



Asian Development Bank

Memorandum

Independent Evaluation Department
Independent Evaluation Division 1

Evaluation Approach

Project Performance Evaluation Report of Financial Sector Intermediation Facility and Equity Investment to the Bhutan National Bank in Bhutan

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I. Background

1. Bhutan's financial sector is relatively small with two commercial banks—Bank of Bhutan (BB) and Bhutan National Bank (BNB), a development finance institution—Bhutan Development Finance Corporation (BDFC), one insurance company—Royal Insurance Corporation of Bhutan (RICB), and one pension fund—National Pension and Provident Fund Plan (NPPF Plan), all of which are majority owned and operated by the Government.

2. In 1997, ADB approved the Financial Sector Intermediation Facility (FSIF) which consisted of the following:

- (i) Loan 1565-BHU was a \$4 million equivalent policy-based program loan to rationalize government control over private businesses, liberalize interest rates and improve its management, rationalize foreign exchange transactions, improve sector efficiency, improve the legal framework for private business, support entrepreneurship, and upgrade the human resources in financial institutions. It was disbursed in two tranches that were 4½ years apart, with the second drawn in December 2002.
- (ii) Loan 1566-BHU was an investment loan in the form of a \$4 million equivalent development finance loan. It was designed to provide, through BNB and BDFC, foreign exchange credit to qualified private small- medium enterprise (SME) in industry and agriculture. The loan was fully drawn in 2004. The project completion report (PCR) indicated that 281 SMEs benefitted from the credit line.
- (iii) Equity Investment 7139-BHU would have allowed ADB to invest up to \$790,000 equivalent in BNB shares. It was justified on the basis that it would support financial sector reforms, demonstrate the effects of reform, increase competition, promote trade and export, and advocate change. ADB invested a total of \$532,000 equivalent in BNB, for about 20.1% of its shares. Citicorp Investment Bank also made an equity investment for almost the same number of shares.
- (iv) Technical assistance grant (TA-2902-BHU) made available up to \$500,000 equivalent to upgrade the institutional capacities of the government agencies and monetary authorities involved in the FSIF.

II. Program Objectives and Scope at Appraisal

3. As indicated in the Report and Recommendation of the President to the Board of Directors (RRP),¹ the key objectives or outcomes of FSIF were to (i) improve access to credit by the private sector; (ii) create a supportive Government policy environment for private sector business activities; (iii) create an enabling legal framework for financial sector operations and private sector business activities; and (iv) enhance private entrepreneurship and management skills, and provide better access to market information. The scope or outputs of the FSIF were to (i) support the Government to institute a series of policy reform measures to remove impediments for the financial and banking sector and private sector development; (ii) provide long-term foreign exchange funding to private sector subprojects and assist the participating financial institutions (PFIs) to improve their institutional capabilities, and operational and financial performance; and (iii) play a catalyst role in the privatization of a State-owned financial institution.

4. The FSIF aimed to accelerate economic development through strong private sector growth, to facilitate the expansion of the country's domestic revenue base, and to reduce dependence on foreign aid for industrial expansion. It is proposed that the PPER assess this using the growth of the domestic private sector in these sectors in terms of volume and variety of investments, changes in financial depth, and private sector deposit and credit volumes; and by looking at the national revenue base, and the balance of trade. Improved soundness and efficiency of the financial system would be treated as the outcome, and standard financial soundness and efficiency indicators will be used to assess. The program tranche conditions will be the outputs of the policy based loan, and the objectives of each of the intermediation loan, the equity investment, and the TA would also be treated as FSIF outputs.

III. Findings of the Program and Project Completion Reports

5. Two PCRs were circulated on the FSIF: a Program Completion Report for the policy-based loan, the development finance loan and the technical assistance grant in December 2003, and a Project Completion Report² for the Bhutan National Bank (the equity component) in March 2004.

6. Under the PCR, the FSIF (excluding the equity investment) was rated highly relevant, efficacious, less efficient, likely sustainable and with moderate institutional and other impacts. Overall, the FSIF was successful. The FSIF was said to have brought about "an important package of reforms and initiated development of a sound and efficient financial system and a strong private sector. FSIF was broad based and touched on some critical concerns in the financial and private sectors. Despite delays in compliance with one policy action, the process has been initiated for building a market system to provide risk and term financing to the private sector and creating the right environment for the private sector to grow. The FSIF has also raised awareness in the Government and other stakeholders of some of the critical issues of governance, efficiency, and best market practice..."

7. The PCR rated the equity investment in BNB as successful since it met the objective of establishing a sustainable and accredited financial institution in Bhutan. "It has also

¹ ADB. 1997. *Report and Recommendation of the President to the Board on the Proposed Loans and Technical Assistance Grant and Proposed Equity Investment Financial Sector Intermediation Facility (Bhutan)*. Manila.

² IED independently reviewed the Program Completion Report, and validated the methodology used and the rating given.

provided impetus for the development of the capital market in Bhutan through the introduction of new products and support for the Government's liberalization and reform program. With ADB's help, BNB enhanced competition in Bhutan's financial sector by providing better and more responsive services for the private sector, hence reducing the effective cost of capital." BNB's satisfactory financial performance confirmed the successful rating.

IV. Evaluation Approach and Methodology

8. The evaluation of FSIF will involve a review of program related documents and background material, meetings with key stakeholders in Bhutan including representatives of the RMA, BNB, and BDFC, as well as ADB staff involved in the formulation and implementation of FSIF. The work will be shared between the author of this approach paper as Mission Leader, an international consultant familiar with banking sector issues in South Asia, and a domestic consultant. The terms of reference are attached as Appendix 1.

9. The PPER will evaluate each of the two loans, the equity investment, and the TA separately, based on the broad criteria set out below, as suggested by the ADB Guidelines for Preparing Performance Evaluation Reports for Public Sector Operations (Addendum 1). For Loan 1566-BHU, the PPER will examine the outcomes of the credit portfolio, including the financial and economic impacts thereof. The PPER will draw a stratified random sample of sub-borrowers for more an in-depth information study. The size of the sample will depend in part on the practicalities of interviewing sub-borrowers outside Thimphu. However the target is a 10% sample, selected on a dollar-unit weighted basis. Geographic and sector distribution will be considered, as will distribution across types of borrowers, and success rate. For EI 7139-BHU, the PPER will evaluate the development impact of investment, and ADB's investment profitability, work quality, and additionality. An overall assessment of FSIF, as a program in its entirety, will then be made based also on the broad criteria below.

- (i) Relevance
 - a. quality of assessment of sector and macro-economic problems and conditions
 - b. responsiveness of program design to sector constraints and opportunities
 - c. adequacy of policy dialogue on reform options
 - d. consistency with Bhutan's overall development strategy and economic reforms
 - e. government's role in the design and ownership of the reforms
 - f. consideration of capacity and political constraints
 - g. coordination with activities of development partners
- (ii) Effectiveness
 - a. achievement of program outputs and outcome
 - b. assessment of factors affecting achievements of outputs and outcomes
- (iii) Efficiency
 - a. program effects relative to program costs
 - b. efficiency of preparation and implementation process
 - c. program management costs
 - d. timeliness of outputs and outcomes
- (iv) Sustainability
 - a. likelihood that resources and conditions are sufficient to support outcomes
 - b. absence of policy reversals

- c. continued support for program outcomes from key stakeholders
- (v) Impacts
 - a. economic development through strong private sector growth
 - b. expansion of domestic revenue base
 - c. degree of dependency on foreign aid for industrial expansion
 - d. governance framework of BNB
 - e. governance and efficiency of service delivery
- (vi) Institutional Development and Other Impacts
 - a. better definition, stability, transparency, enforceability, and predictability of institutional arrangements
 - b. better alignment of mission and capacity of relevant agencies with their mandate
 - c. impact of Loan 1566-BHU on women entrepreneurs
 - d. anticipated and unanticipated (positive and negative) impacts, particularly the socio-economic impacts

V. Special Issues

10. The PCR for the FSIP concluded that it “should be viewed in the context of a long-term process and its impact should be assessed within such a framework”.³ That is, the challenges of excess liquidity and excessive risk aversion in the commercial banks, institutional capacity constraints and weaknesses in the policy/legal framework for the financial sector and the private sector in Bhutan were unlikely to be fully resolved within the FSIP program period. Nevertheless the report said that the FSIP had been instrumental in initiating a process of change in a crucial period and would, in time, achieve its objectives.

11. A key task of the PPER will be to assess whether the FSIP did indeed impart momentum for change that has been carried on since. It is not expected that the problems in Bhutan’s financial sector will be fully resolved even now. In 2009 private sector access to credit is still highly constrained. This is evidenced by the fact that the share of domestic credit to the private sector relative to all credit is approximately 25% in Bhutan compared with an average among countries in the region of about 45%.⁴ The Bhutan Chamber of Commerce and Industry, in a 6-dzongkhag-tour in mid-2009, found that “Most small businesses find it difficult to access finance, due to the high and difficult collateral asked by financial institutions.”⁵ Similarly a survey of 248 firms in June 2009 found that access to credit was one of the main constraints to small business development in Bhutan.⁶ The result is that the private sector’s access to credit in Bhutan is rated very low compared with other countries.⁷ In this connection, the PPER will assess the reforms relating to monetary policies and how these have affected interest rate policies and flows, the growth of the private sector, and the deepening of the revenue base.

12. However, credit to the private sector in Bhutan is growing at very high rates; and the pace of financial reform may be accelerating.⁸ The PPER will assess the degree to which the

³ ADB. 2003. *Program Completion Report on the Financial Sector Intermediation Facility to the Kingdom of Bhutan*. Manila. Page 14.

⁴ 2007 data quoted by “Bhutan Economic Update” (September 2009) World Bank, Economic Policy and Poverty Team, South Asia Region, Ananya Basu. Page 4.

⁵ See www.bcci.org.bt August 2009.

⁶ World *Climate Assessment*. Bhutan.

⁷ International Finance Corporation. *Doing Business Report 2010*, ranks Bhutan 177th out of 183 countries on the ease of getting credit.

⁸ World Bank. 2007. Growth of credit to the private sector was 32.7% in May 2009 (year-over-year). This was high but the rate was even higher in 2008.

FSIP created momentum for reform. It will base this assessment on the achievements of the FSIP during the program period (legislative and policy reforms during the period, improvements in institutional capacity, and specific outcomes of loans made by the participating financial institutions using ADB funds). It will also base its assessment on developments since 2004, including the degree to which reforms under the FSIP have been effectively implemented and the degree to which subsequent reforms have built on the achievements on the FSIP.

1. The Policy-based Program Loan (1565-BHU)

13. The PPER will assess more than whether the tranche release conditions were met. It will investigate whether policy and legal changes have, in addition to being enacted, been successfully implemented. Where implementation has been successful (or less than fully successful) the PPER will attempt to identify the factors that have influenced these outcomes.

14. One aspect that is likely to be important is the degree to which policy dialogue on structural reforms involved the private sector and, later, involved the newly empowered institutions of the national assembly and government.⁹ How much progress was made in changing the “deeply entrenched problem of lack of transparency in business practices and a lack of a governance structure in the financial sector”?¹⁰ Did the FSIP lay the groundwork for subsequent efforts by the ADB to improve corporate governance in Bhutan’s financial sector?¹¹

2. The investment loan to provide loans to SMEs (1566-BHU) and TA (2902-BHU)

15. The Completion Report concluded that Loan 1566-BHU “was instrumental in catalyzing development of new private entrepreneurship; promoting new economic activities; creating employment for the marginalized, particularly women; and helping strengthen the private sector. The PPER will examine the evolution of the private sector in Bhutan during the program period, and during the five years since program completion.

16. The outcomes of the sub-loans made by BDFC will be important to an understanding of the impact of the FSIF. These will be studied in as much depth as possible. In what sectors were the loans made? What was their geographic distribution (concentration in Thimphu)? Decentralization is a current issue in development in Bhutan. The highly centralized financial system may have been a factor in constraining access to credit. What were the sizes of loans and how does this relate to the sizes and characteristics of private firms in Bhutan? What were the collateral requirements for the loans and were they reasonable? The role of women in private sector activities in Bhutan is relevant; and their access to credit will be examined. What has been the experience with repayment? Has repayment varied by sector, for example in the agricultural sector, the industrial sector and the services sector? What were the calculated economic and financial rates of return of the projects at entry and at completion?

17. The PCR stated that subprojects “generated about 1,830 incremental jobs under Loan 1566, well within the targeted level of 1,000 to 2,000 at appraisal”.¹² The PPER will review the basis of this claim of incremental job creation and assess the direct and indirect economic impacts of the subloans. One factor will be the credibility of the allocation of the subloans to

⁹ Footnote 3. Page 12.

¹⁰ Footnote 3. Page 12.

¹¹ For instance ADB TA 3905. (2002) Technical Assistance to the Kingdom of Bhutan for Strengthening the Capacity of the Royal Monetary Authority and the Royal Securities Exchange of Bhutan.

¹² Footnote 3. Page 10.

ADB funds. The PPER team will examine whether the portfolio of subloans under 1566-BHU matches the general portfolio of the Bank, and, in particular, the degree to which it provided microfinance and/or rural loans. The BDFC, being government owned, had a social mandate and was the only organization offering loans for rural development. At the time the Completion Report commented that “BDFC has inadequate risk management functions compared to existing volumes, portfolio structure and best banking practices. BDFC lacks tools and skills for identifying, measuring and controlling and monitoring all types of risk.”¹³

18. The investment loan was drawn down more slowly than expected. This raises the question whether insufficient capital in the participating financial institutions was a significant factor; or was the loan essentially a vehicle for ADB to be able to influence institutional and framework factors in the financial sector, such as inadequate corporate governance and structural/policy problems including the lack of competition and excessive concentration in the public sector?

19. Development aid appears to play a large role as a source of capital for commercial lending in Bhutan. If so aid dependency might be a significant risk factor.

20. The technical assistance provided under TA 2902-BHU will be examined to determine the degree to which it contributed to sustainable institutional strengthening and/or structural reform in the financial sector in Bhutan. There were several significant policy reforms during the FSIF period, including, inter alia, revision of the foreign exchange regulations, liberalization of the interest rate regime, and issuing new regulations on foreign direct investment. Technical assistance was provided to help BDFC improve its capability to undertake credit analysis; and to assist the Bhutan National Bank to upgrade its technology, train staff, improve software and improve the quality of its services. The evaluation team will assess the degree to which the FSIF catalyzed these changes and the momentum with which institutional changes have proceeded since.¹⁴

21. The FSIP raised issues of the weak payments system, the lack of standardized accounting systems and incomplete flows of financial information. The PPER team will assess the degree to which momentum was created for reforms in these areas.

3. The equity investment by ADB in the Bhutan National Bank (EI-7139-BHU)

22. The main effect of the ADB investment in BNB was to change the decision making structure of the Bank, and it may have brought a new perspective to Board deliberations. It also diversified ownership and thereby strengthened the Bank's balance sheet. The evaluation team will investigate the effects of these changes over time, and whether ADB was able to use its position as part owner to influence the behavior of the Bank and also the beliefs and behavior of the key stakeholders in the Bank, which commonly had holdings and influence in other financial and business institutions in Bhutan as well as in BNB.

23. The implications of the quick withdrawal of the other strategic investor, Citicorp, will be examined. The project completion report raises the issue “How can ADB ensure that such a strategic partner, with relevant banking experience, will remain a shareholder for a long time

¹³ Footnote 3. Page 14.

¹⁴ Several TA projects by ADB have been relevant, including TA 3905 that focused on the Royal Monetary Authority and the Royal Securities Exchange.

and thus play an active role in the management and corporate governance of an institution, with long term impact?”¹⁵

24. The PPER team will examine how the ownership structure of BNB has evolved in the past decade, the role that ADB has played, and the issue of expanding private sector ownership and competition in the banking sector in Bhutan. Has ADB's ownership position provided opportunities to influence both the institution and, more broadly, reforms in the financial sector in Bhutan? For example was the BNB more innovative in developing new products to rely less on collateral-based lending after the ownership restructuring?

25. **Identification of lessons for future ADB assistance in Bhutan's financial sector.** IED will also review experience gained from earlier and later assistance to the sector and identify useful lessons and possible follow-up actions. The effectiveness of policy conditions, as well as the combination of policy based assistance with a financial intermediation loan, an equity investment, and a capacity development, will also be assessed.

VI. Resource Requirements and Recusment of Director, IED1

26. The PPER will require about 44 person days of international consulting services in the area of banking and the financial sector. It will also require about 20 person days of local consulting services for the setting up of meetings in Bhutan, establishing of local contacts, and gathering relevant local information. The terms of reference for each of the two consultants are attached as Appendix 3 to this EAP. The budget for the PPER will be charged to IED1. However, as Director, IED1 has recused himself,¹⁶ supervision of this work will be transferred to Director IED2.

VII. PPER Schedule

27. The proposed schedule for the PPER is as follows:

Mission preparation	20–November 2009
Recruitment of consultant	9–13 November 2009
Independent Evaluation Mission	7–14 December 2009
IED Internal review	25 January 2010
Interdepartmental circulation	25 February 2010
Draft to Editor	12 March 2010
Review and approval by Director, IED1	17 March 2010
Submission to Director General, IED	19 March 2020

¹⁵ ADB. 2004. *Project Completion Report on the Equity Investment in Bhutan National Bank (EI 7139)*. Manila. Page 9.

¹⁶ Director, IED1 commented extensively on the concept paper and proposal for this facility, and participated in a mission for the same.

BASIC DATA
Financial Sector Intermediation Facility (Loans 1565-BHU[Sf] and 1566-BHU[Sf];
Equity Investment 7139-BHU)

Program Institution Building					
TA No.	Technical Assistance Name	Type	Person-Months	Amount (\$000)	Approval Date
2902	Capacity Upgrading of Financial Sector Infrastructure and Entrepreneurial Development	AD	13	500	23 Oct 1997

Key Program Data (\$ million)	Appraisal	Actual
ADB Loan Amount—Utilization	4.0 ^a	3.9 ^a
ADB Loan Amount—Cancellation	-	-

Key Project Data (\$ million)		
ADB Loan Amount—Utilization	4.0 ^a	3.8 ^b
ADB Loan Amount—Cancellation	-	9.1 ^c

Key Equity Investment Data (\$ million)	
Approved	0.532 ^d
Subscribed	0.532 ^d

Key Dates	Expected	Actual
Fact-Finding		14-23 January 1997
Appraisal		21-30 July 1997
Loan Negotiations		17-18 September 1997
Board Approval		23 October 1997
Loan Agreement		20 April 1998
Loan Effectiveness	19 July 1998	20 April 1998
Program Loan Tranche Release		
First Tranche	20 April 1998	30 June 1998
Second Tranche	20 October 1999	23 December 2002
Program Completion	30 June 2002	23 December 2002
Loan Closing		
Loan 1565	30 June 2002	23 December 2002
Loan 1566	24 July 2002	9 January 2003
Months (effectiveness to completion)	48	57

Borrower	Government of Bhutan
Executing Agency	Royal Monetary Authority

Mission Data		
Type of Mission	No. of Missions	No. of Person-Days
Fact-Finding	1	36
Appraisal	1	20
Project Administration		
Review	9	31
Program Completion	1	6
Independent Evaluation	1	

AD = advisory, ADB = Asian Development Bank, Nu = ngultrum, SDR = special drawing right

^a Equivalent to SDR2,939,000 at the time of loan approval and closing.

^b Equivalent to SDR2,932,248.23 at the time of loan closing.

^c Equivalent to SDR6,751.77 .

^d Equivalent to Nu22.725 million.

STATUS OF REFORM IMPLEMENTATION AS OF PCR DATE

Policy Measures under the Program Components and Outputs	Program Targets	Status of Implementation
1. Policy Loan First Tranche Release Conditions		
Liberalize the interest rate structure and remove administered sectoral interest rate controls	Allow financial institutions to determine deposit and lending rates, while keeping their interest spreads initially at a maximum of 6% until sufficient Competition exists between financial institutions	Complied with. Interest rates on deposits and advances were fully liberalized effective April 1999. However, Section 10.11.1 of Royal Monetary Authority (RMA) Prudential Regulations of 2002, which took effect 1 July 2002, provides that the deposit and lending rates may be revised from time to time with the approval of the Board of Directors of the financial institution and subsequent RMA approval.
Abolish the requirement for Royal Insurance Corporation of Bhutan (RICB) to provide 10% fixed return on the Government Employees Provident Fund (GEPF)	A formal agreement is to be reached between Government and RICB	Complied. The Government subsidized GEPF to cover the difference as follows: 1998 Nu 15,964,202.04 (08/14/88) 1999 Nu 8,181,088.52 (10/05/99) 2000/01 Nu 54,342,227.00 (09/25/01) Total Nu 78,487,567.56 (\$1,763,021.16 equivalent) <ul style="list-style-type: none">RMA justified the subsidy until 2001 as part of adjustment costsOn 30 March 2000, the National Pension and Provident Fund Bureau (NPPFB) was established with assistance under an Asian Development Bank (ADB) technical assistance (TA) grant. On 3 July 2000, it took over the GEPF operation from RICB.On 8 April 2002, the Government allowed NPPF and the Armed Forces Pension and Provident Fund (AFPPF) to undertake limited financing activities such as loans to the Government and public limited companies, as well as housing loans to the members. The Government promotes both the NPPF Plan and AFPPF.
Clean up Bhutan National Bank's (BNB) nonperforming assets, inherited from the Unit Trust of Bhutan	Cleaning up the loan portfolio should be complete before loan effectivity and ADB's equity investment	Complied with. The Government and BNB signed
Issue and publish policies and regulations regarding foreign exchange transaction-as agreed with ADB.	Move toward current account convertibility for third-country transactions, as agreed with the International Monetary Fund (IMF)	Complied with
Make effective the Commercial Sales of Goods Regulation	To be approved by the Government	Complied with

Policy Measures under the Program Components and Outputs	Program Targets	Status of Implementation
Draft a set of policies and regulations regarding import licensing schemes as agreed with ADB	Policies and regulations to be made public	Complied with. The responsibility for the issuance of licenses for import from third countries was transferred from the Ministry of Finance to the Ministry of Trade and Industry (MOTI) in July 2002. As of 31 July 2003, the following accomplishments were reported: (i) MOTI had issued 3,068 import licenses; (ii) MOTI had registered 390 importers all of which were domestic companies; and (iii) between July 2002 to July 2003, the MOTI had authorized imports worth Nu4.57 billion (roughly \$30 million equivalent), representing an increase of almost 200% from prior period level.
Review current case-by-case approach to foreign investment and move toward developing transparent foreign investment policy and	Actions to be taken by the Government to initiate the policy review process	Complied with
Improve the industrial licensing system and rationalize administrative requirements for industrial locations, pricing, and raw materials as agreed with ADB.	Issue and publish rules and regulations	Complied. Based on available statistics, the total number of industrial licenses issued increased by 221% from 4,115 in June 1997 to 13,199 by June 2002. In addition, the number of trade licenses increased by 134% from 7,045 in June 1997 to 16,465 as of the end of December 2002
2. Policy Loan Second Tranche Release Conditions		
Improve RMA's Prudential Guidelines and strengthen its banking supervision function	Institute a system of fines and penalties for violating prudential guidelines	Complied with. Prudential guidelines were strengthened. A system of fines and penalty clause for violations was incorporated in April 1999. The guidelines were further strengthened with the issuance of RMA Guidelines of 2002, which took effect 1 June 2002. Major changes include a corporate governance framework, more stringent standards for bank supervision, increased provisioning requirement for bad debt, and others.
Develop market infrastructure, including a credit information bureau and an interbank market	Credit information bureau and the interbank market to be operational and self-sustaining	Based on TA 2902 recommendations, there is no need at present to establish a sophisticated credit information bureau because Bhutan's financial institutions have developed an effective system for sharing credit information. Options for an automated credit bureau have been developed and are currently evaluated by RMA. Because Bhutan's financial sector is thin and the system has excess liquidity, TA 2902 observed that an interbank market is not envisaged in the immediate future. RMA can cover liquidity shortfalls at financial institutions for a maximum of 3 days. RMA committed to develop the necessary market infrastructure and regulations for an interbank market, should a liquidity condition so demand.

Policy Measures under the Program Components and Outputs	Program Targets	Status of Implementation
		At the time of the Project Completion Review Mission, the financial institutions, except perhaps Bhutan Development Finance Corporation because of its increasing demand for industrial and agriculture loans, are still experiencing excess liquidity.
Make effective the Real and Personal Property Act, Bankruptcy Act, Negotiable Instruments Act, and amendments to the Companies Act	Being approved by the National Assembly	Complied with. The National Assembly approved in August 1999 the Real and Personal Moveable and Immovable Property Act. The Negotiable Instruments and Amendments to Companies Act were approved in July 2000.
Improve operational efficiency of the payments system	Including branches of commercial banks outside of Thimphu in the clearing and settlement system	Complied with. Based on the recommendation under ADB TA 2902: Capacity Upgrading of Financial Sector Infrastructure and Entrepreneurial Development. Phuensholing clearinghouse established on 3 July 2000.
Issue and publish a set of import licensing regulations as agreed with ADB	Import licensing regulations to be issued and made public	Complied with. The Government approved Rules and Procedures for Imports from Third Countries on 5 June 2001.
Remove any form of government subsidy to GEPF	Restructure GEPF and make it independent	<p>Complied with. However, the Government provided subsidies to GEPF to cover the differences as follows: 1998 Nu 15,964,202.04 (08/14/88) 1999 Nu 8,181,088.52 (10/05/99) 2000/01 Nu 54,342,227.00 (09/25/01) Total Nu 78,487,567.56 (\$1,763,021.16 equivalent)</p> <p>RMA justified the subsidy until 2001 as part of adjustment costs. The government subsidy covering the 10% return on GEPF was removed on 31 December 1999.</p> <p>On 30 March, NPPFB was established assistance under an ADB TA. On 3 July 2000, it took over the GEPF operation from RICB.</p> <p>On 8 April 2002, the Government allowed NPPF and the AFPPF to undertake limited financing activities such as loans to the Government and public limited companies, as well as housing loans to members. The Government promoted and supported both NPPF and AFPPF.</p>

Policy Measures under the Program Components and Outputs	Program Targets	Status of Implementation
Issue and publish policies and regulations regarding foreign direct investment (FDI) as agreed with ADB	Regulation on FDI to be drafted and adopted	<p>Complied with. Council of Ministers approved the FDI policy on 3-December 2002, and the executive order to treat the policy as regulations until it is legislated was also issued on that day. Rules and regulations to operationalize the policy have already been drafted and will be issued soon.</p> <p>MOTI has received some 10 proposals, particularly from India, as a result of the FDI policy. MOTI is currently reviewing the proposals.</p>
3. Conditions for DFI Loan 1566 utilization		
Strengthen the participating financial institutions' (PFIs) organizational structure for project financing and upgrade PFI staff capability in project finance and banking skills	Project finance unit to be set up in each PFI and appropriate procedures to be adopted	Complied with. Only BDFC participated, and it was able to utilize the entire proceeds of the development finance loan (about \$3.82 million equivalent) to finance 281 subprojects, of which 4 were above the free limit. BNB did not utilize the loan as it is still experiencing excess liquidity, and chose to utilize its own funds to finance lending operations.
PFIs are to maintain compliance with all eligibility criteria under the credit line	<p>Any noncompliance to be reported and corrective measure to be taken promptly. Eligibility criteria are the following:</p> <ul style="list-style-type: none"> • Maintain compliance with RMA prudential guidelines as amended from time to time; • Maximum infection ratio of 20%; • Minimum debt service ratio of 1.25 times; and • Minimum return on average assets of 1%. 	<ul style="list-style-type: none"> • Complied with • Partly complied with. Full compliance occurred in 2001 and 2002 • Complied with • Complied with

STATUS OF COMPLIANCE WITH LOAN AND EQUITY INVESTMENT CONDITIONS

A. A. Loan 1565-BHU(SF): Financial Sector Development Program Loan

Covenant	Reference to Loan Agreement	Status
1. The Borrower shall cause the Program to be carried out according to sound administrative, engineering, environmental, and banking practices.	Loan Agreement, Section 4.01 (a)	Complied with
2 The Borrower shall make available, promptly as needed, the funds, facilities, services, land, and other resources required, to carry out the Program, in addition to the proceeds of the Loan.	Loan Agreement, Section 4.02	Complied with
3.The Borrower shall ensure that the activities of its departments and agencies in carrying out the Program are conducted and coordinated according to sound administrative policies and procedures.	Loan Agreement, Section 4.03	Complied with
4.The Borrower shall maintain, or cause to be maintained, records and documents adequate to identify the eligible items financed out of loan proceeds and to record the progress of the Program.	Loan Agreement, Section 4.04 (a)	Complied with
5 The Borrower shall enable the Asian Development Bank's (ADB) representatives to inspect any relevant records and documents referred to in paragraph (a) of this Section.	Loan Agreement, Section 4.04 (b)	Complied with
6.The Borrower shall (i) maintain, or cause to be maintained, separate accounts for the Program; (ii) have such accounts and related financial statements audited annually, in accordance with appropriate auditing standards consistently applied, by independent auditors whose qualifications, experience, and terms of reference are acceptable to ADB; (iii) furnish ADB, as soon as available but not later than 6 months after the end of each fiscal year, certified copies of such audited accounts and financial statements and the report of the auditors relating thereto (including the auditors' opinion on the use of the loan proceeds and compliance with the covenants of this Loan Agreement), all in the English language; and (iv) furnish to ADB such other information concerning such accounts and financial statements and the audit thereof as ADB shall from time to time reasonably request.	Loan Agreement, Section 4.05	Complied with
7.The Borrower shall furnish, or cause to be furnished, to ADB all such reports and information as ADB shall reasonably request concerning (i) the Loan, and the expenditure	Loan Agreement, Section 4.06 (a)	Complied with

Covenant	Reference to Loan Agreement	Status
of the proceeds and maintenance of the service thereof; (ii) the goods financed out of loan proceeds; (iii) counterpart funds and the use thereof; (iv) program implementation, including accomplishment of targets and carrying out actions set out in the policy letter; (v) financial and economic conditions in the territory of the Borrower and the international balance-of-payments position of the Borrower; and (vi) any other matters relating to the purposes of the Loan.		
8. Without limiting the generality of the foregoing, the Borrower shall cause Royal Monetary Authority to coordinate with Ministry of Finance and furnish ADB semiannual reports on the carrying out of the Program, on accomplishments of targets, and carrying out of actions set out in the Policy Letter. Such reports shall be submitted in such form and in such detail and within such a period as ADB shall reasonably request, and shall indicate, among other things, progress made, action proposed to remedy these problems, and a proposed program of activities and progress during the following quarter.	Loan Agreement, Section 4.06 (b)	Complied with
9. Promptly after the closing date for withdrawals from the loan account, but in any event not later than 3 months thereafter or such later date as may be agreed for this purpose between the Borrower and ADB, the Borrower shall cause Royal Monetary Authority to coordinate with MOF and prepare and furnish to ADB a report, in such form and in such detail as ADB shall reasonably request, on the execution of the Program, including its costs, the performance by the Borrower of its obligations under this Loan Agreement, and the accomplishment of the purposes of the Loan.	Loan Agreement, Section 4.06(c)	Complied with.

B. Loan 1566-BHU(SF): Development Finance Loan

Covenant	Reference to Loan Agreement / Project Agreement	Status
The Borrower shall cause each participating financial institution (PFI) to carry out the Project with due diligence, efficiency, and conformity with sound banking, administrative, business, and environmental practices.	Loan Agreement, Section 4.01 (a)	Complied with

Covenant	Reference to Loan Agreement / Project Agreement	Status
The Borrower shall cause, or cause to be furnished, to Asian Development Bank (ADB) all such reports and information as ADB shall reasonably request concerning (i) the Loan, the expenditure of the proceeds and maintenance of the service thereof; (ii) the Project; (iii) the qualified enterprises, the qualified projects and the subloans; (iv) the administration, operations, and financial condition of each PFI; (v) financial and economic conditions in the territory of the Borrower and international balance-of-payments position of the Borrower; and (vi) any other matters relating to the purposes of the Loan. The Borrower shall cause Royal Monetary Authority (RMA) to furnish ADB, within 1 month after RMA's receipt of semiannual progress reports from each PFI, a report on the progress and problems, if any, regarding the utilization of loan proceeds.	Loan Agreement, Section 4.02	Complied with
The Borrower shall enable ADB's representatives to inspect any qualified enterprise, any qualified project, the goods financed out of the proceeds of the Loan, and any relevant records and documents maintained by each PFI.	Loan Agreement, Section 4.03	Complied with
Except as ADB may otherwise agree, the Borrower shall ensure that the PFIs satisfy the following criteria for participation under the project: (i) a minimum annual collection ratio for the total portfolio of 80%; (ii) a maximum portfolio infection ratio of 20%; (iii) a minimum return on average assets of 1% after tax; (iv) a minimum debt service coverage ratio of 1:25; and (v) compliance with RMA's Prudential Guidelines dated May 1995, as amended from time to time.	Loan Agreement, para. 3, Schedule 5	Complied with Noncompliance for 1998–2000. Complied with in 2001 and 2002. Complied with Complied with other than for 1998 Complied with
The Borrower shall cause RMA to maintain separate accounts and records in respect of the imprest account according to consistently applied, sound accounting principles and shall have these accounts and records audited by independent auditors whose qualifications, experience, and terms of reference are acceptable to ADB, in accordance with sound auditing standards. Promptly after their preparation but in any event not later than 9 months after the close of the fiscal year to which they relate, or not later than 6 months after the date of the closing of the loan account, as the case may be, the Borrower shall cause RMA to furnish to ADB certified	Loan Agreement, para. 4 (c), Schedule 5	Complied with

Covenant	Reference to Loan Agreement / Project Agreement	Status
copies of such audited accounts and records all in the English language.		
The Borrower shall cause the PFIs to provide subloans to qualified enterprises for qualified projects which, except as ADB may otherwise agree, meet the following criteria: (i) a maximum long-term debt to equity ratio of 75:25; (ii) the qualified enterprise has a minimum debt service coverage ratio of 1:25; (iii) a minimum financial internal rate of return (FIRR) higher than the weighted average cost of capital (WACC); and (iv) for subloans of more than the equivalent of \$30,000, a minimum economic internal rate of return (EIRR) of 12%.	Loan Agreement, para. 5, Schedule 5	Complied with Complied with Partly complied with. Financial evaluation was not done for small subprojects below free limit primarily due to logistical problems of getting data from the subloan borrowers from far-flung areas. Not complied with. BDFC's industrial and agricultural lending programs have never undertaken any economic evaluation of viability . Technical and institutional capabilities in BDFC are lacking in terms of project viability evaluation.
The Borrower shall cause the PFIs to ensure that the qualified projects comply with the Borrower's environmental regulations and ADB's environmental guidelines.	Loan Agreement, para. 8, Schedule 5	Complied with
The Borrower shall cause the PFIs to monitor and evaluate the benefits of the qualified projects after they have been completed in accordance with a schedule to be agreed upon by the Borrower, the PFIs, and ADB.	Loan Agreement, para. 7, Schedule 5	Complied with. Small subprojects located in difficult-to-reach, far-flung areas were not regularly monitored because the cost of monitoring was greater than the loan amount.
Within 3 years of effective date—or at any date agreed upon by the Borrower, the PFIs, and ADB—a midterm review shall be carried out by the Borrower, the PFIs, and ADB to comprehensively review Project implementation and benefits, as well as to formulate corrective measures appropriate to remedy identified weaknesses and ensure successful project implementation. The Borrower, the PFIs, and ADB Terms shall agree on the terms of reference for the midterm review.	Loan Agreement, para 8, Schedule 5	Complied with

Covenant	Reference to Loan Agreement / Project Agreement	Status
Except as ADB may otherwise agree, all goods and services to be financed out of loan proceeds shall be procured according to the provisions of Schedule 4 to the Loan Agreement.	Project Agreement, Section 2.1 (a)	Complied with
Except as ADB may otherwise agree, all goods and services to be financed out of loan proceeds shall be procured according to the provisions of Schedule 4 to the Loan Agreement.	Project Agreement, Section 2.1 (b)	Complied with
Except as ADB may otherwise agree, the amortization schedule applicable to each subloan (i) shall not exceed 15 years, including grace period, if any, not exceeding 3 years, from the date when such subloan is approved or authorized for withdrawals from the loan accounts, pursuant to Section 2.2 (a) or (b) of this Project Agreement; and (ii) shall provide for approximately equal semiannual agreement payments for principal plus interest.	Project Agreement, Section 2.03 (b)	Complied with
BDFC shall carry out the Project with due diligence and efficiency and in conformity with sound banking, administrative, financial, engineering, environmental, and business practices.	Project Agreement, Section 3.01 (a)	Substantially complied with, but needs improvement
Except as ADB may otherwise agree, BDFC shall not substantially amend its Articles of Incorporation or its Policy Statement.	Project Agreement, Section 3.01 (c)	Complied with
BDFC shall not make a subloan to any qualified enterprise unless such enterprise has at its disposal, or has made appropriate arrangements to obtain as and when required, all local currency funds, including adequate working capital, and other resources which are required to carry out the qualified project in respect of which the subloan is to be made.	Project Agreement, Section 3.02	Complied with
BDFC shall maintain records and accounts adequate to record the progress of the Project and of each qualified subproject (including the cost thereof) and to reflect, according to consistently maintained sound accounting principles, the operations and financial conditions of BDFC.	Project Agreement, Section 3.03	Substantially complied with, but needs improvement. BDFC is particularly constrained by its old management information system (MIS) called MicroBanker, which urgently needs replacement or upgrade.
BDFC shall promptly inform ADB of any condition which interferes with, or threatens to interfere with, the progress of the Project, the	Project Agreement, Section 3.04(b)	Complied with

Covenant	Reference to Loan Agreement / Project Agreement	Status
performance of its obligations under this project agreement, subsidiary loan agreement, or the accomplishment of the purposes of the Loan.		
BDFC shall furnish to ADB all such reports and information as ADB shall reasonably request concerning (i) the Loan expenditure of the proceeds thereof; (ii) the Project; (iii) the qualified enterprises, the qualified project, and the subloans; (iv) the administration, operations and financial conditions of BDFC; and (v) any other matters relating to the loan purposes.	Project Agreement, Section 3.05 (a)	Complied with
Without limiting the generality of the foregoing, BDFC shall furnish to RMA and ADB semiannual reports on subloan implementation, execution of the Project, and operation and management of BDFC within 45 days after the end of each related period. Such reports shall be submitted in such form and in such detail and within such a period as ADB shall reasonably request, and shall indicate, among other things, progress made and problems encountered during the period under review, steps taken or proposed to be taken to remedy these problems, and proposed program of activities and expected progress during the following period.	Project Agreement, Section 3.05 (b)	Complied with
BDFC shall have its accounts and financial statements (balance sheet, statement of income and expenses, and related statements) audited annually, in accordance with appropriate auditing standards consistently applied, by independent auditors whose qualifications, experience, and terms of reference are acceptable to ADB, and shall, promptly after their preparation but in any event not later than 9 months after the close of the fiscal year to which they relate, furnish to ADB (i) certified copies of such audited accounts and financial statements and (ii) the report of the auditors relating thereto (including the auditor's opinion on the use of loan proceeds and compliance with the covenants of this project agreement, and compliance by BDFC with financial covenants under its long-term borrowings), all in the English language. BDFC shall furnish ADB such further information concerning such accounts and financial statements and the audit thereof as ADB shall from time to time reasonably request.	Project Agreement, Section 3.06 (a)	Complied with

Covenant	Reference to Loan Agreement / Project Agreement	Status
BDFC shall enable ADB's representatives to inspect any qualified enterprise, any qualified project, the goods financed out of the loan proceeds, and any relevant records and documents.	Project Agreement, Section 3.07	Complied with
BDFC shall, promptly as required, take all actions within its powers to maintain its corporate existence; to carry on its operations; and to acquire, maintain, and renew all rights, properties, powers, privileges and franchises necessary to carry out the Project or conduct its business.	Project Agreement, Section 3.08 (a)	Complied with
BDFC shall at all times conduct its business according to sound banking, administrative, financial, environmental, and business practices, and under the supervision of competent and experienced management and personnel.	Project Agreement, Section 3.08 (b)	Complied with
Except as ADB may otherwise agree, BDFC shall not (i) sell, lease, transfer, or otherwise dispose of any of its assets, except in the ordinary course of its business; or (ii) establish or acquire any subsidiary.	Project Agreement, Section 3.08 (c)	Complied with
Except as ADB may otherwise agree, BDFC shall not take, or cause to be taken, any action which would have the effect of amending, abrogating, assigning, or waiving any provision of, or any right or obligation of, the BDFC under the Subsidiary Loan Agreement.	Project Agreement, Section 3.09	Complied with.
BDFC shall cause each of its subsidiaries (if any) to observe the obligations of BDFC under this Project Agreement to the extent to which such obligations may be applicable thereto, as though such obligations were binding upon each of such subsidiaries.	Project agreement, section 3.10	Complied with.

C. Equity Investment 7139 – Bhutan National Bank

- (i) BNB has complied with all the covenants under the subscription and shareholders agreement with (i) ADB, (ii) Royal Government of Bhutan, and (iii) Citicorp Investment Bank (Singapore).
- (ii) All BNB's business and operations conform to the charter documents. BNB has complied with requirements for timely submission of semiannual reports as well as audited financial statements. BNB has provided regular reports to its shareholders. ADB's nominee director regularly attends BNB board meetings, and ADB has been represented at shareholders' meetings, and ADB has represented at shareholders' meetings (usually by ADB's nominee director from ADB's Resident Mission in Nepal).

TERMS OF REFERENCE OF INTERNATIONAL AND DOMESTIC CONSULTANT

I. INTERNATIONAL CONSULTANT – BANKING SPECIALIST (35 WORKING DAYS)

A. A. Qualification and Assignment Duration

1. The services of an international consultant are required to join the Independent Evaluation Mission (IEM) for the evaluation of Loans 1565/1566-BHU(SF): Financial Sector Intermediation Facility, the associated technical assistance project (TA) TA 2902-BHU: Capacity Upgrading of Financial Sector Infrastructure and Entrepreneurial Development and Equity Investment (EI) 7139: Financial Sector Intermediation Facility (collectively, the FSIF) and review ongoing Finance Sector Development Program Loan (the FSDP). The consultant will assist the Mission Leader in information gathering and analysis, and in the preparation, drafting and finalization of the program performance evaluation report (PPER).

B. B. Scope of Work

2. The assignment requires a good knowledge of the banking, financial, and private sector in Bhutan (BHU) as well as familiarity with the liberalizing of private and foreign investments, interest rates, bank restructuring approaches, banking supervision issues, interbank market development, private sector financing and financial intermediation, private sector business enterprises, and related capacity building efforts.

3. The consultant will be engaged for a total of 44 working days on an intermittent basis commencing on 19 November 2009 until 19 March 2010, and is expected to join the PPER mission for two weeks in Bhutan, from 7 December 2009 or thereabouts, based on government concurrence to the IEM.

C. Tasks of the Consultant

4. The consultant will be a member of the IEM, and carry out the following tasks in the context of assessing the relevance, effectiveness, efficiency, sustainability, impact, and institutional development impacts of the loans, and associated TA and EI (collectively, FSIF):

- (i) Review the relevant documents including the Report and Recommendation of the President, Loan Agreements, Equity Agreement, TA reports, TA consultant reports, program and project completion reports (PCRs), back-to-office reports (BTORs), minutes of relevant meetings, relevant country assistance program evaluations, and other materials on Bhutan's banking, financial, and private sector environment at the time of loan approval and now; gather country-specific information and data on the financial, banking, and private sector to help analyze the FSIF; collect country-specific data, information, and documentation as relevant or requested by the Mission leader;
- (ii) Based on the initial desk review, prepare questions for the concerned Government entities, BNB management, and private sector enterprises to gather information for the assignments indicated in these terms of reference (TOR);
- (iii) Assess the design of FSIF in terms of the appropriateness for country context, consistency with expected outcomes, the sequencing of program measures and other economic reform efforts, and suitability of approach and phasing of financial and operational bank restructuring measures;

- (iv) Assess achievement of the FSIF objectives and outcomes of the banking and financial infrastructure components of the program, based on indicators provided by ADB;
- (v) Assess achievement of the commercial loans and EI objectives and their outcomes and impact on the market and economy;
- (vi) Verify whether program conditions were met, project conditions fulfilled, and resulting policy changes have stayed in place; and whether other contractual conditions were met and have stayed in place to the extent relevant;
- (vii) Advise Mission leader on possible issues affecting financial sector development;
- (viii) Assist in the identification of remaining policy and institutional constraints that hinder the development of the banking, financial, and private sector, and analyze the impact of these on sector performance;
- (ix) Assist the IEM in arranging meetings with government officials, state banks, other relevant Government institutions, commercial enterprise and relevant private sector entities;
- (x) Advise Mission leader on the contribution of the loans, DFI, and EI to the implementation of FSIF, giving due consideration to appropriateness of TA, DFI, and EI objectives, scope, and design, and their institutional impact and sustainability; and
- (xi) Conduct other related tasks, including preparation of interview notes of the IEM, as necessary, and requested by the Mission Leader.

B. Outputs and Reporting

5. Prepare and submit the questions referenced in (ii) above in time for the IEM; submit a first draft PPER in the required form and including TOR items (iii) to (viii) by the second week of January 2010, mission; submit a second draft PPER report above by the fourth week of January 2010; and assist in finalizing the PPER for circulation in the third week of March 2010.

II. DOMESTIC CONSULTANT – RESEARCH ASSOCIATE (20 WORKING DAYS)

A. Qualification and Assignment Duration

1. The services of a local consultant are required to join the Asian Development Bank's (ADB's) Independent Evaluation Mission (IEM) for the evaluation of Loans 1565/1566-BHU(SF): Financial Sector Intermediation Facility, the associated technical assistance project (TA) TA 2902-BHU: Capacity Upgrading of Financial Sector Infrastructure and Entrepreneurial Development, and Equity Investment (EI) 7139: Bhutan National Bank (formerly called the Financial Sector Intermediation Facility). The consultant will assist the Mission Leader in information/document gathering, review, and analysis, and in the preparation, drafting and finalization of the program performance evaluation report (PPER).

2. The assignment requires a good knowledge of the banking and private sector in Bhutan (BHU). The consultant will be engaged for a total of 20 working days on an intermittent basis commencing on or about 16 November 2009 until 7 March 2010, and is expected to join the IEM for two weeks in Bhutan, from 4 December 2009 or thereabouts, based on government concurrence to the IEM.

B. Tasks of the Local Consultant

- (i) Review Project-related documents such as the Report and Recommendation of the President, and the project completion reports for the sovereign and non-sovereign operations.
- (ii) In consultation with the Team Leader and the International Consultant, collect in-country Project-related data/documents needed to conduct the evaluation.
- (iii) Process and analyze data as may be needed.
- (iv) Facilitate the logistical arrangements required by the IEM, including contacting and liaising, on behalf of the IEM, the appropriate officials in the Government and in the private sector and the arranging necessary meetings with government officials, state banks, other relevant Government institutions, commercial enterprises and relevant private sector entities specifically including the sub-borrowers of Loan 1566-BHU; and
- (v) Perform other tasks as may be required by the Team Leader.

C. Outputs and Reporting

8. The local consultant will be working with the International Consultant and the Team Leader, and will be supervised by the latter. He/she is expected to submit the database, processed tables and graphs/charts (as may be requested by the Team Leader) with appropriate documentation and write-up (as required by the Team Leader) in both hard and soft copies by the end of the IEM.