutan Development Finance Corporation and Royal Insurance Corporation of Bhutan, as well as regulation of the securities market and oversight of RSEB operations.

¹ Comprised of Mr.V.V.Subramanian, Financial Economist.

² The TA was first listed in *ADB Business Opportunities* (Internet edition) on 20 May 2002.

³ The Poverty Reduction Partnership Agreement between the Government and ADB (23 October 2001) provides a framework for reducing poverty and includes a focus on private sector development.

4. RSEB was incorporated in 1993 under the Companies Act and Financial Institutions Act. Four financial institutions (para. 2) have subscribed to the initial capital of RSEB. RMA acts as a securities commission and provides budgetary grants for RSEB operations. At present, 14 companies are listed on the exchange, with market capitalization of about \$48 million. The country has about 5,000 shareholders. The trading system is fully automated and linked by a local area network to the trading floor. To eliminate delays in the registration of physical transfer of shares, a central depository has been established.

B. Institutional Capacity of the Royal Monetary Authority

5. Effective measures are needed to upgrade RMA's institutional capacities in its functional areas. RMA was initially established as a transitional central banking institution—a monetary authority—which over time was expected to develop into a full-fledged central bank. A review is needed of the RMA Act of 1982 to make it compatible with the requirements of modern central banking, and of the composition of RMA's board; RMA's autonomy needs to be increased. The review should also cover RMA's basic operational functions such as licensing, supervision, regulation of banks and nonbanking financial institutions, provision of financial advice to the Ministry of Finance, and holding and managing of official foreign exchange reserves. Some preliminary work has already been done with assistance from the German Bundesbank. The International Monetary Fund is supportive of ADB's intervention in the revision of the RMA Act.

6. The existing Financial Institutions Act 1992 needs to be revised to enhance RMA's supervisory functions. The existing act does not fully cover all operations of the insurance sector and the development finance institution. RMA should enjoy operational independence in carrying out its supervision of the financial sector. To provide an appropriate legal framework for the insurance sector and open the market to new companies, an insurance act is urgently needed. The draft insurance act needs to be reviewed before it is promulgated. Moreover, training is needed for RMA staff to develop skills and expertise to carry out such supervisions.

7. RMA has no documented accounting manual for its accounting operations, and existing systems and procedures are based on accounting practices adopted over the years. However, with the increasing complexities of its operations, a documented accounting manual in line with international accounting and modern central bank systems and standards is required. Further on-the-job training for implementation of the manual would be necessary.

8. RMA currently is expected to regulate the securities markets and the operations of RSEB but the oversight is very limited. The overall regulatory framework needs to be strengthened, including the legal framework for the securities markets. Due to the lack of a proper legal framework governing the Central Depository, only about 25% of the outstanding securities are deposited with it. With the ongoing financial sector reform process, the existing Securities Exchange Regulations (1993) need to be upgraded to modern legislation, which should also contain a legal framework for the depository to formalize depository operations.

III. THE TECHNICAL ASSISTANCE

A. Purpose and Output

9. The TA will continue ADB's ongoing intervention in the financial sector. The TA will strengthen the autonomy and supervisory function of RMA, and provide the required legal and regulatory framework for the development of insurance and capital markets, as well as RMA's

supervision of the overall financial sector. It will also aim to build capacity within RMA and RSEB for good governance. The TA framework is provided in Appendix 1.

B. Methodology and Key Activities

10. **Subcomponent A: Development of Legislative Framework.** The TA will undertake the following:

- (i) Review and assess the existing RMA Act.
- (ii) Define broad guidelines for a new RMA act in the context of providing RMA with greater autonomy and independence from the Government.
- (iii) As a follow up to (i) and (ii), assess the existing Financial Institutions Act of 1992 and draft amendments to make them compatible with modern industry standards to enhance the effectiveness of the financial sector.
- (iv) Determine the changes required, if any, to the regulatory environment to enable effective implementation of legislation and enforcement.
- (v) Review the existing draft regulations pertaining to the insurance sector and recommend required amendments for legislation. Develop rules and guidelines for effective supervision of the insurance industry of Bhutan by RMA during the interim period until the insurance act is promulgated. Also define the operating and reporting relationship between RMA and the insurance industry.
- (vi) Assess the existing regulations pertaining to the securities market and develop broad guidelines for a new act, including rules and regulations for a depository, to facilitate the building and strengthening of the securities framework and for the operation of the stock exchange and its supervision by RMA.
- (vii) Review and analyze the existing foreign exchange regulations and recommend changes, if required.
- (viii) Examine the operations of RSEB and recommend improvements, if any, in its operations.
- (ix) Develop the broad guidelines that incorporate and link the individual legislation pertaining to RMA, and the insurance and securities markets. Focus on clear allocation of powers and responsibilities between the different legislation and the legal provisions for control of different types of risks.

11. **Subcomponent B: Institutional Strengthening of RMA.** The TA will undertake the following:

- (i) Determine an appropriate corporate governance framework for the operation of RMA including structure of corporate governance.
- (ii) Review and analyse current accounting standards of RMA. Suggest improvements wherever necessary and develop an accounting manual to be

used as the base document for development of the accounting system software. Provide training for implementation of the accounting manual.

- (iii) Help establish supervision units within the Financial Institutions Supervision Department of RMA for insurance and securities markets, and provide necessary in-house training to the supervisory staff for supervision of the insurance and securities markets.

C. Cost and Financing

12. The total cost of the TA is estimated at \$393,000 equivalent, comprising \$329,000 in foreign exchange costs and \$64,000 equivalent in local currency costs (Appendix 2). ADB will provide \$334,000 equivalent, on a grant basis from the Japan Special Fund, funded by the Government of Japan, to cover the entire foreign exchange cost and \$5,000 equivalent of the local currency cost. The Government will finance \$59,000 equivalent of the local currency requirements, including provision of suitable counterpart staff, office space, administrative and clerical services, and physical facilities.

D. Implementation Arrangements

13. The TA will be implemented over 5 months and require about 11 person-months of services from an international consulting firm comprising three international consultants: a central bank financial sector specialist (4 person-months) who will have overall responsibility for the TA and be the team leader, a financial sector regulatory specialist (3 person-months) who will be responsible for the legislative aspects, and an accounting specialist (4 person-months) who will be responsible for advising RMA on standard accounting systems and procedures as well as developing an accounting manual for RMA. The consulting firm will be selected and engaged by ADB in accordance with ADB's *Guidelines on the Use of Consultants*. The TA is expected to commence in November 2002 and be completed in March 2003.

14. RMA will be the Executing Agency. The consultants will submit an inception report to RMA, the Government, and ADB 2 weeks after commencement of the TA; and an interim report 2 months after TA commencement to be discussed at a tripartite meeting of RMA, Government, and ADB. A committee comprising representatives of RMA, the Ministry of Finance and/or Law, and the financial institutions will oversee the review of the existing legal framework and regulations and the amendments proposed by the consultants. In addition, the committee will seek inputs and suggestions from other stakeholders. The draft final report will be submitted 2 weeks before TA completion for discussion at a tripartite meeting. The final report will be submitted after incorporating comments at the end of the consulting period. RMA will provide a brief report on the progress made in enforcing and supervising activities on a yearly basis for the 3 years following TA completion.

IV. THE PRESIDENT'S DECISION

15. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$334,000 on a grant basis to the Government of Bhutan for Strengthening the Capacity of the Royal Monetary Authority and Royal Securities Exchange of Bhutan, and hereby reports this action to the Board.

TECHNICAL ASSISTANCE FRAMEWORK

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<p>Goals</p> <p>?? Improve the overall functioning of the financial sector in Bhutan.</p> <p>?? Reduce poverty.</p>	<p>?? Improved monetary policy framework</p> <p>?? Improved overall soundness and governance of the financial system</p> <p>?? Improved private sector development</p> <p>?? Improved access to financial services</p>	<p>?? Royal Monetary Authority (RMA) annual/inspection reports</p> <p>?? Government reports on banking/ financial practices</p> <p>?? Securities Exchange of Bhutan reports</p>	<p>?? The Government will give high priority to supporting financial sector regulations</p>
<p>Purpose</p> <p>?? Implement an efficient and effective financial sector supervisory system.</p> <p>Outputs</p> <p>?? Improved monetary policy management</p> <p>?? Improved quality of RMA supervision</p>	<p>?? Improved overall regulation and supervision of the financial sector</p> <p>?? Improved performance of the securities markets through increased market capitalization</p> <p>?? Greater autonomy and independence in RMA's operations</p> <p>?? Improved functioning of the financial institutions and capital market intermediaries</p>	<p>?? Technical assistance (TA) completion report</p> <p>?? RMA reports</p> <p>?? Asian Development Bank (ADB) review missions</p>	<p>?? Effective implementation of legislation and enforcement in Bhutan's currently underdeveloped financial system</p>

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<p>Enhanced capacity within RMA and Royal Securities Exchange of Bhutan (RSEB)</p>	<p>Improved accounting systems and procedures for RMA as per modern central bank standards</p> <p>Improved securities market operations through the legal framework</p> <p>Increase in market capitalization by 25% within 2 years of TA completion</p>	<p>TA survey of bank stakeholders, managers, staff, regulators, and clients</p> <p>ADB review mission</p> <p>External consultant report</p>	
<p>Activities</p> <p>1. Legal and regulatory development</p> <p>New RMA Act developed</p> <p>New Insurance and Securities Market Act developed</p> <p>Financial Institution Act and foreign exchange regulations reviewed and amended</p>	<p>Initial study of existing RMA Act/ draft insurance act/ securities regulations are completed by end December 2002</p> <p>Draft RMA / insurance/ securities act developed by February 2003</p> <p>Proposed financial institution act/ foreign exchange regulations amendments are ready by February 2003</p> <p>New / revised act approved by June 2003</p>	<p>Consultant's progress report</p> <p>ADB review mission</p> <p>Consultant's progress report</p> <p>RMA report</p>	<p>Consultants will have ready access to information required</p> <p>RMA will adopt consultant's recommendations</p> <p>Government/RMA will adopt consultant's recommendations</p>

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<p>2. Supervision and Enforcement</p> <p>Supervision units for insurance and securities established under the Financial Institution Supervision Department</p> <p>3. Systems and Procedures</p> <p>Detailed accounting systems and procedures developed as per modern central banking accounting standards and accounting manual developed</p> <p>Accounting systems are operational</p> <p>4. Training</p> <p>Insurance and securities markets acts are developed and accounting manual completed</p>	<p>New / revised act promulgated by September 2003</p> <p>Needs identified by January 2003</p> <p>Separate units for supervision for insurance and securities markets established by February 2003</p> <p>Existing accounting systems and procedures studied by December 2002</p> <p>New accounting systems and procedures developed by February 2003</p> <p>Supervisory staff for insurance and securities trained by March 2003</p>	<p>Consultant's progress report</p> <p>Consultant's progress report</p> <p>RMA report</p> <p>Consultant's progress report</p> <p>RMA report</p> <p>Consultant's progress report</p> <p>RMA report</p> <p>Consultant's progress report</p>	<p>Staff of required skill are available</p> <p>RMA will adopt consultant's recommendations</p> <p>Staff with required skills are available</p>

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
??Training completed	??New accounting systems and procedures adapted and staff trained by April 2003	??RMA report, ADB review mission	
Inputs ??TA consulting services ??Others	??ADB financing of \$334,000 ??International: 11 person-months \$309,000 ??\$25,000	??Contract invoices	??Consultants will be contracted by ADB in a timely manner ??Government counterpart financing will be timely and adequate

COST ESTIMATES AND FINANCING PLAN
(\$'000)

Item	Foreign Exchange	Local Currency	Total Cost
A. Asian Development Bank Financing^a			
1. Consultants			
a. International Consultant Remuneration and Per Diem	286.0	0.0	286.0
b. International Travel	15.0	0.0	15.0
c. Reports and Communications	6.0	2.0	8.0
2. Representative for Contract Negotiations	5.0	0.0	5.0
3. Contingencies	17.0	3.0	20.0
Subtotal (A)	329.0	5.0	334.0
B. Government Financing			
1. Office Accommodation and Transport	0.0	27.0	27.0
2. Remuneration and Per Diem of Counterpart Staff	0.0	10.0	10.0
3. Communications and Materials	0.0	10.0	10.0
4. Contingencies	0.0	12.0	12.0
Subtotal (B)	0.0	59.0	59.0
Total	329.0	64.0	393.0

^a Financed by the Japan Special Fund.

Source: Asian Development Bank estimates.

OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

A. Central Bank Financial Sector Specialist/Team Leader (International, 4 person-months)

1. The technical assistance (TA) will require the services of a central bank financial sector specialist (CBFSS) who, in addition to having overall responsibility for subcomponent A, will also be the team leader. The CBFSS should have (i) extensive experience in central banking operations and financial sector reform issues; (ii) knowledge of banking, finance, insurance, and capital markets; (iii) knowledge of legal frameworks and regulatory functions governing financial activity; and (iv) experience in providing on-the-job training in operational areas.

2. **Financial Sector Review.** The specialist will undertake the following:

- (i) Review and analyze current commercial, banking, and monetary legislation including but not limited to, the Royal Monetary Authority (RMA) Act 1982, Financial Institutions Act 1992, the Foreign Exchange Regulations, and the Securities Exchange Regulations 1993.
- (ii) Review and analyze the current regulatory environment under which the existing financial sector operates.
- (iii) Review and analyze the role of RMA in the financial sector.
- (iv) Determine the legislative changes, if any, required to enhance the effectiveness of the financial sector. This will include recommending changes to existing legislation as well as recommending new legislation.
- (v) Determine the changes required, if any, to the regulatory environment to enable effective implementation of legislation and enforcement, the need for accounting and reporting standards, an examination of enforcement procedures, etc.

3. **Legislation.** Responsibilities include the following:

- (i) Coordinate with the adviser, Bundesbank in reviewing the RMA Act.
- (ii) Based on (i), assist the financial sector regulatory specialist (FSRS) in drafting a new RMA act in the context of the Government providing greater autonomy and independence to RMA.
- (iii) Assist the FSRS in assessing the existing Financial Institutions Act 1992 and in drafting amendments to make it compatible with modern industry standards to enhance the effectiveness of the financial sector.
- (iv) Assist the FSRS in reviewing the existing draft Insurance Act and to recommend required amendments for legislation. Also, in coordination with the FSRS, develop rules and guidelines for effective supervision of the insurance industry by RMA in the interim period, pending promulgation of the insurance act.
- (v) Assist the FSRS in assessing the existing regulations pertaining to the securities markets and developing a draft act to facilitate the building and strengthening of

the securities framework and for the operation of the stock exchange and its supervision by RMA. The draft act will also include the rules and regulations for depositories and its operations.

- (vi) In coordination with the FSRS, determine an appropriate corporate governance framework for the operation of RMA 78 including structure of corporate governance and high level principles.

4. **Others.** These will include the following:

- (i) Coordinate with the FSRS in establishing a separate unit under the Financial Institution Supervision Division for supervising the insurance and securities markets and providing in-house training for the concerned staff.
- (ii) Coordinate with the accounting specialist to develop the accounting manual and incorporate it in the TA report.

B. Financial Sector Regulatory Specialist (International, 3 person-months)

5. The FSRS should have a solid background in legal matters pertaining to the financial sector, in particular banking, insurance, and the capital markets. The consultant will undertake the following;

- (i) Assess the existing RMA Act, 1982 and draft a new RMA act in coordination with the adviser, Bundesbank, and the CBFSS.
- (ii) In coordination with the CBFSS, thoroughly assess the existing Financial Institutions Act 1992 and draft amendments to make it compatible with modern industry standards to enhance the effectiveness of the financial sector.
- (iii) Review the draft insurance act and recommend, in coordination with the CBFSS, required amendments for legislation. Also, in coordination with the CBFSS, develop rules and guidelines for effective supervision of the insurance industry by RMA in the interim period, pending promulgation of the Insurance Act.
- (iv) In coordination with the CBFSS, assess the existing regulations pertaining to the securities markets and develop a draft act to facilitate the building and strengthening of the securities framework and for operation of the stock exchange and its supervision by RMA. The act will include rules for depository and its operations.
- (v) Develop the broad guidelines that incorporate and link the individual legislation pertaining to RMA, and the insurance and securities markets. Focus on clear allocation of powers and responsibilities between the different legislation and the legal provisions for control of different types of risks.
- (vi) Assist RMA, in coordination with the CBFSS, to set up a separate unit within the Financial Institution Supervision Division to supervise the insurance and securities markets, and provide, in coordination with the CBFSS, in-house training for the concerned staff for supervision of the insurance and securities markets.

- (vii) Examine, in coordination with the CBFSS and RMA's internal systems officer, the operations of RSEB and suggest improvements, if any.

C. Accounting Specialist (International, 4 person-months)

6. The consultant should be a certified accountant with extensive experience in central bank operations and its accounting systems and procedures. The consultant will have the following responsibilities:

- (i) Review the operations of the Banking Division of RMA and make necessary additions, revisions, and corrections on the operations and its accounting systems including method of valuation of foreign assets.
- (ii) Link the activities of RMA's Banking Division with other divisions such as Issue Division, Foreign Exchange Division, Reserve Management Unit, and the Administrative Division; and set up an appropriate accounting system among these divisions.
- (iii) Suggest appropriate operational and accounting procedures for the proposed takeover of government account transactions by RMA as banker to the Government, currently handled by the commercial banks.
- (iv) Provide guidance on the preparation and analysis of the financial statements, such as statement of condition, income and expenditure statement, cash-flow statement, and other relevant statements based on international accounting.
- (v) Establish standard operational and accounting procedures on the operation of a currency chest as well as for a clearinghouse.
- (vi) Recommend appropriate internal control systems.
- (vii) Develop an accounting manual to suit the requirements of modern central bank operations, as prescribed under the RMA Act of Bhutan and in accordance with international accounting standards and practices as well as standard guidelines.
- (viii) Provide in-house training for the staff on the implementation of the accounting manual.
- (ix) Coordinate with RMA's internal systems officer to specify the required software for establishing the revised system.