

**TAR:BHU 28075**

**ASIAN DEVELOPMENT BANK**

*This Report has been prepared  
for the use of the Bank.*

**TECHNICAL ASSISTANCE**

**TO THE**

**KINGDOM OF BHUTAN**

**FOR THE**

**CONVERSION OF THE**

**UNIT TRUST OF BHUTAN TO A**

**COMMERCIAL BANK**

**January 1995**

### **CURRENCY EQUIVALENT**

(as of 14 October 1994)

Currency Unit	—	Ngultrum (Nu)
Nu 1.00	—	\$0.032
\$1.00	—	Nu 31.41

### **ABBREVIATIONS**

BDFC	—	Bhutan Development Finance Corporation
BOB	—	Bank of Bhutan
MOF	—	Ministry of Finance
RGOB	—	Royal Government of Bhutan
RICB	—	Royal Insurance Corporation of Bhutan
RMA	—	Royal Monetary Authority of Bhutan
UTB	—	Unit Trust of Bhutan

### **NOTES**

- (i) The fiscal year (FY) of the Government ends on 30 June.
- (ii) In this Report, "\$" refers to the US dollar.

## I. INTRODUCTION

1. Upon request of the Royal Government of Bhutan (the "Government"), a Fact-Finding Mission (the Mission) visited Bhutan from 23 October to 3 November 1994 to evaluate and formulate a technical assistance (TA)<sup>1</sup> for converting the Unit Trust of Bhutan (UTB) from a unit trust operation to a commercial bank. The Mission discussed the objectives, scope, terms of reference, and implementation arrangements of the TA with the Ministry of Finance (MOF), the Royal Monetary Authority (RMA), and UTB. This TA was identified by the Bank's Country Programming Mission in January 1994 and included in the 1994 operational program for Bhutan.

## II. BACKGROUND AND RATIONALE

2. The financial sector in Bhutan is limited in part by the country's small population, and consists of four major institutions in addition to the RMA (the central bank of Bhutan). The Bank of Bhutan (BOB) is the only commercial bank in Bhutan, Bhutan Development Finance Corporation<sup>2</sup> is a long-term lender of funds, UTB is a unit trust operation with license to take deposits, and the Royal Insurance Corporation of Bhutan (RICB) provides insurance services and manages the Government employees' provident fund. In 1993, the Royal Securities Exchange of Bhutan was established through the Bank's TA No. 1699-BHU: Capital Market and Stock Exchange Center Development.<sup>3</sup>

3. The total assets of the four financial institutions were \$141.13 million (Nu 4,432.8 million equivalent) as of 30 June 1994, with BOB accounting for \$87.94 million (Nu 2,762.3 million equivalent) or 62.3 per cent of total assets; RICB for \$27.04 million (Nu 849.3 million equivalent) or 19.16 per cent; UTB for \$20.85 million (Nu 655.0 million) or 14.8 per cent; and BDFC for \$5.43 million (Nu 170.6 million equivalent) or 3.85 per cent. Over the last decade, the increase in the economic activities within Bhutan can be measured by the growth of total assets of these four financial institutions. The comparative total assets as of 31 December 1984 was \$66.21 million (Nu 815.1 million equivalent), indicating an annual compounded growth of 18.3 per cent since then.

4. During the last five years, BOB's monopoly position in the commercial banking sector has resulted in market inefficiencies related to the introduction of new banking products, lack of customer service, and reluctance to introduce technological enhancements to its banking operations. The Government has been concerned for some time about the limited commercial banking facilities available to the public. On several occasions, the Government requested BOB to enhance its customer service and modernize its technical operations, but without any substantive or positive results. The Bhutan Chamber of Commerce and Industry has, on several occasions, petitioned the Government to allow a second commercial bank to be established in Bhutan, and forwarded a proposal to this effect to MOF. Unfortunately, the proposal did not address properly the financial and technical aspects of establishing such a bank. Nevertheless, MOF saw this proposal as an initiative to spur the Government to action. The operations of the Government and its agencies have also been affected by the monopoly banking situation,

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<sup>1</sup> The Project was first listed in the *ADB Business Opportunities* in September 1994.

<sup>2</sup> Established with Bank assistance: Loan No. 934-BHU: Bhutan Development Finance Corporation, for \$2.5 million, approved on 13 December 1988; TA No. 1022-BHU: Institutional Support to the Bhutan Development Finance Corporation, for \$270,000, approved on 4 August 1988; and TA No. 1465-BHU: Institutional Strengthening of the Bhutan Development Finance Corporation, for \$431,400, approved on 11 January 1991.

<sup>3</sup> For \$224,250, approved on 15 May 1992.

because BOB undertakes all banking needs from deposits to disbursements. The current monopoly situation is considered unfavorable for the public, and has resulted in some dissatisfaction with the limited scope and quality of services provided. Accordingly, the Government is clearly in favor of licensing a second commercial bank.

5. The current constraint is most apparent in the service that BOB's clients receive. Therefore, competition is needed to improve customer service, streamline procedures, establish a banking environment that is reasonably comparable with international banking standards. The exporters and importers in Bhutan need improved and diversified banking facilities on a timely basis. The lack of such facilities hampers the trading and other business activities of the private and public sectors. In addition, the Government has substantial international funds flow related to international borrowing and repayments, as well as foreign aid funding. The national budget for fiscal year 1994 showed a total revenue of \$140.0 million (Nu 4,396 million equivalent), of which \$90.3 million (Nu 2,835 million equivalent) or 64.5 per cent is funded by foreign funds (grants of \$88.0 million and loans of \$2.3 million). The flow of foreign funds is expected to increase in the future. The Government, and other sectors of the economy, require well-developed, efficient, and timely banking facilities and services to handle the growing volume of financial transactions.

6. UTB was established in July 1980 as an autonomous entity but under the day-to-day management by RICB. In 1992, UTB was formally separated from RICB and, following the passage of the Financial Institutions Act in 1992, UTB was deemed to have been incorporated under the Act and licensed as a financial institution. UTB is governed by a five-member Board of Directors, all appointed by the Government. The Managing Director is appointed for a five-year term and is in charge of UTB's day-to-day operations.

7. The head office of UTB is located in Thimphu, the capital. UTB has four branches (one each in Phuentsholing, Samdrup Jongkhar, Tashi Gang, and Gelepu) covering the major economic centers of Bhutan. UTB had 63 staff as of 30 June 1994, the smallest number among the four institutions.

8. Currently, UTB is operating as a quasi-bank, except that it does not have check issuance facilities. Its major activity is to sell unit shares. UTB is offering seven schemes of unit share purchases to its clients, with all schemes guaranteed a nominal interest rate of 11.7 per cent. The unit shares are similar to regular time deposits with fixed maturities and fixed interest rates. The unit share schemes can vary in maturities, yield, and service charges on encashment. Furthermore, UTB also accepts savings deposits just like a commercial bank.

9. The asset side of UTB shows lending operations reflecting strong similarities with those of a commercial bank. UTB provides short-term and long-term credit for many purposes such as housing, transportation (heavy and light vehicles), trade and working capital, and loans for shares and industrial capital investment. UTB's major task is to address the mismatch between deposits and assets. The current profile is of short-term funding (unit shares and deposits) versus long-term lending (real estate loans). In a deregulated financial market, this profile would be very dangerous but Bhutan has administered interest rates that prevent any immediate serious problem for UTB. However, the funding mismatch is not a sustainable situation and needs to be addressed soon.

10. As of 30 June 1994, UTB had total assets of Nu 665.5 million, with loans and advances accounting for Nu 529.3 million (79.5 per cent), cash items accounting for Nu 119.7 million (18.0 per cent) and investments and fixed assets for Nu 16.4 million (2.5 per cent). The assets were financed by paid-in capital of Nu 42.5 million (6.4 per cent), of which the Government contributed Nu 40.0 million, while RICB and the Government Provident Fund each provided Nu 1.25 million. Unit shares accounted for Nu 423.8 million (63.7 per cent), deposits accounted for Nu 73.5 million (11.0 per cent), current liabilities were Nu 37.7 million (5.7 per cent), provisions for bad debt Nu 78.3 million (11.8 per cent) and reserves and surplus of Nu 9.7 million (1.5 per cent). During 1993, UTB recorded a net profit of Nu 7.1 million and, for the first six months of 1994, the net profit was Nu 2.5 million.

11. In *Recent Economic Developments* (30 September 1994), the International Monetary Fund (IMF) recommended that a second commercial bank be established in Bhutan because the financial sector has deepened substantially and BOB's lack of efficiency and productivity is resulting in a large amount of funds being held outside the financial system. The IMF also considered UTB to be the best candidate for conversion to a commercial bank. The Mission held individual discussions with the IMF adviser to the RMA and was encouraged to provide the needed TA.

### III. TECHNICAL ASSISTANCE

#### A. Objectives

12. The basic objective of the TA is to develop the financial sector in Bhutan by providing modern banking facilities to the public and the Government. The Government and the Mission believe that UTB is the financial institution best suited for conversion to a commercial bank.

#### B. Scope

13. The scope of the proposed TA includes (i) reviewing the existing structure, activities, operations, and staff skills of UTB; (ii) reviewing the financial viability of a second commercial bank in Bhutan and, if a second commercial bank is viable, evaluating the alternative methodologies available and recommending the most suitable methodology to be used in the conversion of UTB to a commercial bank; (iii) preparing an implementation plan for the conversion, inclusive of the financial arrangements, technology needs, and a timetable of tasks to be completed by the various parties involved; and (iv) preparing the local staff for the conversion and transferring commercial banking knowledge to Bhutan. Detailed Terms of Reference are given in Appendix 1.

#### C. Cost Estimate and Financing Plan

14. The total cost of the proposed TA is estimated at \$154,500 including local currency equivalent of \$8,000 (see Appendix 2). The Bank will finance the entire foreign currency cost amounting to \$146,500 for the consultant's remuneration, per diem, international travel, and documentation preparation. The estimated local cost of \$8,000 equivalent for office accommodation, support staff, local transportation, and related expenses will be borne by UTB. The TA will be funded from the Bank-financed TA program.

#### **D. Implementation Arrangements**

15. One international consultant, with experience in all aspects of commercial banking, will be recruited to undertake the Project. The consultant will work closely with a designated Bhutanese understudy from UTB. A total of four person-months of consultant services will be required. The selection will be made in accordance with the Bank's *Guidelines on the Use of Consultants*.

16. The Executing Agency will be RMA, which will also supervise the conversion through its Banking Supervision Division. The consultant will work in close coordination with RMA and other concerned Government departments. The Implementing Agency will be UTB, which will provide the necessary logistical support throughout the consultant's stay in Bhutan.

17. The consultant will prepare a brief interim report two weeks after being fielded with a detailed outline of the proposed plan of action for the duration of the stay in the field. At the end of the second and third month in the field, the consultant will prepare status reports, with particular emphasis on the progress made in selecting the appropriate methodology for the conversion of UTB. Two weeks prior to completion of the assignment, the consultant will submit the draft final report to RMA and the Bank for review and comments. The final report, incorporating the comments from the RMA and the Bank, will be submitted two weeks after the end of field assignment.

#### **IV. THE PRESIDENT'S DECISION**

18. The President, acting under the authority delegated to him by the Board, has approved the provision of technical assistance, on a grant basis, to the Government of the Kingdom Bhutan in an amount not exceeding the equivalent of \$146,500 for the conversion of the Unit Trust of Bhutan to a Commercial Bank, and hereby reports his action to the Board.

## TERMS OF REFERENCE

### A. Objective

1. The objective of the technical assistance (TA) is to provide an expert (the consultant) to the Royal Government of Bhutan for enhancing the financial sector by developing an implementation plan for converting the Unit Trust of Bhutan (UTB) into a full-fledged commercial bank. The main duties of the consultant will be to evaluate the current operations of UTB, establish the methodology for the conversion, and prepare an implementation plan for the conversion of UTB.

### B. Terms of Reference

2. The terms of reference for the consultant will be as follows:

#### (i) Current Position of UTB

Review and establish UTB's current legal position, organizational structure, activities, operations, financial performance, and position. Evaluate UTB's management and staff skills.

#### (ii) Methodology for Conversion

- (a) Review the financial and economic viability of having two commercial banks operating in Bhutan.
- (b) Review and analyze the various methodologies to convert UTB to a commercial bank.
- (c) Recommend the most suitable methodology to be used in the conversion of UTB.
- (d) Assist the Royal Monetary Authority (RMA) in discussions with possible technical and/or financial management proposals/arrangements that may be made for the new commercial bank during the implementation of the TA.

#### (iii) Implementation Plan

- (a) Prepare an implementation plan for converting UTB to a commercial bank. This plan should consist of a detailed description of each step to be taken, as well as the individual tasks to be performed by UTB and Government departments/agencies.

(Reference in text: page 3, para. 13)

- (b) Establish the technology needs for the commercial bank's systems and procedures, and the priority of each technological item.
  - (c) The implementation plan should indicate the priority of the individual tasks to be performed as well as the consequences if the tasks are not performed.
  - (d) Develop a timetable for the conversion phase of UTB.
- (iv) Information and Training
  - (a) Identify training requirements of UTB staff related to commercial banking operations and recommend how they can best be met.
  - (b) Work in close cooperation with the designated understudy from UTB to facilitate skills transfer.
  - (c) Advise UTB on activities it can undertake to increase public awareness of its new position in the financial sector.
- (v) Reporting Requirements
  - (a) Inception Report (due within two weeks of commencement of assignments)

The inception report should include a detailed work plan inclusive of time frames based on initial findings and consultation with officials of UTB, RMA, the Government, and the private sector.
  - (b) Monthly status reports are due at the end of the second and third months of assignment. The monthly status reports should state the progress made during the last month of work, especially related to each topic of the detailed Terms of Reference.
  - (c) The draft final report is due two weeks before completion of the assignment. The draft final report should be prepared after completion of the implementation plan and will contain a detailed account of the tasks undertaken, the feedback from UTB's management and staff, and recommendations on future aspects of the conversion of UTB to a commercial bank.
  - (d) The final report is due within two week after completion of the assignment and should incorporate the comments of UTB, RMA, the Government, and the Bank.



**ESTIMATED COST AND FINANCING PLAN**  
(in \$)

Item	Foreign Exchange	Local Currency	Total Costs
<b>A. Bank Financing</b>			
1. Consultant's Remuneration	100,000	—	100,000
2. Round Trip Airfare	10,000	—	10,000
3. Per Diem	14,400	—	14,400
4. Report Preparation	2,000	—	2,000
5. Lump Sum Miscellaneous	<u>1,000</u>	—	<u>1,000</u>
	127,400		127,400
Contingency	<u>19,100</u>		<u>19,100</u>
Subtotal	146,500		146,500
<b>B. UTB Financing</b>			
1. Office Accommodation	—	3,000	3,000
2. Support Staff	—	1,500	1,500
3. Local Transport	—	2,000	2,000
4. Office Supplies	—	<u>500</u>	<u>500</u>
		7,000	7,000
Contingency		<u>1,000</u>	<u>1,000</u>
Subtotal		8,000	8,000
<b>Total Estimated Cost</b>			<b>154,500</b>

(Reference in text: page 3, para. 14)