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Kingdom of Bhutan: Strengthening the Debt Management Capacity of the Department of Aid and Debt Management

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T. A. 4398 – BHU

Strengthening the Debt Management Capacity of the Department of Aid and Debt Management

REPORT OF THE THIRD MISSION

MARCH 2006

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ABBREVIATIONS

ADB	Asian Development Bank
BFA	Budget Fund Account
BOB	Bank of Bhutan
CAS	Country Assistance Strategy
CCM	Council of Cabinet Ministers
CPIA	Country Policy Institutional Assessment
CS-DRMS	Commonwealth Secretariat Debt Recording & Management System
CSP	Country Strategy and Program
DADM	Department of Aid and Debt Management
DPA	Department of Public Accounts
DG	Director-General
DMC	Debt Management Committee
DOD	Disbursed Outstanding Debt
FCA	Foreign Currency Account
FY	Financial Year
GDP	Gross Domestic Product
GNI	Gross National Income
HIPC	Highly Indebted Poor Countries
IMF	International Monetary Fund
MOF	Ministry of Finance
PC	Planning Commission
PDMS	Public Debt Management Specialist
PHRD	Policy and Human Resources Development
PLC	Project Letter of Credit
PPTA	Project Preparation Technical Assistance
PRSP	Poverty Reduction Strategy Paper
PV	Present Value
RCSC	Royal Civil Service Commission
RGOB	Royal Government of Bhutan
RMA	Royal Monetary Authority
TA	Technical Assistance
TOR	Terms of Reference
XGS	Exports of Goods and Services and Non-factor Services

REPORT OF THE THIRD MISSION

INTRODUCTION

1. The mission to Bhutan was undertaken under the Asian Development Bank (ADB) technical assistance (TA) for Strengthening the Debt Management Capacity of the Department of Aid and Debt Management (DADM) (TA 4398-BHU). This was the third mission undertaken by Mr Nihal Kappagoda, Public Debt Management Specialist (PDMS) and took place from January 22 to February 8, 2006. The work of the mission was based principally on the request made by the DADM prior to its commencement to complete the work begun during earlier missions on the preparation of:
    a) A Borrowing Policy and Strategy;
    b) Guidelines for On-lending Borrowed Funds;
    c) Guidelines for the Issue and Management of Guarantees; and
    d) A Loan Manual.

2. During the mission, the terms of reference (TOR) for the Debt Management Committee (DMC) established in February 2005 were revised following discussions with the members of the Committee. The staff position in the Loan Division of the DADM was discussed and the job description for a Database Administrator was prepared for discussion by the Director-General (DG)/DADM with the Royal Civil Service Commission (RCSC). A brief review was carried out on the status of the loan database that is being built up using the Commonwealth Secretariat Debt Recording and Management System (CS-DRMS) software that was installed in the DADM by the Crown Agents in November/December 2005.

3. The PDMS had meetings with the DG, Officiating DG and staff of the DADM, in particular those in the Loan Division. He wishes to thank all the staff of the DADM for the cooperation extended to him. The PDMS also had meetings with the Secretary of the Ministry of Finance (MOF) and Head, Research & Statistics Division of the Royal Monetary Authority (RMA). The PDMS was invited to attend a meeting of the DMC held on February 7, 2006 at which the TOR and policy issues outstanding under the ADB TA were discussed. The PDMS wishes to thank the Secretary for providing this opportunity to dialogue with the members of the DMC. It greatly assisted the finalization of debt policy papers prepared under the TA. The list of persons met during the mission is at Annex 1.

4. It should be pointed out that debt management policies are being formulated in the absence of legislation assigning responsibility for government borrowing, the issue of guarantees and on-lending by the government, and public debt management. It is understood that these responsibilities will be included in the Public Finance Act that is being drafted with a timetable for its enactment by

2008[1]. The two sets of activities should proceed hand in hand to ensure that there is coordination and no potential conflicts in the outputs.

5. The report of the mission will cover the following items:
    a) Current debt situation;
    b) DMC and its TOR;
    c) Borrowing Policy and Strategy;
    d) On-lending Borrowed Funds;
    e) Issue and Management of Guarantees;
    f) Loan Manual;
    g) CS-DRMS software and the external loan database;
    h) Staff situation in the Loan Division; and
    i) Institutional strengthening of the DADM.

CURRENT DEBT SITUATION

6. Total external disbursed outstanding debt (DOD) at the end of the financial year (FY) 2004/05 was $ 607.8 million[2]. Of this amount $372.2 million (61.2 percent) was due in Indian Rupees and the balance $235.6 million (38.8 percent) in convertible currencies. The DOD increased to this level from $291.8 million at the end of FY 2001/02, an increase of over 100 percent in three years. The increase in the convertible currency component was 81.4 percent while that in Indian Rupees was 112.8 percent during the same period due to high disbursements on power projects funded by India.

7. The external debt indicators estimated for the FY 2004/05 show that the DOD to gross domestic product (GDP) and exports of goods and non-factor services (XGS) ratios were 87.0 and 237.1 percent respectively. These two indicators were above the ceilings for severely indebted countries. Using averages for the period 2001-2003, the World Bank estimated the present value (PV) of debt service to XGS and PV to gross national income (GNI) to be 252 and 74 percent respectively. The levels of these indicators also classify Bhutan as a severely indebted low income country.[3] However, the external debt service to XGS ratio was 7 percent for the FY 2004/05 and had been around or under 5 percent in the preceding five years. When this ratio is broken down into Rupee and convertible currency debt for 2004/05, the ratios were 5.8 and 12.2 percent respectively, both of which are at levels for a less indebted country. The stock indicators place Bhutan in the category of severely indebted countries while the debt service ratio does not. However, the convertible currency DOD is mostly on concessional terms while the non-convertible currency debt is owed to India and tied to buy

[1] Good Governance Plus, Office of the Prime Minister, Royal Government of Bhutan, 2005.
[2] RMA Annual Report 2004/05.
[3] Global Development Finance, The World Bank, 2005.

back arrangements for the power generated from the projects funded by these loans.

8. The debt stock to GDP ratio is estimated to increase to 103 percent[4] during FY 2006/07 when the Tala Hydropower project is expected to be completed. The ratio is expected to increase further during FY 2007/08 and decline thereafter based on the assumptions that there would be high economic growth and a reduction in the budget deficits. The debt service ratio is expected to average 15-16 percent during the five years beginning in FY 2005/06. A breakdown by currency shows that the convertible currency debt service ratio is projected to average 18.25 percent while that for Indian Rupees is estimated to average slightly in excess of 15 percent.

9. Debt stock estimates and ratios are incomplete without including domestic borrowing by the government which has increased in the past three financial years. The budget deficit was $79.2 million or 11.3 percent of GDP in 2004/05. Sixty five percent of this deficit was met from domestic borrowing.

10. Fiscal indicators determine the impact of government borrowing on the budget. Of these, one is the government debt service to government revenue ratio. It is similar in concept to the debt service ratio and measures the government's ability to meet its debt service obligations from government revenue. This ratio has been in the range of 5.9 to 12.3 percent in the past three financial years. It is projected to increase to 33.5 percent in 2006/07 when payments for the Tala hydropower project begin. Another is the government debt service to government expenditure ratio. The higher the level of this ratio, the lower the flexibility available to the government to respond to adverse shocks, and vice versa. It has been in the range of 2.9 to 6.4 percent in the past three financial years and is projected to increase to 18.3 percent in 2006/07.

11. The Highly Indebted Poor Countries (HIPC) Initiative is being widened to include countries that were not in the original eligibility list. They are being assessed under the "sunset clause" approved by the G8 countries in 2005. Bhutan falls into this group of the countries and complete debt data has been sought by the World Bank and International Monetary Fund (IMF) to enable them to make a final assessment. These will be completed in time for the Spring Meetings of the International Monetary and Financial Committee of the IMF and the Joint World Bank and IMF Development Committee to be held in April 2006.

DEBT MANAGEMENT COMMITTEE

12. The Debt Management Committee was appointed in February 2005 following a decision taken by the Policy Planning Committee of the MOF. It will serve in an

[4] Country Assistance Strategy for the Kingdom of Bhutan, November 2005, The World Bank.

advisory capacity to the Minister of Finance on public debt issues that require the approval of the Minister and/or the Council of Cabinet Ministers. The mandate of the committee is to review the borrowing plan of the public sector covering both domestic and external debt for each plan period and issues relevant to each year's borrowing plan.

13. The Chairperson of the DMC is the Secretary, MOF. The other members are the DG, DADM; Secretary, Planning Commission (PC); Director, Department of Public Accounts (DPA); Heads, Public Enterprise and Policy Planning Divisions, MOF; Deputy Managing Director (Policy & Programs) and Head, Research & Statistics Division, RMA. The Head of the Loan Division of the DADM functions as the Secretary of the DMC.

14. Discussions on the TOR were held by the DMC in July 2005 and again in February 2006. At these meetings, it was agreed that the activities listed in paragraph 10 should fall within the purview of the DMC. It was further agreed that the mandate of the DMC will be restricted to direct domestic and foreign borrowing by the government for its own use or on-lending and state enterprise and private sector borrowing that is guaranteed by the government. Private sector and state enterprise borrowing from abroad that is not guaranteed by the government will be regulated and monitored by the RMA under its exchange control regulations.

15. It is recommended that only the items marked with an asterisk (*) be adopted by the DMC as its immediate TOR and these are listed in Annex 2. The inclusion of the other items should be a medium to long-term objective to be taken up as staff capacity in the DADM increases. All the items have been grouped under functional headings as follows:

Database and Forecasts

a*) review external debt service and public debt service forecasts prepared by the DADM for a 3-5 year period based on the existing debt outstanding and forecast levels of borrowing;

b) discuss emerging debt service problems that have been brought to the attention of the DMC by the DADM/DPA/RMA;

c) review the data collection procedures for domestic and external loans of the public sector introduced by the DADM/DPA/RMA and for unguaranteed external borrowings by the RMA/DADM periodically to enable the DADM to maintain a database of public sector loans and external borrowings of the country;

Policy

d*) adopt specific targets or benchmarks for various debt indicators such as the ratios of external debt service, present value of external debt service to GDP (or GNI) and XGS, government debt service to government revenue and any other indicators that are included in the borrowing policy for monitoring in the future;

e*) review and recommend the public sector borrowing policy prepared by the DADM/DPA using the targets and benchmarks that have been adopted to the Minister of Finance ;

f) review the loan instruments available for public sector borrowing in the domestic and external market periodically;

g) review the policies, strategies and programs of the largest creditors periodically;

Borrowing Program and Approvals

h*) review and recommend the public sector borrowing program proposed in the Medium-Term Fiscal Framework and the strategy for its implementation to the Minister of Finance;

i*) adopt guidelines for the issue, management and monitoring of government guarantees;

j*) adopt guidelines for lending/on-lending, their management and monitoring by the government;

k) review and recommend public sector borrowings and lending/on-lending by the government (where they are considered necessary due to the size of the loan, policy implications, proposed institutional changes etc.) to the Minister of Finance;

l) recommend annual ceilings for the issue of government guarantees to the Minister of Finance;

m*) review all requests for the issue of government guarantees using the guidelines adopted and make recommendations to the Minister of Finance; and

Reports

n*) approve half yearly/annual Status Reports on Public Debt prepared by the DADM/DPA.

BORROWING POLICY AND STRATEGY

16. It has been the policy of the Royal Government of Bhutan (RGOB) to date to seek external grant funding for projects and programs included for implementation in the Five Year Plans. When it has not been possible to secure grant funding, concessional loans from bilateral and multilateral donors have been sought. In the expectation that concessional loans will decline in the future, the RGOB is formulating a borrowing policy and strategy that will enable it to ensure and maintain debt sustainability.

17. A public sector borrowing policy provides a basis on which the sustainability of the annual or multi-year borrowing plan or ceiling adopted by the government can be assessed. These ceilings could be the annual or multi-year level of gross borrowing or the year-end limits on total debt outstanding. The practice has evolved internationally for debt sustainability to be assessed by choosing a set of debt indicators and adopting a ceiling or range for each based on current levels and the direction in which the government wishes the chosen indicators to change. The policy should also set out the categories of debt that are covered. In addition there are a set of non-quantitative issues that need to be included in the borrowing policy.

Categories of Debt

18. The borrowing ceiling of the government is the maximum amount that the government is authorized by the National Assembly to borrow from all sources to cover shortfalls in cash during the financial year. It is an important instrument of national policy that serves to establish the boundaries of prudent borrowing and provides the government with sufficient flexibility in mobilizing loans.

19. A public sector borrowing plan covering both domestic and external borrowings should include direct borrowing by the government both for its own use and on-lending, guarantees issued by the government for borrowing by state enterprises and the private sector, and borrowing by state enterprises without a government guarantee and the RMA. The preparation of such a plan would require information on the investment plans of state enterprises in addition to those of the government. However, when a government borrowing plan is formulated for approval by the National Assembly, only direct borrowing by the government will be included. Other borrowings will not be included as there are no corresponding expenditure items included in the budget for financing. The Minister of Finance should also report the status of guarantees outstanding to the National Assembly periodically as they are contingent liabilities of the government.

20. Other public sector external borrowings and private nonguaranteed external debt should be regulated by the RMA under the provisions of the Foreign Exchange Regulations. These borrowings need to be monitored as the limits placed on government borrowing by the National Assembly will not be adequate for the management of the total external debt of the country.

Debt Indicators and Ceilings

21. The ability of a country or government to service debt depends on the existing debt burden and the projected deficits of the balance of payments and budget, the mix of loans and grants in future financing arrangements, and the build-up of its repayment capacity assessed by the growth in GDP or GNI, XGS and government revenue. In addition, the quality of the country's policies and institutions and exogenous shocks to the economy also influence its ability to service its debts. Some conceptual and definitional issues relating to the use of indicators that are discussed in Annex 3.

22. There are many indicators used to assess a country's indebtedness and the sustainability of its debt. From among these, the following are recommended to the DMC for inclusion in Bhutan's borrowing policy along with the thresholds for each.

a) The ***Debt Service Ratio*** is the proportion of XGS that is absorbed for external debt service payments, i.e., interest, principal and other debt related payments. The basic ratio refers only to long and medium-term debt including repurchases from the IMF. It covers all loans with an original maturity of one year and more. This ratio is relevant for the total external debt of the country.

The ratio was 7 percent in 2004/05 and is projected to increase when payments for the Tala power project begin when it is commissioned. It is recommended that the ceiling for this ratio be kept at 25 percent until the Tala debt service payments are completed after which the ratio should be gradually reduced. The recommended ceiling is the threshold for the indicator for a country that is judged to be a strong performer on the basis of the Country Policy Institutional Assessment (CPIA)[5] conducted for Bhutan in 2004.

b) The ***PV of Debt Service to GNI Ratio*** compares the current cost of future debt service obligations to the overall level of economic activity in the country. Only the current year's PV is compared to the average GNI of the current and the two preceding years. This ratio is relevant for the total external debt of the country and public and publicly guaranteed debt (or government and government guaranteed debt).

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[5] Debt Sustainability and Financing Terms in IDA 14: Further Consideration of Issues and Options, IDA, November 2004.

The latest World Bank estimate of this indicator for Bhutan is 74 percent and is projected to rise. It is recommended that the ceiling for this indicator be kept at 50 percent which is the threshold for a country judged to be a strong performer on the basis of the CPIA[6] in 2004.

c) The ***PV of Debt Service to XGS Ratio*** compares the current cost of future debt service obligations to the capacity of the country to generate foreign exchange receipts. Only the current year's PV is compared to the average XGS of the current and two preceding years. This ratio is relevant for the total external debt of the country.

The latest World Bank estimate of this indicator is 252 percent and is projected to increase. It is recommended that the ceiling for this indicator be kept at 200 percent which is the threshold for a country judged to be a strong performer on the basis of the CPIA[7] in 2004.

d) ***Government Debt Service to Government Revenue Ratio*** is similar in concept to the debt service ratio and measures the government's ability to meet its debt service obligations from government revenue. This ratio is relevant for government and government guaranteed debt (or public and publicly guaranteed debt).

This ratio has been the range of 5.9 to 12.3 percent in the past three financial years. It is projected to increase to 33.5 percent in 2006/07 when payments begin for the Tala hydropower project. It is recommended that the ceiling for this indicator be kept at 40 percent which is the threshold for a country judged to be a strong performer in the CPIA for 2004[8]. Once the Tala payments are completed the ceiling for this indicator should be gradually reduced.

e) The ***PV of Debt Service to Government Revenue Ratio*** is similar in concept to c) above and compares the current cost of future debt service obligations to the government's ability to meet them from government revenue. This ratio is relevant for government and government guaranteed debt (or public and publicly guaranteed debt).

It is recommended that the ceiling for this indicator be kept at 200 percent which is the threshold for a country judged to be a strong performer in the CPIA for 2004[9].

23. It is understood that IMF and World Bank are revising the threshold values of some of the debt indicators in the context of the analysis that is being done to

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[6] Ibid footnote 6.
[7] Ibid footnote 6.
[8] Debt Sustainability in Low Income Countries: Proposal for an Operational Framework and Policy Implications by Mark Allen and Gobind Nankani, IMF and IDA, February 3, 2004.

[9] Ibid footnote 9.

a) judge the eligibility of an expanded list of countries for assistance under the HIPC Initiative and b) determine the implications of the Multilateral Debt Relief Initiative that was endorsed by the G8 countries in 2005. This work is expected to be completed by the time of the Spring Meetings of the committees of the IMF and World Bank. The thresholds that have been proposed in this paper should be revisited when these documents are available.

24. It is not possible for the DADM to estimate the present value of debt service. This will change once the loan database is completed and the CS-DRMS software becomes fully operational. Until then, the nominal value of debt stock, i.e., DOD, should be used for the debt indicators that require the PV of debt service to be estimated. There is no difference between GNI and GDP in Bhutan. When the borrowing plan or ceiling of the government is being formulated, it is recommended that the levels of the PV/GDP, PV/Government Revenue and Debt Service/Government Revenue ratios be estimated to determine debt sustainability. When the loan database is built up, similar indicators could be estimated for government and government guaranteed debt and public and publicly guaranteed debt. In addition to these, the DMC should periodically monitor the Debt Service/XGS and PV/GDP for the total external debt of the country.

25. The use of debt indicators for formulating a borrowing policy and plan has some shortcomings. The critical levels of the debt indicators are based on empirical inter-country studies and are essentially static in nature. A country's annual borrowing requirements should be estimated in the context of both the short-term liquidity needs and long-term development objectives. Liquidity constraints could arise on account of a crisis due to unforeseen external and domestic situations affecting the country. These have to be accommodated without sacrificing the long-term objectives and prejudice to debt sustainability judged on projected levels of debt indicators.

Other Issues

26. It is important for any borrowing policy and plan that loan funds be used for high priority development activities that are productive or to build essential social and physical infrastructure. Individual borrowing decisions should be based on the prudent choice of projects and programs to be funded with borrowed funds. The DMC has been requested to prepare guidelines[10] for the selection of projects and programs for external financing. The financial or economic rates of return should be adequate to generate surpluses to make debt service payments.

[10] Ibid footnote 1.

27. Arrears on debt service payments could accumulate due to bad loan and investment decisions even though the borrowing is within the approved ceiling. These will be closely monitored by the DADM particularly in the case of borrowings by state enterprises and the private sector that are guaranteed by the government and timely corrective action recommended to the DMC.

28. Technical arrears should not be allowed to arise due to delays in making debt service payments. Further, a policy should be adopted to prevent the accumulation of domestic arrears by the government. It will include a ceiling for the total value of arrears that could be accumulated and the maximum period that could elapse after which they should be cleared or converted to medium-term debt.

29. The borrowing policy will not be complete without monitoring the implementation of public sector loans and guarantees issued by the government. Borrowings are made and guarantees issued on behalf of the government by the MOF and it is accountable to the lender. The extent to which the MOF becomes involved depends on the effectiveness of monitoring activities of the supervising Departments and Ministries. The activities of the DADM on loan and project monitoring should be strengthened if this is found to be necessary.

30. Guidelines have been prepared on On-lending Borrowed Funds and the Issue and Management of Guarantees. These are in the two succeeding sections and are an integral component of the government's borrowing policy.

Implementation Strategy

31. The Public Finance Act that is being prepared in Bhutan should stipulate that the total amount of government borrowing will be established annually when the Annual Budget is approved. It is possible that there could be separate legislation that sets borrowing ceilings that are revised from time to time. Typically, this total should include the external and domestic debt of the government. The Minister of Finance will present the borrowing ceiling with a breakdown into domestic and external ceilings for approval when the budget is presented. The government will not be required to seek approval for individual loans from the National Assembly once the annual ceiling is established and the borrowings are within the approved ceiling.

32. It is necessary to be clear whether the annual borrowing ceiling relates to new commitments or anticipated disbursements from past and new borrowing. The latter adds to the stock of DOD. From an operational point of view, it is easier to manage an annual ceiling through new commitments than anticipated disbursements which are difficult to control even for program or balance of payments loans. However, the budget deficit is financed through actual

disbursements. The staff of the DADM and DPA should be clear about the nature of the ceiling adopted for the management of new borrowings.

ON-LENDING BORROWED FUNDS

Why is On-lending Necessary?

33. Public sector borrowers outside the government often seek the assistance of the government when direct borrowing for projects and programs is difficult or not possible. Direct borrowing with a government guarantee is another modality available that is sometimes preferred as it does not increase the level of government debt. There are cost advantages to the borrower in both methods though it is easier for the government to monitor loan utilization in the case of on-lending. However, the level of government debt outstanding increases.

34. The legal basis for the on-lending operations of the government should be included in the Public Finance Act that is being drafted (or other legislation on public sector borrowing). The procedures that need to be followed for the approval of government on-lending and monitoring of performance should be described in the supporting regulations. The principal basis for the decision to on-lend funds is that the completed project or program would generate adequate revenue to make debt service payments without a government subsidy. This requirement may be modified in the case of social infrastructure, environmental protection and some physical infrastructure and other projects assigned national priority.

Terms and Conditions

35. The DADM should set out the terms and conditions for on-lending in a subsidiary agreement to be negotiated with the institution used to channel on-lent funds. They should reflect the conditions for on-lending that are imposed on the government by the lender fully.

36. The repayment period normally stipulated for on-lending depends on the repayment capacity of the project as determined in the feasibility study. In principle, the repayment period should not exceed that in the agreement between the government and the lender. Further, where the government borrows under commercial conditions and on-lends to an intermediary institution for making

sub-loans, the applicable rate of interest should be the interest and fees payable to the lender by the government plus an annual domestic on-lending fee.

37. A preferential rate of interest may be charged for projects such as those in the social sector, that protect the environment and for reconstruction following natural disasters. For reasons of transparency the subsidies implicit in the preferential rates should be estimated and provided explicitly in the budget. The risks arising from exchange rate fluctuations should be borne by the ultimate borrower.

38. The institutions through which government loans are on-lent should take full responsibility for the management of the individual loans that are extended by them. They should be required to provide periodic reports on the implementation of the projects/programs financed by them to the DADM. Similarly, each borrower should be required to submit reports on implementation to the on-lending agency. These and data collected through supervision of the loans by the relevant on-lending agency will provide the basis for the periodic reports submitted by it to the DADM.

39. Debt service payments are made by individual borrowers to the on-lending agency which transfers them to the DADM. In case of default, the on-lending agencies should take the measures necessary to recover the funds from the borrower based on the agreement signed with the borrower and the current laws of Bhutan. Persistent defaulters should be reported to the government through the DMC for guidance on future requests for on-lent funds from this agency.

Guidelines

40. Based on the review of existing arrangements for on-lending and the proposals made in the preceding section, it is recommended that the following guidelines which should be included in the regulations when the Public Finance Act is approved should be adopted by the DMC and implemented.

    a) Borrowed funds could be on-lent to enterprises for their use or lending to a multitude of borrowers;

    b) An institutional analysis of the agency to which loan funds are on-lent should be undertaken to assess its capacity to utilize them efficiently. This should be done by the DADM if the project/program appraisal prepared by the lender does not cover it adequately. A request for TA for institutional strengthening should be made to the lender if this is judged to be necessary at the time that the loan request is made. Coordination between the DADM and supervising Ministry will be necessary for this institutional analysis;

c) The intention to on-lend should be set out in the memorandum prepared by the DADM when seeking approval of the external borrowing and for the on-lending from the Minister of Finance. The memorandum should also set out the risks of on-lending such as weakness in the institutional capacity of the executing agency and any action proposed to rectify this explicitly;

d) On-lending agreements should be signed between the DADM on behalf of the MOF and borrower setting out the on-lent amount, terms of repayment, disbursement procedures, debt service payment arrangements, penalties in case of default, need for the exchange rate risk to be borne by the ultimate borrower and reporting requirements;

e) The DADM should take responsibility for ensuring that these agreements are concluded when the agreement for the external borrowing is signed or within the period permitted for the loan to be declared effective. The only exceptions should be the loans for the power projects for which different procedures currently prevail;

f) Operational procedures should be set up to monitor performance through periodic reports by the recipient of on-lent funds and other methods such as participation in project/program steering committees. The subsidiary loan agreement should provide for adequate reporting where periodic reports to the lender are judged to be inadequate; and

g) Complete documentation on on-lending agreements concluded in the future should be maintained in the DADM.

ISSUE AND MANAGEMENT OF GUARANTEES

The Need for a Guarantee Policy

41. There has been limited use of the guarantee instrument in Bhutan. It is timely for the RGOB to formulate guidelines for the issue and management of guarantees in the expectation that more of this instrument will be issued in the future. They will assist the borrower to obtain more concessional terms than would otherwise be possible. When a payment guarantee is issued, the guarantor takes on an obligation to pay some or all of the principal amount of the debt and accrued interest if the borrower defaults. The guarantor in turn should have a receivable, i.e. the guarantee premium or fee, with possibly some collateral provided by the debtor.

42. Government guarantees are normally given only for borrowings by state enterprises but there are instances where governments have found it necessary to guarantee borrowings by the private sector for public policy reasons. Government guarantees required by joint enterprises between private firms and state entities should be limited to the share of the state entity in the enterprise. The government could provide a guarantee for the whole loan although this is not the usual practice. Problems have arisen in the case of guarantees issued for borrowings by state enterprises that were subsequently privatized. The nature of these guarantees should be clarified when the enterprises are privatized.

43. The issue of guarantees for borrowings allows the government to achieve a range of policy objectives such as reviving ailing sectors of the economy and export promotion. Guarantees have many advantages. These are that a guarantee:
    - is a more attractive option fiscally than the government obtaining a loan to finance a project and on-lending the proceeds. The government avoids building up its debt by providing a guarantee. This factor is more important in the case of larger borrowing requirements;
    - improves the flexibility of the borrowing options as the loan could be tailored to reflect the borrower's needs regarding the maturity and terms of repayment; and
    - offers spin-off benefits, particularly with large-scale projects by bringing the borrowers into direct contact with the lenders providing direct and quick access to new financing arrangements and market instruments.

Terms and Conditions

44. An effective guarantee policy requires a thorough assessment of projects and programs for which guarantees are requested followed by the rejection of all those that are judged to be non-viable. This should be undertaken by the DADM – in collaboration of the supervising Ministry - by reviewing the appraisal prepared by the lender meticulously prior to issuing the guarantee. The purpose of these assessments is to evaluate the prospects of the beneficiary generating adequate income to repay the loan. The government should consider the alternative of borrowing and on-lending the funds by comparing the costs and risks of issuing a guarantee with that of on-lending before a decision is made.

45. The guarantee transfers all or part of the risk of default from the borrower to the guarantor, and entails a cost to the government. Although guarantees do not always require payment, they demand careful management, accounting and administration. Payments arising from default by borrowers may disrupt the fiscal balance when the total amount of guarantees is large. Adequate provision for these debt service payments has to be made in the budget or resources have to be diverted from government programs to meet them if they arise.

46. Three agreements have to be negotiated when government guarantees are issued. The *first* is the loan agreement between the lender and the borrower, the *second*, the guarantee agreement between the lender and the government, and the *third*, the agreement between the government and the borrower setting out the conditions under which the guarantee is issued.

47. Governments must manage each guarantee actively as soon as it is issued and undertake risk analyses on a regular basis when the underlying market conditions change as the levels of risks vary from one project to another. There should be regular consultations between the guarantor and borrower in the case of large guarantees. The borrower should inform the guarantor of an impending default and provide all the relevant financial information before notification from the lender. The lender will call the guarantee in the event of a payment default and notify the guarantor.

48. The total amount of government guarantees issued each year should be within a ceiling set by the DMC and approved by the Minister of Finance. The MOF should have the responsibility for the issue of guarantees for domestic and external borrowings of the public sector and should issue them after obtaining the approval of the Minister of Finance. The processing of documents and other formalities required for the issue and management of guarantees should become the responsibility of the DADM which should also maintain full records of each guarantee.

49. Agencies receiving government guarantees should pay the MOF a guarantee fee up front into a Special Fund. This should cover the *administrative* cost of processing and monitoring the guarantee and the *risk of default* of the loan in question. In addition, the government should make an annual appropriation in the budget of a given percentage of government guarantees outstanding as loan loss provisions. The Fund which is made up of guarantee fees and loan loss provisions should be used only to make debt service payments on guaranteed loans that are in default. Surpluses in the Special Fund should be invested in short-term instruments, at the discretion of the government, and the proceeds used for budget support. Supplementary provision should be sought from general revenue in the event of a shortfall of funds to make debt service payments on loans in default.

Guidelines

50. It is recommended that the following guidelines for processing guarantee applications, managing and monitoring their performance and ensuring that debt service payments are made from the government budget in case of default be adopted by the DMC and included in the regulations that will be drawn up to implement the Public Finance Act:

    a) An institutional analysis of the agency to which a loan guarantee is to be provided should be undertaken to determine its capacity to use the loan

funds efficiently. This should be done by the DADM in collaboration with the supervising Ministry by reviewing the appraisal report prepared by the lender;

b) The DADM should process the application for a guarantee for approval by the DMC and Minister of Finance. The memorandum should set out the risks in issuing the guarantee. The MOF should issue the guarantee through the DADM after obtaining this approval;

c) A guarantee agreement should be signed between the DADM and borrower and include,

- the amount of the guarantee and form of the security that the borrower provides;
- the procedures that the borrower follows on receipt of the invoice for debt service payment from the lender;
- the periodic reports required from the borrower;
- the procedure for the payment of the guarantee fee to the MOF prior to the issue of the guarantee; and
- the procedures to be followed in the case of default.

d) The DADM should take responsibility for ensuring that the guarantee agreement is signed at the time that the agreement for the external borrowing is concluded;

e) Operational procedures should be set up to monitor performance through periodic reports and other modalities to ensure that the loan funds for which guarantees are issued are used for the intended purpose as required in the guarantee agreement;

f) The total amount of government guarantees issued each year should be within the ceiling that is set by the DMC upon recommendation from the DADM and approved by the Minister of Finance. Any revisions to this ceiling should be consistent with the overall fiscal and monetary objectives of the government; and

g) Full records of guarantees issued by the MOF should be maintained in the DADM.

LOAN MANUAL

51. Projects and programs that are included in the Five Year Plan for implementation during the Plan period are selected through a consultative process between the PC, MOF and development Ministries and Departments. They are included in the Plan at an early stage of development. There is no formal process of project or program preparation thereafter such as would be required if an Investment Program is prepared for a medium-term period. Instead, their further development is dependent on the decision to seek loan or grant funds for their implementation.

52. The purpose of the Loan Manual which is at Annex 4 is to introduce the staff involved in loan operations in the DADM to the various steps in the loan cycle that Bhutan goes through when borrowing from abroad[11] for a project or program and the procedures that have to be followed for their utilization and repayment. It is a supplement to the draft Aid and Debt Management Manual that has been under development in the DADM for a number of years.

STAFF POSITION IN THE LOAN DIVISION

53. There were four Programme Officers in the Loan Division in 2003. They were responsible for loan operations (mainly the Front Office functions of a Debt Office) and ad hoc debt management activities. A senior accountant was responsible for initiating action on government external debt service payments and recording loan transactions data in Excel spreadsheets. Since then, one Programme Officer has gone abroad for post-graduate studies. The numbers of loans on which transactions are taking place have increased from 40 to 48 loans. The senior accountant has been provided with the support of two Programme Assistants to deal with loan transactions.

54. The information technology environment in the DADM has changed with the acquisition of the Commonwealth Secretariat Debt Recording and Management System (CS-DRMS) software for loan and grant recording. The software is centrally maintained by the Commonwealth Secretariat in London and upgraded frequently. It is used in some 55 countries world wide. It is important that the investment made by the DADM be safeguarded by the appointment of a System/Database Administrator to the staff. It is recommended that this appointment be made as soon as possible by utilizing the vacant post of Data Manager in the cadre of the DADM. The Administrator should have experience

[11] The cycle for domestic borrowing is different.

in database and systems maintenance, be capable of ensuring that all the staff members of the DADM are fully conversant in the use of the debt management software and provide technical advice to them when required. This officer should establish close links with the Crown Agents and Commonwealth Secretariat - the providers of maintenance support - and CS-DRMS users in the MOFs in other South Asian countries.

55. The Administrator when appointed should perform the following duties:
    a) Maintain the debt management software for debt recording and analysis;
    b) Maintain the data base of public sector debt, ensure that the data is backed up periodically and stored in a safe environment, and implement a system recovery plan;
    c) Analyze public sector debt data using the CS-DRMS software particularly its management tools for debt analysis;
    d) Prepare periodic loan portfolio analyses and annual Status Reports on Public Debt;
    e) Ensure that the hardware, the local area network and links established to use the debt management software are kept operational at all times;
    f) Liaise with the Crown Agents and Commonwealth Secretariat on software inquiries by the staff where necessary;
    g) Train and assist the staff in the use of the debt management software and production of reports
    h) Format tables on public sector debt in consultation with the relevant staff to meet the reporting requirements of the RGOB and international financial institutions;
    i) Keep abreast of developments in information technology that will have an impact on the debt management software;
    j) Liaise with systems staff in other agencies (MOF, DPA and RMA) that may be provided "read only" access to the loan database;
    k) Ensure network and database security and guard against unauthorized access by establishing procedures recommended by the software developers; and
    l) Be fully conversant with all the User and System Administration Manuals that were provided by the software suppliers.

    Tasks c) and d) should be undertaken in close collaboration with the other staff of the Loan Division.

56. As stated in the report of the Second Mission prepared in August 2005, it is recommended that a Debt and Risk Management Analyst be appointed to the Loan Division to assist the Head to service the immediate and future activities of the DMC. The job description for this position should be:

    a) Record and analyze public sector debt using the debt management software particularly its management tools for debt analysis;
    b) Prepare periodic loan portfolio analyses and annual Status Reports on Public Debt;

c) Estimate various debt variables and indicators such as the currency mix and share of foreign debt, maturity profile of the loan portfolio, and ratios of external debt service to XGS, government debt service to revenue and total public and external debt to GDP for consideration by the DMC to assess the evolving public debt situation;
d) Prepare a draft public sector borrowing policy for review and approval by the DMC and report annually on performance;
e) Prepare an annual borrowing plan and implementation strategy in consultation with the other staff of the Loan Division for review and approval by the DMC;
f) Assess the risks to the loan portfolio and recommend the necessary risk management activities;
g) Establish a system for the estimation and monitoring of debt related contingent liabilities and;
h) Prepare periodic reviews of the policies and procedures for the issue of government guarantees and on-lending and their monitoring.

It is recommended that the creation of a new position with this job description should be negotiated with the RCSC as soon as possible.

INSTITUTIONAL STRENGTHENING FOR DEBT MANAGEMENT

57. The ADB provided TA to the DADM to strengthen its capacity for external debt management. The first project was implemented in 2003 and the second during 2004-06. Staff members of the DADM were introduced to concepts of debt management through interaction with the consultants and training provided during implementation. The topics covered were the Requirements for Establishing a Loan Database, Functions and Objectives of Debt Management, Borrowing Policy and Strategy for Implementation, On-lending Borrowed Funds, Issue and Management of Guarantees, and Legal and Regulatory Framework for External Debt Management.

58. In addition to the training obtained under the ADB technical assistance, funding was received from the World Bank and Denmark for capacity building in the DADM. ADB financing was also utilized to purchase the CS-DRMS debt management software to enable databases to be built up on domestic and external debt. Separate modules are available in the software to build up these databases and for grants received. Management tools available in the software will assist staff members of the DADM to undertake periodic debt analysis when the loan database has been completed. Training in the use of the software was provided to the staff at the time of installation.

59. Following a recommendation made at the beginning of the second ADB TA a DMC was set up under the chair of the Secretary of Finance. This has already being dealt with in the section on the DMC and its TOR.

60. These institutional strengthening activities have prepared the DADM to take responsibility for external debt management. It is expected that with the addition of the staff members recommended in this report and their training, the DADM will be geared to perform the debt management tasks that are assigned to it in collaboration with and support from the departments that play a role in public sector loan operations and management.

CS-DRMS SOFTWARE AND THE LOAN DATABASE

61. Staff of the DADM began entering the loan data following the installation of the CS-DRMS software. There was an expectation that the database would be completed by the time the PDMS began his mission on January 23, 2006. Unfortunately this had not been realized partly due to the absence of two staff members on overseas training and the lack of specific work allocations relating to the database to the staff. These issues were dealt with during the mission by the Head of the Loan Division and when the PDMS left Thimphu on February 8, 2006 work was progressing towards the completion of the database by the end of February. Staff members were making e-mail inquiries from the consultant who installed the software when they faced specific difficulties relating to the use of the software and he was responding to them.

62. Once the database is completed, further training is necessary to consolidate the benefits to be derived from the procurement of CS-DRMS as only the basic training was done at the time of the installation. Once the database is completed, the services of a CS-DRMS consultant should be obtained to undertake the following activities:
    a) monitor the remaining data entry if the database had not been completed by the end of February, 2006 and provide additional training to staff as required;
    b) audit the database after completion of data-entry;
    c) train the staff in the use of the Report Writer;
    d) train the staff in the use of the Projects and Disbursements module; and
    e) train the staff in the use of Management Tools in the software.

63. The time required for item (a) will depend on the status of the database at the end of February 2006, staff assigned responsibility for maintaining the database and extent of training they received during the software installation. Item (b) will take a maximum of three weeks and the exact time period will depend on the extent of trouble shooting required. Items (c), (d) and (e) will take one week each. While the report writing course would have to done by a systems consultant, the other training could be done by the consultant who installed the software or a person with similar capabilities.

ANNEX 1

PERSONS MET

Ministry of Finance

- Aum Yanki Wangchuk, Secretary

Department of Aid and Debt Management

- Mr Sonam Wangchuk, Director-General
- Mr Pema Chewang, Officiating Director-General
- Mr Ugyen Norbu, Chief Programme Officer, Loan Division (LD)
- Mr Tshewang Norbu, Deputy Chief Programme Officer, LD
- Mr Tshering Tenzin, Senior Programme Officer, LD
- Ms. Ugyen Lhamo, Assistant Data Manager
- Ms. Tashi Choden, Assistant Data Manager

Royal Monetary Authority

- Rizin Lhamu, Head, Research and Statistics Division

Debt Management Committee

- Secretary, MOF; Director-General, DADM; Secretary, Planning Commission; Director, DPA; Heads of the Public Enterprise and Policy Planning Divisions, MOF; Deputy Managing Director (Policy & Programs) and Head, Research & Statistics Division, RMA.

ANNEX 2
TERMS OF REFERENCE OF THE DEBT MANAGEMENT COMMITTEE

The DMC was appointed to serve in an advisory role to the Minister of Finance on public debt issues. Its broad mandate is to review the borrowing plan of the public sector covering both domestic and external debt for each plan period and issues relevant to each year's borrowing plan.

The Chairperson of the DMC is the Secretary, MOF. The other members are the DG, DADM; Secretary, PC; Director, DPA; Heads of the Public Enterprise and Policy Planning Divisions of the MOF, Deputy Managing Director (Policy & Programs) and Head, Research & Statistics Division of the RMA. The Head of the Loan Division in the DADM functions as the Secretary of the DMC.

The TOR of the Committee that should be adopted for immediate action are the following:

a) review external debt service and public debt service forecasts prepared by the DADM for a 3-5 year period based on the existing debt outstanding and forecast levels of borrowing;

b) adopt specific targets or benchmarks for various debt indicators, e.g., the ratios of external debt service, present value of external debt service to GDP (or GNI) and XGS, government debt service to government revenue and any other indicators that are included in the borrowing policy for monitoring in the future;

c) review and recommend the public sector borrowing policy prepared by the DADM/DPA using the targets and benchmarks that have been adopted to the Minister of Finance**;**

d) review and recommend the public sector borrowing program proposed in the Medium-Term Fiscal Framework and the strategy for its implementation to the Minister of Finance;

e) adopt guidelines for the issue, management and monitoring of government guarantees;

f) adopt guidelines for lending/on-lending, their management and monitoring by the government;

g) review all requests for the issue of government guarantees using the guidelines adopted and make recommendations to the Minister of Finance; and

i) approve half yearly/annual Status Reports on Public Debt prepared by the DADM/DPA.

The TOR will be expanded to include the other items listed in the main report when the staff strength of the Loan Division of the DADM is increased.

ANNEX 4
DEBT INDICATORS: DEFINITIONS AND CONCEPTUAL ISSUES

Judging debt sustainability using debt indicators raises a number of conceptual and definitional issues. These are the types of debt that are to be included in the stock of debt; the measurement of debt burden and debt service payments i.e. the numerator in the debt ratios; repayment capacity, i.e. the denominator in the debt ratios; and the choice of thresholds for the selected ratios.

Three measures of debt burden are normally considered. The first is the nominal stock of debt expressed in a single currency, typically the US dollar. The second is the stock of debt measured in PV terms by discounting the future stream of debt service payments by a series of discount rates relevant to the principal currencies in which the borrower is indebted. The third is the annual or multi-year payments due on debt service. The nominal stock of debt and debt service payments were the preferred measures of debt burden until the early 1990s after which the World Bank, IMF and the Paris Club began to use the PV of debt.

Debt service payments crowd out other high priority claims on resources, both external and domestic. Consequently, current debt service ratios are an indication of present payment difficulties. Low current ratios may mask future problems of high debt stocks due to grace periods and long repayment periods. Projections of debt service ratios also need to be reviewed. The PV of debt is able to capture the concessionality of outstanding debt obligations but takes no account of the growth in repayment capacity that would be captured by projections of debt service ratios.

GDP or GNI is used to measure capacity to make debt service payments and estimate debt indicators. Although it measures the size of the economy, it does not translate into a capacity to pay through exports of goods and services. Exports earnings on the other hand are available to make debt service payments but the ability of the government to utilize them is dependent on the openness of the economy. The usefulness of export earnings as a measure of the capacity to make debt service payments would also depend on scope of debts included in the stock, i.e., total external debt or public and publicly guaranteed debt. Government revenue is a third measure that should be considered for measuring capacity to repay public and publicly guaranteed debt.

Once the indicators are selected it is necessary to determine threshold values that would enable countries to be classified by their state of indebtedness. After the debt crisis of 1982 the World Bank began classifying countries as highly indebted, moderately indebted and less indebted using four external debt indicators. These were the ratios of the nominal stock of external debt to GDP and XGS, and the debt service and the interest payments to XGS. Thereafter, the nominal stock of external debt was replaced by the PV of external debt in the two stock indicators in the early 1990s. More recently, in the context of developing a framework for allocations under IDA 14, threshold values were proposed based on the CPIA for

three indicators, i.e., PV/GDP or GNI, PV/XGS and Debt Service/XGS. Two other indicators, i.e., PV/Government Revenue and Debt Service/Government were also discussed but not included in the group of indicators for making decisions on allocations under IDA 14.

ANNEX 3
LOAN MANUAL
LOAN CYCLE AND AGENCIES INVOLVED

INTRODUCTION

The loan cycle for each lender will defer depending on whether the source is bilateral, multilateral, commercial bank, capital market or some others. There is common ground in the steps that need to be taken and the process involved for these to be described in a single document which will identify the agencies within and outside the government that will be involved at various stages of the loan cycle. It should also assist in clarifying the roles of the different agencies in the loan cycle and set them out in a transparent manner to expedite the mobilization and utilization of loan funds.

Low income countries that are dependent on concessional funds from bilateral and multilateral sources have to work within the loan cycle that is based on the procedures of each donor agency. In Bhutan, 40 of the 48 loans obtained to date have been from multilateral institutions with the majority being provided by the ADB and World Bank. Consequently, the loan cycle and the agencies involved[12] will be described in the context of loans from these two agencies. Countries that are able to obtain funds from commercial banks and capital markets will have greater flexibility and be able to reduce the length of time taken to mobilize funds significantly in comparison to countries that are dependant only on official sources like Bhutan.

THE LOAN CYCLE

Preparation of a Country Strategy

Projects and programs that are funded by foreign donors are based on the priorities articulated by the national authorities and the donor community. Any donor that has a regular program of assistance to Bhutan prepares a multi-year strategy that identifies critical sectors needing assistance and provides guidance for the selection of projects and programs. Bhutan's priorities are currently based on the Ninth Five Year Plan (9FYP) for the period FY 03 to FY 07. Further, as in the case of other low income countries that borrow from the World Bank and/or IMF, Bhutan prepared a Poverty Reduction Strategy Paper (PRSP) in August 2004 covering the three year period FY 05 to FY 07. The PRSP was based on the 9FYP and its performance is reviewed annually.

[12] **These are set out as charts in Attachments 2 and 3.**

The World Bank used the documents that set out Bhutan's priorities to prepare a Country Assistance Strategy (CAS) for the period FY 06 to 09 with the assistance of the government and interested stakeholders. The DADM coordinated this process with the PC, development Ministries and Departments, other donors and civil society. The ADB prepared a Country Strategy and Program (CSP) for the period FY 06 to FY 10 through a similar process. Both the CAS and CSP will straddle the Ninth and Tenth Five Year Plans and the PRSP. Both agencies have planned Mid-Term Reviews of their strategies around the completion of the 9FYP and PRSP. This will provide opportunities for adjustments due to changes in priorities and country conditions that will be reflected in the Tenth Plan.

The PRSPs, CASs, CSPs and other similar documents draw on a range of analytical work on macroeconomic issues and sectors prepared by the staff and consultants of donor agencies.

The other lenders to Bhutan do not provide assistance on a regular basis. In view of this they do not prepare country strategies in the same manner as the ADB and World Bank. Instead they provide assistance in an ad hoc manner following their participation in the Round Table Meeting held for Bhutan on a triennial basis.

Country Program

The next stage in the cycle is the identification of projects or programs and TA activities for a single or multi-year period which is covered by the country strategies. This will become the lending and TA program for the donor for the specified period and is generally referred to as the Country Program. It is developed and prioritized in consultation with the government, the country's other development partners and stakeholders such as private sector organizations and non-governmental organizations. The proposed program will be within the total amount of funds that have been pledged or allocated to Bhutan by the donor for the specified period. The DADM, PC and the concerned Ministries and Departments provide inputs during the identification phase based on national priorities that have been articulated in the 9FYP and PRSP.

The current borrowing program is based on a list of projects and programs approved for external loan funding by the Council of Cabinet Ministers (CCM). Any project that is outside this list should be approved by the CCM when external funding has been agreed.

In the case of the World Bank, the CAS identifies the projects and programs and related activities to be funded during the four year period of the strategy. Apart from changes in the timing of implementation of each project or program within the period of the CAS, there could be changes only following the Mid-Term Review of the strategy.

Based on the timing proposed for a project or program, the staff of the World Bank will prepare a project concept paper or note which will set out the basic elements of each project or program, its proposed objectives, likely risks and alternative approaches to implementation and a likely timetable for the approval process. This concept paper will be reviewed in the World Bank based on the cycle and timetable established for project approval. Staff of the DADM will use the concept paper to submit a loan request to the World Bank on behalf of the government.

The ADB prepares its Country Program for a three-year period during the Country Strategy and Program Update. This annual activity adds another year to the program for which projects and programs are selected following the elimination of those in the current year which are being or will be implemented during the year. The program for the next calendar year is finalized during the Country Program Confirmation Mission that takes place during the last quarter of the year.

The CSP and/or annual CSP Updates prepared by the ADB include the concept paper for each project and program. A memorandum of understanding is concluded once the loan and TA program for the succeeding year is confirmed during the Country Program Confirmation Mission. The program that will be implemented in the next calendar year is confirmed when it is approved by the MOF and ADB management. No separate loan requests are made to the ADB unlike in the case of the World Bank.

Project and Program Development

Following the identification phase, the government will be responsible for the preparation of the project or program for which loan funds are sought. The lender - as is the case with the international financial institutions such as the ADB and World Bank - often provides technical and financial assistance to help the government prepare the projects and programs. When assistance is provided, consultants will be recruited to work with the country's project team and other stakeholders (civil society, beneficiaries and other development agencies that are active in the concerned sector) to determine all the technical, institutional, economic, environmental and financial conditions necessary for the project to succeed. Alternative project implementation modalities will be reviewed and where deemed necessary, environmental and social safeguards assessments will be undertaken.

The ADB provides Project Preparation Technical Assistance (PPTA) to assist the government in this phase of the loan cycle. The World Bank also provides similar funds from the Japan Policy and Human Resources Development (PHRD) Fund, one of the largest trust funds managed by the World Bank. The TA program of the Fund provides grants to assist the Bank's borrowing member countries with the preparation and implementation of operations financed by loans from the

International Bank for Reconstruction and Development and credits from the International Development Association and grants. World Bank procedures require a Pre-Appraisal stage which takes place when there is no PHRD grant for project or program development.

This phase of the cycle could take anything from a few months to 1-2 years. At the end of this period, the project proposal will be agreed between the government, donor and consultants. During the discussions, agreement will be reached on the implementing agency for the project or program, the institutional strengthening needed in the selected implementing agency and sector- depending on the scope of the activity- and policy reforms needed to achieve the objectives. The DADM will coordinate this phase of the loan cycle while the donor funded consultants will work closely with the implementing agency and supervising Department/Ministry.

Loan Issues and Project Appraisal

The lending agency is responsible for the project appraisal stage of the cycle. The documents required and procedures that should be followed could vary depending on the agency. These would lead to the preparation of a Project Appraisal Document for investment projects and a Program Document for adjustment operations which examine the technical, institutional, economic, financial, environmental and social impact and policy aspects. The viability of the project would be assessed by examining project risks and conducting sensitivity analyses. Loan conditions will be proposed to improve sector performance and address key policy issues by the staff of the lending agency while in the borrowing country. This team may be assisted by consultants.

An appraisal report will be prepared by the World Bank at the end of this stage of the loan cycle. In the case of the ADB, the report of the PPTA consultants would include an appraisal of the project. If a separate appraisal is to be undertaken, the ADB will mount a Fact Finding Mission before the Appraisal Report is prepared. The issues that will be covered in an appraisal report are described in Attachment 1.

Loan Negotiations and Approval Phase

Once the loan appraisal has been completed, the lender and borrower will negotiate the measures that are needed to ensure that the loan objectives are met. Where necessary the Appraisal Report will be amended to reflect the measures that are agreed. The loan terms and conditions are then converted into legal obligations and embodied in the loan agreement that is prepared by the lending agency. The draft loan agreement is then negotiated between representatives of the lender and borrower.

Following this negotiation, the Appraisal Report, negotiated loan agreement and other project documents (e.g. the Memorandum of the President in the World Bank, the Report and Recommendation to the President in the ADB etc) are submitted to the Board of the lending agency for approval. Concurrently, the documents are sent to the MOF for approval in accordance with Bhutan's laws and regulations.

Loan Signing and Effectiveness

The loan agreement can be signed by the authorized representatives of the lender and the RGOB once these approvals are obtained. Approval of the RGOB is given by the Minister of Finance. Two other steps are necessary before the loan funds can be utilized. First, the Office of Legal Affairs must certify within a specified period (usually 60 or 90 days) that the agreement is legally binding on the government. Second, the DADM should verify - on behalf of the government - that the policy, institutional and other conditions that should be fulfilled within the stipulated period have been met. The loan is declared effective and available for disbursement once these conditions are met and the legal opinion is submitted and found acceptable.

Project and Loan Implementation

The next stage in the cycle is the actual implementation of the project or program by the responsible agency utilizing the loan funds. Primary responsibility for it is with the implementing agency with the assistance of the supervising Department/Ministry and the DADM on behalf of the government.

It is often the practice for a project/program steering committee to be appointed to provide assistance and guidance to the implementing agency. The committee could consist of the principal stakeholders and include consultants. The lender is responsible for loan supervision and requests progress reports to be submitted at periodic intervals. It is the normal practice for half-yearly project supervision visits to be undertaken by the staff of the lending agency. The ADB prepares a Country Portfolio Review covering all its current activities at the end of each calendar year. The Royal Audit Authority of Bhutan conducts annual audits on loan funded projects and programs.

Consultancy services required during implementation will be financed from the loan or an accompanying TA grant. These services and the goods required for the project will be contracted by the borrower based on the procurement guidelines of the government and lending agency. Where grant funding is utilized, it is likely that the goods and services will be procured by the lending agency.

Depending on the scale of the project, procurement will be subject to international competitive bidding based on the guidelines of the lending agency. Where

permissible and the capacity exists, components of the project could be implemented by local firms chosen through domestic competitive bidding. There could be cases where international firms enter into joint venture arrangements with local firms to implement some components of the project.

Loan utilization or disbursement could take place through three different channels. These are by:

a) direct payment to local and/or international suppliers by the lender;

b) advance payment into an imprest account by the lender. This is replenished by the lender at intervals based on the payments that take place from the account; and

c) reimbursement for claims submitted to the lender by the borrower after making the payment initially.

It is possible that some of the expenditures incurred by the borrower prior to loan effectiveness may be reimbursed by the lender. This has to be negotiated prior to the signing of the agreement.

Loan agreements will indicate the dates for project completion and the final loan disbursements. The latter will generally be six months after project completion. There are other transactions that take place during the period of loan implementation. Depending on the nature of the loan, there could be upfront fees (agency and underwriting fees, commissions etc.) payable on signing of the loan agreement or a capital market issue. In addition, commitment fees are payable as a percentage of the committed undisbursed balance of the loan as provided in the loan agreement, usually at six monthly intervals, from the date that the loan is declared to be effective. These are not applicable to Bhutan at present.

Interest or service payments are due on the DOD as provided in the loan agreement- usually at six monthly intervals. There may be different interest rates applicable during the grace or construction period and thereafter. In some agreements, interest payable during the construction period is treated as a loan disbursement while in others, it is capitalized and subject to a separate repayment profile. The loans to Bhutan from India for power development projects are subject to this treatment.

Once disbursements are completed, any unutilized balance would be cancelled and the loan amount reduced accordingly. It is also possible to increase the loan amount and extend the closing date for the project or program and the terminal date for disbursements. These adjustments have to be formalized through amendments to the original loan agreement.

Evaluation

It is the practice of lending agencies for a Project Completion Report to be prepared by the staff member responsible for the loan at the end of the disbursement period. The comprehensiveness of this report varies from one

lending agency to another. In addition, each agency has a process for in-depth evaluation or audit with the loans chosen on a selective basis. These are referred to as Post-Project Evaluations in the ADB and Post Project Audits in the World Bank. While these reports are prepared by the staff there are instances when external consultants are used. The borrowers are requested to comment on the evaluations/audits and the reports are also submitted to the Boards of the concerned agencies.

One item in the evaluations is the re-estimation of the economic rate of return on the basis of actual implementation costs, updated operating costs and expected benefits. A final judgment on the success or failure of a project or program would have to be made at a later date - at least five years after the last disbursement. These impact evaluations are performed for a small number of selected projects. Special studies could be undertaken on loans to a particular sector or a cluster of projects including those for the study of a specific issue.

Debt Service Payments

Once the disbursements have been completed, interest or service payments, principal repayments and other fees such as agency fees payable on an annual basis are the only remaining loan transactions. The interest or service payments will be due on the DOD. The principal repayments will begin when the grace period ends and will be payable on a half-yearly basis as stated in the loan agreement. There are different types of repayment profiles. These are:

a) equal half yearly installments during the repayment period;

b) equal installments during a part of the repayment period followed by another set of equal installments during the remaining period;

c) unequal payments during the repayment period. In some instances, these unequal payments would be given as percentages of the total loan amount; and

d) annuity payments. These arise when the value of the loan and interest payments due on the basis of equal half yearly repayments are aggregated and divided into equal payments during the repayment period.

THE AGENCIES INVOLVED

There are several agencies in the borrowing country that are involved at different stages of the loan cycle as described above. These are identified in this section - as they relate to the steps of the cycle - to gain a better understanding of the process. In most countries, the law and regulations governing external borrowing assign the primary responsibility for government borrowing and the issue of government guarantees to the Minister of Finance. Consequently, a department in the MOF takes the principal responsibility for them and will be the focal point of contact and coordination for the lenders which is the DADM in Bhutan.

Preparation of Country Strategy

The DADM will coordinate the work of the donor mission preparing a Strategy. The PC will set out Bhutan's priorities based on the Five Year Plan. The Ministry of Foreign Affairs will be consulted when a lender provides assistance to Bhutan for the first time. At the sectoral level, Departments/Ministries responsible for development activities and implementing agencies that function under them would be consulted. Other donors providing assistance to Bhutan and civil society active in the country would also be consulted during the preparation of the Strategy.

Country Program and Project Identification

Each lender will formulate a lending and TA program – the Country Program - based on the CAS or CSP. This could be for a single or multi-year period. The DADM, PC and Departments/Ministries responsible for development activities will assist the lender in the preparation of the Country Program. The activities included in it should be selected from the list of projects/programs identified for external loan funding that have been submitted by the DADM to the CCM and approved by it.

Project/Program Preparation, Loan Request and Appraisal

The implementing agency, supervising Department/Ministry and DADM will be the principal agencies involved in this stage of the cycle. Inputs will be provided by the DPA and Royal Civil Service Commission as required. The DADM will submit the formal request to the lender based on the project concept paper or an equivalent document that has been prepared when a formal request is required. As stated, this is required in the case of the World Bank while the memorandum of understanding signed at the conclusion of the Country Programming Confirmation Mission by the ADB serves this purpose.

Negotiation, Approval and Signing of Loan Agreements

The present procedures require that the project and/or program for which external borrowing is sought be in the list approved by the CCM. The supervising Ministry will take responsibility for obtaining the approval of the government for policy, institutional and financial conditions that are required prior to the signing of the agreement. This Ministry will make a submission to the DMC which will make its recommendation to the Minister of Finance after review.

It will be the responsibility of the DADM to ensure that the loan amount is within the approved ceiling if an external borrowing ceiling is introduced for the government as a component of the budget approval process.

The DADM has the principal responsibility for loan negotiations and will be assisted by the implementing agency and its supervising Department, and the Office of Legal Affairs when required. After the agreement has been negotiated, the DADM will seek the approval of the Minister of Finance for concluding the agreement and for designating a person to sign the loan agreement on behalf of the RGOB. This is based on current procedures.

Prior Conditions, Legal Opinion and Loan Effectiveness

The DADM will be responsible for verifying that all the prior conditions are met during 60-90 day period permitted. It will be assisted by the supervising Ministry and other relevant departments in the MOF. The Office of Legal Affairs will be requested to submit an opinion that the agreement is legally binding on the government. Following this the DADM will submit all the documentation to the lender and request that the loan be made effective and available for drawdown.

Loan Implementation and Supervision

Following loan effectiveness, the implementing agency will proceed to implement the project with the assistance of the supervising Department. As stated, a Project Steering Committee may be appointed to monitor and guide implementation and consist of all the stakeholder departments. The DPA must ensure that local funds are released as budgeted when required. The DADM should be actively involved if any implementation issues need to be raised with the lender. The procedures for loan withdrawals are set out in the following paragraphs.

There are several common elements in the procedures for loan disbursements that are applicable to all foreign loans. There are the following:

a) All withdrawal applications sent to the lender by the implementing agency (IA) are made through the DADM;
b) A Foreign Currency Account (FCA) is opened in the RMA for each loan upon receiving a request from the DADM;
c) A Project Letter of Credit (PLC) Account is opened by the Bank of Bhutan (BOB) for each loan at the request of the DPA. The IA makes withdrawals from the PLC Account when a release letter is issued by the DPA;
d) Transfers from each FCA are made by the RMA to the Budget Fund Account (BFA) at the request of the DADM. A release letter is issued by the DPA to the IA and BOB at the request of the DADM; and
e) When loan disbursements are received in the RMA through any of the modalities stated below, it will inform the DADM of the amount received in foreign currency, the local currency equivalent and date of receipt of the remittance.

There are several disbursement methods established dependent on donor and RGOB procedures. The different modalities are:

a) An imprest account is created when foreign currency of an agreed amount is transferred by the lender after the agreement is signed and the loan becomes effective. The RMA credits the funds to the FCA for the loan. Thereafter, replenishments are made in the foreign currency when replenishment claims for foreign and local currency expenditures incurred are submitted to the donor by the IA through the DADM. The replenishment approved by the lender is transferred to the account of the RMA at the Federal Reserve Bank in New York. The RMA credits the relevant FCA when it is advised of this transfer.

   When a request is made by an IA to withdraw loan funds, the DADM requests the RMA to transfer the required amount of funds from the FCA to the BFA held at the BOB. Once this transfer is made and the DPA informed accordingly, it issues a release letter to the IA to withdraw funds from its PLC.

b) Direct payment in foreign currency is made to a supplier of goods and services upon submission of a withdrawal application to the donor by the IA through the DADM. When this is approved, the payment is made direct to the account of the supplier and a notification sent to the DADM. No funds are received in Bhutan.

c) Direct payment in local currency is made to a supplier of goods and services upon submission of a withdrawal application to the donor by the IA through the DADM. The creditor requests an exchange rate from the RMA for the local currency expenditure that is approved for the specified value date, normally the following day. Thereafter, the loan currency equivalent is transferred to the account of the supplier. These funds do not flow through the FCA in the RMA.

d) Local cost expenditures are reimbursed by the donor when a withdrawal application is submitted by the IA through the DADM. The donor requests an exchange rate from the RMA for the local currency expenditure whose reimbursement is approved for the specified value date, normally the following day. The equivalent amount in loan currency is credited on the value date to the account of the RMA at the Federal Reserve in New York. When advised of this transfer, the RMA credits the BFA held at the BOB with the amount of local currency for which the original exchange rate was quoted by the RMA.

e) The creditor may, at the request of the IA and endorsed by the DADM, provide an irrevocable commitment to reimburse a commercial bank for payments made to a supplier of goods and services through a letter of credit.

f) In the case of on-lending agreements, withdrawal applications in local currency are submitted by the borrower to the creditor through the DADM. As in d) above, the creditor requests an exchange rate from the RMA for the local currency expenditure whose reimbursement is approved for the specified value date, normally the following day. The equivalent amount in the loan currency is credited on the value date to the account of the RMA at the Federal Reserve in New York. When advised of this transfer, the RMA credits the FCA and then the BFA with the amount of local currency for which the original exchange rate was quoted by the RMA. When advised of this transfer, the DADM requests the DPA to issue a release letter to enable the IA it to draw funds from the BFA.

Evaluation Reports

The review of the Project Completion Reports and in-depth evaluations will be the responsibility of the DADM, implementing agency and its supervising Department/Ministry. The DADM will be involved if any major issue has to be raised with the lender and followed up.

Debt Service Payments

The DADM, RMA and DPA are responsible for ensuring that debt service payments are made on time. The DADM receives the payment invoice from the creditor on behalf of the RGOB. It initiates action on debt service payments by requesting the RMA to make the payments and debit the Letter of Credit Account held by the DADM at the BOB for debt service payments for the local currency equivalent of the payments. These payments are finally debited to the head of expenditure of the DADM under which provision is made for government debt service payments by the DPA. When payments are made by the RMA, a payment notification is sent to the DADM indicating the date of payment, foreign currency amount and local currency equivalent of the payment.

The DADM requests each borrower of on-lent funds to make debt service payments on the due dates. When these payments are received, principal payments are credited to the Budget Fund Account and interest payments to the Government Revenue Account of the Department of Revenue and Customs.

Attachment 1
Issues Covered in an Appraisal Report

In the appraisal report the lender has to ensure that the projects are of sound design and have adopted internationally accepted standards. The appraisal missions – the PPTA mission in the case of the ADB - will review the available technical alternatives, solutions proposed and the anticipated results. The technical assessment should ensure that the proposed solution uses technology appropriate to the conditions in the country. A critical part of the appraisal is the collection of technical and other relevant data on which the cost estimates are based and the assessment of the likelihood of physical and financial constraints arising during implementation. Estimates should also be made of the annual operating costs of the completed projects to ensure that adequate attention is paid to the annual budgetary appropriations that will be required.

Institutional strengthening goes beyond the construction of a physical facility and the transfer of funds needed for its operations. It extends to the creation of a viable executing or implementing agency operating in an appropriate macroeconomic and sectoral policy environment with an effective organizational and management structure and adequate trained staff. Institutional capacity is important both during implementation and subsequent operations. It is perhaps the most difficult aspect of an appraisal and requires a good understanding of the cultural environment in which the project is being implemented. Consequently, the lender needs to re-examine the institutional arrangements periodically and when appropriate, adopt a long-term approach to institutional strengthening extending over several projects and years.

Cost benefit analyses of alternative project designs enable the selection of the one that contributes most to the development objectives of the country. While this could be done at different stages of project preparation, the decision has to be made at the appraisal stage when complete information would be available.

Economic appraisal is undertaken in the sectoral setting by examining the investment program of the institutions in the private and public sectors, and the policies that have an impact on the project or program. Whenever possible, the costs and benefits to the country are measured by the economic and the financial rates of return. The former involves the use of shadow and social prices in the analysis. A risk analysis should be undertaken in situations of major uncertainty and it has become a standard practice of lending agencies to assess the risks of achieving the loan objectives.

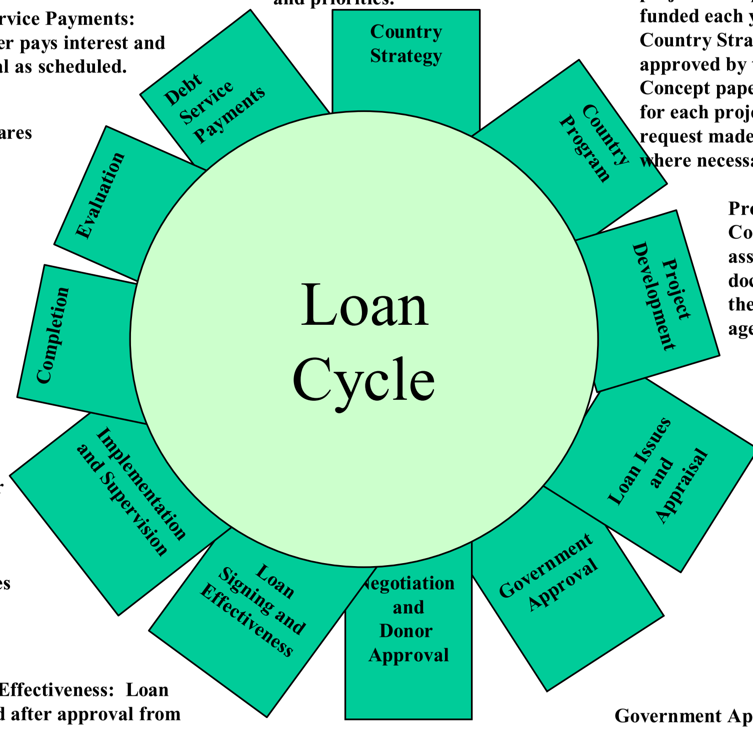
A financial appraisal should be undertaken to ensure that adequate funds are available for the implementation of the project or program. Typically, lenders will only cover the foreign exchange costs and a part of the local costs with the government providing the remaining local funds through budgetary appropriations based on the implementation schedule. When lending to revenue-generating

enterprises, the lenders should determine whether a rate of return will be obtained that would be sufficient to make debt service payments and contribute to the future capital requirements of the enterprise. Where the lending is for other purposes, the lenders would expect some recovery of the investment and operating costs from project beneficiaries, e.g., if the loan funds are used for the construction of a dam for irrigation purposes charges for irrigation water could be levied on the users.

The environmental aspects of a project or program are assessed regularly through an environmental assessment report. It will deal with the likely environmental impact of the planned activity, the consultations that have been held with the persons who will be affected by the investment and the steps that will be taken to mitigate the possible harm that may arise. Where resettlement of people is envisaged as a result of the project, a social safeguards assessment is undertaken in regard to the resettlement of people displaced and the development of indigenous people.

The policy reforms that are needed for the loan proposal to be approved by the lender will also be dealt with in the appraisal report. The necessary policy changes will be discussed during the preparatory phases of the project. They will be finalized in the appraisal report, discussed at the time of loan negotiations and monitored during implementation.

Attachment 2: LOAN CYCLE



Country Strategy (CAS/CSP): Donor prepares multi-year lending and technical assistance program based on the country's development priorities and donor's comparative advantage and priorities.

Country Program: Selection of projects and programs that are to be funded each year based on the Country Strategy. Program approved by the government. Concept papers prepared by donor for each project and program. Loan request made by the government where necessary.

Project and Program Development: Consultants funded by technical assistance prepare program/project documentation in consultation with the borrower and implementing agency.

Loan Issues and Appraisal: Donor prepares appraisal report assessing the technical, institutional, economic, financial, social and environmental aspects of the project or program. Donor discusses policy, institutional and human resource issues critical for loan implementation.

Government Approval: Government approves projects and programs to be externally funded. DMC and MOF approve conditionalities.

Negotiation and Board Approval: The donor and borrower negotiate and finalize loan agreement. Agreement submitted to donor authorities and government for approval.

Loan Signing & Effectiveness: Loan agreement signed after approval from Minister of Finance. Legal opinion and other conditions satisfied for loan to be declared effective and available for disbursement.

Implementation and Supervision: Borrower implements project/program based on loan and project agreements. Loan withdrawals based on lender's guidelines. Lender undertakes supervision missions and ensures that implementation proceeds as planned. Mid-term review by lender. Annual audit by borrower.

Project and Program Completion: The physical aspects of the project are completed by the borrower and disbursements completed. Donor prepares project completion report which is reviewed by borrower. End of project audit conducted by borrower.

Evaluation: Donor prepares loan audit and impact evaluation

Debt Service Payments: Borrower pays interest and principal as scheduled.

Attachment 3: AGENCIES INVOLVED