



Concept Paper

Project Number: 51252-003
August 2019

Proposed Programmatic Approach and Policy- Based Loan for Subprogram 1 and Technical Assistance Grant Kingdom of Bhutan: Financial Market Development Program

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 2 July 2019)

Currency unit	–	ngultrum (Nu)
Nu1.00	=	\$0.01451579
\$1.00	=	Nu68.8905

ABBREVIATIONS

ADB	–	Asian Development Bank
AML	–	anti-money laundering
CFT	–	combating the financing of terrorism
IMF	–	International Monetary Fund
MOF	–	Ministry of Finance
NFIS	–	national financial inclusion strategy
NFLS	–	national financial literacy strategy
NPPF	–	National Pension and Provident Fund
RMA	–	Royal Monetary Authority
RSEB	–	Royal Securities Exchange of Bhutan
TA	–	technical assistance

NOTES

- (i) The fiscal year (FY) of the Government of Bhutan ends on 30 June. “FY” before a calendar year denotes the year in which the fiscal year ends, e.g., FY2019 ends on 30 June 2019.
- (ii) In this report, “\$” refers to United States dollars.

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PROGRAM AT A GLANCE

1. Basic Data		Project Number: 51252-003	
Project Name	Financial Market Development Program (Subprogram 1)	Department/Division	SARD/BHRM
Country Borrower	Bhutan Bhutan	Executing Agency	Ministry of Finance
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Finance	Central banking systems		15.00
	Housing finance		5.00
	Money and capital markets		10.00
	Total		30.00
3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG)	Pillar 2: Access to economic opportunities, including jobs, made more inclusive	Climate Change impact on the Project	Low
4. Drivers of Change	Components	Gender Equity and Mainstreaming	
Governance and capacity development (GCD)	Institutional development	Some gender elements (SGE)	✓
Private sector development (PSD)	Conducive policy and institutional environment		
5. Poverty and SDG Targeting		Location Impact	
Geographic Targeting	No	Nation-wide	High
Household Targeting	No		
General Intervention on Poverty	Yes		
SDG Targeting	Yes		
SDG Goals	SDG1, SDG5, SDG8, SDG10, SDG17		
6. Risk Categorization:	Low		
7. Safeguard Categorization	Environment: C	Involuntary Resettlement: C	Indigenous Peoples: C
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		30.00	
Sovereign Programmatic Approach Policy-Based Lending (Concessional Loan): Ordinary capital resources		30.00	
Cofinancing		0.00	
None		0.00	
Counterpart		0.00	
None		0.00	
Total		30.00	
Note: An attached technical assistance will be financed on a grant basis by the Technical Assistance Special Fund (TASF-6) in the amount of \$500,000.			
Currency of ADB Financing: USD			

I. THE PROPOSAL

1. The proposed program aims to support the Government of Bhutan in adopting timely reforms to enhance the efficiency, stability, and inclusiveness of the finance sector. The program is consistent with strategic pillar 1 (dynamic economic reforms for a resilient and diversified economy) of the draft country partnership strategy, 2019–2023 of the Asian Development Bank (ADB) for Bhutan.¹ The program is aligned with ADB’s Strategy 2030 and two of its operational priorities—1: reducing remaining poverty and inequalities, and 6: strengthening governance and capacity.² It is consistent with the government’s finance sector plan and priorities. A programmatic approach was selected to enable ADB to stay engaged and to help the government implement effective long-term reforms in a fast-changing financial market. The program will be designed to keep the reform momentum that was developed through ADB’s previous programs and technical assistance (TA) support and will be implemented in close coordination with the International Monetary Fund (IMF) and the World Bank.³

II. PROGRAM AND RATIONALE

A. Background and Development Constraints

2. Bhutan’s economy has been growing at an impressive average annual rate of 7.0% since the late 1980s.⁴ The poverty rate dropped from 23.0% in 2007 to 8.2% in 2017. This outstanding economic performance was mainly driven by public-sector-led hydropower development. Aiming to diversify Bhutan’s economy and reduce the dominance of hydropower and the public sector, the government plans to adopt reforms that will enable the private sector to expand and play a more active role in economic activities.

3. Since the Bank of Bhutan was established as the country’s first financial institution in 1968, the finance sector has been steadily evolving. Established in 1982, the Royal Monetary Authority (RMA) is the primary regulator of Bhutan’s financial system and has the status of an autonomous central bank. In addition to formulating and implementing monetary policy to maintain price stability in the country, the RMA also regulates and supervises banks and nonbank financial institutions.⁵ The government recognizes that to promote broad-based economic growth, it must develop a finance sector that offers stronger financial intermediation and is better able to mobilize resources for productive investments.

4. **Underdeveloped nonbank financial institutions.** Bhutan’s finance sector is dominated by banks, which accounted for 86.3% of the sector’s total assets in June 2018, and does not efficiently mobilize long-term funds through the nonbank segment. The capital market, including the government debt market, remains shallow. The government long-term bond market does not exist. To manage short-term liquidity, the government borrows directly from state-controlled banks and issues short-term treasury bills with a maximum maturity of 90 days. This practice is subject

¹ The program is included in the draft country operations business plan for 2020–2022. It is also included for commitment in 2019 in *ADB. 2018. Country Operations Business Plan: Bhutan, 2019–2021*. Manila.² ADB. 2018. *Strategy 2030: Achieving a Prosperous, Inclusive, Resilient, and Sustainable Asia and the Pacific*. Manila.

² ADB. 2018. *Strategy 2030: Achieving a Prosperous, Inclusive, Resilient, and Sustainable Asia and the Pacific*. Manila.

³ An initial draft of the design and monitoring framework is in Appendix 1.

⁴ The average real gross domestic product growth rate was calculated from the fiscal years 1988–2018.

⁵ Nonbank financial institutions include three insurance companies (two insurance companies and one non-life reinsurance company), Rural Enterprise Development Corporation, Credit Information Bureau, National Pension and Provident Fund (NPPF), Central Registry, and the Royal Securities Exchange of Bhutan (RSEB). The RMA Act 2010 and the Financial Services Act of 2011 govern the finance sector and created its enabling infrastructure.

to a high rollover risk. To mobilize long-term funds to finance long-term public investments, the government needs to extend the tenors of government securities. The availability of long-term government bonds will also facilitate institutional investors—e.g., the National Pension and Provident Fund (NPPF) and insurance companies—to diversify their portfolios, which are currently concentrated in few asset classes. The government has yet to establish rules and regulations for a risk-based supervision of important areas, such as risks to the solvency of insurers and the sustainability of pensions. The Royal Securities Exchange of Bhutan (RSEB) and its brokers are grappling with the insufficient participation of individual investors and companies, the low frequency of trading, and liquidity problems. As a result, the exchange does not function as a platform for companies to access equity capital for their long-term investments. Bhutan's housing finance is also at an early stage of development.

5. **Deficient financial infrastructure.** As the finance sector is trying to cope with both digitalization and globalization, it is becoming increasingly important for financial institutions to be well prepared for emerging types of risks. Hence, the RMA needs to upgrade its monetary policy framework and the regulatory and supervisory framework for financial institutions to further stabilize the sector, including strong oversight of banks to prevent fraudulent practices.⁶ Safety and security systems in internet banking need to be regularly upgraded to detect and prevent suspicious or fraudulent transactions. To reduce the risk of money laundering and terrorism financing, Bhutan passed the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) Act in 2018, which needs to be implemented effectively. The country also lacks data backup and data recovery infrastructure for business continuity planning.

6. **Low financial literacy and inadequate financial inclusion.** Bhutan's finance sector has been growing rapidly: the ratio of private sector credit to gross domestic product increased from 15.4% in 2005 to 50.6% in 2018. However, the expansion of private credit does not benefit the population evenly. In rural areas, demand for less complex and less time-consuming banking services is substantially unmet. Women encounter less favorable conditions for accessing finance than men because of their limited exposure to economic opportunities. Against this backdrop, the government introduced the National Financial Inclusion Strategy (NFIS) in 2018. However, its implementation has not been carried out effectively. The government also established the Credit Information Bureau and the Central Registry, both of which intend to help lenders acquire and monitor borrower information, and consequently ease collateral requirements. However, banks still assess loan requests with a heavy focus on collateral, rather than undertaking due diligence on a proposed project's financial viability. This limits the opportunities for young and small-scale entrepreneurs to access credit from banks. Banks need to develop more innovative financial products and services for these underserved segments.

7. **The government's reform agenda.** The program will support the government in its commitment to reforming the finance sector to make it stable, efficient, and inclusive. This support is critical for the government in achieving some key national result areas of the Twelfth Five Year Plan (2018–2023), such as macroeconomic stability, economic diversification, and poverty reduction.⁷ To date, several long-term sector development strategies have been prepared. In 2014, the RMA formulated the Capital Market Master Plan for Bhutan (2014–2024), which provides additional financial intermediation sources, including microfinance intermediaries that

⁶ These include the Prudential Regulations 2017, the Macro-Prudential Regulations 2018, the Rules and Regulations for Establishing Commercial Banks 2018, and the Rules and Regulations for the Cottage & Small Industries Bank 2018.

⁷ *Government of Bhutan, Gross National Happiness Commission. 2018. Twelfth Five Year Plan, 2018–2023. Thimphu.*

can serve as alternatives to commercial banks, on which Bhutan had previously depended. In 2018, the RMA also adopted the NFIS and the National Financial Literacy Strategy (NFLS) (2018–2023), which aim to improve the livelihoods of vulnerable and marginalized segments of the population, including women and youth, by enhancing their financial literacy and capabilities and by giving them better access to financial services.⁸

B. Policy Reform and ADB's Value Addition

8. ADB is a long-term partner in Bhutan's finance sector development efforts, having helped establish the RMA, the RSEB, the NPPF, and the Credit Information Bureau. The design of the proposed program will be based on the achievements and lessons from ongoing TA projects⁹ and previous policy-based programs in support of finance sector reforms, such as the Strengthening Economic Management Program II, which assisted the government in implementing key reforms to deepen the financial market and strengthen financial supervision.¹⁰ As the development landscape has evolved, incremental and more sophisticated reforms are required to ensure the sustainability of reforms initiated under previous programs. The continued support from ADB and other development partners is especially important for a small country such as Bhutan, which faces capacity constraints in implementing complex and wider policy interventions.

9. The following lessons from past engagements will be incorporated in the program design: (i) regular policy dialogue to ensure the government's commitment to politically sensitive reforms; (ii) incremental, rather than rapid, reforms to deal with the insufficient human resource capacity of the government; (iii) close coordination with key development partners, particularly the IMF, the World Bank, and United Nations agencies; (iv) close alignment of a supporting TA and the program to ensure that planned reforms are implemented efficiently and effectively.¹¹

10. **Proposed policy reforms.** The program will consist of two subprograms designed to provide continuous support for the government's finance sector reforms. A third subprogram may be added during the processing of subprogram 2, depending on the government's needs and commitment. The program outcome will be increased stability, efficiency, and inclusiveness of the finance sector. The program outputs will be: (i) nonbank financial system developed; (ii) stability and integrity of the financial system strengthened; and (iii) financial inclusion promoted.

11. **Nonbank financial system developed.** Under subprogram 1, the Ministry of Finance (MOF) will adopt a strategy to issue long-term government bonds, the RMA will take measures to strengthen and improve the solvency of insurance companies, and the government will adopt a national pension policy that creates sustainable and inclusive pension and provident fund schemes. To foster housing finance, the government will adopt a national housing policy that emphasizes the affordability of housing and housing-financing mechanisms. Under subprogram 2, MOF will approve the rules and regulations for long-term government bond issuance. To

⁸ Detailed information on the relatively low financial inclusion of women is in Initial Poverty and Social Analysis (accessible from the list of linked documents in Appendix 3).

⁹ ADB. 2012. *Enhancing Development Management for Sustainable and Inclusive Growth*. Manila (TA 8229); and ADB. 2016. *Developing Anti-Money Laundering and Combating the Financing of Terrorism Approaches, Methodologies, and Controls*. Manila (TA 9287, regional). A list of the past programs and TA projects are in ADB. 2019. *Validation of the Bhutan Country Partnership Strategy Final Review, 2013–2018*. Manila. (forthcoming).

¹⁰ ADB. 2015. Bhutan: Strengthening Economic Management Program II. <<https://www.adb.org/projects/46371-002/main#project-documents>>

¹¹ In July 2018, the program team leader participated in the IMF Article IV consultation mission as a member. She also coordinated closely with the World Bank team that had been responsible for preparing and implementing the Strengthening Fiscal Management and Private Sector Employment Opportunities Development Policy Credit for Bhutan since April 2017.

deepen the capital market, the Office of the Registrar will revise the regulations on issuing corporate bonds and commercial paper.

12. **Stability and integrity of the financial system strengthened.** Under subprogram 1 and with support from the ongoing TA on AML and CFT approaches (footnote 9), the RMA will adopt a design for an online AML reporting system. Building on the guidelines on bank stress tests developed under the Strengthening Economic Management Program II (footnote 10), the RMA will roll out stress testing—consisting of sensitivity tests for credit and liquidity risks—to cover all five banks. Under subprogram 2, the RMA will operationalize the online AML reporting system and adopt a national AML/CFT strategy road map. It will also adopt appropriate frameworks and adequate safeguard measures, including comprehensive plans for bank stress tests. The stress testing will be expanded to cover risks involving interest-rate, foreign-exchange, and interbank contagion.

13. **Financial inclusion promoted.** Under subprogram 1, the RMA will adopt rules and regulations on consumer protection in connection with financial services to empower service users and enhance consumer confidence. The RMA will complete the mapping of the curriculum framework to integrate financial literacy training in primary and secondary schools, technical training institutes, and nonformal education centers focusing on women. Under subprogram 2, the RMA will adopt the joint action plan for the NFIS and the NFLS, and establish an inclusive green finance scheme to promote access to finance by entrepreneurs seeking funding for environment-friendly projects. In addition, under subprogram 2, the transaction TA attached to the program will help the government implement the NFIS and the NFLS. The TA will enable the RMA to increase the number of participants and will ensure that at least 32% of the total participants are women. To promote better access to finance for farmers, the government will improve warehouse operations to facilitate commodity trading, aiming to establish a warehouse receipt financing scheme that will enable farmers to use the receipts as collaterals.

C. Impacts of the Reform

14. The program will support the government with institutional reforms and will build the technical capacity of regulatory and financial institutions. This will help improve the efficiency of financial intermediation, which will encourage private sector investment and improve the economic welfare of Bhutanese people. Banks' capital adequacy ratio will be increased to 18.0%, private sector credit will grow to 20% of overall credit, and 20% of adults will have access to credit by 2022.

D. Development Financing Needs and Budget Support

15. The government has requested a loan of \$30 million from ADB's concessional ordinary capital resources to help finance subprogram 1, with an indicative \$30 million planned for subprogram 2. The government's development financing gap is estimated at Nu29 billion (about \$410 million) during 2018–2023. This gap shall be financed through external borrowing, mainly from ADB and the World Bank on highly concessional terms. Bhutan was assessed to have a moderate risk in the 2018 IMF–World Bank debt sustainability assessment.

E. Implementation Arrangements

16. MOF will be the executing agency. The implementing agencies will be the RMA, the Ministry of Economic Affairs, and the Ministry of Works and Human Settlement. The proceeds of the policy-based loan will be withdrawn in accordance with ADB's *Loan Disbursement Handbook*

(2017, as amended from time to time). The implementation period is July 2018 to December 2019 for subprogram 1, and January 2020 to December 2021 for subprogram 2. ADB will support the government in implementing the post-program partnership framework to ensure sustainable outcomes.

III. TECHNICAL ASSISTANCE

17. Transaction TA of \$500,000 from ADB's Technical Assistance Special Fund (TASF-other sources) is proposed to be attached to subprogram 1. The TA will assist in (i) preparing regulatory frameworks and background analyses, (ii) building the capacity of government agencies and financial institutions to implement reforms, and (iii) raising the public's financial literacy levels.

IV. DUE DILIGENCE REQUIRED

18. The finance sector assessment will be supplemented by a public finance management assessment and a program impact assessment. The initial poverty and social analysis is included as a linked document (footnote 8). A program impact assessment will be completed and will describe the link between the program's reforms and the benefits that will ensue from deepening the financial market and strengthening the integrity and stability of the financial system. The program is expected to be classified as *category C* for all safeguard aspects.

V. PROCESSING PLAN

A. Risk Categorization

19. The proposed program is categorized as *low risk*. The loan amount for subprogram 1 will not exceed \$50 million, and the safeguard categorization of the program is category C. ADB has sound experience with policy-based programs in the sectors of finance and public sector management. Also, MOF, as the executing agency, has a good performance record in implementing and administering policy-based programs. The government has demonstrated strong ownership of and commitment to the reforms under the proposed program.

B. Resource Requirements

20. ADB staff will dedicate an estimated total of 8 person-months to process the program. Additional resources will be provided from BHRM's staff consultants, with an estimated total of 8 person-months of international and national financial sector experts to support the processing.

C. Processing Schedule

Proposed Processing Schedule	
Milestones	Expected Completion Date
Concept paper clearance	July 2019
Loan fact finding	July 2019
Management review meeting	Aug 2019
Loan negotiation	September 2019
Board consideration	November
Loan signing	December 2019

Source: Asian Development Bank.

VI. KEY ISSUES

21. None.

DESIGN AND MONITORING FRAMEWORK
(Initial Draft)

Country's Overarching Development Objectives Macroeconomic stability achieved, economic diversity and productive capacity enhanced, and poverty eradicated and inequality reduced (Twelfth Five Year Plan, 2018–2023) ^a			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
Effect of the Reform Stability, efficiency, and inclusiveness of the finance sector enhanced	By December 2022 a. Banks met capital adequacy ratio of at least 18.0% by 2022 (December 2018 baseline: 15.1%, and minimum regulatory requirement is 12.5%) b. Year-on-year growth of private sector credit reached 20.0% by 2021 (2018 baseline: 15.4%) c. Share of adults who have access to credit reached 20.0% by 2021 (2018 baseline: 16.0%, out of which 56.0% are men and 44.0% are women)	a–c. Annual report of the RMA ^b	External financial and economic shocks
Reform Areas 1. Nonbank financial system developed	Indicative Policy Actions 1.1 Rules and regulations for issuing medium- to long-term government bonds adopted by 2021 (2018 baseline: NA) 1.2 National pension policy adopted by 2019 (2018 baseline: NA) 1.3 Revised regulations for issuing corporate bonds adopted by 2021 (2018 baseline: NA) 1.4 Policies addressing women's constraints in accessing housing finance approved by RMA by 2021 (2018 baseline: NA). 1.5 The proportion of female beneficiaries of pension coverage is at least 20% by 2021 (2018 baseline: 16%)	1.1 MOF resolution and website 1.2 NPPF annual report and website 1.3 Office of the Registrar's website 1.4 RMA annual report and website 1.5 NPPF annual report and website	High staff turnover in key government agencies delays the implementation of reforms.
2. Stability and integrity of the financial system strengthened	2.1 RMA conducted stress testing of five commercial banks by 2019 (2018 baseline: 3) 2.2 Financial institutions' compliance with the Financial Action Task Force's AML/CFT standards on customer due diligence and suspicious transaction reporting increased by 2021 (2018 baseline: APG MER 2016 ratings: customer due diligence—compliant; suspicious transaction reporting—partially compliant) 2.3 Cyber security framework and business continuity plan are adopted by the RMA and financial institutions by 2021 (2018 baseline: NA)	2.1–2.4 RMA resolutions, annual report, and website	

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
	2.4 Online AML/CFT reporting system is operationalized by 2020 (2018 baseline: NA)		
3. Financial inclusion promoted	<p>3.1 The National Financial Inclusion Steering Committee endorsed the action plan for implementing the National Financial Inclusion Strategy by 2019 (2018 baseline: NA)</p> <p>3.2 RMA completed mapping of financial literacy curriculum framework by 2019 (2018 baseline: NA)</p> <p>3.3 The Inclusive Green Finance scheme established by 2020 (2018 baseline: NA)</p> <p>3.4 Strategy for warehouse receipt financing adopted by 2021 (2018 baseline: NA)</p> <p>Under transaction technical assistance^c</p> <p>3.5 At least 32% of the participants in financial literacy training seminars during 2020–2021 are women (2018 baseline: NA)</p>	<p>3.1–3.3 RMA annual report and website</p> <p>3.4 RSEB and RMA annual reports and websites</p> <p>3.5 RMA annual report and website</p>	

Budget Support

Asian Development Bank: \$30.0 million for subprogram 1 (policy-based loan)
 \$30.0 million for subprogram 2 (policy-based loan)
 \$0.5 million transaction technical assistance grant

AML/CFT = anti-money laundering and combating the financing of terrorism, APG = Asia Pacific Group, MER = mutual evaluation report, MOF = Ministry of Finance, NPPF = National Pension and Provident Fund, RMA = Royal Monetary Authority, RSEB = Royal Securities Exchange of Bhutan.

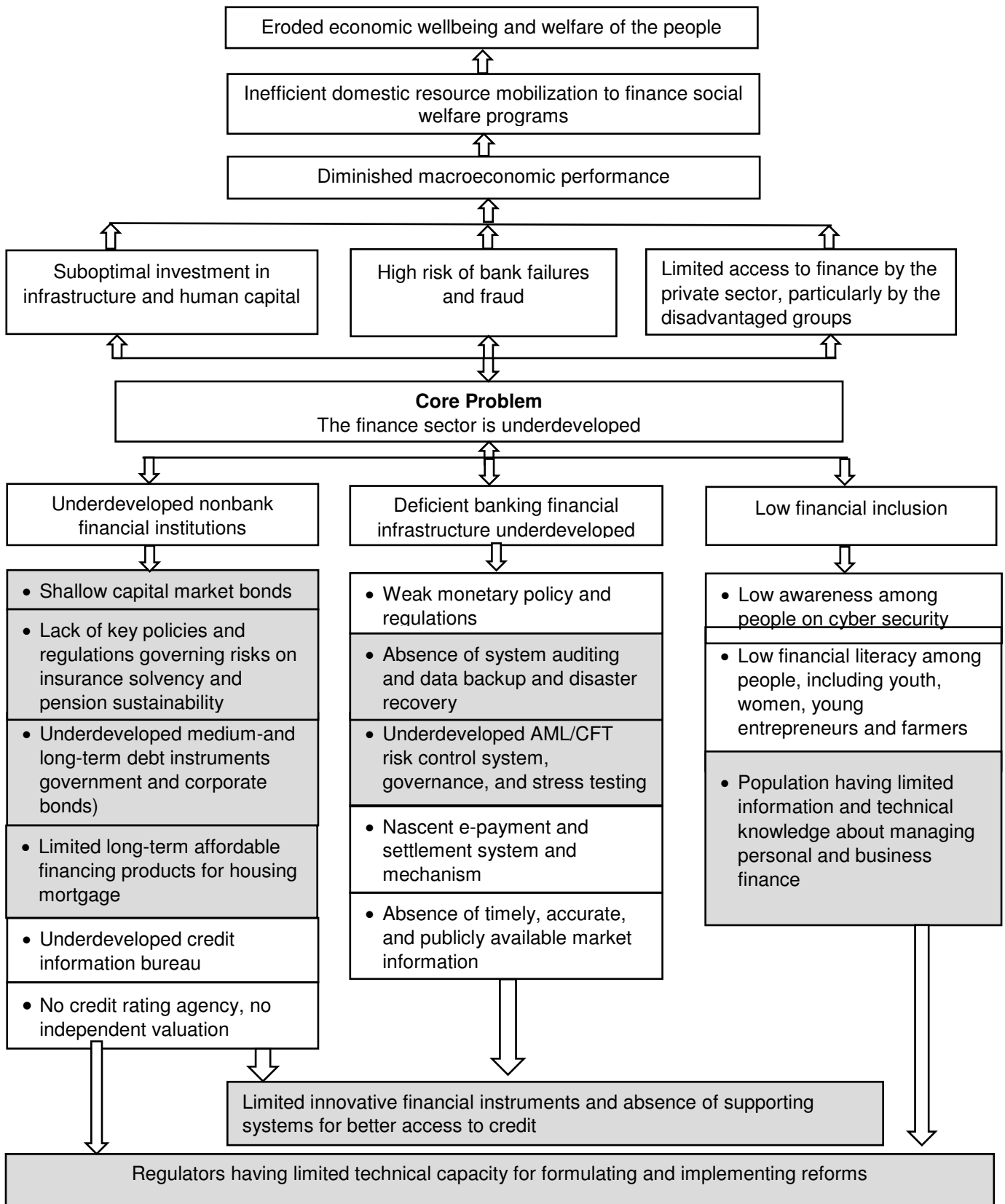
^a Government of Bhutan. 2018. *Twelfth Five Year Plan 2018–2023*. Thimphu.

^b Royal Monetary Authority of Bhutan. 2019. *Annual Report 2018*. Thimphu.

^c The attached transaction TA will be submitted for approval together with subprogram 1.

Source: Asian Development Bank.

Problem Tree



To be covered under the project

AML/CFT = anti-money laundering/ combating the financing of terrorism

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/LinkedDocs/?id=51252-003-ConceptPaper>

1. Initial Poverty and Social Analysis
2. Sector Assessment Summary: Finance