ASIAN DEVELOPMENT BANK

RRP: BHU 29243

REPORT AND RECOMMENDATION

OF THE

PRESIDENT

TO THE

BOARD OF DIRECTORS

ON

PROPOSED LOANS AND TECHNICAL ASSISTANCE GRANT

TO THE

KINGDOM OF BHUTAN

AND A PROPOSED EQUITY INVESTMENT IN BHUTAN NATIONAL BANK

IN THE

KINGDOM OF BHUTAN

FOR THE

FINANCIAL SECTOR INTERMEDIATION FACILITY

September 1997

CURRENCY EQUIVALENTS
(as of 31 August 1997)

Currency Unit	—	Ngultrum (Nu)
Nu1.00	=	$0.028
$1.00	=	Nu35.7

ABBREVIATIONS

BDFC	–	Bhutan Development Finance Corporation
BNB	–	Bhutan National Bank
BOB	–	Bank of Bhutan
FIRR	–	Financial Internal Rate of Return
FISIF	–	Financial Sector Intermediation Facility
GDP	–	Gross Domestic Product
GEPF	–	Government Employees Provident Fund
ILD	–	Industrial Lending Department
IMF	–	International Monetary Fund
IPO	–	Initial Public Offer
NPAs	–	Nonperforming Assets
PFI	–	Participating Financial Institution
RICB	–	Royal Insurance Corporation of Bhutan
RMA	–	Royal Monetary Authority of Bhutan
RSEB	–	Royal Securities Exchange of Bhutan
TA	–	Technical Assistance
UTB	–	Unit Trust of Bhutan
WADR	–	Weighted Average Deposit Rate

NOTES

(i) The fiscal year of the Government ends on 30 June, and the fiscal year of the financial institutions ends on 31 December.

(ii) In this Report, "$" refers to US dollars.

CONTENTS

LOAN AND PROGRAM SUMMARY

Borrower	:	Kingdom of Bhutan
The Proposal	:	The proposed Financial Sector Intermediation Facility (FISIF) is a sector development program, comprising a policy component in the form of a policy loan, an investment component in the form of a development finance loan, and an equity investment; as well as a capacity-enhancing component in the form of a technical assistance (TA) grant.
Rationale	:	The private sector remains weak in Bhutan. The contribution of the nonagricultural private sector to the gross domestic product was only 13 percent in 1995. The country relies heavily on foreign aid even for its industrial investment requirements. Private sector development is stifled because of (i) stringent Government control over private sector business activities, (ii) lack of adequate physical infrastructure, (iii) lack of easy access to credit facilities, (iv) an inadequate legal framework for private sector activities, (v) limited entrepreneurial skills, (vi) inadequate information on export markets, and (vii) lack of technical know-how and use of obsolete technologies. The proposed FISIF is designed as sector development program to provide an integrated and more sustainable approach to address the considerable constraints to private sector development. A sustained and greater contribution from the private sector calls for an efficient and competitive financial sector to mobilize savings to meet the demand from private entrepreneurs. The development of the financial sector in turn requires policy support to restructure the financial system and remove impediments to efficient resource mobilization and allocation. Simultaneously, there is a need to ensure that effective policies and institutional frameworks are in place to promote private sector development and investment. At the same time, long-term foreign currency resources are needed to alleviate a critical shortage of funding for private sector investments. Raising the level of banking skills, especially in project analysis and credit evaluation, and enhancing entrepreneurial skills in the private sector are also to be addressed to ensure sustainability of the reform measures and to improve institutional absorptive capacity to take full advantage of the benefits of the FISIF.
Classification	:	Primary - Economic Growth

The Sector Development Program

Objectives and Scope : The aim of the FISIF is to accelerate economic development through strong private sector growth, so that the country's domestic revenue base will be expanded, and the Government will be able to reduce its dependence on foreign aid for its industrial investment requirements. The objectives of the FISIF are to (i) improve access to credit by the private sector; (ii) create a supportive Government policy environment for private sector business activities; (iii) create an enabling legal framework for financial sector operations and private sector business activities; and (iv) enhance private entrepreneurship and management skills, and provide better access to market information. The scope of the FISIF is to (i) support the Government to institute a series of policy reform measures to remove impediments for the financial and banking sector and private sector development; (ii) provide long-term foreign exchange funding to private sector subprojects and assist the participating financial institutions (PFIs) to improve their institutional capabilities, and operational and financial performance; and (iii) play a catalyst role in the privatization of a State-owned financial institution.

Policy Framework and Actions : The policy component addresses the key reform areas including (i) removal of policy impediments to private sector development by rationalizing Government control over private sector business activities; (ii) liberalization of the interest rate structure and improvement of interest rate management; (iii) rationalization of foreign exchange transactions; (iv) enhancement of efficiency and the competitiveness of the financial system; (v) strengthening the enabling legal framework for financial system operation and private sector business activities; (vi) improvement of private sector entrepreneurship and management skills, and access to information; and (vii) upgrading the human resource base in financial institutions.

Capacity Building : The FISIF addresses the capacity-building needs of the PFIs and Government agencies responsible for the reform program. It is important that credit analysis is strengthened in the PFIs, as well as the capacity of the Government to address economic scenarios that affect private sector development in a timely manner. Private sector entrepreneurship and management skills will be developed through measures aimed at strengthening the investment promotion activities in the Bhutan Development Finance Corporation (BDFC) and Bhutan National Bank (BNB). This will assist the private sector to enhance their participation in industrial development and increase

employment opportunities.

The Investment Component

The development finance loan will provide foreign exchange funds to qualified private sector small- and medium-size industries and commercial agriculture subprojects through a credit line to the PFIs. It will also alleviate the pressure on the liquidity management of the PFIs and lower the general cost of funding for project finance. Sustained growth in the private sector industry and commercial agriculture establishments is projected to generate a financing gap of about $40 million during 1997-2001. The country's financial sector is unable to fully meet the demand for long-term credit. The development finance loan will meet part of this demand.

The equity investment in BNB will play a catalytic role in attracting increased private sector participation in BNB, including a foreign strategic investor with technical expertise. and will boost the public confidence in BNB. A stronger BNB will promote market competition, expand sources of credit for trade and export, and create an advocate of change that will continue the process of reform and liberalization of the financial sector.

Social and Environmental Measures :

The primary beneficiaries of the FISIF are private sector entrepreneurs because the increased competition and improved efficiency in the financial market will provide them with easier access to credit facilities and banking services. Policy reforms will create a policy environment for industrial development that is friendlier to the market and private sector. The proposed Program will benefit many members of the local labor force through increases in employment opportunities, estimated in the range of 1,000 to 2,000, in the nontraditional sectors, and will widen the base for resource mobilization. The environment category of the Program is B. The environmental impact assessment or initial environmental examination will be undertaken for the subprojects. The PFIs will follow the Bank's environmental guidelines in the selection of subprojects, will be responsible for ensuring that subprojects comply with Government environmental regulations, and will ensure that appropriate safeguards and equipment for compliance are built into each subproject.

The Policy Loan

Loan Amount and Terms :

A loan in the amount of SDR 2,939,000 ($4 million equivalent) will be provided from the Bank's Special Fund resources. The loan will have a maturity of 40 years, including a grace period of 10 years, and will carry a service charge of 1 percent per annum.

Program Period and Tranching	:	The Program period is four years after the loan effectivity. The policy loan will be released in two tranches to meet the expected occurrence of adjustment costs. The first tranche of \$2.5 million will be released upon loan effectivity, and the second tranche of \$1.5 million will be released within 18 months of the first tranche release, subject to compliance with the conditions for their releases.
Executing Agency	:	The Royal Monetary Authority (RMA) will be the Executing Agency. The Ministry of Finance will coordinate with concerned ministries and agencies on the reform actions, and RMA will be responsible for implementing matters related to financial policy reforms and institutional strengthening. A policy steering committee will be set up before the loan negotiations, comprising concerned ministries, and be chaired by the secretary of the Ministry of Finance. The committee will provide overall guidance on policy-related matters under the program.
Procurement	:	Contracts for eligible imports costing more than \$1 million will be awarded on the basis of international competitive bidding, subject to the agreement of the Bank. Contracts for eligible imports costing the equivalent or less than \$1 million will be awarded in accordance with standard commercial procurement procedures and practices acceptable to the Bank, in the case of procurement by the private sector; or with the Government's prescribed procurement procedures acceptable to the Bank, in the case of procurement by the public sector. In general, procurement under the Program will be in accordance with the Bank's *Guidelines for Procurement* dated January 1994. Only expenditures on goods and services that are produced in and procured from the Bank's member countries are eligible for financing. Supply contracts for commonly traded commodities will be awarded according to procedures appropriate to the trade and acceptable to the Bank.
Disbursement	:	The Bank's statement of expenditures procedures will be used for liquidation of expenditures under the Program in accordance with the Bank's *Loan Disbursement Handbook* and detailed arrangements agreed to by the Government and the Bank.
Counterpart Funds	:	The counterpart funds generated by the loan will be used by the Government to meet the cost of the reform program.

The Development Finance Loan

Loan Amount and Terms	:	A development finance loan in the amount of SDR 2,939,000 ($4 million equivalent) will be provided from the Bank's Special Fund resources. The loan will have a maturity of 40 years, including a grace period of 10 years, and will carry a service charge of 1 percent per annum.
Implementation Arrangement and Executing Agency	:	The loan will be available as a credit line to the two PFIs, namely BNB and the BDFC, on a first-come, first-served basis. Applications for subloans must be submitted to the Bank for approval within the commitment period of three years. RMA will be the Executing Agency and relend the credit line proceeds on behalf of the Government to the PFIs. Each PFI will onlend to eligible subborrowers on the basis of its own standard terms and conditions.
Onlending and Relending Terms	:	Relending and onlending will be denominated in the Bhutanese ngultrum, and the foreign exchange risk will be borne by the Borrower. The Government will relend to the PFIs at the benchmark long-term market rate, e.g., weighted average commercial bank deposit rate for deposits over 12 months; and the PFIs will onlend to subborrowers based on market interest rates and the evaluation of the risks involved in each subloan. The maximum maturity of the subloans will be 15 years including a grace period of three years.
Periods of Utilization and Commitment	:	The period of utilization will be four years and the period of commitment will be three years after the loan effectivity.
Subloan Size	:	To ensure adequate utilization of the loan proceeds for small- and medium-sized industries and commercial agriculture, the maximum subloan size is set at $500,000 and the minimum size at $5,000, unless otherwise agreed between the Bank and the PFI.
Free Limit	:	$50,000 for BDFC, none for the first five subloans for BNB and $30,000 thereafter.
Procurement	:	The PFIs will require all subborrowers to demonstrate that the procurement procedures adopted are appropriate in the circumstances, that the goods procured are suitable for the subproject, and that the prices paid are reasonable. In general, procurement under the subloans will be in accordance with the Bank's *Guidelines for Procurement*. Only expenditures on goods and services that are produced in and procured from the Bank's member countries are eligible for financing.

Disbursement : An imprest account may be established by RMA in the amount to be agreed by the Bank from which contracts for eligible items costing less than the subloan free limit may be financed. The Bank's statement of expenditures procedures will be used for liquidation of expenditures from and replenishment to the imprest account. The imprest account will be established, managed, replenished, and liquidated in accordance with the Bank's *Loan Disbursement Handbook* and arrangements agreed by the Government and the Bank.

Equity Investment

Main Terms : The Bank will invest up to the equivalent of 25 percent of BNB's issued and paid-up share capital at the price of Nu190 per share. The Bank's investment will be up to Nu28,264,400 or about $790,000. In the event that a foreign bank joins the Bank as the strategic investor, the Bank's investment will be reduced to the equivalent of 20 percent of BNB's paid-up share capital amounting to Nu22,611,520 or about $640,000.

Rate of Return : Based on BNB's financial projections for the next five years, with an average growth rate in profit before tax of 24 percent per annum, the financial internal rate of return for the Bank's investment is calculated as 31.1 percent in US dollar terms. This assumes a purchase price of Nu190 per share, the investment is sold in 2001 at the price/earning ratio of 10, and the depreciation of the ngultrum against the dollar is at 4.3 percent per annum.

Technical Assistance : An advisory TA grant for $500,000 equivalent, financed from the Japan Special Fund, for Capacity Upgrading of Financial Sector Infrastructure and Entrepreneurial Development is included in the Program. The TA has the following objectives: (i) to upgrade the capacity of the concerned Government agencies involved in the reform program; (ii) to strengthen the institutional capabilities of the financial institutions; and (iii) to enhance private sector entrepreneurship and management skills. The TA will require a period of 18 months for implementation, and about 13 person-months of consulting services from a team of four international consultants. The Executing Agency will be RMA. The consultants for the TA are to be engaged in accordance with the Bank's *Guidelines on the Use of Consultants* and other arrangements satisfactory to the Bank.

Risks and Safeguards : Some of the identified risks affecting the successful implementation of the FISIF are unfavorable macroeconomic conditions; lack of Government experience to key policy reform

measures, especially as this will be Bhutan's first experience in program lending under the Bank; lack of entrepreneurial and technical skills; slower than expected approval processes for legislation by the National Assembly; delayed or insufficient and inefficient use of credit line proceeds; unforeseen weakening of institutional capabilities of the PFIs; and unexpected adverse macroeconomic shocks. Effective policy dialogue, better coordination with other international agencies, effective implementation of the TA, and well-designed training programs would provide safeguards against most of the identified risks. The Government has demonstrated strong commitment to reforms, and it has already undertaken several measures as agreed with the Bank.

The risks for the Bank's equity investment in BNB may include difficulties in mobilizing sufficient deposits, inadequate professional standards, adverse regulatory intervention, and the lack of a liquid market for the disposal of the Bank's shares through the stock market. Nevertheless, all risks are regarded as acceptable with major risks adequately mitigated through safeguards such as effective management and prudent banking practices, standard banking products, improved technology and controls, skilled and motivated staff at BNB, and much improved prudential regulations and bank supervision functions by RMA. In addition, the Bank's continued involvement with the development of the capital market in Bhutan is expected to enhance its operational efficiency and institutional capability.

I. THE PROPOSAL

1. I submit for your approval the following Report and Recommendation, in connection with the Financial Sector Intermediation Facility (FISIF), on (i) a proposed policy loan to the Kingdom of Bhutan; (ii) a proposed development finance loan to the Kingdom of Bhutan; and (iii) a proposed equity investment in Bhutan National Bank (BNB). The Report also describes proposed technical assistance (TA) for the Capacity Upgrading of Financial Sector Infrastructure and Entrepreneurial Development, and if the proposed loans and equity investment are approved by the Board, I, acting, under the authority delegated to me by the Board, shall approve the technical assistance.

II. INTRODUCTION

2. The FISIF consists of a policy loan of SDR 2,939,000 ($4 million equivalent); a development finance loan of SDR 2,939,000 ($4 million equivalent) for relending as a credit line to two participating financial institutions (PFIs), the Bhutan Development Finance Corporation (BDFC) and Bhutan National Bank; an equity investment of up to Nu28,264,400 (about $790,000) in BNB; and an advisory TA grant of $500,000 equivalent.

3. A Fact-finding Mission visited Bhutan from 15-31 January 1997. The Mission reviewed recent developments in the financial sector and issues regarding private sector development, and discussed details of the proposed FISIF with the Government of Bhutan. An Appraisal Mission visited Bhutan from 21-30 July 1997, comprising Y. Qian, Mission Leader; L. Boyer, Senior Investment Officer; T. Swe, Senior Programs Officer; and S. Nanwani, Counsel, to finalize various aspects of the proposed Program, including objectives, scope, terms and conditions of the proposed policy loan and the development finance loan, implementation schedule, and procurement arrangements. The Mission reached an understanding with the Government on major aspects of the Program to be supported by the Bank as outlined in the Government's Development Policy Letter and the attached Policy Matrix (see Appendix 1).

III. THE SECTOR

A. Macroeconomic Context

4. Bhutan is located in South Asia, between the People's Republic of China and India. It has a land area of 46,500 square kilometers (km^2). It has a varied climate: tropical in the southern plains; cool winters and hot summers in the central valleys; and severe winters and cool summers in the Himalayas. The terrain is mostly mountainous with some fertile valleys and savanna. The natural resources include timber, hydropower, gypsum, and calcium carbide; forest and woodland cover 72 percent of the country. There is estimated to be about 340 km^2 of irrigated land, or about less than 1 percent of the land area; the area of arable land is about 8 percent. The population is estimated at 600,000; the population growth rate estimated in 1996 is 3.1 percent . By occupation, 93 percent of the labor force is involved in agriculture, 5 percent in services, and 2 percent in industry and commerce. Bhutan faces a severe lack of both skilled and unskilled labor. The industry sector is small and technologically backward, with most of the production of the cottage industry type. Bhutan's hydropower potential, mineral-based industries, and its attraction for tourists are key resources.

5. The country's macroeconomic developments[1] in recent years were generally favorable and the growth of the real gross domestic product (GDP) since 1980 averaged 6.4 percent per annum. However, excluding the discrete jumps in the level of output due to major new power and industrial projects, the underlying growth rate of the economy is estimated to be about 4 percent per annum. The Government continues to rely on foreign aid to meet the resource requirements for financing domestic investment. Tax revenue for the Government was less than 7 percent of GDP in FY1996 due to an extremely narrow tax base. The budget for the Eighth Five-year Plan (FY1997-2001) indicates that the total external resource requirement is Nu22.2 billion ($633 million), or about 63 percent of the total budget. The current account deficit narrowed to about 15 percent of GDP in FY1996 due to strong export growth. Net external resource inflow from abroad, mainly for concessional loans and grants, was larger than the current account deficit; and the overall balance of payments position in FY1996 showed an overall surplus of 16 percent of GDP.

6. The foreign currency reserves of the country increased at an average of 6 percent per annum since FY1989. The total foreign currency reserves stood at $145 million at the end of FY1996, an equivalent of about 17 months of imports. The accumulation of convertible currency reserves is much faster, averaging 15 percent per annum since FY1989 and reached $140 million at the end of FY1996. Nearly half of the annual receipts of the convertible currency reserves are from international organizations and nongovernment organizations for their local expenditures, and about 25 percent are generated from exports and tourism. On the expenditure side, about two thirds of the annual foreign currency expenditures are used for general imports, and 25 percent for principal repayment and interests. There is an obvious mismatch regarding the composition of foreign reserves and the demand for imports. At the end of FY1996, the Indian rupee reserves were only sufficient to support a half month of imports from India where the convertible currency reserves could support seven years of imports from the third countries.

B. Sectoral Description and Recent Performance

1. Private Sector Development

7. Bhutan has a small nonagricultural private sector; its contribution to GDP was only 13 percent in 1995. Private sector industries are generally small in size, and lack capital, and entrepreneurial and technical skills. A decade ago, there were virtually no private sector industries in Bhutan (see Figure 1). There is currently a small but growing nonagricultural private sector, active in business activities involving cement, simple chemicals and carbide, board and paper products, ferro alloys, metal fabrication, food processing, horticulture, tourism, furniture and other wood and forest products, handicrafts, and assorted cottage industries. Development in the power sector has enabled growth in the allied energy-intensive industries. A number of constraints, such as a lack of infrastructure, the restrictive regulatory environment, shortages of capital and labor, lack of access to credit, and difficult terrain, have inhibited the rapid development of Bhutan's private sector industries.

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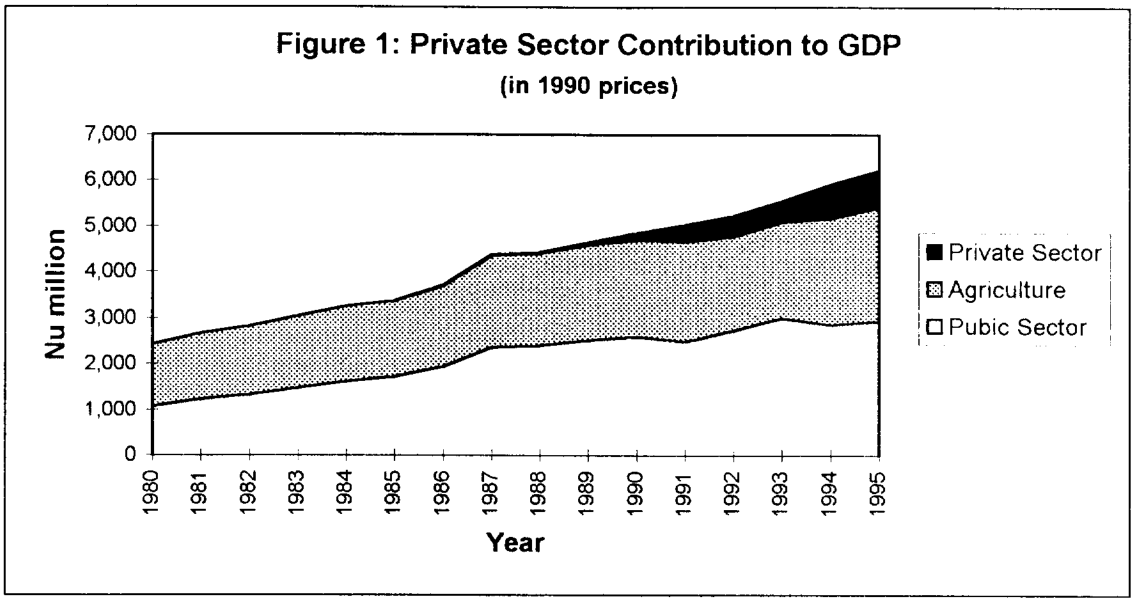
[1] Detailed discussion of the country's macroeconomic development can be found in CER:BHU 97017: *Country Economic Review: Bhutan*, to be circulated in October 1997.



8. The Government has given increased priority to the privatization of public sector enterprises. During the Seventh Five-year Plan (FY1991-1996) several public enterprises were divested. Of the 14 major industries, 10 have majority private ownership at present as opposed to only two in 1990. However, in some cases an outright sale of enterprises was not possible due to the lack of competitive offers. The activities and facilities related to tourism, hotels, and transport services are fully privatized. All the three Government-owned wood manufacturing workshops were auctioned to the private sector for a period of seven years for a fixed royalty.

9. The agriculture sector, all privately owned, contributed 38 percent of the total GDP in 1995. Over the period of 1985-1995 the agriculture sector's contribution to GDP grew annually by 2.9 percent, and that of the manufacturing and mining sectors grew at relatively higher rates of 13.5 percent and 11.6 percent respectively. Bhutan has significant regional and seasonal comparative advantage in the production of horticultural products, particularly in subtropical and temperate fruits (apples, oranges, and cardamom); and in the supply of potatoes and vegetables to off-season (summer) markets in the neighboring areas of India and Bangladesh. There are opportunities for the export of high-value crops such as asparagus, strawberries, stone fruits, and mushrooms. Production of nonperishable products such as essential oils, medicinal herbs, nuts, and dried fruits can bring the benefits of export markets to remote areas of the country. In addition, there is ample potential for intensifying the production of traditional food crops such as rice and maize.

2. The Financial Sector

10. Over recent years, substantial deepening and rapid expansion of the financial sector and growing monetization of the economy was achieved. Since 1980, the financial sector's contribution to GDP in real terms increased by an average of 12 percent per annum compared to 6.4 percent per annum of the real GDP growth. Accompanying the rapid growth,

several financial institutions were established. Today, in addition to the Royal Monetary Authority (RMA), which fulfills the role of a reserve/central bank, there are four major financial institutions in the country. To adequately regulate the banking institutions in the country, the Government enacted the Financial Institution's Act in 1992, and RMA introduced its Prudential Guidelines in 1995. Key indicators of the financial sector are presented in Appendix 2.

11. The Bank of Bhutan (BOB) is currently the largest financial institution in the country in terms of total assets. Over the years, BOB established 26 branch offices throughout the country. About 80 percent of BOB's shares are held by the Government and 20 percent by the State Bank of India, with which BOB has an institutional association. The Royal Insurance Corporation of Bhutan (RICB), established in 1975, provides life and general insurance. Of its total equity, 39 percent is held by the private sector and 61 percent by the Government. The bulk of the liabilities of RICB are funds obtained from the Government Employee Provident Fund (GEPF) for which an assured return of 10 percent per annum is provided.

12. The Bhutan Development Finance Corporation (BDFC) was established in 1988, under the assistance of the Bank, primarily to promote the industrial, agricultural, and commercial development of Bhutan. Its equity is shared between the Government, BOB, BNB, and RICB. The main sources of funds for BDFC are external concessional loans and grants, grants from the Government, and a line of credit from RMA. Nearly 91 percent of its loans are directed to the private sector. The Unit Trust of Bhutan (UTB), established in 1980 and made the second commercial bank with the assistance of the Bank,[1] was named BNB in December 1996. After an initial public offer in July 1996, about 28.5 percent of BNB is now held by the private sector.

13. In 1993, with the assistance of the Bank, the Royal Securities Exchange of Bhutan (RSEB) was established. It was put under the jurisdiction of RMA initially and later incorporated in 1996. At inception, there were seven listed companies. The four financial institutions, namely, BOB, RICB, BNB, and BDFC were founding members. Each has established a fully owned subsidiary brokerage firm. At the end of July 1997, there were 11 stocks being traded on the market with a market capitalization of Nu1.392 billion ($39 million). The number of investors increased from less than 2,000 in 1994 to close to 3,000 in 1996. Shares of BNB and RICB are also being traded on RSEB. Primary and secondary trading of RMA bills and Government bonds are carried out by RSEB and by the end of July 1997, the total outstanding RMA bills amounted to Nu2.531 billion ($71 million).

14. Since its introduction in 1974, the ngultrum has been pegged at par with the Indian rupee, which circulates freely within Bhutan. Cross exchange rates vis-à-vis other currencies are based on the exchange rates prevailing for the Indian rupee. Although large capital transactions with India still need to be approved by the Ministry of Finance, there are no restrictions on payments for current transactions between Bhutan and India. The existing system will continue as trade with India accounts for over 80 percent of the total external trade of Bhutan.

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1 TA No. 2532-BHU:Restructuring the Unit Trust of Bhutan to a Commercial Bank, for $590,000, approved on 13 February 1996.

C. Constraints and Issues

1. Weakness in Private Sector Development

15. Despite relatively higher growth in recent years in the manufacturing sector, private sector development has faced considerable constraints. The key constraints are (i) stringent Government control over private sector business activities; (ii) lack of an adequate physical infrastructure; (iii) lack of easy access to credit facilities; (iv) inadequate legal framework for private sector activities; and (v) limited entrepreneurial skills, and lack of information on export markets and advanced technologies. Because of weak private sector growth, the economic growth in Bhutan has not yet reached its full potential, and the Government faces an inadequate revenue base and continues to rely heavily on foreign aid. The absence of transparent and liberal rules of the game continues to have negative consequences for private sector operations by increasing costs and creating uncertainty.

16. **Industrial Licensing.** The industrial licensing system in place is not transparent and imposes entry barriers on new industrial activities. The private sector faces considerable bureaucratic and discretionary procedures that affect the choice of raw materials, degree of mechanization and production techniques, industrial location, price setting, and marketing. Currently the Commission for Industrial Development is responsible for administering the licensing of large industries, with an investment of more than Nu5 million. The licensing of the small- and medium-size industries with an investment less than Nu5 million, is being handled by the Ministry of Trade and Industries and its regional offices. Great improvements in the industrial licensing system are necessary to make it transparent, as well as friendly to the market and the private sector .

17. **Import Licensing**. In September 1996, the Government reduced tariffs on imports from the third country and adopted a new comprehensive tariff schedule, representing a significant reduction of customs duty on a range of items. It allows imports of capital goods at 0 percent and industrial inputs at 10 percent duty. In general, the import tariff rates on consumer goods vary from 10 to 30 percent, with the exception of alcoholic beverages (50-100 percent). However, the import licensing system, put in effect in February 1997, is found to be inconsistent with the proposed Foreign Exchange Regulation that aims to move toward current account convertibility. In addition, the current import licensing system has the potential to (i) undermine the Government's liberal policy to third country trade; (ii) create a shadow price for foreign imports and raise the domestic price level; (iii) act as an extra bureaucratic barrier and cost to the private sector; and (iv) cause loss of revenue to the Government, as tariffs instead of import licensing would have produced additional revenue and delicensing would have saved administrative costs.

18. **Foreign Investment.** The Government has some concerns that the process of general liberalization of foreign investment should be slow until domestic entrepreneurial capacity is strengthened, otherwise, there will be a risk of foreign domination of the economy. As a result, foreign investment is restricted to a maximum equity participation of 20 percent, is limited to the manufacturing sector, and is allowed only on a case-by-case basis. This has been tantamount to a ban on foreign investment. The experiences of other Bank developing member countries suggests that foreign investment has the potential to bring in not only capital but also managerial skills and international marketing links that would be very useful to promote export-oriented industrial activities and develop domestic entrepreneurial

capacities. A transparent policy and clearly set out regulations for foreign investment would provide a positive signal to foreign investors, while ensuring the preservation of the traditional culture, values, and environment.

19. **Entrepreneurship Development and Investment Promotion.** The entrepreneur class in Bhutan is quite limited since the economy is predominately agricultural, and the dissemination of information on the investment opportunities is limited. Many private sector entrepreneurs do not have sufficient education or adequate skills to develop, finance, and manage projects. There is a need for the financial institutions to be proactive in investment promotion activities. These activities should entail technical support to the private sector in the identification, development, and implementation of investment projects. One solution is to strengthen the investment promotion capability of the financial institutions, particularly BDFC and BNB. This would enable them to undertake proactive investment promotion and provide technical support to the private sector.

2. Weakness of the Financial Sector

20. The continued growth of the economy has created a need for greater competition and increased efficiency in financial intermediation. Despite relative deepening of the financial market in recent years, the access to credit by the private sector entrepreneurs is still difficult. Key constraints are (i) administered interest rates that hinder efficient allocation of resources, and (ii) inefficiencies in the financial system.

21. **Weak Market Competition**. One of main reasons for the inefficiencies in the financial system is the limited competition in the financial sector. Before December 1996, Bhutan had only one commercial bank, BOB. A large percentage of BOB's business was with the Government and Government-sponsored investment projects. BOB's services to the private sector was poor. Since the inauguration of the second commercial bank, BNB, some degree of competition has been brought to the market. However, since interest rates are fixed, competition has focused on providing better and more efficient commercial banking services.

22. **Administered Interest Rates**. Currently, deposit rates are fixed, and financial institutions can not offer better competition and services through interest rates to mobilize domestic saving. Lending rates are fixed by sectors and do not reflect the cost of funding, risk premiums, and loan maturities. The objective of RMA's administered interest rate policy is to maintain interest rates at appropriate levels to encourage economic activity in Bhutan, while keeping them broadly in line with those in India to prevent capital outflows. In pursuance of this objective, deposit rates are set at similar levels as in India, but lending rates are at a lower level and do not reflect the cost of funding, risk premiums, and loan maturity. Interest rate spreads for financial institutions are low. To protect themselves from nonperforming loans, financial institutions try to avoid making seemingly riskier loans, particularly those to the private sector industries, or attach more strict conditions such as a high level of collateral. As a result, the private sector is unable to borrow sufficient loans from financial institutions, and the objective of stimulating private sector economic activity through administered interest rates is not achieved. Liberalization of interest rates is expected to move demand and supply of credit toward market equilibrium, and also allow financial institutions to engage in healthy competition to better serve their customers and to make private sector projects more bankable.

23. **Institutional Capabilities of RMA**. As the central bank, RMA is responsible for developing effective monetary policies, managing foreign exchange reserves, and ensuring soundness of the financial system by enforcing prudential guidelines for financial institutions. Problems such as excess liquidity in the financial system and the large percentage of nonperforming assets (NPAs) among financial institutions signifies that effective measures are needed to upgrade RMA's institutional capabilities in their functional areas. Although prudential regulations of financial institutions were adopted by RMA since 1995, and RMA conducts an annual on-site inspection of every financial institution, there is still no clear rule for RMA to impose penalties in cases of noncompliance. As a result, the financial institutions still lack adequate incentives to improve their operational and financial performance to comply with the prudential regulations.

24. **Government Employee Provident Fund**. The current total accumulated amount of the Government Employee Provident Fund (GEPF) is about Nu1 billion. The Government invests the fund in RICB and requires it to pay a guaranteed return of 10 percent. The actual yield on the GEPF investment portfolio in 1996 was only 7.5 percent, and RICB incurred a loss of roughly Nu25 million that year. The GEPF makes up about 75 percent of RICB's funding, thus the loss levies a heavy burden on RICB, and RICB has to cross subsidize the GEPF from its insurance operations. A number of proposals have been forwarded by RICB to the Government. One option is that the Government allows a flexible return on the GEPF based on the actual performance of the investment, and pays RICB a fixed management fee. The other option is that the Government establishes an proper independent organization to manage the GEPF with its own Board of Directors.

25. **Nonperforming Assets of BNB.** BNB's total NPAs, defined as seven months in arrears and above, amounted to Nu97.4 million ($2.7 million), or about 19.5 percent of the total assets at the end of 1996. About 30 percent of these (Nu29.4 million) are the NPAs for more than three years, assets with terms expired, or suspended properties. Nearly all those three-year and older NPAs were carried over from RICB when UTB was separated from RICB. When the Bank agreed to provide the TA to convert UTB into a full-fledged commercial bank, it was agreed that all of the NPAs should be cleaned up so that the new bank would not be saddled with the heavy burden of the NPAs. If they are not cleaned up, BNB will face great difficulties in improving its operational and financial performance.

D. Government Objectives and Strategy

26. The Government gave the highest priority to the development of a balanced and market-oriented economy to overcome the heavy dependence on subsistence agriculture. Recent policy reform initiatives taken by the Government indicate its strong commitment to creating a conducive environment for private sector participation and development. Specifically, key policy measures adopted in 1996 by the Government included (i) enhancement of competition in the commercial banking market by establishing the second commercial bank; (ii) reduction of tariffs on imports from third countries and adoption of a new comprehensive tariff schedule; and (iii) preparation of several pieces of legislation, including the amendment of the Company Act, Bankruptcy Act, Commercial Sale of Goods Act, and the Copyright Act, as part of the overall effort of creating an enabling environment for private sector development.

27. As envisaged in the Eighth Five-year Plan (1997-2001), the Government will place emphasis on promoting industrial development and expansion through greater participation from private enterprises with an aim to increase the contribution of industry to GDP and to Government revenue on a sustainable and environmentally friendly basis. The Government confirmed its agreement to the policy reform initiated under the FISIF.[1] The measures are in line with the desire of the Government to create a more active private sector in the country. The proposed FISIF will reinforce the Government's determination for reforms through policy dialogue and financial support to meet part of the adjustment costs.

28. The Government will continue its private sector development program during the Eighth Five-year Plan by removing policy-related impediments and providing technical support to the private sector for the need of enhancing entrepreneurial skills. The Government will also continue further liberalization of external trade, reinforce export promotion, and further liberalize the access to foreign exchange for both industrial and consumption purposes.

29. Future reform measures envisaged by the Government for the financial sector development are expected to (i) strengthen prudential supervision of the financial institutions; (ii) develop effective monetary policy tools to enhance indirect monetary control; (iii) improve the viability and competitiveness of the financial institutions; and (iv) promote domestic credit expansion consistent with the balance of payments objectives and sustainable growth in output.

E. External Assistance to the Sector

30. Bhutan has close economic and financial links with India, which provide substantial budgetary support, financing about a quarter of public expenditure, including grants to finance major investment projects. Sources of aid were diversified in recent years, and Austria, Denmark, the Netherlands, Japan, Switzerland, the United Nations system, the World Bank, and the Bank are now the other leading sources of funds.

31. The International Monetary Fund (IMF) was instrumental in strengthening the capabilities of RMA by assisting in the introduction of RMA bills and Government securities, and the improvement of banking supervision functions. There was close coordination between the Bank and IMF during the preparation of the FISIF. The policy component of the FISIF is fully consistent with the recommendations made during IMF's last Article IV consultation mission in September 1996, in which Bank staff participated. The United Nations Capital Development Fund, Swiss Association for Technical Assistance, International Fund for Agriculture Development, Kuwait Fund for Arab Economic Development, and Swiss Development Cooperation also provided assistance to BDFC to support financing in the agriculture and industry sectors. The United Nations Capital Development Fund has tentatively included in their pipeline a credit line to BDFC, beginning 1998, amounting to $2 million to finance microcredits in the agriculture sector, as well as cottage and small industries

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1 Substantial policy dialogue and strengthening of institutional capabilities was carried out under various Bank TA projects, including TA2213-BHU:*Institutional Strengthening of the Ministry of Trade and Industry*, for $400,000, approved on 1 December 1994; TA2284-BHU:*Feasibility Studies of Converting UTB to a Commercial Bank*, for $146,500, approved on 4 January 1995; and TA2532-BHU:*Restructuring of the UTB to a Commercial Bank*, for $590,000, approved on 13 February 1996.

development. Appendix 3 presents a list of recent external assistance projects to the financial sector in Bhutan.

32. The Bank has played an important role in the development of Bhutan's financial sector. Its first involvement was in 1984 when a TA was provided to BDFC to study the development finance mechanism. Subsequently, two other TAs were given to BDFC in 1988 and 1991 mainly for capacity building. Bank also provided a TA to establish the Stock Exchange in 1992 and two TAs to UTB in 1995 and 1996 to assist its conversion to a commercial Bank. In addition to the TAs, the Bank approved a development finance institution loan of $2.6 million to BDFC in 1989.[1]

F. The Bank's Operations and Strategy in the Sector

33. The Bank's sectoral strategy is consistent with the Government's priority in the Eighth Plan of creating an enabling environment for private sector development. Bhutan's financial system is still at a rudimentary level. The small number of institutions and their specialized orientation in financial services limit the scope for competition. Development of a more dynamic and competitive financial system is crucial to economic modernization. The Bank aimed to primarily play a catalytic role to assist Bhutan in the transition from a subsistence economy to a more modern economy through the development of the private sector in the organized economic activities. The strategy also focuses on strengthening the capacity of concerned institutions to enhance a more conducive environment for private sector activities.

34. All Bank TAs in Bhutan's financial sector were implemented successfully and achieved their objectives. The implementation of the development finance institution loan to BDFC was considered successful in meeting its primary objectives and effective in promoting new enterprises in the private sector. However, the utilization of the loan was behind schedule with extensions for about one year and a half. According to the project completion report,[2] the slow utilization of the loan was caused by (i) structural macroeconomic issues in regard to large amounts of foreign aid accounting for more than 30 percent of GDP, mostly for public investments, which partly crowded out private investment; (ii) industrial policy issues on licensing, low material supply, pricing, and strict restriction on project sites; (iii) limitation of physical infrastructure, particularly roads; and (iv) a weak absorptive capacity of the business sector with a lack of project ideas, professional skills, and expertise in project preparation and promotion.

35. It is recommended that future Bank assistance for the financial sector in Bhutan should include support for policy reforms focusing on macroeconomic management, and industry and financial sector policies to effectively promote private investment. Accordingly, the FISIF is designed as a sector development program with a policy component to address the policy constraints.

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1 Loan No. 934-BHU [SF]:*Bhutan Development Finance Corporation Project*, for $2.5 million, approved on 13 December 1988.

2 PCR:BHU 21083:*Bhutan Development Finance Corporation Project*, November 1996.

IV. THE SECTOR DEVELOPMENT PROGRAM

A. Rationale

36. Private sector growth has been weak in Bhutan. GDP contribution from the nonagricultural private sector was only 13 percent in 1995. The country continues to rely heavily on foreign aid, as much as 59 percent of the Government expenditure and 35 percent of GDP in fiscal year 1996. Private sector development is facing considerable constraints including (i) stringent Government control over private sector business activities; (ii) lack of an adequate physical infrastructure; (iii) lack of easy access to credit facilities; (iv) inadequate legal framework for private sector activities; and (v) limited entrepreneurial skills, and lack of information on export markets and advanced technologies.

37. Sustained economic growth requires a greater contribution from the private sector, which in turn calls for an efficient and competitive financial sector to mobilize savings and channel long-term funds to meet the demand from private entrepreneurs. Experience shows that the development of the financial sector requires policy support to restructure the financial system and remove impediments to private sector development.

38. The proposed FISIF is designed to ensure that an adequate policy and institutional framework are in place to promote private sector development and investment. The combination of the policy loan, development finance loan, equity investment, and TA will foster an integrated and long-term approach to sector needs and will enhance the Bank's leverage for promoting policy and institutional reforms. Recent policy reform initiatives taken by the Government indicate its strong commitment to creating a conducive environment for private sector development. The proposed FISIF will reinforce the Government's determination for reforms through policy dialogue and financial support to meet part of the adjustment costs.

B. Objectives and Scope

39. The key objective of the FISIF is to bring about strong private sector growth so that the economic growth of the country can be accelerated and the domestic revenue base will be expanded for the Government, which will reduce heavy dependence on foreign aid. The FISIF is expected to (i) promote an efficient and competitive financial sector by improving resource allocation and enhance institutional capabilities; and (ii) encourage private sector development by removing policy impediments and creating an enabling operational and legal environment.

40. The policy loan will support the Government to institute a series of policy reform measures to remove impediments for the financial and the banking sector, and private sector development. The development finance loan will provide long-term foreign exchange funding to private sector subprojects through a credit line to the PFIs. The loan will also ensure that the PFIs improve their institutional capabilities and operational and financial performance. The equity investment in BNB will play a catalyst role in the privatization of State-owned financial institutions. The size of the policy loan is determined by the adjustment cost for the Government to carry out the policy reform measures. Counterpart funds generated by the policy loan will augment the Government's general budgetary resources

and be used by the Government to meet the adjustment cost. The size of the credit line is determined by the aggregate size of the project pipelines projected by the PFIs.

C. Policy Framework and Actions

41. The policy framework addresses each of the factors that result in the weak private sector growth in Bhutan. The Program Logical Framework (see Appendix 4) addresses the key reform areas including (i) removal of the policy impediments to private sector development by rationalizing Government control over private sector business activities; (ii) liberalization of the interest rate structure and improvement in interest rate management; (iii) rationalization of foreign exchange transactions; (iv) enhancement of the efficiency and competitiveness of the financial system; (v) strengthening the enabling legal framework for financial system operation and private sector business activities; (vi) improvement of private sector entrepreneurship and management skills, and access to information; and (vii) upgrading the human resource base in financial institutions.

42. The policy loan will be released in two tranches to meet the expected occurrence of adjustment costs with the first tranche to be released upon loan effectivity and the second tranche to be released within 18 months from the first tranche release, subject to compliance with the conditions for their releases. The tranche release conditions are designed to take into account the proper timing and sequencing of the policy actions, with a view to optimizing the sequencing of the policy reform steps, as well as minimizing the short-term costs of adjustment. The first tranche release conditions are policy actions to be introduced before the loan is approved by the Board and are expected to be met before loan negotiations.

43. **First Tranche Release Conditions**. First tranche conditions of the policy loan are also tied to the effectivity of the credit line. They are considered crucial for the successful implementation of the whole policy reform package and the utilization of the credit line. These conditions are

(i) improve the industrial licensing system and rationalize administrative requirements for industrial locations, pricing, and raw material supplies based on published guidelines as agreed with the Bank ;

(ii) review the current case-by-case approach to foreign investment and move toward developing a set of transparent foreign investment policy and regulations that will be subsequently issued and published;

(iii) draft import licensing regulations consistent with the foreign exchange regulations as agreed with the Bank;

(iv) make effective the Commercial Sales of Goods Regulation 1997;

(v) remove administered sectoral interest rate controls, and allow financial institutions to determine deposit and lending rates, while keeping their interest spread[1] initially at a maximum of 6 percent, until sufficient

[1] Interest spread = (income from loan/average loan portfolio) - (interest expenses/average long-term liabilities)

competition between financial institutions is in place when the interest spread ceiling will be lifted;

(vi) abolish the requirement for RICB to provide a 10 percent fixed return on the GEPF;

(vii) complete the drafting of the Real and Moveable Properties Act, which will give financial institutions adequate legal rights in their loan collection activities;

(viii) issue and publish a set of policies and regulations regarding foreign exchange transactions as agreed with the Bank; and

(ix) consummate the transactions, under the agreement on the cleaning up of BNB's portfolio of nonperforming loans involving the swap of such assets inherited by BNB from UTB for cash from the Government.

44. **Second Tranche Release Conditions**: The second tranche of the policy loan will be released 18 months after loan effectivity. These conditions are linked to continued commitment of the subloans under the credit line and are necessary to build a better environment for future private sector growth focusing on private sector development. They include

(i) issue and publish a set of policies and regulations regarding foreign investment as agreed with the Bank;

(ii) issue and publish a set of import licensing regulations as agreed with the Bank;

(iii) make effective the Bankruptcy Act and amendments to the Companies Act;

(iv) remove any form of Government subsidy to the GEPF;

(v) improve RMA's Prudential Guidelines and strengthen the banking supervision function by instituting a system of fines and penalties for violations;

(vi) build market infrastructure by creating a credit information bureau and an interbank market;

(vii) improve the operational efficiency of the payments system by including branches of commercial banks outside of Thimphu in the clearing and settlement system; and

(viii) set up an enabling legal framework for the financial system by making the Real and Moveable Properties Act and the Negotiable Instruments Act effective.

45. **Adjustment Costs.** The cost of adjustment is expected to arise from three key policy reform conditions: (i) deregulation of interest rates; (ii) GEPF reform and restructuring; and (iii) cleaning up of BNB's portfolio of nonperforming assets. It is estimated that the deregulation of interest rates will increase the Government's borrowing cost from the domestic market by as much as Nu92 million ($2.6 million) for four years after the effectivity of the FISIF. Reform of the GEPF may require as much as Nu48 million ($1.35 million). About Nu52.4 million ($1.5 million) is needed to clean up BNB's loan portfolio. Lastly, Nu30 million ($850,000) will be required to enhance the institutional capabilities of the financial sector and promote private sector development. Thus, the total adjustment cost of the Program is about Nu222 million ($6.3 million).

D. Capacity Building

46. Weak institutional capacity of the financial sector and weak private sector entrepreneurship and management skills are identified as two major constraints to the improvement of the financial system and the expeditious development of the private sector. The FISIF addresses the capacity-building needs of the financial institutions by setting up an appropriate implementation arrangements for use of the development finance loan, and by implementing institutional strengthening measures under the advisory TA in conjunction with the loan. The proposed equity investment in BNB will bring in the services of foreign banking experts to improve the management skills of BNB. Private sector entrepreneurship and management skills will be developed through measures aimed at strengthening the investment promotion activities in BDFC and BNB, which will assist the private sector to enhance its participation in industrial development and increase employment opportunities.

E. The Investment Project

47. The development finance loan will be used by PFIs to fund small- and medium-size private sector industrial and commercial agriculture projects. A significant high portion of capital cost requirements of industries in Bhutan is in foreign currency as most capital items are imported. While a few large industrial projects have been able to obtain direct foreign currency funding, most projects, particularly small- and medium-size private sector industrial and commercial agriculture projects, have difficulty obtaining foreign currency funding. Sustained growth in the private sector industry and commercial agriculture establishments requires additional loans in the order of $150 million over 1997-2001. The country's financial sector is unable to fully meet the demand for long-term credit. The credit line will meet part of this demand.

48. The equity investment is a logical extension of the financial sector reform program promoted under the FISIF, which aims to open up the financial sector to competition and efficiency enhancement. The Bank's investment will play a catalytic role to attract increased private sector participation, bring in a foreign strategic investor[1] with technical expertise, and assure domestic and foreign investors that the institution is credible and that there will less likely be arbitrary and noncommercial intervention or regulatory discrimination. By converting BNB to a truly private sector institution operated by professionals, the Bank is creating positive advocates for change who will continue the process of reform and liberalization of the financial sector.

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1 The Bank has conducted a wide review of possible partners. Citibank has expressed an interest in investing in BNB.

F. Social and Environmental Measures

49. **Social Impacts**. The primary beneficiaries of the FISIF are the private sector entrepreneurs because the increased competition and improved efficiency in the financial market will provide them with easier access to credit facilities. Policy reforms will create a policy environment for industrial development that is friendlier to the market and the private sector. The proposed Program will benefit a large proportion of the local labor force by increasing employment opportunities, estimated in the range of 1,000 to 2,000, in the nontraditional sectors and widening the base for resource mobilization. As women make up half of the working population in Bhutan, the Program will directly benefit many of them. All subprojects will comply with all the applicable social guidelines of the Bank and indicate the mechanism that will be used to enable the Bank to monitor compliance with this provision.

50. **Environmental Measures**. The environment category of the Program is B. Environmental impact assessment or initial environmental examination will be undertaken for the subprojects. Subprojects to be undertaken by the private sector include subsectors such as minerals, wood-based manufacturing, beverages, and transportation. The environmental impacts of these subprojects could be mitigated to minimize the adverse effects. All subprojects will comply with the Government's environmental regulations.[1] The PFIs will follow the Bank's environmental guidelines in the selection of subprojects and will be responsible for ensuring that subprojects comply with Government environmental regulations, including compliance with environmental quality standards and requirements for environmental impact assessments, and will further ensure that appropriate safeguards and equipment for compliance are built into each subproject.

51. Environmental protection and improvements will be considered as an important area for subproject selection. Reform measures promoted under the policy loan, such as the liberalization of the interest rate structure and the removal of administered sectoral interest rates will make it possible for financial institutions to determine suitable lending rates to environmentally important subprojects. The improvement of the industrial licensing system, market-driven price determination for raw materials and minerals, and increased private sector participation in industrial activities in the long run, will be beneficial for environmental protection.

V. THE PROPOSED LOANS

A. The Policy loan

1. Amount of Loan, Terms, and Source of Funds

52. The loan in the amount of SDR 2,939,000 ($4 million equivalent) will be provided from the Bank's Special Fund resources. The loan will have a maturity of 40 years, including a grace period of 10 years, and will carry a service charge of 1 percent per annum. Policy loan proceeds will be used to finance eligible imports that are produced in and procured from the Bank's member countries. The counterpart funds generated by the loan

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1 The Ministry of Environment is implementing an ongoing Bank TA, TA No. 2531-BHU: *Strengthening Environmental Impact Assessment Capabilities and Preparation of Environmental Guidelines*, for $590,000, approved on 13 February 1996.

will be used by the Government to meet part of the adjustment cost. The list of ineligible items not to be financed by the policy loan is shown in Appendix 5.

2. Implementation Arrangement and Executing Agency

53. **Executing Agency**. RMA will be the Executing Agency. The Ministry of Finance will coordinate with concerned ministries and agencies on the reform actions, and RMA will be responsible for implementing matters related to financial policy reforms and institutional strengthening. A policy steering committee (PSC) has been set up before the loan negotiations, comprising concerned ministries and chaired by the secretary of the Ministry. The committee will provide overall guidance on policy-related matters under the program. A Program implementation unit will be set up and a Program director will be appointed before the loan negotiations. It will implement the day-to-day activities of the Program, including the policy-related matters under the Program.

54. **Reporting Requirements**: RMA, in coordination with the Ministry of Finance, will furnish a half-yearly progress report to the Bank on the progress and problems relating to the institutional and policy reform program agreed under the FISIF.

3. Procurement and Disbursement

55. **Procurement**: The loan proceeds will be used to finance the foreign exchange costs, excluding local duties and taxes, of imports. Except as the Bank may otherwise agree, contracts for eligible imports costing more than $1 million will be awarded on the basis of international competitive bidding. Contracts for eligible imports costing the equivalent or less than $1 million will be awarded in accordance with standard commercial procurement procedures and practices acceptable to the Bank, in the case of procurement by the private sector; or with the Government's prescribed procurement procedures acceptable to the Bank, in the case of procurement by the public sector. In general, procurement under the Program will be in accordance with the Bank's *Guidelines for Procurement* dated January 1994. Only expenditures on goods and services that are produced in and procured from the Bank's member countries are eligible for financing. Supply contracts for commonly traded commodities will be awarded according to procedures appropriate to the trade and acceptable to the Bank.

56. **Disbursement**: The Bank's statement of expenditures procedures will be used for liquidation of expenditures under the Program in accordance with the Bank's *Loan Disbursement Handbook* and detailed arrangements agreed to by the Government and the Bank.

4. Counterpart Funds

57. The counterpart funds generated by the loan will be used by the Government to meet the cost of the policy reform program. The use of the counterpart funds will be monitored by the Bank during Program implementation.

5. Monitoring and Tranching

58. The Program period is four years after the loan effectivity. The policy loan will be released in two tranches to meet the expected occurrence of adjustment costs. The first tranche of $2.5 million is expected to be released upon loan effectivity, and the second tranche of $1.5 million within 18 months from the first tranche release, subject to compliance with the conditions for their release.

59. Monitorable and time-bound actions under the proposed policy loan were identified as conditions for the release of the second tranche, following the midterm policy review carried out by the Government and the Bank concerning the progress in implementing the policy reforms. These required actions and targets are reflected in the Development Policy Matrix and the Program Logical Framework. In addition to the midterm policy review, Bank will also monitor the Program implementation through periodic reviews and the Program progress report submitted by RMA. To facilitate such a review, the Government will provide relevant data and information in such detail as the Bank may reasonably request. The midterm policy review will provide the basis for discussion between the Government and the Bank on further reforms that may be considered necessary for the continued development of the financial sector.

B. The Development Finance Loan

1. Financing Structure, Rationale and Objectives

60. The development finance loan is designed as an umbrella credit line to be made available to qualified PFIs for commitment on a first-come, first-served basis. It will provide foreign exchange resources to finance industrial and commercial agriculture projects in the private sector. It will also alleviate the pressure on the liquidity management of the PFIs and lower the general cost of funding for project finance. The eligibility criteria of subprojects and the main terms and conditions of the credit line, such as the debt-service coverage ratio and the amortization grace period, will help the PFIs to move away from purely collateral-based lending to cash flow-based project finance, and enhance their institutional capability to put private sector proposals into bankable projects.

2. Main Terms and Conditions

61. **Loan Amount, Borrower, and Executing Agency**. The proposed loan from the Special Funds resources will be made available in various currencies equivalent to SDR 2,939,000 ($4 million equivalent). The Borrower will be the Kingdom of Bhutan. The Executing Agency will be RMA.

62. **Lending Mechanism**. The loan will be provided to the Borrower, which will relend the loan proceeds to the PFIs through RMA under subsidiary loan agreements acceptable to the Bank. Each PFI will onlend to eligible subborrowers on the basis of its own standard loan documentation.

63. **Currency of Borrowing, Relending, and Onlending**. The loan will be denominated in SDRs and drawn down in various currencies. Relending and onlending will

be denominated in the Bhutanese ngultrum at the exchange rate prevailing at the time when the respective disbursements are made.

64. **Service Charge and Interest Rate for Borrowing, Relending and Onlending**. The loan to the Government will carry the Special Funds resources terms of 40 years maturity including 10 years grace period with a service charge of 1 percent per annum, payable six-monthly. The relending rate from the Government to the PFIs will be equal to the weighted average commercial bank deposit rates (WADR),[1] published by RMA from time to time and prevailing on the date of withdrawal. The WADR will be adjusted at six-monthly intervals. The applicability of the WADR as the reference rate will be reviewed annually, and this rate will be replaced by the treasury bond rate if the treasury bond rate can be established as a stable benchmark. The onlending rate from the PFIs to subborrowers will be market determined to reflect credit risks and market conditions.

65. **Foreign Exchange Risk**. The foreign exchange risk will be borne by the Borrower.

66. **Allocation of Loan Proceeds**. The loan will be available to two qualified PFIs for commitment on a first-come, first-served basis.

67. **Loan Utilization Period**. Applications for subloans must be submitted to the Bank for approval/authorization for withdrawal within three years of the commitment period, and application for disbursement within four years after loan effectiveness.

68. **Amortization**. The Borrower will repay the loan on standard Special Funds resources terms of 40 years maturity including a 10 year grace period. Relending by the Borrower to the PFIs will be for a fixed period of 15 years inclusive of a 3 year grace period. Subloans from the PFIs to subborrowers will have a maximum maturity of 15 years including a grace period of up to 3 years.

3. Subproject Eligibility Criteria

69. **Sectoral Criteria**. Private enterprises in small- and medium-size industries and commercial agriculture with a special emphasis on (i) export/foreign exchange earnings orientation, (ii) technology enhancement, (iii) optimal use of indigenous raw materials, and (iv) environmental protection and improvements, will be eligible.

70. **Eligible Subproject**. Qualified subprojects should meet the following criteria:

(i) a maximum long-term debt/equity ratio of 75:25;

(ii) a minimum debt-service ratio of 1.25;

(iii) a minimum financial internal rate of return (FIRR) higher than the weighted average cost of capital; and

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[1] The WADR will be calculated as the weighted average rates of commercial bank deposits of over 12 months. It is expected to reflect the cost of long-term funding for financial institutions in Bhutan. Because the ngultrum is pegged at par to the Indian rupee, the WADR is also expected to follow Indian interest rate movements closely.

(iv) a minimum economic internal rate return (EIRR) of 12 percent for subloans above the free limit when it is feasible to calculate the rate for the subproject.

71. **Eligible Expenditure**: The credit line will be used to finance the foreign currency expenditure of eligible subloans. In the case of direct foreign currency expenditure where documentary evidence is available, 100 percent will be eligible for financing. If the actual foreign exchange cost is not available, 50 percent for civil works and 75 percent for locally procured imported machinery will be recognized as the indirect foreign exchange cost and will be eligible for financing. Only expenditures on goods and services that are produced in and procured from the Bank's member countries are eligible for financing.

72. **Subloan Size**: The minimum subloan size will be $5,000 and the maximum subloan size will be $500,000.

73. **Free Limit**: The free limit will be $50,000 for BDFC; zero for the first five subloans for BNB, which will require prior Bank approval; and $30,000 thereafter.[1]

74. **Subproject Benefit Monitoring and Evaluation**: The PFIs will monitor and evaluate the benefits of the subprojects after they are completed and in accordance with a schedule to be mutually agreed upon by the PFIs and the Bank.

75. **Environmental Aspects**. The PFIs will be responsible for ensuring that subprojects comply with the Government's environmental regulations and Bank's environmental guidelines.

4. Eligibility Criteria for Participating Financial Institutions

76. The eligible PFIs are required to meet the following criteria throughout the implementation period of the loan:

(i) a minimum annual collection ratio for the total portfolio of 80 percent;

(ii) a maximum portfolio infection ratio of 20 percent;

(iii) a minimum return on average assets of 1 percent after tax;

(iv) a minimum debt-service cover of 1.25 times; and

(v) compliance with RMA Prudential Guidelines as amended from time to time.[2]

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1 The subloan free limit under the first credit line to BDFC was $25,000. The new free limit of $50,000 for BDFC was set taking into account US dollar inflation during 1989-1997 and the free limit under the credit line from the Kuwait Fund for Arab Economic Development.

2 RMA Prudential Guidelines for Financial Institutions, dated May 1995, cover provisions pertaining to reporting requirements, on-site inspection, capital adequacy ratio, liquidity ratio, single borrower limit, large loans and advances, nonperforming assets, provisions, and other miscellaneous items.

77. **External Audit**: Each PFI will have its accounts and financial statements, including balance sheet, income statement, cash flow statement, and other related statements, audited annually in accordance with sound auditing standards by an independent external auditor acceptable to the Bank. The external auditor will be required to certify in a separate letter to the Bank that all financial covenants under the PFI's long-term borrowings, including the Bank Project Agreement, are complied with.

78. **Reporting Requirements**: Each PFI will furnish to the Bank a half-yearly progress report concerning loan and subloan implementation, the administration, operation, and financial condition of the PFI and other related matters within 45 days after the end of the relevant half-year, and a Program completion report within three months of the loan closing date. Copies of the half-yearly reports will also be furnished to RMA. Within 30 days after the receipt of the above-mentioned half-yearly report from the PFIs, RMA will furnish to the Bank its own report on the progress and problems regarding the utilization of the loan proceeds.

5. Procurement and Disbursement

79. **Procurement**: The PFIs will require all subborrowers to demonstrate that the procurement procedures adopted are appropriate in the circumstances. The PFIs will ensure that the goods procured are suitable for the subproject, and the prices paid are reasonable. In general, procurement under the subloans will be in accordance with the Bank's *Guidelines for Procurement*. The expenditures incurred up to 180 days prior to the receipt by the Bank of subloan application will be allowed under the credit line.

80. **Disbursement**: An imprest account will be established by RMA in the amount to be agreed by the Bank from which contracts for eligible items costing less than the subloan free limit may be financed. The Bank's statement of expenditures procedures will be used for the liquidation of expenditures from and replenishment to the imprest account. The imprest account will be established, managed, replenished, and liquidated, in accordance with the Bank's *Loan Disbursement Handbook* and arrangements agreed to by the Government and the Bank.

6. The Financial Intermediaries

81. Two financial institutions, BDFC and BNB, have qualified to participate under the development finance loan. BDFC operated satisfactorily in an earlier Bank loan[1] and the proposed development finance loan will be one of the major funding sources for BDFC's Industrial Lending Department (ILD) in next few years. BNB was recently set up as country's second commercial bank with the primary objectives of enhancing competition and efficiency of the financial market, and better serving the private sector. In addition to deposits, BNB is actively seeking to secure other sources of funds such as standby credit facilities to alleviate the pressure on its liquidity and maturity management, and to expand its project financing activities. The selection and continued participation criteria of the PFIs were developed to ensure financial stability in terms of solvency, liquidity, and profitability in the context of

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[1] Loan No. 934-BHU [SF]:*Bhutan Development Finance Corporation Project*, for $2.5 million, approved on 13 December 1988.

prudent oversight and supervision. Detailed descriptions of the two PFIs and their financial forecasts are attached as Appendix 6 and 7.

82. BDFC's operating objective is to promote the growth of industrial, agricultural, and commercial enterprises in the country by providing loans and advisory services to private sector entrepreneurs. BDFC operates two profit centers, namely ILD and the Agriculture Lending Department. ILD's funding requirement is met from credit lines from the Bank and other multilateral and bilateral organizations. The operation of the Agriculture Lending Department is financed through the grants received from the United Nations Capital Development Fund and the International Fund for Agriculture Development.

83. As a commercial bank, BNB offers an array of banking products and services, including customized loans, investments, letters of credit, foreign exchange, remittances, and advisory services. In addition to commercial banking services, BNB provides project finance for the industry, agriculture, and service sectors. It also provides short-term loans including working capital loans, bill discounting, guarantees, and underwriting facilities.

84. As of 31 December 1996, the total loan portfolio of ILD of BDFC was Nu228 million as against Nu91 million in 1991, representing an increase of 18.4 percent per annum over five years. The profitability of ILD's operations has grown steadily. Profit before tax in 1996 was Nu9.5 million as against Nu0.35 million in 1990. ILD contributes about 60 percent of BDFC's loan portfolio, but 80 percent of net income after tax. Total arrears of ILD as of end-1996 amounted to Nu21.2 million, as against Nu8.8 million as of end-1993. The management of BDFC has always upheld the importance of loan recovery, and the collection performance of ILD remained above 90 percent throughout the years.

85. As a new commercial bank, the operation scale of BNB is smaller than the country's other commercial bank, BOB. In terms of both total assets and total deposits, BNB is about a quarter of the size of BOB. However, more than 80 percent of BNB's loans go to the private sector, compared with 13 percent for BOB. When BNB was converted from UTB in December 1996, its NPAs made up about 19.5 percent of the total. An asset-for-cash swap was arranged so that BNB can swap part of the NPAs with the Government for cash.

86. The projected disbursement by BDFC during 1997-2001 is $25 million, while the resources available for disbursement amount to $11 million. This leaves a financing gap of $14 million. The projected disbursement by BNB during the same period is $47 million while only $21 million is available, or a financing gap of $26 million. The total financing gap of the two PFIs is about $40 million. The Bank development finance loan will be used to finance private sector industrial and commercial agriculture projects. These sectors comprise more than 75 percent of BNB's portfolio and about 60 percent of BDFC's. Accordingly, the financing gap for projects that could be eligible under the Bank credit line amounts to about $28 million. The proposed development finance loan of $4 million is expected to meet less than 15 percent of the estimated credit requirements. Appendix 8 presents a pipeline of subprojects that could be eligible under the Bank credit line from the two PFIs for 1997.

VI. EQUITY INVESTMENT

A. Description of the Proposed Equity Investment

87. The proposed Bank equity investment in BNB is up to Nu28,264,000 from the Bank's ordinary capital resources by subscribing up to 148,760 common shares of BNB, each having a par value of Nu100, at a price of Nu190 per share. BNB is incorporated in Bhutan as a company under the Companies Act 1989. The Bank's investment in BNB would be reduced depending on firm participation by the foreign strategic investor. Under the Bank equity investment, there will be a subscription agreement between the Bank and BNB, and a shareholders agreement among the Bank, the Government (sponsor of BNB, as it presently owns 67.2 percent of the issued and paidup capital of the common shares of BNB), BNB and a foreign strategic investor. These agreements will be entered into upon terms and conditions generally applied in Bank equity investments in the private sector.

88. Under the proposed Bank equity investment, the Bank will be entitled to be represented on the Board of Directors by one director nominated by the Bank (the ADB Nominee Director), and in the absence of the ADB Nominee Director, by an alternate director nominated by the Bank. A condition of Bank subscription in BNB is that the loan agreement for the program loan is declared effective. A framework agreement dated 13 July 1983 relating to Bank equity operations in Bhutan is in effect between the Government and the Bank. The Government's no-objection to the proposed equity investment in BNB has been obtained.

B. Justification

89. **Support of Financial Sector Reforms**. The equity investment is a logical extension of the Bank's policy dialogue with the Government to open the financial sector to competition, enhance efficiency, reduce the cost of borrowing, increase returns to investors, and provide more efficient channeling of funds to private sectors.

90. **Catalytic and Demonstrational Effect**. The Bank's investment will bring in an equal investment from a foreign bank, and attract increased private sector participation with upgraded management. The Bank's participation assures domestic and foreign investors that the institution is credible, and that there will less likely be arbitrary intervention into normal business activities by the Government.

91. **Increased Competition**. With the Bank's participation, BNB will be in a better position to enhance competition in Bhutan's financial sector by providing better and more responsive services for the private sector, hence reducing the effective cost of capital, and thereby increasing the possibility of making projects viable.

92. **Promote Trade and Export**. With the participation of a foreign commercial bank, BNB will be in a better position to focus on trade, exports, and foreign exchange, and provide services in these interest and exchange rate sensitive areas where time and service are of great importance. BNB will able to enhance links to world markets, help increase foreign exchange earnings, and better contribute to the competitiveness of the country.

93. **Advocates of Change**. By converting BNB to a truly private sector institution operated by professionals, the Bank is creating positive attitudes for change that will support the continuation of the process of reform and liberalization of the financial sector.

C. Rate of Return on the Bank Investment

94. **Pricing**. The earnings approach was utilized in valuing the shares of BNB. This approach was considered most suitable for financial institutions. An appropriate price/earnings ratio at which the projected earnings per share of BNB could be valued to arrive at an acceptable price was selected on the basis of comparable financial institutions in India and those listed companies in Bhutan.[1]

95. The Government and the Bank agreed on the purchase price of Nu190 per share in December 1996. At that time, there was hardly any trading on BNB shares following the initial public offer. The preliminary purchase price was first determined by looking at the book value per share of Nu218 in December 1996 and applying a discount factor of 15 percent.[2] The preliminary purchase price was then justified based on the earnings approach and a series of sensitivity tests. Share in BNB have become among the most traded shares on RSEB since the market learned the news of the proposed Bank equity investment. The price of BNB shares went up from the initial public offer price of Nu165 per share to a range of Nu195-225. The latest price on 4 July 1997 was Nu225 per share. Nevertheless, the volume of trade on the stock market was still relatively thin with roughly 1,000 shares changing hands each month. Instead of direct sales to the Bank and its foreign partner, if the Government divests 40 percent of the BNB shares through the stock market, the additional supply of 238,016 shares will likely dampen the market price.

96. **Disposal of Investment and FIRR**. Bank investment can be disposed of through RSEB or another transparent mechanism satisfactory to both the Bank and the Government. A model was built to estimate the FIRR under different purchase and selling prices and other assumptions (see Appendix 9). Based on the financial projections for BNB for the next five years with an average growth rate in profit before tax of 24 percent per annum, the FIRR for the Bank's investment is calculated as 31.1 percent in the base case, given the purchase price of Nu190 per share and assuming that the investment is sold in 2001 at the price/earnings ratio of 10, and a 4.3 percent per annum depreciation of the ngultrum against the dollar. In the worse case scenario where the growth rate of profit before tax is reduced by 50 percent and the ngultrum's depreciation against the dollar is increased to 7 percent per annum, the FIRR for the Bank's investment is estimated at 9.5 percent, which is still above the Bank's ordinary capital resources rate. The financial projections for BNB are considered conservative and much lower than other recent financial projections for equity investments in new commercial banks.[3] Table 1 shows the result of the sensitivity analysis based on different market price/earnings ratios at the time of disposal.

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1 The three year average (1994-1996) price/earning ratio for five private Indian finance companies was 12.7. The average price/earning ratio of six Bhutanese companies listed in RSEB in 1994 was 6.4.

2 The discount factor takes into account the risks of the equity investment. Similar discount factors were used in other Bank equity investments, including in the State Bank of India Capital Markets Limited.

3 For example, in the case of recent Bank equity investments in two new private Indian commercial banks, the annual growth rate of net profit after tax for both banks was projected to be near 40 percent in the first five years of operation.

Table 1: Sensitivity Analysis of Selling Price

Market Price/Earnings Ratio	Total Value ($ million)	FIRR on Nominal Terms	FIRR with per annum Ngultrum Depreciation of 4.3 Percent	7 Percent
5	1.0	15.0	10.2	7.5
7	1.3	25.1	19.9	16.9
10	1.9	36.7	**31.1**	27.8
15	2.9	51.3	45.1	41.4
20	3.8	62.6	55.9	52.0

Assumptions:

1. The Bank will subscribe up to 148,760 shares or 25 percent of BNB's capital at the price of Nu190 per share with the value of about $790,000.
2. The investment will be sold in 2001 at a price of 10 times the earnings per share.
3. The ngultrum depreciation of 4.3 percent is based on the average of projected inflation differentials during the period of 1997-2001.

VII. THE TECHNICAL ASSISTANCE

97. An advisory TA grant of $500,000 equivalent for Capacity Upgrading of Financial Sector Infrastructure and Entrepreneurial Development accompanies the FISIF. The TA has the following objectives: (i) to upgrade the capacities of the Government agencies involved in the reform program; (ii) to strengthen institutional capabilities of the financial institutions; and (iii) to enhance private sector entrepreneurship and management skills. The TA will require a period of 18 months for implementation, and about 13 person-months of consulting services from a team of four international consultants: a financial sector policy specialist as the team leader, a financial sector operations specialist, a financial legal and regulatory specialist, and a private sector development specialist. Detailed terms of references and cost estimates can be found in Appendix 10. The TA will be financed by the Bank on a grant basis from the Japan Special Fund, funded by the Government of Japan. The Executing Agency will be RMA. RMA will coordinate the consultants' activities with various Government agencies and financial institutions and provide office space, secretarial support, local transport, and logistical support. The consultants for the TA are to be engaged by the Bank in accordance with the Bank's *Guidelines on the Use of Consultants* and other arrangements satisfactory to the Bank.

VIII. BENEFITS AND RISKS

A. Expected Impacts

98. The primary beneficiaries of the FISIF are private sector entrepreneurs because increased competition and improved efficiency in the financial markets will provide them with easier access to credit facilities. The removal and streamlining of Government regulations and restrictions on industrial licensing, location, raw materials sourcing, and access to foreign exchange for the import of industrial goods, will create a policy environment for industrial development that is friendlier to the market and the private sector. The likely rise in the lending rate during the adjustment period may increase the cost of borrowing for the private sector. However, such costs will be more than offset by the efficiency improvements in the financial markets and assured accessibility to credit facilities. The Bank's equity

investment in BNB will directly support financial sector reforms, play a catalytic role to attract increased private sector participation, increase competition in the market, promote trade and export, and be an advocate of change that will continue the process of reform and liberalization of the financial sector.

B. Risks and Safeguards

99. **Policy Loan.** Unfavorable macroeconomic conditions, lack of Government experience in key policy reform measures, lack of entrepreneurial and technical skills, and slower than expected approval processes for legislation by the National Assembly are some of the identified risks affecting the successful implementation of the policy program under the FISIF. Effective policy dialogue, better coordination with other international agencies, effective implementation of the TA provided by the Bank in conjunction with the loan, and well-designed training programs would provide safeguards against most of the identified risks. The Government has demonstrated strong commitment to reforms and has already undertaken several measures as agreed with the Bank.

100. **Development Finance Loan**. Risks could arise from delayed or insufficient and inefficient use of loan proceeds, unforeseen weakening of institutional capabilities of the PFIs, and unexpected adverse macroeconomic shocks. These risks are considered acceptable in the light of (i) the general satisfactory performance of an earlier loan to BDFC and suitable operational procedures adopted in BNB through an earlier Bank TA to establish BNB as a commercial bank; (ii) the strong growth of the Bhutanese economy and good potential for private sector development; and (iii) the Government and RMA's demonstrated commitment to policy reforms and the strengthening of institutional capabilities.

101. **Equity Investment**. The risks in the Bank's equity investment in BNB are regarded as acceptable with major risks adequately mitigated. These may include (i) difficulties in mobilizing sufficient deposits from the public, (ii) inadequate professional standards while BNB is rapidly growing, (iii) losing control of insider and behest loans, (iv) adverse regulatory intervention, and (v) lack of a liquid market for the disposal of the Bank's shares through the RESB. Nevertheless, all the risks are expected to be adequately mitigated through safeguards such as BNB's positive reputation and service orientation, standard products, appropriate technology and controls, skilled and motivated staff, effective management, and prudent banking practices. In addition, RMA has made a good effort to promote an efficient and competitive banking sector in the country and is expected to improve prudential regulations and its bank supervision function. Lastly, the Bank's continued involvement with the development of the capital market in Bhutan, including the restructuring of the GEPF to make it an efficient participant in the capital market, the establishment of an adequate regulatory framework, and improving the operation of the central depository and the clearing system, is expected to enhance the operational efficiency and the market liquidity of RSEB.

IX. ASSURANCES

102. The Government has given the following assurances, in addition to the standard assurances and the tranching conditions stated earlier in this Report, which have been incorporated in the legal documents:

(i) The Government will (a) ensure that the policies adopted and actions taken as described in the Policy Letter continue in effect for the duration of the Program period; and (b) promptly adopt the other policies and take the other actions included in the Program as specified in the Policy Letter, and ensure that such policies and actions continue in effect for the duration of the Program period.

(ii) The Government will speed up the privatization process of public-owned enterprises during the Program period.

(iii) During the Program period, the Government will strengthen the investment promotion activities of BDFC and BNB, and assist the private sector in identifying, developing and implementing investment projects.

(iv) During the Program period, the Government will develop the financial sector by

(a) rationalizing the management arrangement under GEPF and strengthening the operation of RICB to make it an efficient participant in the capital market;

(b) strengthening RMA's capability in foreign exchange risk management and developing monetary policy tools to enhance indirect monetary control;

(c) speeding up the development of the capital market by establishing an adequate regulatory framework and improving the operation of the central depository and the clearing system; and

(d) organizing a training program, acceptable to the Bank, for bankers at RIM.

(v) The Government will cause the PFIs to ensure that the subprojects comply with the Borrower's environmental regulations and the Bank's environmental guidelines.

(vi) The Government will cause the PFIs to monitor and evaluate the benefits of the subprojects after they have been completed in accordance with a schedule to be agreed upon by the Government, the PFIs and the Bank.

X. RECOMMENDATIONS

103. I am satisfied that the proposed loans and equity investment would comply with the Articles of Agreement of the Bank and recommend that the Board approve:

(i) the policy loan in various currencies equivalent to Special Drawing Rights 2,939,000 to the Kingdom of Bhutan for the Financial Sector Development Program, with a service charge at the rate of one percent per annum and with an amortization period of 40 years, including a grace period of 10 years, and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan Agreement presented to the Board;

(ii) the development finance loan in various currencies equivalent to Special Drawing Rights 2,939,000 to the Kingdom of Bhutan for the Development Finance Loan Project, with a service charge at the rate of one percent per annum and with an amortization period of 40 years, including a grace period of 10 years, and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan and Projects Agreements presented to the Board; and

(iii) an equity investment in Bhutan National Bank in Ngultrum (Nu) of up to Nu28,264,400 from the Bank's ordinary capital resources by subscribing up to 148,760 common shares of BNB, each having a par value of Nu100, at a price of Nu190 per share.

Mitsuo Sato
President

29 September 1997

APPENDIXES

ROYAL GOVERNMENT OF BHUTAN
MINISTRY OF FINANCE

TASHICHHO DZONG
THIMPHU : BHUTAN
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DEVELOPMENT POLICY LETTER
Financial Sector Intermediation Facility

8/MFS/97/856

18 September, 1997

Mr. Mitsuo Sato
President
Asian Development Bank
Manila, Philippines

Dear Mr. President,

The Kingdom of Bhutan has made significant progress in socioeconomic development in the last decade and the vast majority of people have enjoyed significant improvements in the quality of life. The success achieved by the country is largely due to the adoption of appropriate policies and strategies by the Royal Government of Bhutan (RGOB) as well as the emergence of a small and growing private sector. Moreover, the measures and initiatives taken by the RGOB within the planning framework continue to pay high dividends.

A. Rationale (Development Objectives)

As envisaged in the Eighth Five Year Plan (1997-2001), the RGOB will place emphasis on: (i) promoting industrial development and expansion through greater participation from private enterprises with the aim to increase the contribution of industry to the GDP and to Government revenue on a sustainable and environmentally friendly basis; and (ii) broadening employment opportunities and skills development, particularly for women, and enhancing the living standards and working conditions of those employed. To achieve these underlying objectives the most important strategies for RGOB are to: (i) provide an enabling environment for the private sector; (ii) explore possibilities of further privatization of Government-owned enterprises; (iii) provide necessary incentives and adequate infrastructure; (iv) make optimal use of indigenous raw materials; and (v) promote cottage and small-scale industrial enterprises.

Sustained economic growth requires greater contribution from the private sector, which in turn calls for an efficient and competitive financial sector in order to mobilize savings and

channel long-term funds to meet the demand from private entrepreneurs. The RGOB's reform agenda in the financial sector is aimed to create a competitive environment, greater mobilization of resources and improvements in financial intermediation, to deepen and widen the capital and money markets, and to help the development of the private sector.

B. Recent Economic Development

The country's macroeconomic development in recent years has been generally favorable. Growth in the real GDP is estimated to have picked up to about 7.0 percent in 1996. The domestic investment rate tends to fluctuate considerably from year to year depending on whether a major investment project has been commissioned. While gross domestic investment has increased to almost 60 percent of GDP in 1996, gross national savings was maintained at about 25 percent of GDP. External debt is estimated at close to 40 percent of GDP while debt-service ratio increased temporarily to 31 percent in fiscal year (FY) 1996 mainly by repayment of the loan for the Chukha hydroelectric power plant. This is nevertheless, considered manageable. RGOB has adopted a prudent fiscal policy and the fiscal deficit has been kept to a low level at about two percent of GDP in FY1996. Newly commissioned projects, together with an adjustment in electricity export tariff to India in 1995, also generated additional fiscal revenues that helped maintain a comfortable budgetary position in FY1996. A doubling of the electricity tariff to India, which came into effect from 1 April 1997, will enhance the capability of the RGOB to cover recurrent expenditures through domestic revenue.

Bhutan has a small industrial sector and its contribution to GDP was only 13 percent in 1995. Private sector industries are generally small in size and lack capital, and entrepreneurial and technical skills. A decade ago, there was virtually no private sector industry in Bhutan. There is now today a small and growing private sector, active in business activities, including export and import trade, and in production of cement, simple chemicals and carbide, board and paper products, ferro alloys, metal fabrication, food processing, horticulture, tourism, furniture and other wood and forest products, handicrafts, and assorted cottage industries. Development in the power sector has enabled growth in allied energy-intensive industries.

Over the recent years, substantial deepening and rapid expansion of the financial sector and growing monetization of the economy has been achieved. Since 1980, the financial sector's contribution to GDP in real terms increased by an average of 12 percent per annum compared to 6.4 percent per annum of the real GDP growth. Accompanying the rapid growth, several financial institutions have been established. Today, in addition to the Royal Monetary Authority (RMA) which fulfills the role of a reserve/central bank, there are four major financial institutions in the country. In order to adequately regulate the overall banking institutions in the country, the RGOB enacted the Financial Institution's Act in 1992 and RMA introduced its Prudential Guidelines in 1995.

C. Recent Reform Measures and Prospects

The RGOB has given the highest priority to the development of a balanced and market oriented economy in order to overcome the heavy dependence on subsistence agriculture. Recent policy reform initiatives taken by the RGOB indicates its strong commitment to creating a

conducive environment for private sector participation and development. Specifically, key policy measures announced or adopted over the last year by the RGOB are the following:

(i) Introduced competition in the commercial banking market by converting Unit Trust of Bhutan (UTB) into the second commercial bank, known as the Bhutan National Bank (BNB). RGOB will also support BNB's privatization and permit foreign investment in the newly created commercial bank;

(ii) Lowered the interest rates on loans for manufacturing and other sectors;

(iii) Reduced tariffs on imports from third countries and adopted a new comprehensive tariff schedule, representing a significant reduction of customs duty on a range of items;

(iv) With the agreement of RMA, the Royal Insurance Corporation of Bhutan (RICB) would act as a management agent for the Government Employee Provident Fund (GEPF) and instead of providing a fixed return of 10 percent, returns on GEPF investment are proposed to reflect market conditions;

(v) RMA took steps leading towards liberalization of interest rates, allowing interest rates on deposits larger than Nu5 million to be negotiable;

(vi) RMA announced the removal of restrictions on foreign exchange transactions, and eventually would move towards convertibility on current account transactions;

(vii) Instead of the Loan Commission tackling the problem of non-performing loans on an ad hoc basis, an adequate legal framework would be put in place. The Real and Personal Properties Act had been drafted. As an interim measure, the RGOB issued a regulation to provide financial institutions with an adequate legal basis as envisaged under the proposed Real and Personal Properties Act; and

(viii) As part of the effort of creating an enabling environment for private sector development, the Ministry of Trade and Industry (MTI) initiated the preparation of several pieces of legislation, including the amendment of the Company Act, Bankruptcy Act, Commercial Sale of Goods Act, and the Copyright Act.

However, there is still much to do to create an enabling environment for private sector growth and build a competitive and efficient financial system. The following have been identified as major constraints to private sector development: (i) restrictive Government control over private sector business activities; (ii) inadequate access to credit; (iii) inadequate legal framework for business activities; and (iv) lack of skill and access to information by the private sector. Because of weak private sector growth, the economic growth in Bhutan has not yet reached its full potential, and RGOB has faced an inadequate revenue base for its investment program and continued to rely heavily on foreign aid, as much as 59 percent of Government expenditure and 35 percent of GDP in 1995.

D. The Policy Reform Program

The Financial Sector Intermediation Facility (FISIF) has been formulated, in consultation with the Asian Development Bank (ADB). The key objective of the FISIF is to accelerate economic growth through strong private sector growth, so that the domestic revenue base would be expanded, and the RGOB would be able to reduce its dependence on foreign aid. Main supporting objectives of the FISIF are to: (i) create a supportive Government policy environment for private sector business activities; (ii) improve private sector access to credit; (iii) create an enabling legal framework; and (iv) enhance private sector business management skills, and provide better access to market information.

The FISIF is expected to (i) support the RGOB to institute a series of policy reform measures to remove impediments in the financial and the banking sector and in the development of the private sector through a policy loan; (ii) provide long-term foreign exchange funding to private sector subprojects and assist participating financial institutions (PFIs) to improve their institutional capabilities and operational and financial performance through a development finance loan; and (iii) play a catalyst role in the privatization of state-owned financial institutions through ADB's direct equity investment in the Bhutan National Bank (BNB), a newly created commercial bank. The combination of policy loan, development finance loan, and equity investment will foster an integrated and long-term approach to sector needs, and enhance the effectiveness of promoting policy and institutional reforms.

The policy loan, based on the proposed reform agenda and institutional strengthening measures, is aimed at addressing weaknesses associated with the private sector development. The disbursement of the policy loan would be tied to tranche release conditions, which are set with a goal to accelerate economic growth through private sector led industrial development by removing policy related impediments to private sector projects. First tranche conditions are considered crucial for the success of the reform program and the utilization of the development finance loan. Accordingly, these conditions have been implemented by RGOB and financial institutions even before loan negotiations. The second tranche release conditions also are connected to the continued utilization of the development finance loan and are considered necessary to build a better environment for private sector growth. The proposed accompanying TA for Capacity Upgrading of Financial Sector Infrastructure and Entrepreneurial Development will upgrade capacities of concerned RGOB agencies involved in the reform program and strengthen institutional capabilities of the financial sector. The reform program and institutional strengthening measures are outlined in the attached Development Policy Matrix. Main policy areas and objectives are the following:

1. Remove policy impediments to private sector development by rationalizing Government control over private sector business activities

Policy impediments to private sector development exist mainly in three areas: (i) industrial licensing scheme which imposes restrictions on industrial location and sourcing of raw materials, etc.; (ii) absence of rules on foreign investment; and (iii) restrictions on foreign trade and access to foreign exchange. RGOB has complied with the first tranche release conditions of the policy loan before loan negotiations as follows:

(i) **improve industrial licensing system and rationalize administrative requirements for industrial locations, pricing and raw material supplies based on published guidelines.** The RGOB approved and issued on 2 September 1997 the General Guidelines for Establishment and Operations of Industrial and Commercial Ventures in Bhutan.

(ii) **review current case-by-case approach to foreign investment and move towards developing a set of transparent foreign investment policy and regulations which will be subsequently issued and published.** The RGOB signed in July 1997 the UNDP-assisted TA to review foreign investment policies as part of RGOB's private sector development strategy.

(iii) **draft import licensing regulations consistent with the foreign exchange regulations.** The committee chaired by the Managing Director of Royal Monetary Authority (RMA) completed the draft. Two inter-ministerial meetings were called to discuss and fine-tune the draft. The draft has been forwarded to the Ministry of Finance (MOF) for implementation.

(iv) **issue and publish a set of policies and regulations regarding foreign exchange transactions.** The RGOB approved and published the new Foreign Exchange Regulation on 21 August 1997.

During the program period of FISIF, the RGOB will (i) issue and publish a set of policies and regulations regarding foreign investment; (ii) issue and publish a set of import licensing regulations; and (iii) speed up the privatization process of public-owned enterprises (POE) by floating their shares in the stock market.

2. Liberalize Interest Rate Structure

The administered interest rates still hinder efficient allocation of resources and result in inefficiencies in the financial system. Deposit rates are fixed. Accordingly, financial institutions have no incentive to offer better interest rates in mobilizing domestic saving. Lending rates are fixed by sectors and do not reflect cost of funding, risk premiums, and loan maturities. The GEPF guarantees a return of 10 percent which levies a heavy burden on the financial institution that relies on it as one of its major sources of funding. Moreover, administered interest rates create potential risk of misalignments as interest rates in India have been liberalized. Before loan negotiations, the RGOB has complied with the first tranche release conditions of the policy loan as follows:

(i) **remove administered sectoral interest rate controls, and allow financial institutions to determine deposit and lending rates, while keeping their interest spread initially at a maximum of 6 percent, until sufficient competition among financial institutions is in place when the interest spread ceiling will be lifted.** The pertinent circular from RMA to financial institutions on interest rate liberalization was issued on 3 September 1997 following its approval at RMA's Board Meeting on 2 September 1997.

(ii) **abolish the requirement for RICB to provide 10 percent fixed return on Government Employee Provident Fund.** An agreement was signed between the RGOB and the RICB on 21 August 1997 to provide GEPF a return based on actual portfolio performance net of a 1.25 percent fund management fee to RICB.

During the FISIF program implementation period, RGOB will (i) remove any form of Government subsidy to GEPF; and (ii) rationalize the management arrangement for GEPF and strengthen the operations of RICB to make it an efficient participant in the capital market.

3. Improve efficiency and the competitiveness of the financial system

Constraints in the Bhutanese financial system are due to: (i) limited competition among financial institutions; (ii) financial institutions generally lack skilled and experienced human resources and their operational and finance performance are poor due to a portfolio of increasing non-performing assets; (iii) inadequate legal and regulatory framework; (iv) limited RMA capabilities on monetary control and banking supervision; and (v) under-developed capital market. Before loan negotiations, the RGOB complied with the first tranche release conditions as follows:

(i) **RGOB to consummate the transactions, under the agreement on the cleaning up of BNB's portfolio of non-performing loans involving the swap of such assets inherited by BNB from UTB for cash from the RGOB.** Following the RGOB/BNB agreement signed on 1 September 1997, RGOB will disburse the cash to BNB for Nu52 million of NPAs prior to loan effectiveness.

During the FISIF program implementation period, RGOB and the RMA will (i) improve RMA's prudential guidelines and strengthen banking supervision function by instituting a system of fines and penalties for violations of prudential guidelines; (ii) build market infrastructure by creating a credit information bureau and an interbank money market; (iii) improve the operational efficiency of the payments system by including branches of commercial banks outside of Thimphu in the clearing and settlement system; (iv) strengthen RMA's capability in foreign exchange risk management and develop effective monetary policy tools to enhance indirect monetary control such as reserve requirement and open market operations; and (vi) speed up the development of the capital market by establishing an adequate regulatory framework and improving the operation of the central depository and the clearing system.

4. Set up an enabling legal framework for the financial system and private sector business activities

The Loan Commission was established by RGOB to bring about the necessary legislative and administrative changes to address the issue of NPAs. Before loan negotiations, the RGOB has complied with the first tranche release conditions as follows:

(i) **make effective the Commercial Sales of Goods Regulation**. The RGOB adopted the regulation in April 1997.

(ii) **complete the drafting of the Real and Movable Properties Act which will give financial institution adequate legal rights in their loan collection activities.** The draft was completed by RMA and has been submitted to the RGOB for review.

During the FISIF program implementation period, the RGOB will make effective the Real and Personal Movable Act, Bankruptcy Act, the Negotiable Instruments Act, and amendments to Companies Act.

5. Improve private sector entrepreneurship and management skills and access to information

Weaknesses in private sector institutional capabilities require financial institutions to be pro-active in investment promotion activities, because (i) the private sector is not well developed; (ii) entrepreneurial skills are scarce; and (iii) the dissemination of information on the investment opportunities is limited. Investment promotion activities should entail technical support to the private sector in the identification, development and implementation of investment projects. During the FISIF program implementation period, the RGOB will strengthen the investment promotion capability of the financial institutions, particularly the two participating financial institutions (PFIs), under the development finance loan, such as, Bhutan Development Finance Corporation (BDFC) and BNB. This would enable them to undertake pro-active investment promotion and to provide technical support to the private sector, and assist the private sector in the identification, development and implementation of investment projects.

6. Improve human resource development and capacity building in the financial institutions

Weak human resource base and management skills in financial institutions have been identified as one of the major constraints to the improvement of the financial system. Financial institutions in the country now need more advanced training in many areas from the basic banking knowledge to sophisticated new banking techniques and management skills. During the FISIF program implementation period, RGOB will identify the need for upgrading the quality of human resources in financial institutions and assist financial institutions to organize a training program for bankers at the Royal Institute of Management (RIM).

E. Conclusion

The RGOB is looking forward to working with the ADB in implementing these FISIF program reform measures aimed at pursuing policies conducive to private sector development and improving the efficiency and competitiveness of the financial system. Specifically, a successful program will: (i) rationalize Government supervision over private sector business activities; (ii) deregulate interest rates and rationalization of foreign exchange transactions; (iii) enhance efficiency and the competitiveness of the financial system; (iv) establish an enabling legal framework; (v)

improve private sector entrepreneurship and management skills; and (vi) enhance the quality of the human resource base in financial institutions.

Yours sincerely,

Dorji Tshering
Finance Minister

Development Policy Matrix
(Timing of Conditionalities and Disbursement Schedule)

Policy Area and Objective	First Tranche Release Conditions (to be met at Loan Negotiation)	Second Tranche Release Conditions (expected by 30 April 1999)	Development Policy Letter and/or Loan Agreement
Policy Reforms:			
• Remove policy impediments to private sector development by rationalizing Government control over private sector business activities.	Improve industrial licensing system and rationalize administrative requirements for industrial locations, pricing and raw material supplies based on issued and published guidelines as agreed with the Bank. Review current case-by-case approach to foreign investment and move toward developing a set of transparent foreign investment policies and regulations. Draft a set of import licensing regulations consistent with the foreign exchange regulations as agreed with the Bank.	Issue and publish a set of policies and regulations regarding foreign investment as agreed with the Bank. Issue and publish a set of import licensing regulations as agreed with the Bank.	Speed up the privatization process of public-owned enterprises (POE) by floating their shares in the stock market.
• Liberalize interest rate structure and rationalize foreign exchange transactions.	Remove administered sectoral interest rate controls, and allow financial institutions to determine deposit and lending rates, while keeping their interest spreads initially at a maximum of 6 percent until sufficient competition between the financial institutions is in place when the ceiling is to be lifted. Abolish the requirement for Royal Insurance Corporation of Bhutan (RICB) to provide 10 percent fixed return on the Government Employees Provident Fund (GEPF). Issue and publish policies and regulations regarding foreign exchange transactions as agreed with the Bank.	Remove any form of Government subsidy to the GEPF.	Rationalize the management arrangement for the GEPF and strengthen the operations of RICB to make it an efficient participant in the capital market.

[1] Interest spread = (income from loan/average loan portfolio) - (interest expenses/average long-term liabilities)

Policy Area and Objective	First Tranche Release Conditions (to be Met at Loan Negotiation)	Second Tranche Release Conditions (expected by 30 April 1999)	Development Policy Letter and/or Loan Agreement
Institutional Strengthening:			
• Improve the efficiency and competitiveness of the financial system.	Government to consummate the transactions, under the agreement on the cleaning up of portfolio of Bhutan National Bank (BNB) of nonperforming loans involving the swap of such assets inherited by BNB from the Unit Trust of Bhutan (UTB) for cash from the Government.	Improve RMA's prudential guidelines and strengthen the banking supervision function by instituting a system of fines and penalties for violations of prudential guidelines. Build market infrastructure by creating a credit information bureau and an interbank market. Improve the operational efficiency of payments system by including branches of commercial banks outside of Thimphu in the clearing and settlement system.	Strengthen RMA's capability in foreign exchange risk management and develop effective monetary policy tools to enhance indirect monetary control such as reserve requirement and open market operations. Speed up the development of the capital market by establishing an adequate regulatory framework and improving the operation of the central depository and the clearing system.
• Set up an enabling legal framework for the financial system operation and private sector business activities.	Make effective the Commercial Sales of Goods Regulation. Complete the drafting of the Real and Movable Properties Act, which will give financial institution adequate legal rights in their loan collection activities.	Make effective the Real and Personal Movable Act, Bankruptcy Act, the Negotiable Instruments Act, and amendments to Companies Act.	
Human Resource Development:			
• Improve private sector entrepreneurship and management skills, and access to information.			Strengthen the investment promotion activities of Bhutan Development Finance Corporation (BDFC) and BNB, and assist the private sector in the identification, development, and implementation of investment projects.
• Upgrade the human resource base in the financial institutions.			Set up a self-sustainable bank training program at Royal Institute of Management.

Appendix 2

FINANCIAL SECTOR KEY INDICATORS

Indicators	1996	1990-1996 Average
Growth Rate of Total Assets	22.5%	15.6%
of Which from Claims on Private Sector	13.6%	17.6%
Growth Rate of Total Deposits	12.7%	16.8%

(As of March 1997, Nu. million)	Total Assets	Claims on Private Sector	Total Deposits	Capital Account
Bank of Bhutan	4,753.0	880.8	2,978.6	371.0
Royal Insurance Corporation of Bhutan	1,208.4	757.8	-	69.0
Bhutan National Bank	661.5	519.0	645.3	130.6
Bhutan Development Finance Corporation	434.9	393.2	-	233.8
Total	**7,057.8**	**2,550.8**	**3,623.9**	**804.4**

Appendix 3

EXTERNAL ASSISTANCE TO THE FINANCIAL SECTOR

Year	Source of Aid	Project	Executing Agency	Technical Assistance Amount	Loan Amount
1984	ADB[1]	Industrial Sector & Facility Study for Development Finance Mechanism	BDFC	$460,000	
1988	ADB	Institutional Support to BDFC	BDFC	$270,000	
1988	HELVETAS[2]	Small Scale Industry Revolving Fund (Phase I & II)	BDFC	$70,000	
1988	IFAD[3]	Punaka-Wangdi Valley Development (Credit Portion)	BDFC		$254,759
1989	ADB	Bhutan Development Finance Corporation	BDFC		$2 million
1991	UNCDF[4]	Agricultural Credit Phase III	BDFC		$1.5 million
1991	ADB	Third TA for Institutional Strengthening of BDFC	BDFC	$431,000	
1991	SDC[5]	Small & Medium Enterprise Development Fund	BDFC	$153,000	
1992	KFAED[6]	Bhutan Development Finance Corporation	BDFC		$4.5 million
1992	ADB	Capital Market & Stock Exchange Center Establishment	RMA	$224,250	
1995	ADB	Conversion of UTB to a Commercial Bank	RMA	$146,500	
1996	ADB	Restructuring of UTB to a Second Commercial Bank	RMA	$600,000	

BDFC = Bhutan Development Finance Corporation; RMA = Royal Monetary Authority of Bhutan

1 Asian Development Bank
2 Swiss Association for Technical Assistance
3 International Fund for Agricultural Development
4 United Nations Capital Development Fund
5 Swiss Development Cooperation
6 Kuwait Fund for Arab Economic Development

PROGRAM LOGICAL FRAMEWORK

Hierarchy of Objectives	Program Targets	Monitoring Mechanism	Risks and Assumptions
GOAL			
• Promote an efficient and competitive financial sector by improving resource allocation and enhancing institutional capabilities.	At least one financial institution (such as the BNB[1]) to be privatized with the participation of the foreign investment.	Program progress reports submitted by RMA[2] and reports by Bank review missions.	Lack of banking and management skills, slow progress in policy front to bring in foreign investment.
• Encourage private sector development by removing policy impediments and creating an enabling operational and legal environment.	A Policy Steering Committee (PSC) to be set up to provide overall guidance on policy-related matters under the program. Private sector investment to surpass the public sector investment at the completion of the Project.	Project progress and Bank review missions.	Unfavorable macroeconomic condition, lack of Government commitment to reforms, inconsistencies in Government's "balanced development" strategy.
PURPOSE			
• Remove policy impediments to private sector development by rationalizing Government control over private sector business activities.	Conditions for first tranche release of the policy loan and the effectivity of the credit line to be met before the loan negotiation. Other measures to be met before the second tranche release.	Development Policy Letter (DPL), Program progress reports, and Bank review missions.	Slower than expected policy: making process by Government.
• Improve efficiency of resource allocation by liberalizing interest structure, adopting transparent foreign exchange policies, improve RMA's banking supervision capabilities, and build an adequate market infrastructure.	- ditto -	- ditto -	Lack of qualified managers, lack of general banking skills, PFIs' financial performance being affected by adverse economic conditions.
• Set up an enabling legal framework for the financial system operation and private sector business activities.	- ditto -	- ditto -	Slow progress of the legal approval process in the National Assembly.
• Improve private sector entrepreneurship and management skills, and access to information, and upgrade human resource base in financial institutions.	- ditto -	- ditto -	Lack of budget support from the Government on bank training.

Hierarchy of Objectives	Program Targets	Monitoring Mechanism	Risks and Assumptions
Components and Outputs			
• Policy loan first tranche release conditions:			
- Liberalize the interest rate structure and remove administered sectoral interest rate controls.	Allow financial institutions to determine deposit and lending rates, while keeping their interest spreads initially at a maximum of 6 percent until sufficient competition between financial institutions is in place.	A letter from Government indicating that the condition was fulfilled with supporting documents, such as RMA's Circular on interest rate liberalization.	Lack of Government commitment regarding interest rate liberalization for fear of capital outflow.
- Abolish the requirement for Royal Insurance Corporation of Bhutan (RICB) to provide 10 percent fixed return on the GEPF.[3]	A formal agreement is to be reached between Government and RICB.	Supporting documents include a copy of signed agreement.	Inadequate institutional capability in managing the GEPF.
- Clean up BNB's loan portfolio of nonperforming assets inherited from the Unit Trust of Bhutan.	Cleaning up the loan portfolio should be done before the loan effectivity and Bank's equity investment.	Closely follow up with the Government before loan effectivity.	Concerns that other financial institutions may require the same treatment from Government.
- Issue and publish policies and regulations regarding foreign exchange transactions as agreed with the Bank.	Move toward current account convertibility for third country transactions as agreed with the International Monetary Fund (IMF).	Supporting documents include a copy of issued regulation.	RMA's concern of losing control of foreign exchange reserves of the country.
- Make effective the Commercial Sales of Goods Regulation.	To be approved by the Government.	Supporting documents include a copy of issued regulation.	Slow progress of the legal approval process in the National Assembly.
- Draft a set of policies and regulations regarding import licensing schemes as agreed with the Bank.	Policies and regulations to be made public	A letter from Government indicating that the condition was fulfilled with supporting documents.	Limited flexibility in trade reforms due to smuggling potential for goods from Bhutan to India.
- Review current case-by-case approach to foreign investment and move toward developing a set of transparent foreign investment policy and regulations.	Actions to be taken by the Government to initiate the policy review process.	A letter from Government indicating that the condition was fulfilled with supporting documents.	Concerns over foreign dominance of the economy.

Hierarchy of Objectives	Program Targets	Monitoring Mechanism	Risks and Assumptions
Components And Outputs (Cont.)			
- Improve the industrial licensing system and rationalize administrative requirements for industrial locations, pricing, and raw material supplies as agreed with the Bank.	Issue and publish rules and regulations.	Supporting documents include a copy of issued regulation.	Government's concern on environment degradation and the depletion of natural resources.
• Policy loan second tranche release conditions:			
- Improve RMA's prudential guidelines and strengthen its banking supervision function.	Institute a system of fines and penalties for violations of prudential guidelines.	RMA banking supervision reports, Program progress reports, Bank review missions.	Difficulties in solving the problem of nonperforming debts.
- Build market infrastructure including a credit information bureau and an interbank market.	Credit information bureau and the interbank market to be operational and self sustaining.	Program progress reports, Bank review missions.	Dominating position of BOB[4] may make it reluctant to participate in these activities.
- Make effective the Real and Personal Properties Act, Bankruptcy Act, Negotiable Instruments Act, and amendments to Companies Act.	Be approved by the National Assembly.	Program progress reports, Bank review missions.	Slow progress of the legal approval process in the National Assembly.
- Improve the operational efficiency of the payments system.	Including branches of commercial banks outside of Thimphu in the clearing and settlement system.	Program progress reports, Bank review missions.	Insufficient infrastructure may slow down the process.
- Remove any form of Government subsidy to the GEPF.	Restructure the GEPF and make it independent.	Program progress reports, Bank review missions.	Political implication may slow down the reform process.
- Issue and publish policies and regulations regarding foreign investment as agreed with the Bank.	Regulation on foreign investment to be drafted and adopted.	Program progress reports, Bank review missions.	Concerns over lack of domestic entrepreneurial capacity and the foreign domination of the economy.

Hierarchy of Objectives	Program Targets	Monitoring Mechanism	Risks and Assumptions
Components And Outputs (Cont.)			
• Conditions for credit line utilization:			
- Strengthen the PFIs organizational structure for project financing and upgrade PFI staff in project finance and banking skills.	Project finance unit to be set up in each PFI and appropriate procedures to be adopted.	Program progress reports, Bank review missions.	Lack of qualified personnel.
- The PFIs are to maintain compliance with all eligibility criteria under the credit line.	Any noncompliance to be reported and corrective measure to be taken promptly. Eligibility criteria are the following:	RMA banking supervision reports, Program progress reports, Bank review missions.	Inadequate inspection and reporting system.
	* maintain compliance with RMA prudential guidelines as amended from time to time;		Difficulties in solving the problem of nonperforming debts.
	* minimum annual collection ratio of 80 percent based on a consistent formula agreeable to the Bank;		
	* maximum infection ratio of 20 percent;		
	* minimum debt service ratio of 1.25 times; and		
	* minimum return on average assets of 1 percent after tax.		

Hierarchy of Objectives	Program Targets	Monitoring Mechanism	Risks and Assumptions
Activities			
• The policy loan of $4 million will be released in two tranches if respective sets of policy reform conditions have been met.	The size of the program portion is determined by the adjustment cost for the Government to carry out the policy reforms. Counterpart funds generated by the program portion will be used to cover adjustment costs.	Program progress reports, Bank review missions, Bank's disbursement database	Delay in disbursement due to delays in implementing policy reforms
• A credit line of $4 million will be made available for the PFIs to finance eligible small- and medium-scale private sector industrial and commercial agricultural subprojects.	The size of the credit line is determined by the aggregate size of subproject pipelines projected by the PFIs.	Program progress reports, Bank's PAU reports, and the disbursement database	Slow disbursement and less than full utilization due to inadequate demand as a result of delay in implementing policy reforms
• An equity investment will be made together with an equal contribution of a foreign bank to privatize BNB.	The foreign bank is expected to send banking advisers to BNB.	Bank review missions	Delay in implementing policy reforms to bring in foreign investment
• A TA in conjunction with the loan in the amount of $500,000 to upgrade the capacities of concerned Government agencies involved in the reform program and strengthen institutional capabilities of the financial sector.	The TA will require a period of six months for its implementation, and about 13 person-months of the services from a team of four international consultants.	Program progress reports, TA status reports and Bank review missions	Slow in implementation

1 Bhutan National Bank
2 Royal Monetary Authority, the central bank
3 Government Employees Provident Fund
4 Bank of Bhutan

Appendix 5

INELIGIBLE ITEMS FOR IMPORT

1. The following items are ineligible for import:

(i) Expenditures for goods included in the following Customs Coordination Council Nomenclature chapters or headings as designated by the Bank by notice to the Government:

Chapter	Heading	Description of Items
22	22.03 - 22.10	Alcoholic beverages
24	24.01	Tobacco, unmanufactured tobacco refuse
24	24.02	Tobacco, manufactured (whether or not containing tobacco substitutes)
28	28.50 - 28.52	Radioactive and associated materials
71	71.01 - 71.04	Pearls, precious and semiprecious stones, unworked or worked
71	71.05 - 71.06 71.09 - 71.15	Jewelry of gold, silver, or platinum group, metals (except watches and watch cases), and goldsmiths' or silversmiths' wares (including set gems)
71	71.07 - 71.08	Gold, nonmonetary (excluding gold ores and concentrates)
84	84.59	Nuclear reactors and parts thereof, fuel elements (cartridges), nonirradiated for nuclear reactors

(ii) Expenditures in the currency of the Borrower or for goods supplied from the territory of the Borrower;

(iii) Payments made for expenditures incurred more than 180 days prior to the Effective Date;

(iv) Expenditures for goods supplied under a contract that any national or international financing institution or agency shall have financed or agreed to finance including any contract financed under any loans from the Bank; and

(v) Expenditures for goods intended for a military or paramilitary purpose or for luxury consumption.

BHUTAN DEVELOPMENT FINANCE CORPORATION

A. History, Ownership, Organization, and Management Structure

1. **History**. The Bhutan Development Finance Corporation (BDFC) is the only development bank in Bhutan. Before its establishment, the function of development banking was carried out by the rural credit section and the industrial credit section of the Royal Monetary Authority (RMA). These two sections were later separated from RMA with the help of technical assistance from the Bank and transformed into an autonomous organization, namely BDFC, with the formal signing of the Royal Charter in 1988. BDFC is now registered under the Companies Act of 1989 as well as the Financial Institution Act of 1992. The Government of Bhutan through the RMA regulates the overall operation of BDFC.

2. **Ownership and Organization**. BDFC has an authorized capital stock of Nu200 million, with a paid-up capital of Nu100 million. BDFC is owned by the Government, 87 percent; the Bank of Bhutan (BOB), 7.5 percent; the Royal Insurance Corporation of Bhutan (RICB), 3 percent; and the Bhutan National Bank (BNB), 2.5 percent. BDFC is governed by a Board of Directors, chaired by the finance minister. The Board consists of seven members representing the Ministry of Finance, RMA, Ministry of Agriculture, Ministry of Trade & Industries, and Bhutan Chamber of Commerce.

3. The chief executive officer of BDFC is a managing director who is appointed by the Royal Civil Service Commission on advice of the Ministry of Finance. BDFC has an Industrial Lending Department (ILD); an Agriculture Lending Department (ALD); a Legal Division; and an Internal Audit & Supervision Division. BDFC's staff strength is 68 at headquarters and 54 at dzongkhag (district) offices.

B. Operations

4. **Corporate Strategy**. The primary objective of BDFC is to promote the expansion of economic and social development through the acceleration of industrial and agricultural development activities by (i) providing financial, technical, and advisory assistance; (ii) mobilizing external and internal capital for investment in the business sector; and (iii) promoting industrial and agricultural development through credit facilities, guarantees, investing in equities, shares, debentures, and bonds.

5. **Scope of Operations**. As a development bank, BDFC conducts its operations within the general norms of the economic policies, plans, and priorities of the Government, while keeping the projects economically and financially profitable. BDFC's scope of operations includes loans, investments, leasing, financial services, and project development. While financial assistance is provided primarily for the acquisition of fixed assets, BDFC may also finance seasonal and short-term credit requirements in the agriculture sector, as well as working capital requirements.

6. **Financial Resources**. BDFC keeps two separate sets of financial statements for its two profit centers, namely ILD and ALD. ILD has a paid-up capital of Nu34 million and its funding requirement is met from the paid-up capital and credit lines from the Bank and other multilateral and bilateral organizations. ALD's operation is financed through the grants

received from United Nations Capital Development Fund (UNCDF) and International Fund for Agricultural Development (IFAD).

7. **Lending Policy**. BDFC's Royal Charter, Statement of Business Policies, and the resolutions of the Board provide the guidelines for lending procedures. Priority for lending is accorded to resource-based activities and those with export or import-substituting potential. Since 1994, emphasis was also placed on funding animal husbandry activities. BDFC is also governed by its development and social mandate to provide small loans to farmers without any security. Unlike other financial institutions, BDFC is not permitted to finance general trade, transport, or real estate activities. At the head office level, decisions to approve/reject loan applications are made by the Management Committee during its Pipeline Meeting. At the district level, the District Loan Committee comprised of various sectoral heads, decides on loan applications up to a ceiling of Nu20,000.00 per client.

8. **Project Appraisal and Monitoring**. BDFC's loan processing time from receipt of application to approval ranges from one week to four months, depending on the loan size, project issues, and response time of the sponsors. Loan documentation, disbursement, and project supervision are the responsibility of the appraising officer. Detailed guidelines are laid down in the manuals for legal documentation and follow-up. Disbursement is made following an evaluation at the site of the implementation status of the project, of the contributions already brought in by sponsors, and of the future financing requirements. As far as recovery of loans is concerned, reminder letters are being sent quarterly to clear outstanding arrears. Collection teams comprising project officers and recovery personnel are also deployed to follow up distant clients. Credit officers stationed in dzongkhags (districts) are also required to assist in loan supervision and recovery.

9. BDFC has established an Investment Center that provides professional service for project formulation, preparation, supervision, and evaluation. This service is currently being provided to local entrepreneurs, institutions, and Government agencies.

10. **Accounting and Auditing**. BDFC's accounting and internal reporting systems are considered satisfactory. Regular reports covering the full range of management control functions are generated, and adequate systems are in place to ensure that these reports are acted upon promptly. An internal audit unit was established to ensure proper management of the system, and avoid misuse and irregularities. External audits are done by an independent auditor annually. The external audit requirement has operated satisfactorily to date and is expected to continue to provide an annual review of BDFC's accounting practices and financial status.

11. **Experience with the Bank**. BDFC utilized a Bank loan[1] during 1989-1994 to finance a total of 113 subloans for $2.3 million for private sector industrial projects of which 13 subloans amounting $1.7 million were above the free limit of $25,000. Twenty-eight subloans totaling $2 million were above $10,000, which accounted for 87 percent of the total amount of the subloans financed by the Bank. Based on the available data, the total cost of the subprojects under the loan was $5.9 million. In terms of the loan amount, BDFC subprojects were concentrated in (i) paper manufacturing (27.9 percent), (ii) wood manufacturing (26.8 percent); and (iii) mining (14.6 percent). The majority of subprojects

[1] Loan No. 934-BHU [SF]: Bhutan Development Finance Corporation Project, 1989.

were located in Thimphu and Paro, which are relatively more industrialized than the rest of the country. The majority of the subloans have maturities of five to eight years.

12. Despite generally satisfactory performance of the project, the speed of utilization of the loan was slower than expected and the loan was extended twice for about one year and a half. According to the project completion report,[1] the slow utilization of the loan was caused by (i) structural macroeconomic issues due to the large amounts of foreign aid accounting for more than 30 percent of the gross domestic product, mostly for public investments, which partly crowded out private investment; (ii) industrial policy issues on licensing, low material supply, pricing, and strict restriction on project sites; (iii) limitation of physical infrastructure particularly roads; and (iv) a weak absorptive capacity of the business sector with a lack of project ideas, professional skills, and expertise in project preparation and promotion. The report recommended that future Bank assistance for the financial sector in Bhutan should include support for policy reforms focusing on macroeconomic management and industry and financial sector policies to effectively promote private investment.

C. Financial Performance and Portfolio Quality

13. **Financial Performance**. As of 31 December 1996, the total loan portfolio of ILD was Nu228 million as against Nu91 million in 1991, representing an increase of 18.4 percent per annum over five years. The total loan approval in 1996 amounted to Nu88 million; loan disbursement amounted to Nu38 million. The profitability of ILD's operations has been growing steadily. Profit before tax in 1996 was Nu9.5 million as against Nu0.35 million in 1990. There was also a considerable improvement in the cash flow position of ILD. The ending cash balance as of end-1996 was Nu3.1 million as against Nu0.25 million as of end-1990. This marks an overall increase of 12.4 times. ILD contributes about 60 percent of BDFC's loan portfolio, but 80 percent of net income after tax.

14. **Portfolio Quality**. Total arrears of ILD as of end-1996 amounted to Nu21.2 million, as against Nu8.8 million as of end-1993. The BDFC management has always upheld the importance of loan recovery, and the collection performance of ILD has remained above 90 percent throughout years.

15. **Projected Performance**. For 1997, profit before tax from ILD is projected to reach Nu10.3 million, reflecting an earning spread of 8.1 percent. Profit before tax from ILD is projected to increase at 9.5 percent per annum over the forecast period to Nu16.6 million in 2001, although the earning spread is estimated to decline to 5.5 percent from 10 percent in 1996. ILD's cash flow position is expected to remain steady during the forecast period with the debt-service coverage ratio staying at 1.9 times for most of years. The total assets of ILD will increase at the rate of 22.2 percent per annum over the forecast period reaching Nu762 million in 2001 from Nu302 million in 1997. The debt/equity ratio will increase from 1.5 times in 1996 to 5 times in 2001. The organizational structure of BDFC, the past and projected financial performance, the schedule of funds needed for new loans, and underlying assumptions for financial forecasts are attached.

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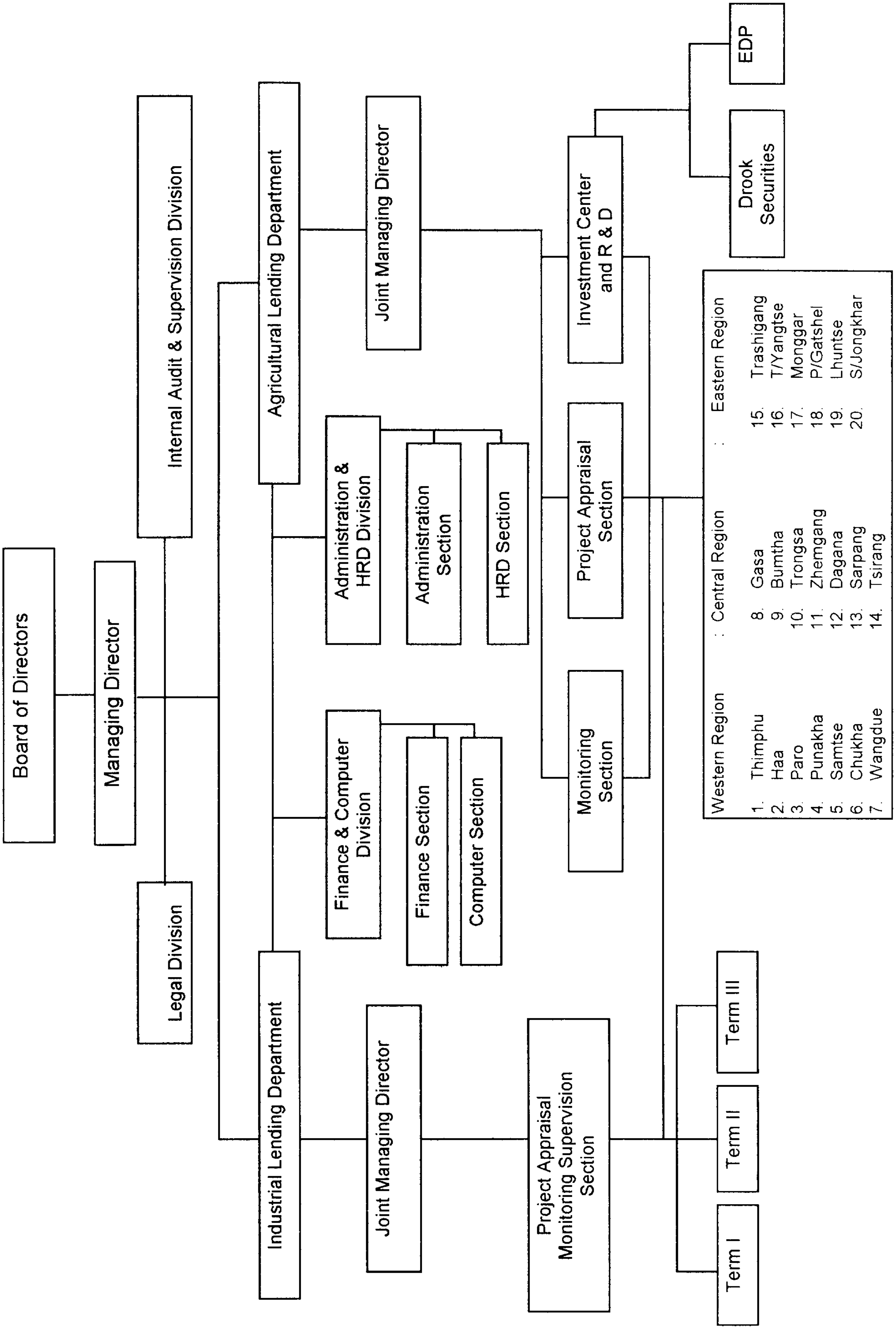
[1] PCR BHU21083: *Bhutan Development Finance Corporation Project*, November, 1996.

Bhutan Development Finance Corporation Organization Chart



HRD = Human Resources Department; R&D = Research & Development; EDP = Enterprises Development Program

Bhutan Development Finance Corporation (ILD)
Balance Sheet
(1990-2001, Nu '000)

Item	Actual						Projection				
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
A. Assets											
1. Current Assets											
Cash	360	680	453	4,031	608	3,107	-	-	-	-	-
Bank Balances	1,100	2,496	3,314	5,735	9,542	16,492	10,979	10,737	15,652	21,730	25,548
Current Maturities Accounts Receivable	1,514	7,728	1,897	1,572	1,855	2,919	3,649	4,561	5,701	7,126	8,908
Collection Arrears/Others	484	1,391	142	1,544	3,261	2,962	3,258	3,584	3,942	4,337	4,770
Subtotal (1)	**3,458**	**12,295**	**5,806**	**12,882**	**15,266**	**25,480**	**17,886**	**18,882**	**25,295**	**33,193**	**39,226**
2. Loan Portfolio											
Gross Portfolio	60,226	114,018	127,944	156,373	193,657	228,555	285,695	357,118	446,398	557,996	697,494
Less: Current Maturities	1,514	7,728	1,897	1,572	1,855	2,919	3,649	4,561	5,701	7,126	8,909
Bad Debt Provision	2,500	3,000	3,024	6,869	9,666	10,659	12,199	14,047	16,265	18,926	22,119
Subtotal (2)	**56,212**	**103,290**	**123,023**	**147,932**	**182,136**	**214,977**	**269,847**	**338,510**	**424,432**	**531,944**	**666,466**
3. Fixed Assets	1,128	2,391	3,382	3,585	3,690	5,900	6,489	7,138	7,852	8,637	9,503
Less: Accumulated Depreciation	452	556	705	1,023	871	1,244	1,553	1,893	2,267	2,678	3,131
Subtotal (3)	**676**	**1,835**	**2,677**	**2,562**	**2,819**	**4,656**	**4,936**	**5,245**	**5,585**	**5,959**	**6,372**
Other Assets	16,254	18,146	25,616	20,312	13,586	6,703	9,587	9,587	9,587	20,588	50,587
Subtotal (A)	**76,600**	**135,566**	**157,122**	**183,688**	**213,807**	**251,816**	**302,256**	**372,224**	**464,899**	**591,684**	**762,651**
B. Liabilities											
1. Current Liabilities	1,701	7,022	6,793	9,998	19,190	14,622	16,083	17,692	19,461	21,407	23,547
2. Long-term Loans											
Outstanding Borrowings	48,634	87,272	96,014	115,656	104,646	141,935	198,519	273,517	373,114	507,030	685,561
Less: Current Maturities KFAED	-	-	-	-	-	-	-13,000	-26,000	-39,000	-52,000	-65,000
Less: Current Maturities ADB	-	-	-	-	-	-	-	-	-1,800	-3,600	-5,400
Subtotal (B)	**48,634**	**87,272**	**96,014**	**115,656**	**104,646**	**141,935**	**185,519**	**247,517**	**332,314**	**451,430**	**615,161**
3. ADB TA Grant	146	1,090	936	936	-	-	-	-	-	-	-
C. Equity											
Paid-in Capital	25,000	25,000	33,876	33,875	33,876	33,876	33,876	33,876	33,876	33,876	33,876
Retained Earnings	1,119	15,182	19,503	23,223	56,095	61,383	66,778	73,139	79,248	84,971	90,067
Subtotal (C)	**26,119**	**40,182**	**53,379**	**57,098**	**89,971**	**95,259**	**100,654**	**107,015**	**113,124**	**118,847**	**123,943**
Total Liabilities and Equity	**76,600**	**135,566**	**157,122**	**183,688**	**213,807**	**251,816**	**302,256**	**372,224**	**464,899**	**591,684**	**762,651**
Ratios:											
Current Ratio	2.0	1.8	0.9	1.3	0.8	1.7	1.5	1.6	1.8	2.0	2.5
Debt-Equity Ratio	1.9	2.2	1.8	2.0	1.2	1.5	1.8	2.3	2.9	3.8	5.0

KFAED = Kuwait Fund for Arab Economic Development; ADB = Asian Development Bank; TA = Technical Assistance.

Bhutan Development Finance Corporation (ILD)
Income Statement
(1990-2001, Nu '000)

Item	Actual						Projection				
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Income from Operations	9,150	14,335	16,831	21,371	26,881	27,279	34,099	42,623	53,279	66,599	83,249
Operating Expenses											
Interest Expenses	2,379	4,891	6,466	8,681	8,169	9,446	14,477	19,689	27,226	36,866	49,976
Staff & Administrative Costs	2,627	3,299	3,381	3,607	4,516	6,842	7,435	8,550	9,833	11,308	13,004
Depreciation	102	82	111	192	198	281	309	340	374	411	453
Bad Debt Provision	2,375	500	107	3,962	3,043	1,757	1,540	1,848	2,218	2,661	3,193
Total Operating Expenses	**7,483**	**8,772**	**10,065**	**16,442**	**15,926**	**18,326**	**23,761**	**30,427**	**39,651**	**51,246**	**66,626**
Profit Before Tax	1,667	5,563	6,766	4,929	10,955	8,953	10,338	12,196	13,628	15,353	16,623
Corporate Tax	-	-	-	-	-	2,686	2,971	3,509	3,917	4,408	4,760
Appropriations											
Dividends	-	-	-	-	-	1,694	1,250	1,250	2,500	3,750	5,000
Transfer to Reserves	1,667	5,563	6,766	4,929	10,955	4,573	5,986	7,288	7,040	6,997	6,636
Ratios (in %)											
Net Profit/Average Equity	6.7	22.3	20.0	14.6	32.3	26.4	29.2	34.5	38.5	43.4	46.8
Salaries & Administrative Expenses/ Average Total Assets	3.4	2.4	2.2	2.0	2.1	2.7	2.2	2.2	2.0	1.9	1.7
Interest Spread [a]	10.3	7.0	6.4	6.2	6.1	5.3	4.6	4.1	4.0	4.0	3.2
Earning Spread [b]	7.4	10.3	5.0	6.4	5.3	10.0	8.1	7.1	6.4	5.9	5.5

[a] Interest spread = (income from loan/average loan portfolio) - (interest expenses/average long-term liabilities)

[b] Earning spread = (income from all loans + income from equity investment)/(average loan portfolio + average equity portfolio) - (cost of all debt + dividends paid on equity)/(average debt + average equity)

Bhutan Development Finance Corporation (ILD)
Cash Flow Statement
(1990-2001, Nu '000)

Item	Actual						Projection				
	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Cash Inflow											
Net Profit After Interest & Taxes	1,667	5,563	6,766	4,929	10,955	6,267	6,645	7,611	8,609	9,473	10,097
Add back: Depreciation & Amort.	102	82	111	192	198	281	309	340	374	411	453
Provision for Bad Debts	2,375	500	107	3,962	3,043	1,757	1,540	1,848	2,218	2,661	3,193
Interest Expense on Borrowings	2,379	4,891	6,466	8,681	8,169	9,446	14,889	20,514	27,984	38,027	51,417
Cash Flow from Operations	6,523	11,036	13,450	17,764	22,365	17,751	23,383	30,313	39,185	50,572	65,160
Subloan Repayments	3,106	13,788	12,270	14,261	-	15,789	20,570	32,140	40,175	50,219	62,775
Available for Debt Servicing	9,629	24,824	25,720	32,025	22,365	33,540	43,953	62,453	79,360	100,791	127,935
Cash Flow from Nonoperating Activities											
Share Capital Increase	7,500	-	8,876	-	-	-	-	-	-	-	-
Drawdown of Foreign Currency Loans	-	-	-	-	9,715	37,289	56,584	74,998	99,597	133,916	178,531
Others (TA Grants for Equipment)	39,857	38,638	8,742	17,653	-	-	1,462	1,609	1,769	1,946	2,140
Decrease in Bank Balance (Int. bearing)	-	-	-	-	-	-	-	-	-	-	-
Others (TA Grants for Equipment)	146	1,090	(154)	-	-	-	1,462	1,609	1,769	1,946	2,140
Net Cash Provided by Nonoperating Activities	47,503	39,728	17,464	17,653	9,715	37,289	59,508	78,216	103,135	137,808	182,811
Total Sources of Funds	**57,132**	**64,552**	**43,184**	**49,678**	**32,080**	**70,829**	**103,461**	**140,669**	**182,495**	**238,599**	**310,746**
Applications											
Debt Service											
Repayment of ADB Loan	-	-	-	-	-	-	13,000	13,000	14,800	14,800	14,800
Interest on Borrowing	2,379	4,891	6,466	8,681	8,169	9,446	14,477	20,514	27,984	38,027	51,417
Required for Debt Service	2,379	4,891	6,466	8,681	8,169	9,446	27,477	33,514	42,784	52,827	66,217
Disbursement of Subloans	38,687	42,348	35,129	35,816	37,329	55,011	77,709	103,563	129,454	161,819	202,274
Increase in Bank Balance (int. bearing)	100	1,396	817	2,422	3,817	6,950	(16,492)	-	-	-	-
Increase in Arrears	(1,970)	907	(1,249)	1,402	1,717	299	296	326	358	395	433
Increase in Fixed Assets	336	1,263	991	203	105	2,210	590	649	714	785	864
Dividends	-	-	-	-	-	1,694	1,250	1,250	2,500	3,750	5,000
Increase/(Decrease) in Current Assets	666	6,214	(5,831)	(325)	283	1,064	-	-	-	-	-
(Increase)/Decrease in Current Liabilities	1,251	5,321	(229)	3,205	(9,192)	(1,461)	-	-	-	-	-
Investment	14,571	1,891	7,471	(5,304)	(6,726)	(6,883)	3,297	-	-	11,000	30,000
Total Cash Outflow	**56,020**	**64,231**	**43,565**	**46,100**	**35,502**	**68,330**	**94,127**	**139,302**	**175,810**	**230,576**	**304,788**
Cash											
Opening Balance	(599)	513	834	453	4,031	609	3,108	10,980	10,738	15,653	21,730
Change During the Year	1,112	321	(381)	3,578	(3,422)	2,499	7,872	(242)	4,915	6,077	3,818
Closing Balance	**513**	**834**	**453**	**4,031**	**609**	**3,108**	**10,980**	**10,738**	**15,653**	**21,730**	**25,548**
Debt-service Coverage Ratio	4.0	5.1	4.0	3.7	2.7	3.6	1.6	1.9	1.9	1.9	1.9

Bhutan Development Finance Corporation (ILD)
Schedule of Funds Needed for New Loans
(Nu'000)

Item	Projections				
	1997	**1998**	**1999**	**2000**	**2001**
Projected Disbursements:	86,277	115,311	160,000	222,606	306,523
Cash Available for Disbursements:	19,693	40,313	60,403	88,690	127,992
Financing Gap:	56,584	74,998	99,597	133,916	178,531
Financing Plan:					
Kuwait Fund for Arab Economic Development	56,584				
Asian Development Bank	0				
Net Financing Gap	**0**	**74,998**	**99,597**	**133,916**	**178,531**

Bhutan Development Finance Corporation

Assumptions

Industrial Lending Department

1. Increase in level of portfolio is estimated at 30 percent every year.

2. Interest income from loans is worked out at 13 percent per annum on average loans receivable.

3. Minimum liquidity of Nu5.0 million is estimated to be retained to meet operating and other liquidity requirements.

4. Dividends represent earnings on investment with BNB and BOB 8.5 percent per annum on an estimated average investment of Nu16.252 million

5. Sundry Income: Represents miscellaneous income (guarantee commission fee and any other income not included under the main income account.

6. Interest Expense: 7.53 percent on average ADB loan and new credit line outstanding and 7 percent on Kuwait Fund for Arab Economic Development.

7. Personnel, Operating, and Administrative Expense: 15 percent increase every year based on 1996 actuals.

8. Depreciation: 20 percent on straight line method on an estimated constant value of fixed assets

9. Provision for bad debts is assumed at 4 percent on the loans receivables.

10. Provision for Income Tax: Provided at 30 percent on income after providing for bad debts

11. Transfer to Reserves: Income after dividend was transferred to reserves.

12. Repayment period of old and new portfolio are estimated at an average of 10 years.

13. Drawdown on credit lines are determined by the level of new loans and the availability of funds arising from repayment by borrowers.

14. Fixed Assets: Land value carried forward at cost and others as estimated.

15. Past due levels are assumed at most recent period level of 20 percent of portfolio.

BHUTAN NATIONAL BANK

A. History, Ownership, Organization, and Management Structure

1. **History**. Bhutan National Bank (BNB) was converted from the Unit Trust of Bhutan (UTB) into a full-fledged commercial bank under Bank assistance in December 1996. UTB was established in July 1980 as a division of the Royal Insurance Corporation of Bhutan (RICB). It started functioning as an independent financial institution in 1992 to promote and mobilize saving, and channel capital to the productive sectors.

2. **Ownership**. As part of the conversion effort, Government broadened BNB's ownership base. Its equity capital base was increased from Nu42.5 million to Nu59.5 million through an initial public offer (IPO) in July 1996. Although the IPO was undersubscribed with 429 individuals subscribing to its shares, it made BNB the widest owned financial institution in the country. Currently, the public holds 28.6 percent of BNB's shares, the Government owns 67.2 percent, and RICB and GEPF each own 2.1 percent.

3. **Management and Organization**. BNB's Board of Directors currently has seven members including a representative of the private shareholders. The Board is chaired by the minister of Finance and the ex-officio members are secretary of Finance; director of Trade and Industry; managing director of the Royal Monetary Authority (RMA), president of the Bhutan Chamber of Commerce and Industry; and managing director of BNB. To strengthen its management further, BNB has engaged an operations adviser from the State Bank of India.

4. BNB's current staff strength is 82. With its headquarters in Thimphu, it has one branch office in Phuntsoling, a major commercial and industrial area. BNB is organized along function lines of commercial banking, such as cash and tellers, credit and loans, treasury, accounts, securities, and internal audit.

B. Operations

5. **Corporate Strategy and Scope of Operations**. A Mission and Goals Statement, together with the Strategy Statement, guides BNB's operations. These statements are forward looking and business oriented in nature and provide good direction for the management and the staff of BNB. In addition to commercial banking services, BNB provides project finance for industry, agriculture, and service sectors. It also provides short-term loans including working capital loans, bill discounting, guarantees, and underwriting facilities.

6. **Financial Resources**. Other than deposit liabilities, BNB has not yet availed of loans from financial institutions. BNB is actively seeking other sources of funds such as a standby credit facility to alleviate the pressure on liquidity management. Long-term funds would also allow BNB to diversity its lending activities into those projects that require longer periods of repayment.

7. **Lending Policy, Project Appraisal, and Monitoring**. BNB has operational manuals including project appraisal procedures that are meticulously followed throughout the organization. Delegation of authority is adequately done to ensure prompt attention and

decision making. The credit approval requirements demand rigid investigation of both project and credit risks. It is always a team approach involving more than one senior executive and loan officer. BNB takes about a week to appraise, document, and finally approve loans. Except for the time taken to receive creditworthiness information on the clients from other financial institutions, BNB itself is working toward reducing the time taken to process a loan, ensuring that it will not in any way compromise its appraisal standards and norms.

8. **Accounting and Auditing**. BNB follows the guidelines issued by RMA on income recognition, asset classification, and provisioning. BNB's operations are subject to internal audit, and it uses a reputable firm of chartered accountants as the external auditor. A management information system has been in place since January 1997, along with its modern computer system to ensure compliance with its credit policies and procedures, including those stipulated in its operating framework, and statutory and regulatory requirements.

9. **Experience with the Bank**. Before the establishment of BNB, Bhutan only had one commercial bank with limited commercial banking facilities available and a poor standard of services. The lack of efficiency and productivity resulted in a large amount of funds being held outside the financial system. To increase competition in the banking sector and to meet the demand from the business community and public, the Bank approved a technical assistance (TA) in 1995[1] to study the feasibility of converting UTB to a commercial bank. The conversion process was implemented under another TA in 1996.[2]

C. Financial Performance and Portfolio Quality

10. **Operation Scale and Financial Performance**. As a new commercial bank, the operation scale of BNB is smaller than country's other commercial bank, the Bank of Bhutan (BOB). In terms of both total assets and total deposits, BNB is about a quarter of the size of the BOB. However, 100 percent of BNB's loans go to the private sector. For comparison, only 13 percent of BOB's loans go to the private sector.

11. **Portfolio Quality**. When BNB was converted from UTB early this year, its total nonperforming assets (NPAs), defined as 7 months in arrears and above, amounted to Nu97.4 million ($2.7 million), or about 19.5 percent of total assets at the end of 1996. About 30 percent of these (Nu29.4 million) are NPAs for more than three years, assets with terms expired, or suspended properties. Nearly all those three-year and older NPAs were carried over from RICB when UTB was separated from RICB. When the Bank agreed to provide the TA to convert the UTB into a full-fledged commercial bank, it was agreed that all the NPAs should be cleaned up so that the new bank would not be saddled with their heavy burden. If the NPAs are not cleaned up, BNB will face great difficulties in improving its operational and financial performance. An asset-for-cash swap was arranged so that BNB can swap the remaining NPAs with the Government for cash. The Government then will have the option to either let BNB continue the collection effort for a fee, or to establish an asset management company that will act as a Government agent to manage the portfolio.

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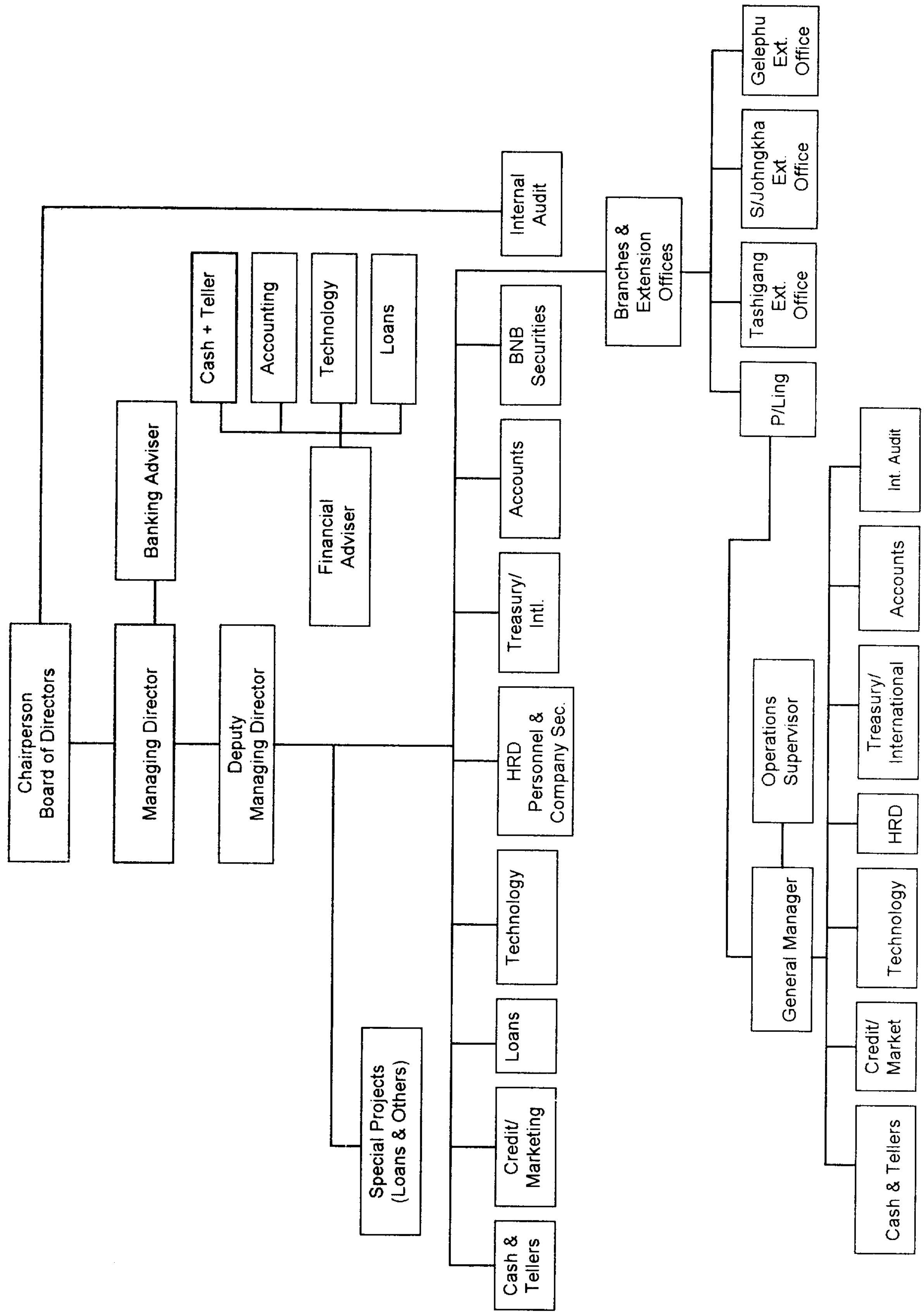
1 TA No. 2284-BHU:*Feasibility Studies of Converting UTB to a Commercial Bank*, for $146,500, approved on 4 January 1995.

2 TA No. 2532-BHU:*Restructuring of the UTB to a Commercial Bank*, for $590,000, approved on 13 February 1996.

12. **Projected Performance**. BNB projected that its loan and advances portfolio would increase at an average rate of 19.2 percent per annum during 1997-2001, reaching Nu1.4 billion ($39 million) in 2001. Total income will increase at the rate of 16.6 percent per annum to Nu203 million ($5.7 million), and the profit before tax is projected to increase by 24 percent per annum during the same period to Nu40 million ($1.1 million). The organizational structure of BNB, the past and projected financial performance, the schedule of funds needed for new loans, and underlying assumptions for financial forecasts are attached.

Bhutan National Bank
Organizational Chart



HRD = Human Resources Department; UTB = Unit Trust of Bhutan.

Bhutan National Bank
Projected Balance Sheets
(1997-2001, Nu million)

	Item	Actual	Projection				
		6mos1997	1997	1998	1999	2000	2001
A.	**Assets**						
	Cash/Cash Reserve Requirement	27.2	35.0	40.0	50.0	60.0	70.0
	Bank Balances (incl. Fixed Deposits)	58.6	168.7	198.3	225.6	260.8	306.0
	RMA discount bills and general A/C	160.2					
	Subtotal	**246.0**	**203.7**	**238.3**	**275.6**	**320.8**	**376.0**
	Gross Loan Portfolio	628.2	698.3	838.0	1,005.5	1,206.7	1,448.0
	Less: Provisions	109.6	54.0	54.3	54.7	55.1	55.5
	Net Portfolio	518.6	644.3	783.6	950.8	1,151.6	1,392.5
	Sundry Advances	7.0	4.0	3.0	3.0	4.0	5.0
	Net Loans and Advances	**525.6**	**648.3**	**786.6**	**953.8**	**1,155.6**	**1,397.5**
	Gross Fixed Assets	17.0	17.0	18.0	19.0	20.0	21.0
	Less: Accumulated Depreciation	2.2	4.0	5.0	7.0	9.0	11.0
	Net Fixed Assets	14.8	13.0	13.0	12.0	11.0	10.0
	Equity Investments	9.2	9.2	9.2	9.2	9.2	9.2
	Subtotal	**24.0**	**22.2**	**22.2**	**21.2**	**20.2**	**19.2**
	Subtotal (A)	**795.6**	**874.3**	**1,047.1**	**1,250.7**	**1,496.5**	**1,792.6**
B.	**Liabilities**						
	Current Liabilities & Sundry Provisions	6.0	9.0	12.0	14.0	17.0	22.0
	Unit Shares	88.2					
	Interest Accrued on Unit Shares	8.0					
	Fixed Deposits	559.7	716.2	859.4	1,031.3	1,237.6	1,485.1
	Subtotal (B)	**661.9**	**725.2**	**871.4**	**1,045.3**	**1,254.6**	**1,507.1**
	ADB Grant for Capital Equipment	2.6	3.0	3.0	3.0	3.0	3.0
C.	**Shareholders Equity**						
	Share Capital	59.5	59.5	59.5	59.5	59.5	59.5
	Share Premium	11.1	11.1	11.1	11.1	11.1	11.1
	Reserves	60.5	75.5	102.1	131.8	168.4	212.0
	Subtotal (C)	**131.1**	**146.1**	**172.6**	**202.3**	**238.9**	**282.5**
	Total Liabilities & Equity	**795.6**	**874.3**	**1,047.1**	**1,250.7**	**1,496.5**	**1,792.6**
	Debt-Equity Ratio	5.0	5.0	5.0	5.2	5.3	5.3

RMA = Royal Monetary Authority of Bhutan; A/C = Accounts; ADB = Asian Development Bank.

Bhutan National Bank
Projected Income Statements
(1997-2001, Nu million)

Item	Actual	Projection				
	6mos1997	1997	1998	1999	2000	2001
Interest Income	41.1	99.5	115.0	136.0	163.0	195.0
Other Income	3.2	5.0	6.0	6.0	7.0	8.0
Total	**44.3**	**104.5**	**121.0**	**142.0**	**170.0**	**203.0**
		22.8	26.6	30.7	36.0	43.0
Interest Expenses	27.1	53.5	55.0	66.0	79.5	95.0
Payroll and Administration	10.3	21.0	25.0	30.0	36.0	43.0
Depreciation	-	1.5	1.7	1.8	1.9	2.0
Bank Promotion	-	1.8	1.6	0.7	-	-
Provisions	-	5.0	5.3	5.7	6.1	6.5
Total	**37.4**	**82.8**	**88.6**	**104.2**	**123.5**	**146.5**
Profit Before Tax	7.0	21.7	32.4	37.8	46.5	56.5
Less: Taxation	-	-	-	-	13.9	16.9
Accretion to General Reserve	**7.0**	**21.7**	**32.4**	**37.8**	**32.5**	**39.5**
Ratios (in %)						
Profit Before Taxation/Average Equity	11.0	13.5	17.4	17.8	18.5	19.4
Profit After Taxation/Total Income	15.8	15.3	18.4	19.0	13.6	13.9
Payroll & Administration/Average Total Assets	2.8	2.5	2.4	2.5	2.5	2.5
Interest Spread [a]	3.6	3.9	4.0	4.0	4.0	4.0

PBT = Profit Before Tax; PAT = Profit After Tax.

[a] (Income from loan/average loan portfolio) - (interest expenses/average long-term liabilities)

Bhutan National Bank
Projected Cash Flow Statements
(1997-2001, Nu million)

Item	Actual	Projection				
	6mos1997	1997	1998	1999	2000	2001
Profit After Tax	7.0	26.5	27.0	30.0	37.0	44.0
Add Back						
Depreciation	-	1.5	1.7	1.8	1.9	2.0
Provisions	-	5.0	5.3	5.7	6.1	6.5
Other Noncash Charges and Losses	-	1.2	1.4	1.7	2.0	2.4
Funds from Operations	**7.0**	**34.2**	**35.4**	**39.2**	**47.0**	**54.9**
Increase in Deposits	289.0	447.0	143.2	171.9	206.3	247.5
Total Sources	**296.0**	**481.2**	**178.7**	**211.1**	**253.3**	**302.4**
Additions to Fixed Assets	1.8	2.0	1.0	1.0	1.0	1.0
Decrease in Unit Shares	230.0	326.0	-	-	-	-
Increase in (Nonliquid) Working Capital	34.8	161.0	137.7	166.6	201.1	240.3
Total Applications	**266.6**	**489.0**	**138.7**	**167.6**	**202.1**	**241.3**
Surplus/(Deficit)	29.5	-7.8	40.0	43.5	51.2	61.1
Liquid Assets						
Opening Balance	216.6	216.6	208.7	248.8	292.3	343.4
Increase/ (Decrease)	29.5	-7.8	40.0	43.5	51.2	61.1
Closing Balance	246.0	208.7	248.8	292.3	343.4	404.5

SCHEDULE OF FUNDS NEEDED FOR NEW LOANS
Bhutan National Bank
(Nu million)

Item	Projection				
	1997	1998	1999	2000	2001
Projected Disbursements:					
Pipeline Cases	180	-	-	-	-
Future Prospects	443	290	218	250	288
Total	623	290	218	250	288
Cash Available for Disbursements	484	120	43	52	50
Financing Gap	139	170	175	198	238

Bhutan National Bank

Assumptions

1. **Deposits**
The annual growth on the base (1996) is estimated as 20 percent (1997 to 2001) on the immediate preceding year, although the current cost of funds is around 10 percent per annum. Deposit liabilities are assumed to be 30 percent of the total deposits.

2. **Loans**
The annual growth on the base (1996) is estimated as 30 percent in the first year and 20 percent thereafter (1997 to 2001) on the immediate preceding year. Average yield taken at 13.5 percent per annum.

3. **Investments**
No new equity participation in projects is contemplated. Dividends from existing investments are expected to continue at present rates.

4. **Other Operations**
Income from the discounting of bills, commission, exchange on instruments, and brokerage on merchant banking are considered to a reasonable extent.

5. **Transactions with RMA**
   (a) Cash reserve requirement is at 15 percent of demand deposits; however, corresponding interest is not factored into the profitability for conservatism.
   (b) Deployment of surplus liquidity in bank deposits and with Royal Monetary Authority discount bills is expected to generate income at 5.5-6.5 percent per annum.

6. **Operating Expenses**
The revenue budget for 1997 considered. Thereafter, the annual compound growth on the base (1997) is provided at 20 percent per annum, vis-a-vis activity volumes and inflation (assumed as 10 percent per annum).

7. **Fixed Assets**
Addition to/replacement of facilities and equipment envisaged as Nu2.1 million (1997) and Nu1 million per annum (thereafter). The depreciation is calculated at 10 percent straight line method (average).

8. **Taxation**
The income tax was applied from 1998 onward at 30 percent.

9. **General**
The impact of writing off suspended loans and the swap of the nonperforming assets for cash with the Government are incorporated in the forecast.

Appendix 8

Pipeline of Subprojects
(BDFC and BNB for Year 1997)

	Subprojects Particulars	Location	Purpose	Project Cost (Nu '000)
1	Druk Talc & Minerals Company	Phuentsholing	New	16,500
2	Green Wood Manufacturing	Phuentsholing	New	17,440
3	Tyre Tretreading	Phuentsholing	New	3,940
4	Stone Crushing Unit	Thimphu	Expansion	300
5	HDPE Bag	Phuentsholing	New	30,000
6	Coco Cola Bottling	Phuentsholing	New	80,000
7	Audio/Video	Thimphu	Equipment	150
8	Bulldozer	Thimphu	Equipment	8,806
9	Cable Crane Unit	Zhemgang	Equipment	936
10	Cable Crane	Gedu	Equipment	23,500
11	Cable Crane	Paro	Equipment	668
12	Construction Equipment	Thimphu	Equipment	1,520
13	Tractor	Gidagom	Equipment	215
14	Fruit Processing Industry	Bumthang	Expansion	300
15	Handicraft Unit	Paro	Expansion	100
16	Metal Craft	Thimphu	Modernization	300
17	Plastic Industry	Paro	Expansion	83
18	Weaving Unit	Thimphu	New	150
19	Wood-based Industry	Lobeysa	New	1,300
20	Incense Unit	Thimphu	Expansion	150
21	Pan Masala	Samchi	Expansion	700
22	Cement	Gomtu	Modernization	20,005
23	Sand Quarry	Paro	Modernization	60
24	Automobile Workshop	Thimphu	New	500
25	Bakery and Confectionery	Bumthang	New	200
26	Leksol Transport	Thimphu	Expansion	7,110
27	Passenger Transport	Gelephu	Expansion	1,250
28	Tailoring	Phuntsholing	Expansion	160
29	Backhoe	Thimphu	Equipment	1,720
30	BDL Milk Processing Unit	Phuentsholing	Modernization	5,500
31	Wood Based Industry	Thimphu	Expansion	1,500
32	Radak Slate Mine	Lobeysa	Expansion	8,000
	Total			**233,063**

BDFC = Bhutan Development Finance Corporation; BNB = Bhutan National Bank.

Appendix 9, page 1

SHARE PRICING MODEL: BHUTAN NATIONAL BANK
(Nu millions)

Base Case [a]	Actual	Projected				
	1996	1997	1998	1999	2000	2001
Income						
Interest Income	86.8	99.5	115.0	136.0	163.0	195.0
Other Income	2.6	5.0	6.0	6.0	7.0	8.0
Total	**89.4**	**104.5**	**121.0**	**142.0**	**170.0**	**203.0**
Expenditure						
Interest Expense	51.3	53.5	55.0	66.0	79.5	95.0
Other Operating Expenses	17.8	22.8	26.6	30.7	36.0	43.0
Depreciation	0.8	1.5	1.7	1.8	1.9	2.0
Provisions	4.7	5.0	5.3	5.7	6.1	6.5
Total	**74.6**	**82.8**	**88.6**	**104.2**	**123.5**	**146.5**
Profit Before Tax	14.9	21.7	32.4	37.8	46.5	56.5
Tax Expenses	0.0	0.0	9.7	11.3	13.9	16.9
Profit After Tax	14.9	21.7	22.7	26.5	32.5	39.5
Extra-ordinary Item [b]	10.6					
Total Net Worth (After Tax)	129.6	151.3	174.0	200.5	233.0	272.5
Capital Structure (No. of shares)						
Government	400,000	161,984	161,984	161,984	161,984	161,984
GEPF	12,500	12,500	12,500	12,500	12,500	12,500
RICB	12,500	12,500	12,500	12,500	12,500	12,500
Private	170,040	170,040	170,040	170,040	170,040	170,040
Bank/Foreign	0	238,016	238,016	238,016	238,016	238,016
Total	**595,040**	**595,040**	**595,040**	**595,040**	**595,040**	**595,040**
Book Value Per Share (Nu)	**217.8**	**254.3**	**292.4**	**336.9**	**391.6**	**458.0**
Earnings Per Share (Nu)	**25.0**	**36.5**	**38.1**	**44.5**	**54.7**	**66.4**
Share Price (Bank Investment)	-	190.0	-	-	-	664.3
Bank Investment Amount (Nu million)	-	28.3	-	-	-	-
Net Cash Flow (Nu million)	-	-28.3	0.0	0.0	0.0	98.8
Net Cash Flow ($ million)	-	-0.8	0.0	0.0	0.0	2.4
Price/Book Value Per Share	**0.87**	-	-	-	-	-
Price/Earnings Per Share	**7.60**	-	-	-	-	**10.00**
Financial Internal Rate of Return						**31.1%**
Assumptions						
Bank/Foreign Investment (Price/Share)		190				
Market Price/Earnings Per Share		10				
Exchange Rate Depreciation (p.a.) [c]		4.3%				

GEPF = Government Employee Provident Fund; RICB = Royal Insurance Corporation of Bhutan; p.a. = per ann

[a] Based on financial forecast for BNB where average annual growth rate of the profit before tax is 24 percent.

[b] Write-back of past reserve created to hedge exchange fluctuation.

[c] Based on average inflation differentials between US$ and Indian rupees during the forecast period.

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SHARE PRICING MODEL: BHUTAN NATIONAL BANK
(Nu millions)

Worse Case [a]	Actual	Projected				
	1996	1997	1998	1999	2000	2001
Profit Before Tax	14.9	18.3	22.8	24.7	27.5	30.5
Tax Expenses	0.0	0.0	6.8	7.4	8.3	9.1
Profit After Tax	14.9	18.3	15.9	17.3	19.3	21.3
Extra-ordinary Item	10.6					
Total Net Worth (After Tax)	129.6	147.9	163.9	181.1	200.4	221.8
Capital Structure (No. of shares)						
Government	400,000	161,984	161,984	161,984	161,984	161,984
GEPF	12,500	12,500	12,500	12,500	12,500	12,500
RICB	12,500	12,500	12,500	12,500	12,500	12,500
Private	170,040	170,040	170,040	170,040	170,040	170,040
Bank/Foreign	0	238,016	238,016	238,016	238,016	238,016
Total	**595,040**	**595,040**	**595,040**	**595,040**	**595,040**	**595,040**
Book Value Per Share (Nu)	**217.8**	**248.6**	**275.4**	**304.4**	**336.8**	**372.7**
Earnings Per Share (Nu.)	**25.0**	**30.7**	**26.8**	**29.0**	**32.4**	**35.9**
Share Price (Bank Investment)	-	190.0	-	-	-	358.6
Bank Investment Amount (Nu million)	-	28.3	-	-	-	-
Net Cash Flow (Nu million)	-	-28.3	0.0	0.0	0.0	53.3
Net Cash Flow ($ million)	-	-0.8	0.0	0.0	0.0	1.2
Price/Book Value Per Share	**0.87**	-	-	-	-	-
Price/Earnings Per Share	**7.60**	-	-	-	-	**10.00**
Financial Internal Rate of Return						**9.5%**
Assumptions						
Bank/Foreign Investment (Price/Share)		190				
Market Price/Earnings Per Share		10				
Exchange Rate Depreciation (p.a.)		7.0%				

GEPF = Government Employees Provident Fund; RICB = Royal Insurance Corporation of Bhutan; p.a. = per annum.
[a] Assuming BNB's average annual growth rate of the profit before tax is 12.7 percent.

TECHNICAL ASSISTANCE FOR CAPACITY UPGRADING OF FINANCIAL SECTOR INFRASTRUCTURE AND ENTREPRENEURIAL DEVELOPMENT

A. Background and Rationale

1. An advisory technical assistance (TA) is proposed for Capacity Upgrading of Financial Sector Infrastructure and Entrepreneurial Development in conjunction with the Financial Sector Intermediation Facility (FISIF) Project. In addition to the TA, the proposed FISIF consists of a policy component in the form of a policy loan; an investment component in the form a development finance loan for relending as credit line to two participating financial institutions (PFIs), Bhutan Development Finance Corporation (BDFC) and Bhutan National Bank (BNB); and an equity investment in BNB, the country's second commercial bank newly created under a Bank TA. The FISIF is designed to ensure that an adequate policy and institutional framework are in place to promote private sector development and investment. The combination of the policy loan, credit line, equity investment, and TA will foster an integrated and long-term approach to sector needs and will enhance the Bank's leverage for promoting policy and institutional reforms.

2. The policy component of the FISIF covers following areas: (i) industrial, trade, and private sector development policies; (ii) financial market structure including the interest rate and foreign exchange policies; (iii) establishment of an adequate legal and regulatory framework; (iv) and human resources development policies. The proposed development finance loan will require the PFIs to meet minimum eligibility criteria and to adopt the Bank's standard quality criteria of subloans. Assistance is needed to upgrade the capacities of concerned Government agencies involved in the reform program and the Royal Monetary Authority (RMA, the central bank). Assistance is also needed by the PFIs to strengthen their institutional capabilities to successfully utilize the Bank credit line.

3. Weak institutional capacity of the financial sector and weak private sector entrepreneurship and management skills were identified as two major constraints to the improvement of the financial system and the expeditious development of the private sector. The financial institutions in the country generally lack adequate human resources and are saddled with nonperforming assets. The capability of RMA to enforce prudential regulations by imposing penalties in the cases of noncompliance is very limited, and the financial institutions lack adequate incentives to improve their operational and financial performance to comply with the prudential regulations. The weaknesses in the financial sector have become more critical in areas such as (i) lack of an adequate legal and regulatory framework; (ii) lack of liquidity management by commercial banks through an interbank market; (iii) lack of reliable credit information on borrowers, which delays the processing of loans; and (iv) lack of an efficient clearing and payments system.

4. The nascent state of the private sector requires financial institutions to be proactive in investment promotion activities, because entrepreneurial skills are scarce and the dissemination of information on the investment opportunities is limited. Investment promotion activities should entail technical support to the private sector in the identification, development,

and implementation of investment projects. It is necessary to strengthen the investment promotion capability of the financial institutions, particularly the two PFIs, i.e., Bhutan Development Finance Corporation (BDFC) and BNB. This would enable them to undertake proactive investment promotion and to provide technical support to the private sector.

B. The Technical Assistance

1. Objectives

5. The main objective of the TA is to upgrade the institutional capacities of the Government agencies and monetary authorities engaged in the policy reform program envisaged under the FISIF for the development of an efficient and competitive financial system to create an enabling environment for private sector development. The TA will also identify measures to strengthen institutional capabilities of the financial institutions; and enhance private sector entrepreneurship and management skills.

2. Scope

6. The TA will finance the service of consultants and necessary equipment to assist

(i) The Government to review the case-by-case approach to foreign investment and develop a transparent regulatory framework for promoting foreign investment in coordination with the ongoing program of the United Nations Development Program;

(ii) The Government to review the current structure and operations of the Government Employees Provident Fund (GEPF) and provide policy recommendations for its restructuring;

(iii) RMA to draft a negotiable instruments act and improve financial institution prudential guidelines and supervision functions;

(iv) RMA to improve the operational efficiency of the payments and clearing system;

(v) RMA to strengthen its institutional capabilities in foreign exchange risk management and develop effective monetary policy tools to enhance indirect monetary control, such as reserve requirements and open market operations;

(vi) Royal Securities Exchange of Bhutan (RSEB) to review its operations and provide recommendations on institutional strengthening measures, and to draft legislation on the central depository system;

(vii) RMA to set up a banking training program at the Royal Institute of Management; and

(viii) BDFC and BNB to strengthen their institutional capabilities in investment promotion and private sector support activities including project identification, planning and implementation support to the private sector, and entrepreneurship development.

3. Cost Estimates and Financing Plan

7. The total cost of the TA is estimated at $510,000 equivalent. The details are in Table 1. The entire foreign exchange cost of $500,000 will be financed by the Bank on a grant basis from the Japan Special Fund, funded by the Government of Japan. The local currency cost of $10,000 equivalent for the consultants' office space, secretarial and support services in kind, local travel, and other administrative support will be provided by the Government.

4. Implementation Arrangements

8. The TA will require a period of 18 months for implementation, and about 13 person-months of services from a team of four international consultants (at 3.25 person-months each): a financial sector policy specialist as the team leader, a financial sector operations specialist, a financial legal and regulatory specialist, and a private sector development specialist. Since the required methodology and tasks to be undertaken by the experts are stated clearly in the terms of reference, it is expedient to recruit consultants based on the procedures of simplified technical proposals and in accordance with the Bank's *Guidelines on the Use of Consultants*. Before proceeding to Bhutan, the consultant team will spend one to two days in Manila en route to Bhutan for appropriate briefings.

9. The Executing Agency will be RMA. RMA will coordinate the consultants' activities with various Government agencies and financial institutions, and provide office space, secretarial support, local transport, and logistical support.

10. The consultants will submit an inception report to RMA and the Bank two weeks after the commencement of work. The interim report will be submitted nine months after the commencement of the TA to provide recommendations for key policy reform and institutional strengthening measures. The draft final report will be submitted one month before the completion of the Project to review the implementation status of the policy reform and institutional strengthening measures, and will be discussed at a meeting attended by the Bank, RMA, other concerned Government agencies, and the consultants during the midterm policy review (MPR) prior to the release of the second tranche of the policy loan.

C. Terms of Reference

11. The terms of reference for the consultants will include, but will not necessarily be limited to, the following:

1. Financial Sector Policy Specialist

12. The specialist will

(i) provide overall leadership of the consulting team, formulate a plan to upgrade the capacity of the finance sector infrastructure and

entrepreneurial development, build adequate institutional capacity of the Government agencies that are responsible for implementing the FISIF policy reform measures, and coordinate with Government agencies in overseeing and monitoring the progress of implementation of the FISIF;

(ii) review the current structure and operations of the GEPF, recommend ways to improve the structure and operational performance before its restructuring, and provide policy guidance to the Government on possible directions of the restructuring of the GEPF; and

(iii) recommend the suitable management and operational procedures for the Government to manage the NPAs swapped from BNB.

2. Financial Sector Operations Specialist

13. The consultant will

(i) identify the weaknesses of the present clearing and payments system at RMA and recommend suitable improvement measures;

(ii) evaluate the needs for an interbank market and a credit information bureau for Bhutan's financial system and recommend their organizational structures; and

(iii) identify the need to upgrade the quality of human resources in the financial institutions and work with RMA and RIM to develop a sustainable banking training program.

3. Financial Legal and Regulatory Specialist

14. The consultant will

(i) evaluate the present banking supervisory capabilities of RMA, recommend suitable measures to improve its prudential regulations and enhance its supervision function, and set up necessary reporting requirements for financial institutions to assist RMA in tracking compliance with prudential regulations;

(ii) review the current situation and recommend measures to build an adequate legal and regulatory framework, and assist RMA in drafting the Negotiation Instruments Act and other legislation and regulations if required; and

(iii) evaluate the need for strengthening the legal and regulatory framework for RSEB and assist RSEB in drafting a regulation on the operation of the central depository.

4. Private Sector Development Specialist

15. The specialist will

(i) review the Government's current case-by-case approach to foreign investment and assist the Government in the preparation of transparent policy and regulations regarding foreign investment;

(ii) evaluate the current system of administrative controls over private sector business activities, including the employment of foreign labor, and assist the Government in the preparation of transparent policies to rationalize various controls; and

(iii) assist BDFC and BNB to strengthen their investment promotion activities including helping private sector entrepreneurs to identify feasible projects and make them bankable;

Table 1: Estimated Costs and Financing Plan
($)

Item	Foreign Exchange	Local Currency	Total
A. Bank Financing (JSF)			
1. Consultants (Remuneration, Travel, and Out of Pocket Expenses)			
a. International Consultants	351,000		351,000
b. International Travel	24,000		24,000
c. Reports and Communication	4,000		4,000
2. Equipments	50,000		50,000
3. Contract Negotiations	5,000		5,000
4. Miscellaneous TA Administration and Support Costs	1,000		1,000
5. Contingency	65,000		65,000
Subtotal (A)	**500,000**		**500,000**
B. Government Financing			
1. Office Accommodation (in kind)		4,000	4,000
2. Secretarial Assistance		1,000	1,000
3. Domestic Transportation		4,000	4,000
4. Contingencies		1,000	1,000
Subtotal (B)		**10,000**	**10,000**
Total	**500,000**	**10,000**	**510,000**