

TAR:BHU 29240

ASIAN DEVELOPMENT BANK

TECHNICAL ASSISTANCE

TO THE

KINGDOM OF BHUTAN

FOR

RESTRUCTURING OF THE UNIT TRUST OF BHUTAN

TO A COMMERCIAL BANK

February 1996

CURRENCY EQUIVALENTS
(as of 15 January 1996)

Currency Unit	—	Ngultrum (Nu)
Nu1.00	=	\$0.028
\$1.00	=	Nu35.77

ABBREVIATIONS

BOB	—	Bank of Bhutan
IMF	—	International Monetary Fund
RICB	—	Royal Insurance Corporation of Bhutan
RMA	—	Royal Monetary Authority of Bhutan
TA	—	Technical Assistance
UTB	—	Unit Trust of Bhutan

NOTE

- (i) The fiscal year of the Government ends on 31 December
- (ii) In this Report, "\$" refers to US dollars.

I. INTRODUCTION

1. At the request of the Royal Government of Bhutan, a Fact-finding Mission visited Bhutan from 5 through 9 November 1995 to discuss possible Bank technical assistance (TA) for restructuring the Unit Trust of Bhutan (UTB) to a commercial bank. The need for the TA was identified by the Bank's Country Programming Mission in 1995, and it has been included in the 1996 operational program for Bhutan. The Government confirmed that the TA is in accordance with its current development policies,¹ and reached an understanding with the Fact-finding Mission on the TA's objectives, scope, cost estimates, financing plan, and terms of reference. The TA is a follow up to implement the recommendations and findings of the previous TA No. 2284-BHU: Conversion of the Unit Trust of Bhutan to a Commercial Bank (TA2284).²

II. BACKGROUND AND RATIONALE

2. In support of the Government's development efforts to transform the Bhutanese economy from a subsistence one to a more diversified one, and to promote greater participation by the private sector, a more efficient and competitive financial sector is necessary. The Government strategy is to improve the financial sector institutions to enable them to contribute to this process. The size of the financial sector in Bhutan is limited because of the country's small population. Currently there are four major institutions in addition to the central bank, known as the Royal Monetary Authority (RMA): the Bank of Bhutan (BOB), the only commercial bank; the Bhutan Development Finance Corporation, which is the lender of long-term funds; the Royal Insurance Corporation of Bhutan (RICB), which provides insurance services; and UTB.

3. BOB's operations have been inefficient and unsatisfactory to the public because of its monopoly position in commercial banking. It has been reluctant to introduce new banking products and technological enhancements such as computer systems. The Government has been concerned for some time about the limited commercial banking facilities available, poor standard of services, and lack of competition. Pressure from the business community and public to establish the second commercial bank has been building up in recent years. The International Monetary Fund (IMF) recently recommended³ that a second commercial bank be established in Bhutan to increase competition, since the financial sector has deepened substantially and the lack of efficiency and productivity on the part of BOB was resulting in a large amount of funds being held outside the financial system. A second commercial bank could be created through conversion of an existing financial institution or through establishment of a new bank with foreign participation. However, a number of studies indicated that it seemed unlikely that the economy could support another financial institution at the present time, and conversion would be a more viable alternative.

4. UTB in many respects was already functioning as a bank, mobilizing a large volume of funds through its mostly urban branches. It was formed in July 1980; jointly owned by the Government and RICB; and operated under the auspices of RICB until January 1992, when it was hived off as a deposit-taking institution licensed under the Financial Institutions Act. UTB is not a unit trust in the normal way, wherein units fluctuate in value according to a periodic

¹ The TA first appeared in *ADB Business Opportunities* in October 1995.

² For \$146,500, approved on 4 January 1995.

³ *Recent Economic Developments*, IMF Central Asia Department, 1 September 1995.

valuation of the underlying assets, with governance by a trust deed; rather the unit shares are similar to regular time deposits with fixed maturities and fixed interest rates. It can be more accurately categorized as a quasi-bank, except that it does not have check issuance facilities. UTB's lending operations reflect strong similarities with those of a commercial bank. It provides short-term and long-term credit for many purposes such as housing, transportation, trade and working capital, and industrial capital investment. Thus, UTB is considered by IMF as the best candidate for conversion to a commercial bank.

5. The Bank approved and implemented TA2284 in 1995 to study the feasibility of converting UTB to a commercial bank. The final report of the TA reviewed UTB's existing financial and organizational structures, examined the financial viability of having a second commercial bank in Bhutan, and presented an implementation plan for the conversion. The study found that the existing operating environment of the financial sector offered moderate prospects for growth in banking-related services. Statistics show that the real output in Bhutan has grown at an average of 4-5 percent per annum since 1992, and the total deposits in the banking sector have increased by 8 percent per annum during the same period. The recapitalization requirement for the new commercial bank is estimated to be about one third of its total capital, or around Nu 30 million (\$850,000). Under relatively conservative assumptions about loan provisioning, the newly established commercial bank is expected to achieve a return on equity of 5 percent in 1996 and 28 percent in 2000.

6. At the tripartite meeting for TA2284 held in July 1995, the prospects of inviting foreign bank partnership(s) in the newly created commercial bank were extensively discussed. There was consensus that a foreign bank to form a joint venture or a technology partnership would introduce capital, technical expertise, technological support, banking management expertise, and operational and development strategy to the new commercial bank. However, the consultant responsible for TA2284 found that foreign banks might not be currently interested in Bhutan, given the limited market size and the large share of nonperforming loans in UTB's portfolio. Since the Government would like to have an operating bank immediately, and attracting a foreign bank would take a longer time, it was agreed that the conversion and incorporation of UTB to a commercial bank would be carried out by UTB itself supported by Bank TA. However, after the new bank becomes fully operational for 1-2 years and establishes a track record, the Government must take steps to divest and privatize it and to remove the current impediment to the entry of foreign banks. In doing so, the Government would consider approaching the Bank for an equity investment, and identifying, with the help of the Bank, a foreign partner.

7. The Government has given high priority to the conversion of UTB, and the targeted date for the new commercial bank to become functional is 1 July 1996. During the TA Fact-finding Mission, the Government indicated its desire to see continuing assistance and involvement by the Bank in terms of possible equity investment and identifying a foreign bank partner. An amendment of UTB's articles of incorporation has been drafted, assisted by the IMF Advisor to RMA, and is now awaiting finalization once the organization structure of the new bank is determined. The initial recapitalization will be done by the Government; however, as part of the overall privatization policy of the Government, RMA has approved the floating of one third of the new bank's capital (Nu 30 million or \$850,000) immediately after the conversion.

8. An implementation plan was developed under TA2284 that involves 19 action programs. Step-by-step procedures and guidance on critical issues are given for each action program within a broad timetable. The implementation plan recommends the formation of a

conversion team and identifies areas of concern such as legal requirements, capital structure of the new bank, conversion of the unit schemes, risk management strategy, liability and liquidity management, organizational structure, training needs, establishment of various banking services, computerization, strategic planning, accounting and internal audit, and premises relocation. A proper system of administration and the implementation of the conversion process are also recommended.

9. Nonperforming loans, currently at 17.8 percent of the portfolio, stand as one of the major obstacles to the financial health of the new commercial bank. A workout strategy was designed under TA2284 to be carried out along with the conversion process to tackle the problem of nonperforming loans. In addition to straightforward collection procedures, the workout strategy calls for setting up a team to prioritize nonperforming loans, identify case-by-case the precise problems impeding debt service, and establish various methods of collection. It is expected that sufficient provisions for doubtful debt will be provided in the first year of the new commercial bank's operation so that the problem of nonperforming loans will be solved before 1997, and that in one-year's time, nonperforming loans will be eliminated to have a clean portfolio preparatory to the Government's efforts of divestment of the bank and to bring in foreign partnership(s).

III. THE TECHNICAL ASSISTANCE

A. Objectives

10. The main objective of the TA is to carry out the implementation plan of the conversion and incorporation of UTB to a commercial bank, clearing the loan portfolio of the new bank, preparing local staff for the conversion, transferring commercial banking knowledge, and advising the new bank in all area of its operations. The TA will also assist UTB in acquiring modern banking facilities and equipment. The establishment of the new bank is only the first step in introducing competition in Bhutan's banking sector. The new bank must be able to operate efficiently, to be financially sound, and to deliver high quality service and innovations to the market. Specifically, the ratio of provisions for doubtful debts and interest suspense to loans must be lowered to international norm after 1997.

B. Scope

11. A conversion team will be established comprising two experienced international consultants; two local general bankers, who will be offered permanent appointments after the conversion at the new bank; and two UTB Deputy Managers. The team will carry out actions in areas of incorporation and other legal aspects, capital structure, risk management, liability and liquidity management, organization, training, various banking services, computerization, strategic planing, accounting and internal auditing, and premises relocation. The team will be supervised and assisted by the Managing Director, the Financial Advisor, and the Internal Auditor of UTB. The team is also expected to receive extensive cooperation and contributions from the offices of the Managing Director and the IMF Advisor to RMA, and from the Ministry of Finance.

12. Two individual international consultants on the conversion team will be hired under the TA. The scope of the TA covers action programs for the conversion process and day-to-day advisory and training in all areas of operation of the new bank. Specifically, it includes (i)

reviewing the implementation plan and associated action programs recommended by the Final Report of TA2284; (ii) forming the structure of the incorporation, determining the new bank's capital structure and legal requirements, formulating risk management and control strategies, and recommending methods for closure of unit schemes and conversion of unit holders to bank customers; (iii) resolving the problem of nonperforming loans; (iv) establishing the business development plan and marketing strategy, trade financing, and remittance functions, and an effective liability and liquidity management structure; (v) identifying the organization structure for the new bank, organizing all training related activities including internships at Indian commercial banks, and preparing operation manuals and policy directives; (vi) improving the existing accounting system; preparing a chart of accounts; establishing a proper internal audit scheme; and putting in place computer systems for general accounting, commercial banking, and the management information system; (vii) formulating an effective deposit campaign program and building up a customer base; (viii) contributing to RMA's effort of setting up a check clearing system for Bhutan's banking system; and (ix) moving UTB's operations from its existing location to an interim location and eventually to a new location. Terms of reference for the consultants are given in Appendix 1.

C. Cost Estimates and Financing Plan

13. The total cost of the TA is estimated at \$600,000 equivalent. The details are given in Appendix 2. The entire foreign exchange cost of \$577,000 and part of the local currency cost of \$13,000 equivalent will be financed by the Bank on a grant basis. Local currency costs of \$10,000 equivalent for the consultants' office space, secretarial and support services in kind, domestic travel, and other administrative support will be provided by UTB.

D. Implementation Arrangements

14. The TA will require a period of six months for implementation, from February to July 1996. The Executing Agency for the TA will be RMA, which will also supervise the conversion through its Banking Supervision Division. The consultants will work in close coordination with RMA and other concerned Government departments. The Implementing Agency will be UTB. UTB will organize the conversion team. During implementation of the TA, UTB will release certain key staff members from time to time to participate full-time in TA-related activities. UTB will also provide training facilities, case study materials, office space and equipment, secretarial support, and communication facilities. A summary of the implementation plan developed under TA2284 with 19 action programs and step-by-step procedures and guidance is provided in Appendix 3.

15. The TA requires 12 person-months of the services of two international individual consultants, each for six person-months. The banking advisor will be the conversion team leader to oversee the conversion process. The operations advisor will be responsible for setting up a branch office in Phuentsholing, for cash management operations, and for trade settlement and remittance services for the new bank. Both are required to have formal banking qualifications and broad commercial banking experience. Practical experience in training of staff and the capability to produce instruction manuals are desirable. The selection and engagement of consultants will be made in accordance with the Bank's *Guidelines on the Use of Consultants*. Equipment and supplies will be procured in accordance with arrangements satisfactory to the Bank.

16. The consultants will submit to RMA, UTB, and the Bank an inception report and an interim report two weeks and three months, respectively, after the commencement of work.

The draft final report comprising management and institutional recommendations regarding commercial bank operations after the conversion, and the Government's plan of eventual divestment and privatization, will be submitted two weeks prior to completion of the assignment and will be discussed at a meeting attended by the Bank, RMA, UTB, and the consultants. The consultants will finalize the report within two weeks after the tripartite meeting. In addition, UTB will provide monthly status reports on the progress of the TA and the performance of the consultants.

IV. THE PRESIDENT'S DECISION

17. 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 Royal Government of Bhutan in an amount not exceeding the equivalent of \$590,000 for the purpose of Restructuring of the Unit Trust of Bhutan to a Commercial Bank, and hereby reports his action to the Board.

TERMS OF REFERENCE

The terms of reference for the consultants will include, but will not necessarily be limited to, the following:¹

A. For the Banking Advisor, Assisted by the Operations Advisor and Other Members of the Conversion Team

- (i) Review the implementation plan and the associated action programs specified in the Final Report for TA2284-BHU: "Conversion of the Unit Trust of Bhutan to a Commercial Bank," and make necessary adjustments.
- (ii) Fulfill the legal requirements for the incorporated new bank.
- (iii) Determine the new bank's capital structure and adequacy requirements.
- (iv) Set up a workout team to resolve the problem of nonperforming loans.
- (v) Help the Unit Trust of Bhutan (UTB) management to set up conditions of appointments, recruit, and form the conversion team.
- (vi) Identify the organization structure for the new bank, specifying required positions and officers to be appointed, and training requirements.
- (vii) Organize training-related activities, including prioritization of training needs and identification of trainees; schedule timetables; and obtain texts and materials.
- (viii) Arrange internships at Indian commercial banks for high level managers in four functional areas of commercial banking: accounting, cash management, loans, and bills.
- (ix) Establish a business development and marketing strategy; and introduce a planning system for the new bank, including the one year operational plan and the five year strategic plan.
- (x) Carry out the plan of moving UTB's operations from its existing location to an interim location and eventually to a new location.
- (xi) Improve the existing accounting system; prepare a chart of accounts; and establish a comprehensive and effective internal audit system in the new bank, including designation of the internal auditor, training, preparation of an audit plan, and compliance duties.

¹ Detailed step-by-step action program associated with each item on the terms of reference are specified in the Final Report of TA No. 2284-BHU: "Conversion of the Unit Trust of Bhutan to a Commercial Bank."

B. For the Operations Advisor, Supervised by the Banking Advisor and Assisted by Other Members of the Conversion Team

- (i) Set up a branch operation in Phuentsholing.
- (ii) Recommend methods for closure of unit schemes and conversion of unit holders to bank customers.
- (iii) Set up functional and administrative arrangements for cash services to customers.
- (iv) Formulate an effective deposit campaign program.
- (v) Formulate risk management and control strategies for the new bank, covering operating risks from credit, liquidity, foreign exchange, investment, and other risks from such as fraud and disaster.
- (vi) Establish an effective liability and liquidity management structure, and formulate funding strategies for the immediate postconversion period.
- (vii) Establish stationery requirements for new bank's functions and put in place a relevant administrative and control system.
- (viii) Put in place computer systems for general accounting, commercial banking, and management information systems.
- (ix) Establish trade settlement, financing, and remittance functions within the new bank, and build up a customer base.
- (x) Set up the foreign exchange dealing section and related settlement function for the new bank.
- (xi) Prepare operational manuals, record management's policy directives, and provide guidance in day-to-day operations.
- (xii) Interact with and contribute to Royal Monetary Authority's (RMA) efforts to set up a check clearing system for Bhutan's banking system.

C. Reporting Requirement

The consultants will submit to RMA, UTB, and the Bank an inception report and an interim report two weeks and three months, respectively, after the commencement of work. The draft final report will be submitted two weeks prior to completion of the assignment and will be discussed at a meeting attended by the Bank, RMA, UTB, and the consultants. The consultants will finalize their report within two weeks after the tripartite meeting. In addition, UTB will provide monthly status reports on the progress of the TA and the performance of the consultants.

ESTIMATED COSTS AND FINANCING PLAN
(in US Dollars)

A. Bank Financing	Foreign Exchange	Local Currency	Total
1. International Consultants (Remuneration and Out-of- Pocket Expenses)	277,000	3,000	280,000
2. Equipment (e.g. Computers, Vehicle and Office Equipment)	180,000		180,000
3. Seminars, Conferences, Workshops, Training, and Fellowships	25,000	8,000	33,000
4. Studies, Surveys, and Documents	15,000		15,000
5. Contract Negotiations	5,000		5,000
6. Miscellaneous TA Administration and Support Costs		1,000	1,000
7. Contingency	75,000	1,000	76,000
Subtotal (A)	577,000	13,000	590,000
B. Government Financing			
1. Office Accommodation (in kind)		4,000	4,000
2. Secretarial Assistance		4,000	4,000
3. Domestic Transportation		1,000	1,000
4. Contingencies		1,000	1,000
Subtotal (B)		10,000	10,000
TOTAL COST	577,000	23,000	600,000

(Reference in text: page 4, para. 13)

**CONVERSION IMPLEMENTATION PLAN
DEVELOPED UNDER TA2284**

No.	PROGRAM	OBJECTIVES
1.	Legal requirements	Carry out the actions required by UTB's Articles, the Financial Institutions Act, and the Companies Act necessary to effect UTB's change of status to a licensed bank.
2.	Capital structure of new bank/adequacy requirements	(a) Project capital needs and adequacy situation in terms of RMA's Prudential Regulations as of the conversion date (provisionally 1.7.96). (b) Examine prospects for (part) privatization at an appropriate time.
3.	Unit schemes discontinuance: at conversion date; campaign to preserve relationships/deposit base	(a) Plan methodology for closure of unit schemes to new funds at conversion date. (b) Design public relations/marketing campaign to recruit unit holders as new bank customers.
4.	Risk management and control strategy (i): credit risk	Formalize assessment/decision making/"housekeeping" procedures for credit risk.
4A.	Risk management and control strategy (ii)	(a) Identify risks associated with operations apart from credit, liquid, foreign exchange, and investment risks. (b) Develop safeguarding strategies.
5.	Formation of conversion team	Recruit/form a team to implement the conversion.
6.	Liability and liquidity management strategies	(a) Establish a structure for management, etc. (b) Formulate funding strategies for postconversion period. (c) Establish maturity mismatch profile. (d) Establish emergency/contingency strategy (e) Formalize range of deposit projects and business development. (f) Establish cost of funds management strategy.

(Reference in text: page 4, para. 14)

No.	PROGRAM	OBJECTIVES
7.	Organizational structure and personnel complement	Establish: (a) organizational structure; (b) job positions required, and personnel complement (total of positions); (c) officers to be appointed to job positions; and (d) skills/training shortfalls, planning corrective action.
8.	Training needs and strategies	(a) Identify/prioritize all training needs, etc. (b) Prepare strategies for providing training. (c) Identify officers to receive training. (d) Establish a workout timetable for training. (e) Obtain texts and materials needed.
9.	Establishment of trade settlement/financing and remittance services	Establish trade settlement/financing and remittance functions (Billing Department), together with a customer base.
10.	Computerization - systems design and implementation (i) general accounting systems (ii) commercial banking processes	Put in place general accounting systems and systems covering commercial banking operations - adopting electronic data processing, processes suitable to the market conditions and transaction volumes, and (at least) matching systems being installed by competitor.
11.	Planning: (i) strategic plan (5 years horizon) (ii) operational plan (1 year)	Introduce a planning system - via strategic (5 year) plan: (a) Define the bank's purpose and mission. (b) Set objectives for both short- and long-term. (c) Produce and implement strategies to achieve objectives. (d) Establish a review/monitoring system via operational (1 year) plan. (e) Set new bank's business plan including profit target/income projections/expense budget. (f) Establish variance/monitoring procedures.

No.	PROGRAM	OBJECTIVES
12.	Clearing system - checks, payment orders	Consult/contribute/interact to establish a clearing system for the Bhutan Banking System.
13.	Stationery requirements	Establish stationery requirements for functions/administration, procure supplies, and put in place an administrative and control system.
14.	Business development strategy products/services range	Establish a business development (marketing) strategy and decide the services and products.
15.	Premises relocation: Thimphu and Phuentsholing	Transfer existing operations in both centers.
16.	Internal audit	Establish a comprehensive and effective internal audit system to protect assets, pinpoint risks, and ensure that decisions are taken in terms of appropriate discretion/at the proper management levels.
17.	Cash services and management	Set up functional and administrative arrangements for cash services to customers; security and management systems.
18.	Bank's regulations instructional manuals	Prepare manuals for general operations, lending, international, and human resources
19.	Foreign exchange dealing	Set up: (a) Foreign Exchange Dealing Section, and (b) Related Settlement Sector, as an adjunct to Trade Settlement and Remittance Services.