



Report and Recommendation of the President to the Board of Directors

Project Number: 51252-005
September 2021

Proposed Policy-Based Loan for Subprogram 3 Kingdom of Bhutan: Financial Market Development Program

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 22 September 2021)

Currency unit	–	ngultrum (Nu)
Nu1.00	=	\$0.014
\$1.00	=	Nu73.78

ABBREVIATIONS

ADB	–	Asian Development Bank
COVID-19	–	coronavirus disease
GDP	–	gross domestic product
IED	–	Independent Evaluation Department
IFRS	–	International Financial Reporting Standards
IMF	–	International Monetary Fund
MOF	–	Ministry of Finance
NPL	–	nonperforming loan
OP	–	operational priority
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., FY2022 ends on 30 June 2022.
- (ii) In this report, “\$” refers to United States dollars.

Vice-President	Shixin Chen, Operations 1
Director General	Kenichi Yokoyama, South Asia Department (SARD)
Deputy Director General	Manmohan Parkash, SARD
Directors	Sabyasachi Mitra, Public Management, Financial Sector and Trade Division (SAPF), SARD Shamit Chakravarti, Country Director, Bhutan Resident Mission, (BHRM), SARD
Team leader	Manohari Gunawardhena, Senior Financial Sector Specialist, SAPF, SARD
Team members	Brando Angeles; Associate Environment Officer; Environment, Natural Resources and Agriculture Division; SARD Ricardo Carlos Barba, Principal Safeguards Specialist, Portfolio, Results and Quality Control Unit, Office of the Director General (SAOD-PR), SARD Lisette Cipriano, Senior Digital Technology Specialist (Financial Technology Services), Finance Sector Group, Office of the Cluster Head, Sustainable Development and Climate Change Department Ma. Kristina Hidalgo, Senior Financial Sector Officer, SAPF, SARD Lyailya Nazarbekova, Principal Counsel, Office of the General Counsel Maria Charess Pabatao, Senior Operations Assistant, SAPF, SARD Rayhalda D. Susulan, Safeguards Officer (Resettlement), Office of the Director General, SARD Francesco Tornieri, Principal Social Development Specialist (Gender and Development), SAOD-PR, SARD Nidup Tshering, Senior Social Development Officer (Gender), BHRM, SARD
Peer reviewer	Arup Kumar Chatterjee, Principal Financial Sector Specialist, Sustainable Development and Climate Change Department

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PROGRAM AT A GLANCE

1. Basic Data		Project Number: 51252-005	
Project Name	Financial Market Development Program (Subprogram 3)	Department/Division	SARD/SAPF
Country	Bhutan	Executing Agency	Ministry of Finance
Borrower	Bhutan		
Country Economic Indicators	https://www.adb.org/Documents/LinkedDocs/?id=51252-005-CEI		
Portfolio at a Glance	https://www.adb.org/Documents/LinkedDocs/?id=51252-005-PortAtaGlance		
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. Operational Priorities		Climate Change Information	
✓ Addressing remaining poverty and reducing inequalities		GHG reductions (tons per annum)	0.000
✓ Accelerating progress in gender equality		Climate Change impact on the Project	Low
✓ Tackling climate change, building climate and disaster resilience, and enhancing environmental sustainability			
✓ Strengthening governance and institutional capacity		ADB Financing	
		Adaptation (\$ million)	1.15
		Mitigation (\$ million)	1.15
		Cofinancing	
		Adaptation (\$ million)	0.00
		Mitigation (\$ million)	0.00
Sustainable Development Goals		Gender Equity and Mainstreaming	
SDG 1.b		Some gender elements (SGE)	✓
SDG 5.a			
SDG 8.10			
SDG 10.1, 10.4			
SDG 12.6			
SDG 13.a			
SDG 16.6			
SDG 17.5			
4. Risk Categorization: Low		Poverty Targeting	
		General Intervention on Poverty	✓
5. Safeguard Categorization		Environment: C Involuntary Resettlement: C Indigenous Peoples: C	
6. 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	
Currency of ADB Financing: US Dollar			

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed policy-based loan to the Kingdom of Bhutan for subprogram 3 of the Financial Market Development Program.

2. The program supports key policy reforms designed to address finance sector deficiencies in terms of institutions, markets and products, vulnerabilities caused by inadequate risk-based supervision, concentration of risk, and insufficient inclusiveness.¹ The programmatic approach aligned support to key government reform programs over the medium to long-term to (i) increase access to finance for the private sector through stronger markets and institutions, and (ii) improve financial inclusion to enable economic diversification efforts in Bhutan. The Asian Development Bank (ADB) Board of Directors approved the programmatic approach, which was originally designed to comprise two subprograms totaling \$60 million in loans for subprograms 1 and 2 (\$30 million each). Subprogram 3 was proposed to the Board of Directors in October 2020 at the time of approval of subprogram 2. Subprogram 3 included important implementation of key policy areas achieved under subprograms 1 and 2 while introducing complementary areas to complete policy reforms like corporate governance, improved risk performance by financial institutions and building data integrity through robust mechanisms like data warehousing. Subprogram 3 was processed 6 months ahead of program completion in March 2022 to enable timely reforms, as required by the coronavirus disease (COVID-19) impact on financial markets.

II. PROGRAM AND RATIONALE

A. Background and Development Constraints

3. **Macroeconomic context.** Bhutan is a lower middle-income country with average per capita income of \$3,122 in fiscal year (FY) 2020.² Gross domestic product (GDP) growth averaged 6.7% over 3 decades ending in FY2019. Reduced economic activity curtailed GDP growth. A potential increase in tourism and the recommencement of projects that were stalled because of the departure of skilled workers from the country during the pandemic will help GDP grow (Table 1). The fiscal gap over the 5-year period of FY2019–FY2023 (estimated at \$400 million) was revised to \$530 million after COVID-19 pandemic. Significant deficits continue from FY2020 to FY2022.³ The fiscal deficit in FY2021 is almost exceeding the targeted 5% of GDP because of pandemic-related expenditure. There is an estimated increase in capital investment-related expenditure in FY2022. Although there was an increase in the debt-to-GDP ratio, the non-hydropower-related debt of about 30% of GDP in March 2021 was well within the public debt policy threshold of 35%.⁴

¹ Independent Evaluation Department (IED). 2019. [Validation of the Country Partnership Strategy Final Review, 2014–2018 in Bhutan](#). Manila; and ADB. 2015. [Completion Report: Strengthening Economic Management Program in Bhutan](#). Manila.

² World Bank. [The World Bank in Bhutan: Overview](#). FY-Fiscal Year July 1- June 30. All others -calendar years.

³ Total expenditure of Twelfth Five Year Plan (FY2018–2023) is \$4.3 billion (increase of 38.0% on previous 5-year plan).

⁴ Hydropower debt is backed by guaranteed power purchase agreements by India. Fiscal deficit is usually analyzed excluding hydro-power related debt due to low repayment risk of the power purchase agreements.

Table 1: Macroeconomic Indicators, FY2019–FY2024

Item	(%)					
	FY2019	FY2020	FY2021 ^a	FY2022 ^a	FY2023 ^a	FY2024 ^a
GDP growth	4.3	(0.9) ^b	(3.4) ^b	3.7 ^b	6.9	8.1
Fiscal deficit/GDP	1.6	1.9	7.3	8.6	0.4	0.5
Debt/GDP	106.6	119.9	124.7	124.9	130.9	117.1
Non-hydro debt/GDP	24.4	30.1	31.6	32.7	29.7	26.4

() = negative, FY = fiscal year, GDP = gross domestic product.

Note: The FY ends on 30 June, e.g., FY2022 ends on 30 June 2022.

^a Estimate.

^b Asian Development Bank. [Economic indicators for Bhutan](#) (accessed July 2021).

Source: Government of Bhutan, Ministry of Finance. 2021. [National Budget, Financial Year 2021–22](#). Thimphu.

4. The government's general macroeconomic policy has displayed a *moderate* risk with rising fiscal deficits due to COVID-19. The Public Finance Act, 2007 of Bhutan has laid out the fiscal process. The government's Twelfth Five Year Plan (FY2018–2023) focuses on national priorities for determining fiscal expenditure. The government has allocated one of the highest capital budgets at 33% of the Twelfth Five Year Plan, 2019–2023 (total plan is \$530 million) for FY2021–FY2022. Proposed simplification of the import tax structure would enable better coverage and compliance, improving the fiscal position. Monetary policy measures to mitigate the impact of COVID-19 (e.g., reduced interest rates and debt moratoriums) are still in force, although the Royal Monetary Authority (RMA) will be looking to end these concessions by the end of 2022.

5. **Development problems.** Most of Bhutan's population lives in rural areas that are vulnerable to climate-related hazards and where employment opportunities are limited.⁵ The national poverty rate decreased from 23.0% in 2007 to 8.2% in 2017, but it is expected to have deteriorated during the period of COVID-19-related lockdowns. Bhutan's economy is mainly driven by the state sector, with high reliance on hydropower exports. Economic diversification remains low. The government has prioritized private sector development to drive and diversify the economy and create employment. The private sector is dominated by microenterprises and sole proprietorships with relatively low access to formal finance and low skill level and innovation. COVID-19 exposed the inadequate access to finance and collateral-based lending practices by banks, which result in reduced private sector participation in the economy. COVID-19-related lockdowns and the absence of tourism resulted in unemployment increasing to 5.0% in 2020 from 1.8% in 2019.⁶

6. **Impact of the coronavirus disease.** The COVID-19 pandemic has dampened growth prospects. The government's fiscal expenditure increased because of measures provided to combat the adverse impacts of the pandemic; budget support to provide essential items while fiscal income reduced due to deferment of sales and import taxes, rent payments by tourist sector businesses, and electricity charges by industries. The services sector, which comprised 43.4% of GDP in 2019, contributed 40.6% in 2020. The sector's growth rate decreased to 7.9% in 2020 from 12.5% in 2019.⁷ A decline of international tourist arrivals by 35.0% reduced tourism revenue by 33.9% in 2020. The industry sector contracted by 1.1% in 2021, with declines in construction and manufacturing sectors because of migrant labor shortages, disruptions in supply of raw

⁵ Climate Change Assessment (accessible from the list of linked documents in Appendix 2).

⁶ The women's unemployment rate increased from 3.3% in 2019 to 6.0% in 2020 (compared to the men's unemployment rate, which increased from 2.2% in 2019 to 4.1% in 2020). The overall youth unemployment rate increased from 11.9% in 2019 to 22.6% in 2020, with that of girls increasing from 13.8% in 2019 to 25.4% in 2020 and that of boys increasing from 9.7% in 2019 to 19.2% in 2020. These data indicate the stronger economic effect of the COVID-19 pandemic on women and youth. <https://www.nsb.gov.bt/publications/labour-force-survey-report/>.

⁷ Government of Bhutan, Ministry of Finance (MOF). 2021. [National Budget, Financial Year 2021–22](#). Thimphu.

materials, and low domestic demand. Post-COVID-19 fiscal deficits are expected to widen because of reduced revenue to the government from tourism royalties, income, and sales taxes. Under a longer containment scenario of the pandemic, Bhutan is expected to lose \$142 million of GDP, with tourism losses estimated at \$78 million.⁸

7. **Finance sector context.** The sector is limited, with a concentration in regulation and a dominance of banks. Bhutan's financial system comprises five banks, two insurance companies, and five microfinance institutions. The RMA includes the electronic clearing house, the financial inclusion secretariat, the consumer protection cell, and the central registry. The system also comprises the credit information bureau, the Bhutan electronic clearing house, the Royal Securities Exchange of Bhutan (RSEB [also acts as the Central depository]), the Office of the Registrar of Companies, Ministry of Economic Affairs, the Bhutan Accounting Standards Board, and the Royal Audit Authority. The RMA regulates all financial institutions, including pension and provident funds and microfinance institutions, and fintech service providers in addition to the RSEB. Bhutan's finance sector has been growing rapidly, as reflected in measures on market depth such as the increase in credit to the private sector, which went from 15.4% in 2005 to 67.9% in December 2020. Banks provided 75.0% of credit to the economy as of December 2020. Nonperforming loan ratios (NPLs) rose to 14.6% in December 2020 (10.9% in December 2019). Market capitalization was 26.4% of GDP in December 2020. The corporate bond market is still illiquid despite the first government bond issuance in 2020 under subprogram 2. The RSEB had registered 13 corporate bonds worth Nu6.9 billion as of December 2020.

8. **Binding constraints.** Finance sector constraints, which impede the financial intermediation process, include (i) underdeveloped nonbank financial institutions and markets, (ii) deficient financial infrastructure and lack of capacity at banks, and (iii) the combined effects of low financial literacy and inadequate financial inclusion. Removing these constraints would promote well-functioning financial markets, including strong institutions, transparent legal structures, and rules and regulations that cater to the latest requirements of electronic commerce. This would help improve financial inclusion, which affects more women than men, and mobilize domestic resources to meet development needs and achieve economic diversification.

9. **Significant risks to the banking sector.** The banking segment is thinly capitalized, although capital is above the regulatory threshold of 10%. Loan asset quality has steadily deteriorated because of aggressive credit expansion during 2013–2019. By June 2020, NPL ratio (nonperforming loans to total loans) rose to 16.3% because of the pandemic from 15.0% in June 2019 as micro, small, and medium-sized enterprises struggled to meet debt repayments. In December 2020, NPLs had declined to 11% due to moratorium on loan repayments introduced by banks because of monetary measures introduced by the RMA.⁹ Weakening capital buffers with high NPLs, even prior to the pandemic, weigh on banks' profitability, despite an increase in net profit after tax in March 2021 on the back of wider interest margins and loan growth. Expertise at financial institutions in restructuring NPLs and strengthening credit underwriting skills is urgently required. Banks have asset and liability mismatches because of borrowings through short-term deposits and lending on long-term assets. These were mitigated by a high current and savings account composition of 52% of total deposits as of December 2020.

10. **Risk exposure of nonbank financial institutions.** Bhutan's nonbank financial system consists of five microfinance institutions, two insurance companies, and one superannuation fund. The insurance sector is permitted to extend credit because of the nonavailability of alternative

⁸ ADB. [Data Library: COVID-19 Economic Impact Assessment Template](#) (accessed 12 August 2021).

⁹ RMA. <https://www.rma.org.bt/news/Phase%202/Monetary%20Measures.pdf> (accessed September 28 2021)

investments. Insurance companies follow similar regulations to banks in extending credit. Insurance sector NPL ratio was 22.2% in December 2020, within the overall NPL ratio of 11.0% in the finance sector. The insurance sector requires immediate capital strengthening to absorb possible credit losses from NPLs and contain its impact on the broader financial system. Moving the insurance sector away from credit operations would be a necessary long-term measure as capital markets develop and alternative investments increase. RMA issued solvency regulations for the first time in 2019 on life insurance portfolios. The solvency ratio on life insurance stood at 25% in December 2019 but improved to 68% in December 2020 (still below the minimum requirement of 100%). The improvement in 2020 was because of the accounting treatment under revised RMA regulations on insurance risk requirements. The insurance sector is expected to comply with the regulatory ratio by 2022. The growth in the life insurance category will continue to increase risks as the sector extends credit using the life insurance funds. Risks will be mitigated by complying with solvency requirements. The non-life insurance portfolio and reinsurance portfolios are comparatively less in volume than life insurance.¹⁰ In addition, a focus on improvement in the reinsurance business, with risk-based pricing based on actuarial valuation, needs to be in place to address the sector's profitability and sustainability.

11. **Housing sector concentration.** Bank lending relied heavily on housing loans before 2012. Housing loans comprised 27.4% of finance sector credit as of December 2020.¹¹ A housing market demand survey was conducted in March 2021 to identify the demographics of housing finance requirements in the congested urban areas in Bhutan; this survey will be used to formulate strategies by the Ministry of Works and Human Settlements and the RMA. The results of this survey showed a declining rate of homeownership, an increase in rental housing and occupation of substandard housing units, and a high rent burden for low-income households. Significant efforts are required to facilitate access to affordable housing and promote homeownership.¹²

12. **Nascent shallow capital markets.** Debt capital markets benefited through the issuance of Treasury bonds (under subprogram 2) amounting to Nu3.7 billion with 3-year and 10-year maturities and fixed coupon rates.¹³ Investors of these bonds are mostly insurance companies and pension funds followed by banks and other institutional investors. Mandatory listing of all government bonds in the future would incentivize more investors to enter the market. Equity markets are expected to continue to slow down in 2021 because of the continued adverse effects of COVID-19; market capitalization decreased by 7.70% from Nu51.41 billion in 2019 to Nu47.45 billion in 2020 because of lower prices and the delisting of two mining companies. In 2020, the capital market experienced a decrease of 22.89% in the value of shares and only 2 out of 19 listed companies (three companies were removed from the list in 2020) paid dividends to their shareholders; in 2019, 8 out of 22 listed companies paid dividends. There were no initial public offerings for fundraising in 2020.

13. **Developing the financial infrastructure.** The RMA and the RSEB need to build their capacity to make surveillance more efficient. Gradually reducing concentration of regulation at

¹⁰ Insurance companies invest in loans. Earlier solvency was calculated on gross loans, although significant loan loss provisions have already been made. Revised regulations require solvency to be calculated on net loans.

¹¹ Middle- and lower-income urban households spend an estimated 40%–60% of their disposable income on rent because of lack of affordable housing. Government of Bhutan, National Statistics Bureau. 2017. [Bhutan Living Standards Survey Report 2017](#). Thimphu.

¹² The Urban Water Group of ADB's South Asia Department is processing a project on housing finance with the National Housing Development Corporation of Bhutan to promote affordable housing supply for low-income households, with a focus on gender. ADB. [Bhutan: Green and Resilient Affordable Housing Sector Project](#).

¹³ The Government of Bhutan issued a 3-year bond for Nu3 billion at a coupon rate of 6.5% in September 2020 and a 10-year bond for Nu700 million at a coupon rate of 3.98% in February 2021.

the RMA and delegating to other related entities like the RSEB and establishing a separate cell on insurance within the RMA with reporting lines to a different authority would lead to stronger institutions. To this end, the RMA has developed a data warehousing policy under subprogram 3. A lack of underwriting capacity and credit rating institutions prevents the supply of funds to the markets. In its fourth follow-up report to the 2016 mutual evaluation report on Bhutan, the Asia/Pacific Group on Money Laundering rated the country's effectiveness *low*, both for the regulator (the RMA) and financial institutions' compliance with anti-money laundering/combating the financing of terrorism requirements based on improvements made after the introduction of the Anti-Money Laundering and Counter Terrorism Act, 2018.¹⁴

14. Low financial literacy and inadequate financial inclusion. As of December 2020, 76.1% of the adult population in Bhutan (of which 52.7% were men and 47.3% women) held savings accounts. Only 21.8% of the adult population had access to credit (of which 57.2% were men and 42.8% women). This is partly because banks still assess loan requests against collateral, rather than considering a borrower's financial viability. Similarly, only 25.3% of the adult population had life insurance, of which 59.6% were men and 40.4% women.¹⁵ Many rural communities lack access to formal remittance services.¹⁶ Therefore, the benefits of modern electronic and online payment systems have yet to reach all, and cash still dominates the payment system.¹⁷

15. Financial inclusion through institutions and digitalization. National CSI Development Bank Ltd. was established on 22 February 2020, and the Tarayana Foundation launched the Tarayana Micro Finance for Rural Development program to meet the financial needs of rural communities on 20 February 2020. Collective loan accounts in the country stood at 3,551 as of December 2020, an indication of the inherent challenges in the finance sector, which include lack of formal credit history, lack of collateral, and low financial literacy. Under subprogram 3, the use of innovative technology for inclusive finance through a sandboxing (cybersecurity practice where codes are run, observed, and analyzed in a safe, isolated environment on a network) framework was initiated by the RMA in 2020, which targets financial inclusion.¹⁸

16. Government reform agenda. The government is committed to continue reforms to make the finance sector more responsive to emerging priorities, while remaining stable and inclusive. This support is critical for the government to achieve national key result areas of the Twelfth Five Year Plan, such as macroeconomic stability, economic diversification, improved access to finance, and poverty reduction. In 2017, the government approved the Financial Sector Development Action Plan, which details reform actions that affect the banking system, nonbank financial institutions, financial inclusion, and financial literacy. The National Credit Guarantee Scheme was launched in 2020 as a countercyclical policy measure during the COVID-19 pandemic to improve access to finance. A National High-Level Committee was established in

¹⁴ Asia/Pacific Group on Money Laundering. 2021. [4th Follow-Up Report: Mutual Evaluation of Bhutan](#). Sydney; Government of Bhutan, RMA. 2017. [Bhutan: National Money Laundering and Financing of Terrorism Risk Assessment](#). Thimphu; and Asia/Pacific Group on Money Laundering. 2016. [Anti-money laundering and counter-terrorist financing measures: Bhutan - Mutual Evaluation Report](#). Sydney.

¹⁵ Government of Bhutan, RMA. 2020. [State of the Financial Inclusion Report 2019](#). Thimphu.

¹⁶ C. T. Niang et al. 2013. [Connecting the Disconnected: Coping Strategies of the Financially Excluded in Bhutan](#). Washington, DC: World Bank.

¹⁷ Government of Bhutan, RMA. 2019. [Payment System Report 2018](#). Thimphu.

¹⁸ From a technology standpoint, the RMA is developing the following in RMA fintech sandboxing: (i) a mobile (voice assisted) application for the visually impaired to read currency notes as part of financial inclusion, (ii) an e-know-your-customer platform to lower the cost of know-your-customer processes for bank account openings, and (iii) Loan Tech (trade name) online loan application driven by the COVID-19 situation.

2020 under the finance minister as chair, which set up a comprehensive NPL resolution framework that was adopted in 2021.

17. Subprogram 3 is included in ADB's Indicative Country Pipeline and Monitoring Report, 2022–2024.¹⁹ The program is aligned with operational priority (OP) 1 of ADB's Strategy 2030 (addressing remaining poverty and reducing inequalities); OP2 (accelerating progress in gender equality), OP 3 (tackling climate change, building climate and disaster resilience, and enhancing environmental sustainability); and OP 6 (strengthening governance and institutional capacity).²⁰ Subprogram 3 was advanced by 6 months to enable reforms, particularly in the insurance sector, and NPLs of the financial system to be implemented as early as possible, given that the pandemic has exacerbated issues in the finance sector.

B. Policy Reform, ADB's Value Addition, and Sustainability

18. **Risk-based surveillance introduced under reforms.** The Macro-Prudential Regulations were adopted in 2018. In 2019, risk management guidelines were issued by the RMA to provide minimum standards in risk mitigation at financial institutions and to encourage them to adopt and implement a sound risk management framework.²¹ In addition, directives on risk-based solvency and capital requirements were issued by the RMA for insurance and reinsurance companies in Bhutan in September 2019.

19. **Policy reforms proposed through the program.** Subprogram 1 laid the groundwork in terms of strategies and processes in the areas of capital markets, insurance, pensions, gradual compliance with international market standards, cybersecurity, and consumer protection.²² Subprogram 2 followed with policies developed in the same reform areas and initial operationalization of international market standards and demand-side analysis for financial inclusion. Subprogram 3 was introduced to add depth to reforms in areas like development of capital markets through listing government bonds and revision of rules of cottage and small industries sector equity issuers to add liquidity, insurance strategy including broadening the scope of insurance products and the number of providers, advance implementation of compliance with international financial market standards (IFRS, Basle III) and strengthened integrity of the financial system with better information management and use of digitalization for payment systems for inclusion and efficiency. Subprogram 3 will maintain the reform momentum and introduce new finance sector reforms like data warehousing to increase the accuracy and integrity of data, stress testing of insurance business and developing a green taxonomy. Reforms introduced through subprograms 1 and 2 (i) helped start the government bond issuance; (ii) increased bank deposits by 42% (from Nu117.18 billion in March 2019 to Nu141.7 billion in March 2021); and (iii) exhibited growth in the private sector with increased market capitalization, financial inclusion (including life insurance), and expansion of private sector pensions and provident funds as evidenced by a 15.15% increase in membership (56,809 in 2019 to 65,414 in 2020).

20. Subprogram 3 is a single tranche intervention like subprograms 1 and 2. Refinements to subprogram 3 policy actions and addition of new areas based on the COVID-19 impact on

¹⁹ ADB. 2021. Indicative Country Pipeline and Monitoring Report, 2022–2024. Manila.

²⁰ ADB. 2018. [Strategy 2030: Achieving a Prosperous, Inclusive, Resilient, and Sustainable Asia and the Pacific](#). Manila.

²¹ Government of Bhutan, RMA. 2018. [Macro-Prudential Rules and Regulations 2018](#). Thimphu; and Government of Bhutan, RMA. 2019. [Risk Management Guidelines 2019](#). Thimphu.

²² International market standards include International Financial Reporting Standards (IFRS), Basel III Capital Accord and Anti Money Laundering and Combating the Financing of Terrorism.

markets and advancement of reforms have been included in the policy matrix. These are presented in detail in the government's Development Policy Letter (Appendix 3), Amendments and Additions to the Policy Matrix (Supplementary document 12) and the Policy Design and Monitoring Framework (Appendix 1).

21. Impact of subprogram 3 to mitigate the coronavirus disease effects on financial markets. Subprogram 3 addresses rising NPLs and reduced investment caused by lockdowns because of the pandemic. Capital market activity was reduced because of the lack of new debt and/or equity issuances on the stock exchange during the pandemic. Revisions to alternative investments board rules facilitated cottage and small industries to list equity helping to increase capital market activity. Introducing comprehensive NPL management strategies will help to combat deteriorating asset quality in financial institutions in the post-COVID-19 era. Implementation of reforms in the insurance sector and fintech to support innovation will result in increased connectivity, inclusion, and employment.

22. Reform area 1: Nonbank financial systems developed. The objectives were to develop capital markets on both the demand and supply sides to increase access to finance by the private sector and improve governance of systems and issuers. Subprogram 1 developed a strategy for bond issuance, and policies on new housing financing and pensions. Under subprogram 2, the government issued two bonds with tenors to maturity of 3 years in September 2020 and 10 years in February 2021. A pension strategy to cover private sector employees and the self-employed, with a gender focus, was approved. Under subprogram 3, government bonds have been listed on the RSEB, adding liquidity to the debt markets, establishing yield curves, and providing an alternative investment option to long-term investors in the country.²³ To attract more cottage and small industry entities to capital markets, revisions were made to rules and regulations on alternative investment market instruments.²⁴ Subprogram 3 also concentrated on improved corporate governance and corporate social responsibility rules. A housing market demand survey was conducted in key urban areas based on which the RMA issued a directive on housing finance which incentivizes financial institutions to develop finance schemes focused on identified needs of the focusing finance sector.²⁵ The RMA developed an insurance strategy to widen the scope of insurance products and investments made by insurers after regulations were imposed in 2019.

23. Reform area 2: Stability and integrity of the financial system strengthened. Under subprogram 1, the RMA instituted risk-based bank supervision, including stress testing, and designed templates for institutional risk profiles and risk assessment that will significantly assist RMA supervision. Under subprogram 2, the reforms were continued in the areas of risk assessment, with emphasis on credit and cybersecurity risks, and the inclusion of International Financial Reporting Standard (IFRS) 9 in prudential requirements.²⁶ All financial institutions operationalized an online anti-money laundering reporting system. Subprogram 3 will focus on

²³ ADB. 2012. [Technical Assistance to the Kingdom of Bhutan for Capital Market Development](#). Manila; and Government of Bhutan, National Statistics Bureau. 2019. [Economic Census of Bhutan, 2018–2019](#). Thimphu.

²⁴ Alternative investment market is a separate platform on RSEB for cottage and small industry based companies to raise equity capital. These small business entities usually fund themselves through a venture capital funds (Jabchor) and not continue on to list their businesses. Jabchor is a joint initiative by the RMA, the Company Registry Division of the Ministry of Economic Affairs, the RSEB, the Bhutan Chamber of Commerce, and Thimphu Tech Park Limited to promote alternative sources of equity financing.

²⁵ The survey revealed that a deficit exists in the supply side of housing units despite about 6,147 units added annually to the existing stock. In order that financial institutions are incentivized reduced risk weights have been assigned to all new housing loans going forward by the RMA.

²⁶ The Accounting and Auditing Standards Board of Bhutan signed an agreement with the IFRS Foundation to adopt the IFRS in a phased manner (phase 1 during 2013–2015, phase 2 during 2016–2017, and phase 3 during 2018–2019), aiming for full adoption and compliance by 2022.

implementing IFRS 9, revised rules on anti-money laundering, and further alignment with Basel III, leading to enhanced stability, efficiency, and inclusiveness in financial markets. This will also lead to increased compliance with risk-based supervision and compliance in both the banking and nonbanking sectors. RMA formulated a comprehensive NPL strategy where key aspects like credit underwriting, asset valuation, and monitoring were analyzed in depth to recommend strategies to be adopted by the RMA and all financial institutions. RMA will be implementing these strategies with capacity building acquired from ADB's TA and commence monitoring NPLs on annual basis on new loans created after the COVID-pandemic hit the country.²⁷

24. **Reform area 3: Financial inclusion promoted.** Under subprogram 1, the RMA approved the National Financial Inclusion Strategy, 2018–2023 and the National Financial Literacy Strategy, 2018–2023.²⁸ Under subprogram 2, the RMA approved an action plan for the National Financial Literacy Strategy and the National Financial Inclusion Strategy that included (i) identifying the responsible agencies and clear timelines for developing a gender-responsive and socially inclusive financial literacy program, (ii) conducting surveys on demand and use of financial products by women and other user groups, and (iii) ensuring disaggregating data and analysis by sex. RMA established a consumer redress mechanism to provide redress to aggrieved consumers, promote fair trade practices, and empower and enhance consumer confidence in financial services. The RMA approved an inclusive green finance road map in 2020 to promote access to finance for entrepreneurs seeking funding for environment-friendly projects. Subprogram 3 will focus on developing a green taxonomy in line with the phased approach of the RMA's green finance road map. Fintech options through sandbox arrangements have been established to promote digital inclusion (footnote 17).

25. **Changes to policy actions in the policy design and monitoring framework.** After further consultations with the government, the indicative policy actions of subprogram 3 were revised by the project team to add clarity and strengthen the objectives. A new area of revisions to rules and regulations on the Alternative Investment Market Board of the RSEB was added.²⁹

26. **Post-program engagement framework.** The framework was included to facilitate a structured dialogue on finance sector reforms between ADB, the Ministry of Finance (MOF), and the RMA. The post-program engagement framework includes (i) development of further strategies and implementation activities, (ii) awareness and capacity building activities, and (iii) structured monitoring by supervisory agencies related to the three reform areas. The framework was expanded to include the following actions: a government bond issuance program adding liquidity to capital markets, several companies adopting the new corporate governance and corporate social responsibility rules, new listings on the Alternative Investment Market board of RSEB and formulating a strategy for RSEB's to develop green finance. Under the development of the nonbanking financial system pillar of the framework, proposed amendments of the Financial Services Act, 2011 will be enacted. Under the strengthening of the stability and integrity of the financial system pillar, IFRS implementation and commercial banks achieving International Organization for Standardization certifications on data security standards are included.³⁰ Financial inclusion will be strengthened through public awareness activities to educate

²⁷ ADB. 2020. [Technical Assistance to the Kingdom of Bhutan for Strengthening the Financial Market Development Program](#). Manila.

²⁸ Government of Bhutan, RMA. 2018. [National Financial Inclusion Strategy, 2018–2023](#). Thimphu; and Government of Bhutan, RMA. 2018. [National Financial Literacy Strategy, 2018–2023](#). Thimphu.

²⁹ These amendments and additions have been explained in detail in Amendments and Additions to Policy Matrix, Subprogram 3 (accessible from the list of linked documents in Appendix 2).

³⁰ Payment Card Industry Data Security Standard, and International Organization for Standardization 27001:2013 certifications.

consumers on consumer protection for financial services.

27. **ADB's value addition.** ADB has supported the government's reform agenda through a strategic framework; informed policy dialogue; evidence-based studies; and sequencing and pacing of reforms, particularly in planning and coordinating various elements of reforms. ADB has been a long-standing partner in Bhutan's development since 1982. The Bhutan–ADB partnership in the finance sector began in 1984, with the provision of the Industrial Sector Study and technical assistance (TA) for the Establishment of a Development Financing Mechanism.³¹ ADB helped to strengthen the RMA's central banking role as the single regulator of banks and nonbanks under the Financial Institution Act, 1992. ADB has maintained a high level of continuity through an advisory role, particularly in its core sectors.³² The One ADB approach has been implemented more effectively since 2017, when ADB's Bhutan Resident Mission expanded and undertook core tasks in country operations. A programmatic approach with two subprograms were selected and approved in 2019 to enable ADB to stay engaged and to help the government implement effective long-term reforms.

28. **Lessons.** The program has drawn on lessons from ADB's previous policy-based programs that supported finance sector reforms.³³ The design of subprogram 3 is based on the achievements and lessons of subprograms 1 and 2. Subprogram 1 interventions laid the groundwork with (i) a strategy on long-term government bond issuance, and (ii) policies on national housing with a focus on affordable housing and pension and provident funds. Subprogram 2 policy actions ensured that issuing government bonds and planned issuances with an acceptable frequency would be in place. Both analyzed the housing deficit and lack of adequate financial mechanisms in the affordable housing sector. Complying with comprehensive credit underwriting standards would need to be pursued with capacity building, coupled with robust information systems to mitigate NPLs in the system. Establishing a data warehousing policy is seen as an important deliverable for the RMA, enabling timely and accurate prudential regulations and effective monitoring. The IED's validation report noted that efforts to diversify the economy cannot be sustained without accompanying public sector management and finance reforms that strengthen governance (footnote 1).

29. **Development partner coordination.** The involvement of development partners in the finance sector in Bhutan is well defined.³⁴ Access to credit was identified in a diagnostic study on Bhutan that ADB prepared with the Government of Australia and the Japan International Cooperation Agency. The government adopted its Capital Market Master Plan in 2014 following ADB TA, which created a blueprint for a debt market strategy.³⁵ The International Monetary Fund (IMF) is helping the RMA set up a liquidity forecasting framework. The World Bank created the Financial Sector Development Action Plan for Bhutan, which the government approved in 2017. Other World Bank engagements included (i) policy on strengthening and TA for capacity building in the insurance sector, and (ii) a multi-donor trust fund to help the Accounting and Auditing Standards Board in Bhutan on implementing IFRS by large companies in Bhutan (including the RMA). ADB collaborated closely with the IMF and the World Bank during program formulation.

³¹ ADB. 2014. [Three Decades of Development Partnership: Royal Government of Bhutan and Asian Development Bank](#). Manila.

³² IED. 2019. [Validation of the Country Partnership Strategy Final Review, 2014–2018 in Bhutan](#). Manila: ADB.

³³ ADB. 2015. [Completion Report: Strengthening Economic Management Program in Bhutan](#). Manila; and ADB. 2018. [Completion Report: Strengthening Economic Management Program II in Bhutan](#). Manila.

³⁴ Development Coordination (accessible from the list of linked documents in Appendix 2).

³⁵ ADB. 2012. [Technical Assistance to the Kingdom of Bhutan for Capital Market Development](#). Manila.

C. Expected Outcome of the Reforms

30. The expected outcome of the program is increased stability and inclusiveness of the finance sector. The program will support the government with institutional reforms, while improving the technical capacity of regulatory and financial institutions. The performance indicators are included in the policy design and monitoring framework (Appendix 1). The impacts are as follows: (i) all bonds issued from 2018 to 2023 increase by 6.0%, reaching Nu9.3 billion; (ii) the year-on-year growth of private sector credit provided by commercial banks increases from 14.7% in 2017 to 17.0% for 2019–2022; and (iii) the share of adults with access to credit reaches 20.0% by 2022 (2018 baseline 16.0%). New outcome indicators were introduced with the subprogram 3: the RMA is to include gross NPL ratio for new loans with effect from December 2021 (on an annual basis), the financial inclusion indicator improves to 80% by 2022, and the share of adults who have access to life insurance is at least 20% by 2022.³⁶

D. Development Financing Needs and Budget Support

31. The fiscal gap of the government in FY2021 was financed through external borrowings of \$55.3 million and internal borrowings of \$129.1 million.³⁷ The fiscal gap of FY2022 is expected to be met from external borrowings up to \$60.6 million and internal borrowings up to \$172.8 million. ADB and the World Bank together are expected to provide all of the external financing. The balance, 74% of the fiscal deficit in FY2022 or \$172.8 million, will be financed through short-term government bills and bonds (Table 2). The IMF assessed Bhutan as *moderate* risk in the 2018 IMF–World Bank debt sustainability assessment.

Table 2: Government Fiscal Position, as of 30 April 2021
(\$ million)

Indicator	FY2021	FY2022
Total revenues	775.55	772.43
Total expenditure	959.99	1,005.84
Fiscal deficit	(184.42)	(233.42)
Fiscal deficit (% to GDP)	(7.3)	(8.6)
Financing		
Financing need	184.42	233.42
External borrowing ^a	55.29	60.59
Internal borrowing	129.13	172.83

() = negative, FY = fiscal year, GDP = gross domestic product.

Note: The FY of the Government of Bhutan ends on 30 June. “FY” before a calendar year denotes the year in which the FY ends, e.g., FY2022 ends on 30 June 2022.

^a Includes borrowings from multilateral development banks such as the Asian Development Bank and the World Bank. FY2021 ADB borrowings were \$37.5 million while FY2022 ADB loan of \$30 million are included.

Source: Government of Bhutan, Ministry of Finance. 2021. [National Budget, Financial Year 2021–22](#). Thimphu.

32. The government has requested a concessional loan of \$30 million from ADB’s ordinary capital resources to help finance the program. The loan will have a 24-year term, including a grace period of 8 years; an interest rate of 1.0% per year during the grace period and 1.5% per year thereafter; and such other terms and conditions set forth in the draft loan agreement. The loan under subprogram 3 will be disbursed in a single tranche. The loan has been advanced to

³⁶ NPL included as an indicator to check asset quality and financial inclusion to cover insurance under subprogram 3.

³⁷ External borrowings are met by ADB (53%), World Bank (42%), and International Fund for Agricultural Development and Japan International Cooperation Agency (5%) of the total requirement.

October 2021 given the increased pace of reforms required in financial markets because of the COVID-19 pandemic.

E. Implementation Arrangements

33. The MOF is the executing agency, and the RMA and the Ministry of Works and Human Settlement are the implementing agencies. A steering committee, chaired by the secretary of the MOF and established under subprograms 1 and 2, will continue to guide and monitor the implementation of subprogram 3. The proceeds of the policy-based loan will be withdrawn following ADB's *Loan Disbursement Handbook* (2017, as amended from time to time) in a single tranche. The implementation period is October 2020–September 2021 for subprogram 3. All policy actions accomplished under subprograms 1 and 2 remain effective. Processing is expected to complete by October 2021 within the implementation period for subprogram 3 (December 2020 to March 2022) and all policy actions have been successfully completed.

III. DUE DILIGENCE

34. **Safeguards.** In compliance with ADB's Safeguard Policy Statement (2009), the program is classified *category C* for environment, involuntary resettlement, and indigenous peoples safeguards. It is not expected to have any environmental, involuntary resettlement, and indigenous peoples safeguard impacts following the definition of ADB's Safeguard Policy Statement.³⁸ The funds are for budget support and development of institutional capacity and reforms in financial markets. Counterpart support will be in the form of counterpart staff, office and housing accommodation, office supplies, secretarial assistance, domestic transportation, and other in-kind contributions. A matrix of potential environmental and social safeguards impacts has been prepared to assess each policy action.

35. **Poverty and social.** Bhutan's limited financial market development has had a disproportionate impact on the poor. Only 25% of adults in the poorest 40% of households in Bhutan have a bank account, while the rate in other developing economies is 50% based on 2014 data (footnote 6). Further, as of December 2020, although 76.08% of adults in Bhutan had a savings account, only 21.79% had access to credit and 25.29% held an insurance policy.

36. **Gender elements.** The program's objectives and activities align with the goal of advancing gender equality and women's empowerment by improving women's access to financial resources. The program includes two gender-related policy action areas: (i) the housing market demand survey focused on addressing demand-side factors related to women in providing access to housing finance, and (ii) the RMA will adopt a data warehousing policy with sex-disaggregated data templates that will enable gender focused financial information for decision making by the RMA and financial institutions. The program is categorized *some gender elements*. The housing market demand survey consisted of 40% female respondents in Thimphu and 37% in other urban areas (refer paras 14 and 15).

37. **Governance.** Bhutan's financial management risk is *moderate*. The 2016 public expenditure and financial accountability assessment reported improvements from the previous assessment (2010).³⁹ The lowest scores were given for accounting and reporting, government transparency, and budget reliability. The government has implemented four of the five reform measures. These measures are the public expenditure management system and the integration

³⁸ Summary Poverty Reduction and Social Strategy (accessible from the list of linked documents in Appendix 2).

³⁹ World Bank. 2010. [Bhutan: Public Financial Management Accountability Assessment](#). Washington, DC.

of the civil service information system with the payroll system.⁴⁰ Fiduciary arrangements for the proposed budget support are through the MOF.

38. **Anticorruption.** Bhutan consistently scores high on global indexes for control of corruption, ranking 24th out of 180 economies in Transparency International's 2020 Corruption Perceptions Index. ADB's Anticorruption Policy (1988, as amended to date) was explained to and discussed with the government and the MOF.

39. **Economic impact.** The reforms are expected to improve overall financial market system and inclusiveness, and economic welfare (especially of women). The reforms will (i) improve financial literacy; (ii) enhance access to finance; and (iii) enable (a) people to take economic risks to pursue income-generation opportunities, (b) business development of the private sector, and (c) improved efficiencies of financial intermediation.

40. **Risks and mitigating measures.** Major risks and mitigating measures are described in detail in the risk assessment and risk management plan.⁴¹ Economic diversification mitigated by government's reform measures like mobilizing domestic revenues through timely goods and services tax implementation, prioritizing expenditure on development and welfare, and planning for contingencies. Another risk is that high NPLs impact financial system stability; this has been mitigated by NPL resolution strategies and solvency requirements on all life insurance products with effect from 2019. Both risks are rated *medium*.

IV. ASSURANCES

41. The government and the Ministry of Finance have assured ADB that implementation of the program shall conform to all applicable ADB policies, including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the loan agreement.

V. RECOMMENDATION

42. I am satisfied that the proposed policy-based loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of \$30,000,000 to the Kingdom of Bhutan for subprogram 3 of the Financial Market Development Program, from ADB's ordinary capital resources, in concessional terms, with an interest charge at the rate of 1.0% per year during the grace period and 1.5% per year thereafter; for a term of 24 years, including a grace period of 8 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.

Masatsugu Asakawa
President

29 September 2021

⁴⁰ The integration of the planning and monitoring system with a multiyear rolling budget system remains to be implemented.

⁴¹ Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

POLICY DESIGN AND MONITORING FRAMEWORK

Country's Overarching Development Objective				
Macroeconomic stability achieved, economic diversity and productive capacity enhanced, and poverty eradicated and inequality reduced (Twelfth Five Year Plan, 2018–2023) ^a				
Outcome		Risks and Critical Assumptions		
Stability, efficiency, and inclusiveness of the finance sector enhanced.		External financial and economic shocks may limit the effectiveness of completed reforms.		
Prior Actions Subprogram 1 Completed January 2018– November 2019	Prior Actions Subprogram 2 Completed December 2019– September 2020	Prior Actions Subprogram 3 Completed October 2020 – September 2021	Outcome Indicators	Post-Program Engagement Framework October 2021- June 2023
Reform Area 1: Nonbank financial system developed				
1.1 Ministry of Finance (MOF) approved a strategy for the issuance of long-term Government bonds including implementation plan.	2.1. MOF approved the detailed Rules and Regulations for long-term government bond issuance. ^a 2.2. The government (MOF) issued its first domestic long-term bond.	3.1a. RMA Executive Committee approved the listing rules for government bonds and bills for implementation immediately to facilitate secondary market trading. 3.1b Government (Ministry of Finance-MOF) listed all outstanding and new treasury bonds on the Royal Securities Exchange of Bhutan (RSEB) to facilitate secondary market transaction. Sources – Listing Rules with confirmation of approval by RMA and listing of government bonds on the RSEB announced on RSEB's website and issuance of government bonds announced on MOF's	By October 2022 a. Volume of bonds traded in the capital market increased to Nu9.30 billion (7% increase) (2018 baseline: Nu8.76 billion). December 2020 Nu8.65 billion Source: Royal Securities Exchange of Bhutan (RSEB) annual report	4.1. MoF to approve a bond issuance program covering long-term tenors with regular issuances through a transparent issuance mechanism.

Prior Actions Subprogram 1 Completed January 2018– November 2019	Prior Actions Subprogram 2 Completed December 2019– September 2020	Prior Actions Subprogram 3 Completed October 2020 – September 2021	Outcome Indicators	Post-Program Engagement Framework October 2021- June 2023
	<p>2.3. Office of the Registrar approved the revised regulations for corporate bonds and commercial paper issuance liberalizing issuance requirements.</p>	<p>website.</p> <p>3.2a. RMA Executive Committee approved revised rules and regulations pertaining to the Alternative Investment Market (AIM) Board for immediate implementation to increase participation by Micro, Cottage, Small, Medium and Large Enterprises (MCSML) and investors on AIM.</p> <p>Sources – Revised rules and regulations and confirmation of approval by RMA.</p> <p>3.2b. RMA Executive Committee approved the revised regulations on the issuance of equity and bonds by companies including (i) trading market rules and regulations, (ii) market trade reporting rules, and (iii) listing rules to align with evolving market conditions and revised AIM rules for implementation with effect from 28 August 2021.</p> <p>Sources – Revised regulations on issuance of equity and bonds and</p>		<p>4.2. At least 10 eligible companies have been listed on AIM.</p> <p>4.3. RSEB to develop an action plan/strategy to attract both domestic and local investors to raise green finance with the objective of joining the Sustainable Stock Exchanges Alliance (SSE) and encourage raising of green capital</p> <p>4.4. The Office of the Registrar to carry out awareness campaign on the new requirements for corporations and investors, including banks and nonbank financial institutions; and to report on the status of corporate bond issuance and identifies constraints and gaps.</p> <p>4.5. Adoption by companies of revisions to corporate governance and corporate social responsibility.</p>

Prior Actions Subprogram 1 Completed January 2018– November 2019	Prior Actions Subprogram 2 Completed December 2019– September 2020	Prior Actions Subprogram 3 Completed October 2020 – September 2021	Outcome Indicators	Post-Program Engagement Framework October 2021- June 2023
<p>1.2. Cabinet approved a new National Housing Policy (NHP) which aims to expand safe and affordable housing through fiscal incentives to ease high rental burden and promote home ownership for disadvantaged groups, including women.</p>	<p>2.4. MOWHS approved the long-term strategy for public housing with financing mechanisms including (i) fiscal measures and incentives for affordable housing (MOF), and (ii) policy addressing constraints in accessing housing finance by women.</p>	<p>confirmation of approval by RMA.</p> <p>3.2c. Office of the Registrar approved Corporate Governance & Corporate Social Responsibility Regulations on September 1, 2021 to be adopted by all issuers of debt and equity to improve transparency.</p> <p>Source – Corporate Governance and Corporate Social Responsibility Regulations document approved by the Office of the Registrar.</p> <p>3.3. RMA issued directives based on housing market demand survey conducted by MOWHS which included gender focused data collection to facilitate affordable housing finance products encompassing tenure, loan to value, and preferential risk weights.</p> <p>Source – Report on housing market demand based on survey and RMA directives as described published on their website.</p>		<p>4.6. MOWHS to monitor the implementation of affordable housing policy including measures to address women’s constraints in accessing housing finance.</p>

Prior Actions Subprogram 1 Completed January 2018– November 2019	Prior Actions Subprogram 2 Completed December 2019– September 2020	Prior Actions Subprogram 3 Completed October 2020 – September 2021	Outcome Indicators	Post-Program Engagement Framework October 2021- June 2023
<p>1.3. RMA Board issued a Directive requiring the assessment of the solvency of insurance companies based on compliance with prudential regulations in addition to risk-based solvency margins.</p>	<p>2.5. RMA Board endorsed the proposed amendments to the Financial Services Act 2011, including provisions allowing composite insurance by the insurance companies, for submission to the Cabinet.</p> <p>2.6. MOF approved the strategy for the expansion of coverage to the private sector and self-employed individuals of which 61% consist of women, covering the following:</p> <ul style="list-style-type: none"> (i) licensing requirements of pension providers, (ii) identified pension and provident fund service providers, and (iii) defined roles and 	<p>3.4. RMA Board approved the Insurance Sector Strategy for implementation by 1 September 2021 which incorporates widening the scope of insurance products and alternative investments.</p> <p>Source – Strategy document and confirmation of RMA board approval.</p>		<p>4.7. Cabinet to submit to the Parliament the proposed amendments to Financial Services Act 2011, including provisions allowing composite insurance by the insurance companies.</p> <p>4.8. RMA/Insurance sector to hold public awareness sessions on the benefits of the insurance sector strategy.</p> <p>4.9. RMA to approve rules and regulations of the insurance sector including revised investment criteria.</p> <p>4.10. RMA/MoF/MoLHR/NPPF to carry out awareness activities on retirement schemes in consultation with stakeholders for the public.</p> <p>4.11. MOF to assess the sustainability of the existing pension and provident fund schemes, propose pension reforms, to carry out actuarial</p>

Prior Actions Subprogram 1 Completed January 2018– November 2019	Prior Actions Subprogram 2 Completed December 2019– September 2020	Prior Actions Subprogram 3 Completed October 2020 – September 2021	Outcome Indicators	Post-Program Engagement Framework October 2021- June 2023
<p>1.4. Cabinet approved the National Pension and Provident Fund Policy to expand membership coverage to include private sector and self-employed individuals, including expanded coverage for women.</p>	<p>responsibilities for schemes and fund managers.</p> <p>2.7. RMA approved the rules and regulations on:</p> <p>(i) licensing requirements for pension and provident fund service providers, and</p> <p>(ii) defined roles and responsibilities for schemes and fund managers.</p>			<p>valuations and review investment policies for pension, provident fund, and gratuity schemes.</p>
Reform Area 2: Strengthening the integrity and stability of the financial system				
		<p>3.5. RMA Executive Committee approved an NPL management Strategy including:</p> <p>(i) foreclosure guidelines, and</p> <p>(ii) write-off policy and asset transfer Policy to be adopted by both banks and nonbanks by 1 September 2021.</p> <p>Source – NPL Management Strategy document approved by RMA.</p>	<p>By October 2022:</p> <p>b. Year-on-year growth of private sector credit by commercial banks increased to at least 17.0% (2014–2018 baseline: 14.7%).</p> <p>Source: RMA monthly bulletin on the RMA website December 2020 13.3%</p> <p>Source: RMA Annual Report</p>	<p>4.12. RMA to approve strategy on securitization of financial sector assets in Bhutan (the strategy will include policy and legal structure required for securitization).</p> <p>4.13. RMA to approve rules and regulations on securitization of financial sector assets in Bhutan.</p> <p>4.14. RMA to conduct a feasibility study for the establishment of asset reconstruction company.</p>

Prior Actions Subprogram 1 Completed January 2018– November 2019	Prior Actions Subprogram 2 Completed December 2019– September 2020	Prior Actions Subprogram 3 Completed October 2020 – September 2021	Outcome Indicators	Post-Program Engagement Framework October 2021- June 2023
	<p>2.8. Online AML Reporting System is operationalized by all financial institutions to ensure integrity and efficiency of transmission of the information submitted to RMA.</p> <p>2.9. RMA implemented risk profiling and assessment of all commercial banks to ensure that commercial banks risk reporting is standardized and meets</p>	<p>3.6. RMA Executive Committee approved and issued for compliance by all financial institutions the following with effect from September 1 2021:</p> <p>(i) updated guidelines on Capital Markets, and Money Service Businesses based on sections¹ of the Guideline on Anti Money Laundering and Countering of Financing of Terrorism for Capital Market Intermediaries 2020 and</p> <p>(ii) sections 313-332 of the revised Anti Money Laundering and Combating the Financing of Terrorism Rules and Regulations, 2018.</p> <p>Source – Guidelines approved by RMA Executive Committee.</p> <p>3.7a. RMA strengthened the risk-based monitoring based on Basel III guidelines with effect from 1 September 2021 for financial sector by having,</p> <p>(i) approved Risk-Based Supervision Manual,</p>	<p>c. RMA to include gross NPL ratio for new loans with effect from December 2021 on an annual basis. (Source: RMA annual supervision report - <i>New loans are loans created by Financial Institutions with effect from April 2020</i>).</p> <p>(Baseline: Not included)</p>	<p>4.15. RMA to provide training to REs on risk-based approach (RBA) to combat and prevent ML and TF.</p> <p>4.16. RMA to build capacity within and FI officers in the areas of risk-based supervision and stress testing.^c</p> <p>4.17. RMA to conduct</p>

Prior Actions Subprogram 1 Completed January 2018– November 2019	Prior Actions Subprogram 2 Completed December 2019– September 2020	Prior Actions Subprogram 3 Completed October 2020 – September 2021	Outcome Indicators	Post-Program Engagement Framework October 2021- June 2023
	<p>prudential reporting requirements consistently under risk-based supervision.^b</p>	<p>(ii) completed stress testing of all banks, (iii) completed stress testing on non-insurance business of insurance companies, and 3.7b. RMA developed guidelines on stress testing on insurance companies for the insurance business effective from 1 September 2021.</p> <p>Sources – Confirmation letter from RMA that (i) through (iii) had been completed.</p> <p>Confirmation letter from RMA that the guidelines for stress testing for insurance companies has been developed and the guidelines document.</p> <p>3.8. The RMA Executive Committee developed and approved the Guidelines on Trade Receivables Discounting System with effect from 1 January 2021 to assist commercial banks in implementing relevant sections on trade receivable discounting under the Payment and Settlement System Rules and Regulations approved by the RMA Board in</p>		<p>annual risk-based supervision of the financial sector and publishes Annual Supervision Report for all the FIs through publications on RMA's website.</p>

Prior Actions Subprogram 1 Completed January 2018– November 2019	Prior Actions Subprogram 2 Completed December 2019– September 2020	Prior Actions Subprogram 3 Completed October 2020 – September 2021	Outcome Indicators	Post-Program Engagement Framework October 2021- June 2023
<p>1.5. Parliament approved the AML/CFT Act and RMA approves rules and regulations to implement the Act.</p> <p>1.6. RMA issued a Directive on loan provisioning and impairment of loans in line with the Bhutan Accounting Standards.</p> <p>1.7. RMA (i) issued a Directive on implementing cyber security framework and business continuity plan, and (ii) establishes Financial Institution Cyber Response Team (FICRT) responsible for proactively preventing cyber threats and exposed liabilities.</p> <p>1.8 RMA issued a Directive on loan provisioning and impairment of loans in line with the Bhutan Accounting Standards.</p>	<p>2.10. RMA approved revised Prudential Regulations to incorporate International Financial Reporting Standards (IFRS) 9 on impairment of loans, which requires financial institutions to recognize and provide for credit losses for financial statement reporting purposes.</p> <p>2.11. Cyber security controls and actions indicated in Annexure 1 to the RMA Directive are implemented by at least 2 banks and these banks applied for Payment Card</p>	<p>2018.</p> <p>Source – Guidelines and Directives on Trade Receivables Discounting System issued by RMA.</p> <p>3.9. RMA issued guidelines, with effect from 1 September 2021, on compliance with IFRS 9 by financial institutions to ensure consistency in reporting and improve risk assessment.</p> <p>Source– Guidelines on IFRS 9 Implementation in Financial Institutions.</p> <p>3.10. RMA Board approved the Policy on Centralized Data Warehouse and Data Analytics for implementation with effect 28 August 2021, to ensure better access to information and decision making with</p>		<p>4.18. RMA to monitor compliance with the revised Prudential Regulations and reports annually through publications on RMA's website.</p> <p>4.19. RMA to provide training on IFRS 9 to board members, senior management, and line management of financial institutions.</p> <p>4.20. All commercial banks to certify for Payment Card Industry Data Security Standard (PCI DSS) ISO 27001:2013 certifications.</p>

Prior Actions Subprogram 1 Completed January 2018– November 2019	Prior Actions Subprogram 2 Completed December 2019– September 2020	Prior Actions Subprogram 3 Completed October 2020 – September 2021	Outcome Indicators	Post-Program Engagement Framework October 2021- June 2023
	Industry Data Security Standard (PCI DSS) ISO 27001:2013 certifications.	focus on gender disaggregated data in all relevant templates. Source – Policy document approved by RMA.		4.21. Commercial banks to provide quarterly progress report to RMA on the progress in implementing cyber security measures.
Reform Area 3: Financial Inclusion Promoted				
1.9 RMA approved Consumer Protection for Financial Services (CPFS) Rules and Regulations to empower and enhance consumer confidence in the finance sector. 1.10 RMA approved the National Financial Literacy Strategy (NFLS) 2018–2023 and the National Financial Inclusion Strategy (NFIS) 2018–2023.	2.12. Financial Service Providers (FSPs)— comprising 5 banks, 3 insurance companies and 6 microfinance institutes—established formal consumer grievance redressal mechanisms ^c following Consumer Protection for Financial Services (CPFS) Rules and Regulations issued by the RMA in 2019 which promote self-regulation in the financial sector and financial consumer education and disclosure for consumers to make effective and informed financial decision. 2.13. RMA approved an action plan for NFLS 2018–2023 and NFIS 2018–2023 that includes (i) responsible agencies, clear timelines	3.11. RMA Board approved and implemented with effect from 28 August 2021, rules and regulations on the warehouse receipt financing to ensure financial institutions	By October 2022: d. Share of adults who have access to credit is at least 20% (2018 baseline: 16%) Source: RMA monthly report December 2020 21.8% Source: State of Financial Inclusion annual report, (https://www.rma.org.bt/) e. Financial Inclusion Indicator improved to 80%. ^c (2018 baseline: 64%) December 2020 at 76.1%	4.22. FSPs to benchmark towards strengthening their internal capacity and operation with CPFS rules and regulations. 4.23. RMA to adopt supervisory mechanism to effectively enforce CPFS rules and regulations. 4.24. RMA/Financial institutions to carry out public awareness activities to educate consumers on their rights under CPFS rules and regulations. 4.25. To ensure implementation of action plan is on track and RMA to report on an annual basis on the status of the implementation of NFIS

Prior Actions Subprogram 1 Completed January 2018– November 2019	Prior Actions Subprogram 2 Completed December 2019– September 2020	Prior Actions Subprogram 3 Completed October 2020 – September 2021	Outcome Indicators	Post-Program Engagement Framework October 2021- June 2023
	<p>for development of gender-responsive and socially inclusive financial literacy program which will produce relevant information to include in product development by financial institutions,</p> <p>(ii) conduct surveys on demand and use for financial products by women and various groups, and ensure data and analysis is disaggregated by sex which will provide information on specific product needs of women,</p> <p>(iii) expanding financial literacy curriculum framework beyond mainstream education and local government to include nonformal education and technical and vocational education and training and developing strategy for warehouse receipt financing to promote better access to finance for farmers using warehouse receipts as collaterals.</p> <p>2.14. RMA approved</p>	<p>commence offering appropriate lending products.</p> <p>Source – Rules and regulations document approved by RMA and confirmation of implementation from RMA.</p> <p>3.12. RMA Executive</p>	<p>Source: State of Financial Inclusion annual report, (https://www.rma.org.bt/)</p> <p>f. Share of adults who have access to life insurance is at least 20%. (2018 baseline: 18%) Source: RMA monthly report December 2020 16.8%</p> <p>Source: State of Financial Inclusion annual report, (https://www.rma.org.bt/)</p>	<p>and NFLS.</p> <p>4.26. RMA to report on the status of implementation of the above strategy.</p> <p>4.27. To implement warehouse receipt financing strategy and RMA board to approve the rules and regulations for warehouse receipt financing.</p> <p>4.28. RMA to implement</p>

Prior Actions Subprogram 1 Completed January 2018– November 2019	Prior Actions Subprogram 2 Completed December 2019– September 2020	Prior Actions Subprogram 3 Completed October 2020 – September 2021	Outcome Indicators	Post-Program Engagement Framework October 2021- June 2023
	<p>Inclusive Green Finance Roadmap^d which will have milestones of how it will be established through RMA regulations and supervision by RMA on financial institutions offering Green Finance.</p>	<p>Committee approved the Green Taxonomy Framework (pillar in the Green Finance Roadmap of RMA) for implementation with effect from 28 August 2021 to identify financial products and economic activities that can qualify as green investments in order that financial institutions can introduce new products and services and align existing products with the qualifying green finance definition.</p> <p>Source – Green Taxonomy Framework document implemented by RMA and confirmation of implementation by RMA.</p> <p>3.13. RMA board approved the FinTech Regulatory Sandbox Framework and implemented it on 29 October 2020 through setting up the FinTech website, formation of committees from relevant agencies to perform technical evaluation and produce final report on fintech ideas for sandboxing.</p> <p>Source – Confirmation of implementation by RMA. (www.fintechbhutan.bt)</p>		<p>an inclusive green finance scheme to promote access to finance to entrepreneurs seeking funding to environmentally friendly projects.</p> <p>4.29. Approval of fintech proposals submitted to the sandbox.</p>

Prior Actions Subprogram 1 Completed January 2018– November 2019	Prior Actions Subprogram 2 Completed December 2019– September 2020	Prior Actions Subprogram 3 Completed October 2020 – September 2021	Outcome Indicators	Post-Program Engagement Framework October 2021- June 2023
				4.30. RMA to advance feasibility of CBDC work as appropriate in the introduction of a digital currency.

Budget Support:
ADB: \$30 million loan for Subprogram 3 (loan from ordinary capital resources)

ADB = Asian Development Bank, AML = anti-money laundering, CFT = combating the financing of terrorism, CPFS = Consumer Protection for Financial Services, FICRT = Financial Institution Cyber Response Team, FSP = Financial Service Provider, MOF = Ministry of Finance, MOWHS = Ministry of Works and Human Settlement, PDMF = policy design and monitoring framework, RMA = Royal Monetary Authority, RSEB = Royal Securities Exchange of Bhutan.

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

^b At the start of the program the outcome indicators have been targeted to be completed in line with governments Twelfth Five Year Plan, 2018-2023.

^c Financial Inclusion Indicator contains access to Savings deposits.

Contribution to Strategy 2030 Operational Priorities: Operational priority indicators to which this operation will contribute results are detailed in Contribution to Strategy 2030 Operational Priorities (accessible from the list of linked documents in Appendix 2).

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://www.adb.org/Documents/RRPs/?id=51252-005-3>

1. Loan Agreement
2. Sector Assessment (Summary): Finance
3. Contribution to Strategy 2030 Operational Priorities
4. Development Coordination
5. International Monetary Fund Assessment Letter
6. Summary Poverty Reduction and Social Strategy
7. Program Economic Assessment
8. Risk Assessment and Risk Management Plan
9. List of Ineligible Items
10. Approved Report and Recommendation of the President to the Board of Directors: Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1 and Technical Assistance Grant Kingdom of Bhutan: Financial Market Development Program
11. Approved Report and Recommendation of the President to the Board of Directors: Proposed Policy-Based Loan for Subprogram 2 and Technical Assistance Grant Kingdom of Bhutan: Financial Market Development Program

Supplementary Documents

12. Amendments and Additions to Policy Matrix, Subprogram 3
13. Climate Change Assessment

DEVELOPMENT POLICY LETTER



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FINANCE MINISTER

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MINISTRY OF FINANCE
TASHICHHO DZONG
THIMPHU



Development Policy Letter

DMEA/ADB-FMDP III/2021/ 151

26th August, 2021

Mr. Masatsugu Asakawa
President
Asian Development Bank
6 ADB Avenue, Mandaluyong City
1550 Metro Manila

Subject: Financial Market Development Program -Subprogram 3

Dear Mr. Asakawa,

This letter of Development Policy lays out the key elements of the Royal Government of Bhutan's (RGoB) proposed Financial Market Development Program. The RGoB requests the assistance of the Asian Development Bank in the form of the Policy Based Lending for US\$ 30 million. This financing will be used to support development objectives under the 12th Five Year Plan namely its strategic thrust for developing an inclusive, sustainable and equitable economy. The assistance from the Asian Development Bank is needed to especially support the RGoB's reforms to enhance efficiency, stability and inclusiveness of the finance sector. Bhutan's initiative to develop and deepen the financial sector will contribute to increasing non-food consumption, which has been the main driver of reducing poverty in Bhutan through improved financial inclusion and economic growth.

The Royal Government of Bhutan would like to thank the Asian Development Bank for its continued support to Bhutan's development programs for over three decades. From the past policy-based lending, Bhutan has benefitted substantially as it has helped to deepen various Policy and Institutional reforms in the country. The RGoB was able to introduce various institutional and policy reforms to deepen the financial market and strengthen financial supervision, improve revenue and macroprudential management, strengthen financial literacy and mobilize savings, create a legal and regulatory framework for the capital markets, improve budget and debt management systems, strengthen revenue management system etc. Likewise,



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to support the government with institutional reforms and build the technical capacity of regulatory and financial institutions to help improve the efficiency of financial intermediation, encourage private sector investment and improve the economic welfare of Bhutanese people. ADB approved the programmatic approach for the Financial Market Development Program I (FMDP I) and FMDP II in 2019 and 2020. Implementation periods for FMDP I was January 2018 to November 2019 and December 2019 to September 2020 for FMDP II. Both these subprograms supported increased access to finance to the private sector, strengthening the stability and integrity of the financial sector and improving financial inclusion to enable economic diversification efforts in the country over the medium and long term.

Further, the FMDP III implemented from October 2020 to September 2021 is intended to continue the reforms commenced under the first two subprograms with incremental benefits while policy actions undertaken under subprograms 1 and 2 remained effective. The attached policy matrix indicates the actions that have already been completed under subprogram 3, building on those that are already completed from 2018 to 2019 under subprogram 1 and under subprogram 2 in 2020 in the three reform areas mentioned above. All policy actions (as discussed and set out in the policy matrix attached hereto) under subprogram 3 in the areas of developing the nonbanking sector, strengthening the stability and integrity of the financial sector, and promoting financial inclusion were successfully completed. The outputs are categorized under three main outputs as follows:

(i) *Non-bank financial systems developed.* Policy actions under output 1 include: RMA's approval of listing rules for government bond and bills to facilitate secondary market trading; RMAs approval of revised regulations on listing issuance of equity by companies and Office of the Registrar's approval of the Corporate Governance Corporate Social Responsibility Regulations to be adopted by debt and equity issuers, MOWHS approval of an affordable housing finance strategy, RMA board approval of the Insurance Sector Strategy.



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(ii) **Stability and integrity of the financial system strengthened.** Policy actions under output 2 include: RMA's approval of an NPL Strategy to reduce NPLs and improve risk management, RMA's approval of the revised rules and regulations on AML and Financial Intelligence of financial institutions, RMA's strengthening of the risk-based monitoring using Basel III guidelines of the financial sector; RMA Board's approval of the Rules and Regulations for Trade Receivable Discounting System; RMA Board's approval of the amended Foreign Exchange Rules and Regulations, RMAs implementation of IFRS9 adoption by financial institutions, RMA Board approval of the Policy on Centralized Data Warehouse and Data Analytics.

(iii) **Financial inclusion promoted.** Policy actions under output 3 include: RMA Board approval of rules and regulations on the warehouse receipt financing, RMA approval of an inclusive Green Finance Strategy to promote access to finance to entrepreneurs seeking funding to environmentally friendly projects.

The above reforms will improve the overall economic welfare through increased employment, business development of the private sector, enhanced access to finance and improved efficiencies of financial intermediation which is seen to meet the government's requirement to strengthen domestic resource mobilization. These reforms are vital in post-COVID-19 economic recovery and in achieving sustained and inclusive growth in the medium to long run. The continued programmatic approach of the 3rd subprogram and post-program partnership framework will ensure sustainability of the program, providing a structured dialogue from the medium term leading on to long lasting and more effective reforms in the financial markets.

We would like to thank ADB for working closely with the Government in developing this program and would like to confirm our commitment to its successful implementation. We would like to express our appreciation for the support and the assistance



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extended by the ADB to Bhutan's socio-economic development. We look forward to continued support and fruitful collaboration in the years to come.

Yours Sincerely

A handwritten signature in black ink, appearing to be 'Namgay Tshering'.

(Namgay Tshering)

Finance Minister