

ASIAN DEVELOPMENT BANK

TAR:BHU 36225

TECHNICAL ASSISTANCE
(Financed by the Japan Special Fund)

TO THE

KINGDOM OF BHUTAN

FOR

INSTITUTIONAL DEVELOPMENT OF THE
BHUTAN DEVELOPMENT FINANCE CORPORATION

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
BDFC	–	Bhutan Development Finance Corporation
DBS	–	development banking specialist
RMA	–	Royal Monetary Authority
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 requested technical assistance (TA) from the Asian Development Bank (ADB) for the institutional development of the Bhutan Development Finance Corporation (BDFC). 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 from 22 April to 2 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. Bhutan's financial sector comprises the Royal Monetary Authority (RMA) functioning as the central bank; two commercial banks, the Bank of Bhutan and the Bhutan National Bank (government owned); two nonbank financial institutions, the Royal Insurance Corporation of Bhutan, and BDFC; and one pension and provident fund, the National Provident and Pension Fund Bureau. In addition, the Royal Securities Exchange of Bhutan, which was established in 1993 with ADB assistance, deals with a limited number of traded stocks, government bonds, and RMA bills. Limited clearing and payment mechanisms have also been established. Due to the small size of the economy, the supervision of the whole financial sector is entrusted to RMA. The sector's development will be necessary to foster the Government's poverty reduction policy.³ The rationale for ADB's intervention in the financial sector is to promote private sector development in Bhutan. It is also consistent with ADB's country strategy for Bhutan.

3. BDFC is the sole development finance institution in Bhutan, established in 1988 under a Government charter to promote and finance industrial, agricultural, and commercial enterprises, and now operating under the Companies Act and Financial Institutions Act. BDFC is mandated to operate under the overall economic policy of the Government and in the process has been lending for industrial and agricultural activities, as well as microfinance. It is seen as an instrument to pursue Government policies for the industry and agriculture sectors. Moreover, a large percentage of people living and working in the poorer, nonmonetized rural areas have little or no financial services. Accordingly, BDFC provides the only rural credit facility, but this scheme has had limited success because of its high operating costs.

4. Total assets of BDFC as of 31 December 2001 were Nu809 million. Loan receivables comprise 79% of total assets. Industrial lending comprises 65% of the total loan assets, while agriculture lending comprises the remaining 35%. Moreover, commercial agriculture lending cross-subsidizes BDFC's microfinance operations at present. In view of the low profitability, the Government has granted a tax holiday to BDFC for 5 years (1997/98–2001/02).

5. BDFC has a key role to play in poverty reduction through the provision of financial services. Nonetheless, the current dual role has impacted BDFC's operations and BDFC urgently needs to reassess its future role. With less than 3% of the total financial assets in 2000

¹ Comprised of 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.

and a total gross loan portfolio of Nu642 million (at December 2001), BDFC is a relatively small part of Bhutan's financial system and has not been able to grow as fast as other financial institutions, partly because it has been encumbered with low quality assets and low profitability. BDFC's lending operations rely entirely on lines of credit through assistance from foreign concessional lending (including ADB, United Nations Capital Development Fund, and Kuwait Fund for Arab Economic Development), equity infusion by the Government for capital reserves, and bonds issued by the Government.

B. The Role of BDFC

6. BDFC's multipurpose lending activity has adversely affected its operational viability. In most cases, development finance institution structured for industrial and agricultural lending cannot cost effectively deliver microcredit. The Government's current mandate requires BDFC to operate as a development bank to promote the expansion of economic and social development through accelerated industrial and, in particular, agricultural development in rural areas, thus making it difficult for BDFC to be self-sustaining. In fulfilling its role as a development bank, BDFC is required to make small rural agricultural loans for which the operating costs are too high for it to be commercially viable. The Government will need to assess the ensuing policy and institutional implications.

7. Given the dominance of agriculture in Bhutan's overall economic development, BDFC would be expected to play a continuing role in financing agriculture, including microfinance, in addition to industrial activities. However, BDFC cannot be expected, with its available resources, to service the entire financing needs of these sectors all by itself. An assessment of the demand for financial services by various economic subsectors and income groups, and the supply of such services is needed. In the process, economic activities or target groups not adequately served or excluded in the context of the Government's strategy for agriculture and rural development should be assessed. A detailed institutional and financial analysis of BDFC should then be conducted to review the existing role played by BDFC in the context of the Government's policy for agriculture and industrial activities, and to identify markets and products as possible focus for its future role. This should be followed by development of a sustainable strategic plan for BDFC in the context of achieving the objectives required by its revised role. The need for a review of BDFC's existing role was also identified in the recent financial sector review TA,⁴ provided to assist the Government develop a vision and prepare a medium- and long-term strategy for financial sector development, in particular for the private sector in Bhutan.

8. Once the role and objectives of BDFC in the financial system are clarified, a strategic choice will be needed as to whether state ownership is the most efficient tool to achieve these objectives or whether efforts should be made to improve their performance by increasing commercial orientation and increased independence from the Government. If Government ownership is to continue, operational policies and procedures should be in place that would eventually lead to BDFC becoming self-sustainable. Subsidies, if any, to BDFC should be allocated on a targeted basis.

9. In carrying out its role, BDFC would also need to ensure that it operates in a way that minimizes the likelihood of continuing losses from poor practices and procedures so that risk is taken into account when pricing its loan products. Policies based on best practices should be established within BDFC, including for (i) setting standards for disclosure, (ii) setting minimum

⁴ ADB. 2001. *Technical Assistance to Bhutan for Financial Sector Review*. Manila.

capital adequacy requirements, (iii) setting levels of provisioning, (iv) advising on strengthening of legislation, (v) determining training requirements, and (vi) establishing loan systems. Clear performance indicators need to be established for development banking.

III. THE TECHNICAL ASSISTANCE

A. Purpose and Output

10. The TA will continue ADB's ongoing intervention in the financial sector. The TA will enable BDFC to define its future role in the context of its multipurpose lending operations and aim to institutionally strengthen BDFC and make it sustainable through the development of a sustainable strategic plan for future operations. In the process, the TA will also aim to provide BDFC with the appropriate institutional setup and organization structure to achieve its objective as defined by its revised role. The TA framework is provided in Appendix 1.

B. Methodology and Key Activities

11. **Subcomponent A: Business Planning for BDFC.** The TA will

- (i) assess the demand for financial services by various economic subsectors, and income groups and the supply of services; and assess economic activities or target groups not adequately served or excluded in the context of the Government's strategy for industrial, agriculture, and rural development;
- (ii) review the existing role played by BDFC in this context;
- (iii) conduct a detailed institutional and financial analysis of BDFC;
- (iv) define the future role to be played by the institution in the context of its lending operations to the industry and agriculture sectors;
- (v) develop a sustainable strategic plan for BDFC in the context of achieving the objectives required by its revised role;
- (vi) develop an operational plan that specifies the activities required for operationalization; and
- (vii) prepare an implementation timetable that provides activities, time frames, and milestones.

12. **Subcomponent B: Organizational Development for BDFC.** TA activities include

- (i) review the existing organizational structure and operations of BDFC;
- (ii) develop a redesigned organization structure for BDFC, such as organization chart, and roles and responsibilities of key personnel; and
- (iii) determine an appropriate corporate governance framework for the operation of BDFC including corporate governance structure.

C. Cost and Financing

13. The total cost of the TA is estimated at \$236,000 equivalent, comprising \$197,000 in foreign exchange costs and \$39,000 equivalent in local currency costs (Appendix 2). ADB will provide \$200,000 equivalent, on a grant basis from the Japan Special Fund, funded by the Government of Japan, to cover the entire foreign exchange cost and \$3,000 equivalent of the local currency cost. The Government will finance \$36,000 equivalent of the local currency requirements, including provision of suitable counterpart staff, office space, administrative and clerical services, and physical facilities.

D. Implementation Arrangements

14. The TA will require 6.5 person-months of consulting services from a team of two international consultants: a development banking specialist (3.5 person-months) who will have overall responsibility for the TA and be the team leader, and a rural credit specialist (3 person-months) who will be responsible for reviewing the agricultural and microcredit operations of BDFC. Appendix 3 provides outline terms of reference for the consultants. The team 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.

15. BDFC, the Executing Agency, will coordinate consultants' activities and provide office space, secretarial support, local transport, and logistical support.

16. The consultants will submit an inception report to BDFC, the Government, and ADB 2 weeks after TA commencement. They will submit an interim report 2 months after TA commencement, which will be discussed at a tripartite meeting. The draft final report, to be submitted 2 weeks before TA completion, will be presented to the BDFC board and discussed at a tripartite meeting. The findings and recommendations under the report will also be disseminated at a workshop comprising the stakeholders, representatives of industries, and the agriculture community. The final report will be submitted after incorporating comments at the end of the consulting period.

IV. THE PRESIDENT'S DECISION

17. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$200,000 on a grant basis to the Government of Bhutan for Institutional Development of the Bhutan Development Finance Corporation, and hereby reports such action to the Board.

TECHNICAL ASSISTANCE FRAMEWORK

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<p>Goal</p> <ul style="list-style-type: none"> • Improve the overall functioning of the financial sector in Bhutan. • Reduce poverty. 	<ul style="list-style-type: none"> • Overall sustainability and viability of the operations of the Bhutan Development Finance Corporation (BDFC) achieved through improved quality of lending in the context of the Government's policy mandate for BDFC • Improved soundness and better governance of the financial system • Improved private sector development • Improved access to financial services 	<ul style="list-style-type: none"> • BDFC's annual reports • Government reports on banking and financial practices • Royal Monetary Authority (the central bank) annual reports 	<ul style="list-style-type: none"> • The Government and BDFC accept the recommended revised role for BDFC
<p>Purpose</p> <ul style="list-style-type: none"> • Develop an efficient and effective. development financial institution meeting the Government's objective for lending to the industry, agriculture, and microfinance sectors 	<ul style="list-style-type: none"> • Improved quality of industry, agriculture, and microfinance lending portfolio 	<ul style="list-style-type: none"> • Technical assistance (TA) completion report 	<ul style="list-style-type: none"> • Effective implementation of recommendations by BDFC

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<p>Output</p> <ul style="list-style-type: none"> • Define the future role of BDFC. • Strengthen BDFC and make it operationally viable and sustainable. 	<ul style="list-style-type: none"> • Sustainable and improved operational viability of BDFC through identified markets and specified range of products and services • Improved governance through redesigned organizational structure 	<ul style="list-style-type: none"> • TA survey of bank stakeholders, managers, staff, regulators, and clients • Asian Development Bank (ADB) review missions • Consultant's progress report 	<ul style="list-style-type: none"> • Environment remains conducive to targeted lending
<p>Activities</p> <p>1. Assess demand and supply.</p> <ul style="list-style-type: none"> • Assesses the demand for financial services by various economic subsectors and income groups, and the supply of services. Assess whether economic activities of target group are adequately served. • Review the role of BDFC in the context of the above. <p>2. Institutional Analysis</p> <ul style="list-style-type: none"> • Conduct a detailed financial and institution analysis of BDFC. 	<ul style="list-style-type: none"> • Initial study of existing practices is completed by end December 2002 • Recommendations for improvement are submitted by February 2003 • The draft final report submitted 2 weeks before TA completion and presented to the BDFC board as well as discussed at a tripartite meeting 	<ul style="list-style-type: none"> • Consultant's progress report • ADB review mission 	<ul style="list-style-type: none"> • Consultants will have ready access to information required • BDFC will adopt consultant's recommendations

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<ul style="list-style-type: none"> • Develop a sustainable strategic plan for BDFC in the context of achieving the objectives required by its revised role • Develop and implement operational plan for BDFC • Determine an appropriate corporate governance structure for BDFC 	<ul style="list-style-type: none"> • The findings and recommendations of the report are disseminated at a workshop comprising the stakeholders, and representatives of industries and the agriculture community • The final report is submitted after incorporating comments, at the end of the consulting period in March 2003 • A new/revised role for BDFC is approved by April 2003 • A new/revised role is implemented by June 2003 • Code of corporate governance adopted by BDFC by June 2003 	<ul style="list-style-type: none"> • Reports by BDFC • Reports by BDFC 	
<p>Inputs</p> <ul style="list-style-type: none"> • TA consulting services • Others 	<ul style="list-style-type: none"> • ADB financing of \$200,000 • International: 6.5 person-months \$185,000 • \$15,000 	<ul style="list-style-type: none"> • Contract invoices 	<ul style="list-style-type: none"> • 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. Remuneration and Per Diem of International Consultants	169.0	0.0	169.0
b. International Travel	10.0	0.0	10.0
c. Reports and Communications	5.0	1.0	6.0
2. Contingencies	13.0	2.0	15.0
Subtotal (A)	197.0	3.0	200.0
B. Government Financing			
1. Office Accommodation and Transport	0.0	22.5	22.5
2. Remuneration and Per Diem of Counterpart Staff	0.0	8.5	8.5
3. Contingencies	0.0	5.0	5.0
Subtotal (B)	0.0	36.0	36.0
Total	197.0	39.0	236.0

^a Financed by the Japan Special Fund.
Source: Asian Development Bank estimates.

OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

A. **Development Banking Specialist and Team Leader (International, 3.5 person-months)**

1. The development banking specialist (DBS) should have (i) extensive practical banking experience, preferably in both commercial and development banks; (ii) experience in strategic planning; and (iii) experience in human resource planning, in particular in assessing skills mix and training requirements. The DBS will be the team leader.

2. **Strategic Planning Exercise.** Specific responsibilities include the following:

- (i) Review and analyze in detail, existing Bhutan Development Finance Corporation (BDFC) operations, at headquarters and branch levels in the context of the Government's mandate to BDFC and its operational policy. This will involve travel to branches to observe and analyze operations. The review should also cover BDFC's environment due diligence procedures.
- (ii) In coordination with the rural credit specialist, conduct a detailed institutional and financial analysis of BDFC; and determine the operational viability of its overall loan portfolio comprising industrial, agricultural, and microfinance.
- (iii) Based on the analysis, define the future role to be played by BDFC in the context of its lending operations to the industry and agriculture sectors, including microfinance. In the process, identify markets and specified range of products and services. Examine whether any changes or revisions in the existing regulations are required to extend such products and services. Examine whether other existing financial institutions could extend similar financial services.
- (iv) Together with BDFC management, develop a sustainable strategic plan for BDFC in the context of achieving the objectives required by its revised role. The plan should include the prioritization of specific activities required. The capital and ownership of BDFC will be reviewed and analyzed together with the need for and potential sources of long-term credit. Examine the desirability of enacting a special law or provision to allow BDFC to mobilize resources through public deposits or issue of debt securities and whether such debt securities, could qualify as commercial banks statutory reserves under the regulations of the Royal Monetary Authority.
- (v) Develop an operational plan that specifies the activities required for operationalization.
- (vi) Provide an implementation timetable that provides activities, time frames, and milestones.

3. **Organizational Development.** Specific activities include the following:

- (i) Review the existing organizational structure and operations of BDFC.
- (ii) Develop a redesigned organization structure for BDFC.

- (iii) Define roles and responsibilities of key personnel.
- (iv) Determine an appropriate corporate governance framework for the operation of BDFC including structure of corporate governance.

B. Rural Credit Specialist (International, 3 person-months)

4. The specialist should have (i) extensive practical banking experience, preferably in both commercial and development banks; (ii) extensive experience in rural credit, including microfinance; (iii) experience in strategic planning; and (iv) experience in human resource planning, in particular in assessing skills mix and training requirements.

5. Specific responsibilities include the following:

- (i) Review and analyze in detail, existing BDFC agriculture and microfinance operations, at headquarters and branch levels in the context of the Government's mandate to BDFC and its operational policy. This will involve travel to branches to observe and analyze operations.
- (ii) Assess BDFC's outreach and pattern of rural credit delivery, and its impact on BDFC's operational viability.
- (iii) Assess the demand for financial services by various economic subsectors, and income groups and the supply of services. Assess economic activities or target groups not adequately served or remaining excluded in the context of Government's strategy for agriculture and rural development.
- (iv) Examine the pricing structure for BDFC's agriculture lending products, in particular microfinance and make recommendations, if required, to improve operational viability.
- (v) Based on the study, identify markets and specified range of products and services to make BDFC operationally sustainable.
- (vi) Examine whether a clear and transparent policy of subsidy for specific branch operations is required for social and outreach considerations.
- (vii) Recommend measures to enhance efficiency in delivering prompt financial services to meet the overall operational policy of BDFC.
- (viii) Assist the DBS in conducting a detailed institutional and financial analysis of BDFC; and determining the operational viability of its overall loan portfolio comprising industrial, agricultural, and microfinance.
- (ix) Based on the analysis, assist the DBS to define the future role to be played by BDFC in the context of its lending operations to the industry and agriculture sectors, including microfinance.
- (x) Together with BDFC management, assist the DBS to develop a sustainable strategic plan for BDFC in the context of achieving the objectives required by its

revised role. The plan should include the prioritization of specific activities required.

- (xi) Assist the DBS to develop an operational plan that specifies the activities required for operationalization.
- (xii) Assist the DBS to provide an implementation timetable that provides activities, time frames, and milestones.
- (xiii) Study the legislative and regulatory framework for the rural banking subsector and suggest improvements, if required.