ADB

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Program Performance Evaluation Report
November 2010

Bhutan: Financial Sector Intermediation Facility and Equity Investment in Bhutan National Bank

Independent Evaluation Department

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 10 June 2010)

Currency Unit	–	Ngultrum (Nu)
Nu1.00	=	$0.021505
$1.00	=	Nu46.50

ABBREVIATIONS

ADB	–	Asian Development Bank
BDFC	–	Bhutan Development Finance Corporation
BNB	–	Bhutan National Bank
BoB	–	Bank of Bhutan
CAPE	–	country assistance program evaluation
CIB	–	credit information bureau
EIRR	–	economic internal rate of return
FDI	–	foreign direct investment
FIRR	–	financial internal rate of return
FSDP	–	Financial Sector Development Program
FSIF	–	Financial Sector Intermediation Facility
GEPF	–	Government Employees Provident Fund
IFC	–	International Finance Corporation (World Bank)
IMF	–	International Monetary Fund
MSME	–	micro, small and medium enterprises
NPL	–	nonperforming loan
NPPF	–	National Pension and Provident Fund
PCR	–	project completion report
PPER	–	program performance evaluation report
RGoB	–	Royal Government of Bhutan
RICB	–	Royal Insurance Corporation of Bhutan
RMA	–	Royal Monetary Authority
SME	–	small and medium enterprises

NOTES

(i) The fiscal year (FY) of the Government ends on 30 June. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2000 ended on 30 June 2000.

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

Key Words

adb, asian development bank, assistance, bhutan, equity, evaluation, finance, financial sector, investment, intermediation, loan, performance, policy-based program

Director General	H. S. Rao, Independent Evaluation Department
Director	H. S. Hettige, Independent Evaluation Division 2, Independent Evaluation Department
Team leader	E. L. P. Araneta, Principal Evaluation Specialist, Independent Evaluation Department (until 15 March 2010)
Team members	A. Anabo, Senior Evaluation Officer, Independent Evaluation Department N.Gamo, Evaluation Officer, Independent Evaluation Department I. Garganta, Senior Operations Evaluation Assistant, Independent Evaluation Department **Independent Evaluation Department, PE-734**

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The guidelines formally adopted by the Independent Evaluation Department (IED) on avoiding conflict of interest in its independent evaluations were observed in preparing this report. Dr. Kenneth Watson and Mr. Dawa Sherpa were the consultants. Hernike Feig, Principal Evaluation Specialist, IED acted as peer reviewer. To the knowledge of the management of IED, the persons preparing, reviewing, or approving this report had no conflict of interest.

BASIC DATA
Financial Sector Intermediation Facility (Loans 1565-BHU[SF] and 1566-BHU[SF]; and Equity Investment 7139-BHU)

Program Institution Building

TA No.	Technical Assistance Name	Type	Person-Months	Amount ($000)	Approval Date
2902	Capacity Upgrading of Financial Sector Infrastructure and Entrepreneurial Development	AD	13	500	23 Oct 1997

Key Program Data ($ million)	**Appraisal**	**Actual**
ADB Loan Amount—Utilization	4.0[a]	3.9[a]
ADB Loan Amount—Cancellation	-	-
Key Project Data ($ million)		
ADB Loan Amount—Utilization	4.0[a]	3.8[b]
ADB Loan Amount—Cancellation	–	[c]
Key Equity Investment Data ($ million)		
Approved		0.790[d]
Subscribed		0.534[e]

Key Dates	**Expected**	**Actual**
Fact-Finding		14-23 January 1997
Appraisal		21-30 July 1997
Loan Negotiations		17-18 September 1997
Board Approval		23 October 1997
Loan Agreement		20 April 1998
Loan Effectiveness	19 July 1998	20 April 1998
Program Loan Tranche Release		
First Tranche	20 April 1998	30 June 1998
Second Tranche	20 October 1999	23 December 2002
Program Completion	30 June 2002	23 December 2002
Loan Closing		
Loan 1565	30 June 2002	23 December 2002
Loan 1566	24 July 2002	9 January 2003
Months (effectiveness to completion)	48	56

Borrower	Government of Bhutan
Executing Agency	Royal Monetary Authority

Mission Data

Type of Mission	**No. of Missions**	**No. of Person-Days**
Fact-Finding	1	36
Appraisal	1	20
Project Administration		
Review	9	31
Program Completion	1	6
Independent Evaluation	1	48

[a] Equivalent to SDR 2,939,000 at the time of loan approval and closing.
[b] Equivalent to SDR 2,932,248.23 at the time of loan closing
[c] Equivalent to SDR 6.751.77 or $9,145.81.
[d] Equivalent to Nu28.264 million.
[e] Equivalent to Nu22.725 million.
AD = advisory, ADB = Asian Development Bank, BHU = Bhutan, Nu = ngultrum, SDR = special drawing right, SF = special fund, TA = technical assistance

EXECUTIVE SUMMARY

In the mid-1990s, Bhutan's financial system was heavily burdened with nonperforming loans (NPLs) that, on average across all financial institutions, were close to 40% of outstanding loans. Other key problems in the financial sector included limited institutional capacities, evidenced by weaknesses in basic financial systems and practices, and limited access by small and medium enterprises (SMEs) to credit, especially in rural areas. It was therefore imperative to strengthen the financial institutions in many basic ways, to move toward a market-based system as distinct from a centrally administered system, and to privatize financial institutions. However, these reforms needed to be balanced with stronger supervision. It was in this context that the Financial Sector Intermediation Facility (FSIF) was designed and its main objectives were to promote an efficient and competitive financial sector and encourage private sector development through the removal of policy impediments to private sector development, improvements in the efficiency of resource allocation, the establishment of an enabling legal framework for the financial sector and for private business activities, and enhancements in private entrepreneurship and management skills, and access to market information.

The FSIF was approved in October 1997 and was structured as a sector development program consisting of four components: (i) a policy-based program loan of $4 million to the Royal Government of Bhutan (RGoB) to support policy reforms in the financial sector and the private sector, and to support the privatization of Bhutan National Bank (BNB); (ii) a development finance loan of $4 million to RGoB, to be administered by the Ministry of Finance, as a credit facility for participating financial institutions; (iii) an equity investment of up to $790,000 in the common shares of BNB; and (iv) a technical assistance grant of $500,000 to upgrade the institutional capacities of financial institutions in Bhutan.

Overall, the FSIF was rated *partly successful.* This was based on the partly successful ratings of each of the public sector components, namely the policy-based program loan, the development finance loan, and the technical assistance grant, and the successful rating of the equity investment in BNB. The partly successful ratings of the three public sector components were in turn based on overall assessments of *relevant*, *less effective*, *less efficient*, and *less likely sustainable*. On the other hand, the successful rating of the equity investment in BNB resulted from *excellent* ratings in ADB profitability and ADB work quality, and *satisfactory* ratings in development impact and ADB additionality.

The FSIF was deemed *relevant* as its objectives were congruent with RGoB's Development Policy Letter, RGoB's financial sector strategy, and ADB's country strategy for Bhutan. However, the FSIF was limited by insufficient depth in the analysis of underlying problems, and the absence of a cohesive strategy for the financial sector based on the best options to address its structural problems. Reforms were piecemeal. Stronger analysis of Bhutan's financial sector should have preceded the design of the FSIF to avoid design weaknesses and subsequent delays.

The FSIF was rated *less effective* because many outcomes envisaged at appraisal were not achieved. For instance, under the program loan several laws were approved, but some of them have not been implemented, partly because of deficiencies in the approved laws. In other instances, the outputs were achieved but they did not translate into meaningful outcomes. For instance, despite the liberalization of interest rates and the removal of administered sectoral interest rate controls, there has not been any real change in interest rate levels or any competition in the setting of rates. The development finance loan was *less effective* because the funds were lent to urban SMEs instead of the original target of rural agricultural enterprises.

There was also insufficient evidence that permanent jobs were created or that SMEs expanded their operations as a result of the loans.

The FSIF was rated *less efficient*. The release of the second tranche of the policy-based program loan was delayed by three years because of RGoB's delay in complying with the condition relating to a foreign direct investment (FDI) policy. However, the completion of the development finance loan was delayed by only a few months. As for the technical assistance, some consultants had to be changed, completion was delayed by more than three years, and some of the budget was unspent and diverted to another use.

The FSIF was assessed as *less likely sustainable*. Some of the policy conditions of the program loan were met only in a formal way rather than as deep-rooted substantive changes. The FDI Policy (2002) and regulations (2005) were in place for only three years before the RGoB initiated a major review and revision (2008), which was still underway, as of August 2010.[1] The financial sustainability of Bhutan Development Finance Corporation (BDFC) continues to be in question because of high and volatile NPL rates. BDFC in particular appears to be dependent on government subsidies, with periodic infusions of new capital to cover write-offs.

ADB performance was assessed as *satisfactory* by the project completion report (PCR) for the FSIF, and ADB's Independent Evaluation Department (IED) confirms this rating, with some qualifications. ADB focused on important issues, put a broad facility in place to address them, and conducted operations efficiently. However, it should have undertaken a more detailed analysis and been more involved in the policy substance of its tranche release conditions.

Since the equity investment in BNB was a nonsovereign operation, it was evaluated on a different set of criteria. Its development impact was assessed as *satisfactory*. The partial privatization of BNB resulted in a structural change for the better in the credit market in Bhutan. For the first time, there was a commercial bank that was not wholly owned and controlled by RGoB and its agencies. This contributed to greater depth in the loans market and also led to a gradual change in banking culture towards more attention to customer service. ADB's profitability was rated *excellent* because of the investment's high financial internal rate of return (FIRR) of 31.8%. ADB received $1.7 million in divestment proceeds and $745,847 in cash dividends as against its investment of $509,063.[2] The quality of ADB work on its equity investment in BNB was *excellent*. The investment was well designed, well linked with the FSIF policy-based program loan, and well executed. ADB deserves particular credit for insisting on the ultimate divestiture of its shares to the public rather than to RGoB and its agencies. ADB's additionality was *satisfactory.* It helped clean up BNB's NPLs and added to the credibility of BNB through direct investment in shares and participation on the BNB board. These factors were important to the partial privatization of BNB. However, ADB had limited impact on BNB's business strategy and operations during the investment period.

Several lessons can be learned from the design and implementation of the FSIF. A lesson from the program loan is that insufficient analytical underpinnings could lead to formal rather than substantive compliance with tranche release conditions. Joint undertakings with other donors and RGoB might have strengthened the substantive analysis of policies and the

[1] The Ministry of Economic Affairs commented that "Policies and regulations are being reviewed to make it contextual and relevant to changes that have taken place in sectors and overall development. The FDI Policy review initiated in 2008 is to improve on the FDI Policy 2002 and not restart the process from scratch."

[2] The original investment was valued at $533,565 but this was revalued to $509,063 based on the exchange rate at the time of divestment for purposes of computing for the gain or loss on the sale of the investment.

robustness of the dialogue with RGoB. The failure to establish a credit information bureau and to liberalize interest rates provides other examples of the consequences of poor analysis. The development finance loan also lacked a good understanding of the real problems behind the lack of credit to SMEs. A lesson from the investment in BNB is that a small equity investment can have a large impact in the right circumstances, especially if it is supported by technical assistance and policy reforms. Another lesson is that if ADB brings a private partner into the deal, it needs to be sure that there are adequate incentives and safeguards in the contract for that partner to stay the course.

The findings of this evaluation of the FSIF should be considered in conjunction with ongoing ADB operations in the country, particularly the Micro, Small and Medium Enterprises Sector Development Program, and when the next phase of ADB's involvement in the financial sector in Bhutan is designed.

H. Satish Rao
Director General
Independent Evaluation Department

I. INTRODUCTION

A. Evaluation Purpose, Process and Limitations

1. The Financial Sector Intermediation Facility (FSIF) to the Kingdom of Bhutan had four components: a policy-based program loan of $4 million, a development finance loan of $4 million, an equity investment in Bhutan National Bank (BNB) in the amount of $790,000 and a technical assistance (TA) grant in the amount of $500,000. It was approved in 1997[1] and was substantially completed by 2003, with one component active until 2006.

2. This is the program performance evaluation report (PPER) for the FSIF, covering all four components. The Independent Evaluation Department (IED) of the Asian Development Bank (ADB) prepared this report for three main reasons. First, the FSIF was the first sector development program and the first major finance sector intervention of ADB in Bhutan, and so it is important to assess the appropriateness of this particular modality and the impact of the program on the development of the financial sector in Bhutan. Second, the PPER served as an input to the assessment of the finance sector in the concurrent country assistance program evaluation (CAPE) for Bhutan. Finally, lessons from the experience in designing and implementing the FSIF will help improve ADB's future operations in the financial sector in Bhutan.

3. The PPER is based on a review and analysis of documents, observations and interviews in Bhutan from 7–22 December 2009, and interviews of ADB staff involved in the design and implementation of the FSIF. The evaluation team drew upon approval documents, reports of review missions, and completion reports.[2] In Bhutan, the evaluators interviewed senior managers of the financial institutions that had been supported by the FSIF.[3] They also interviewed officials of departments and central agencies of the Royal Government of Bhutan (RGoB).[4] The evaluators met with representatives of private companies and organizations,[5] and visited 15 small and medium enterprises (SMEs) that had borrowed from the Bhutan Development Finance Corporation (BDFC) against the credit line funded by the FSIF through the Ministry of Finance of the RGoB. The evaluation team also interviewed other development agencies in Bhutan.

4. The FSIF was a complex instrument that included several different interventions, addressed many policy and structural issues in the financial sector, and had substantial interactions with every financial institution in Bhutan, several departments of RGoB, the central bank, the commercial and development banks, the insurance companies, pension funds, and the stock exchange. It was not possible to measure results fully in all the areas that the FSIF

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[1] ADB. 1997. *Report and Recommendation of the President to the Board of Directors: Proposed Loans and Technical Assistance Grant and Proposed Equity Investment to Bhutan for Financial Sector Intermediation Facility*. Manila.

[2] ADB. 2003. *Completion Report: Financial Sector Intermediation Facility in Bhutan.* Manila. ADB. 2004. *Completion Report: Equity Investment in Bhutan National Bank.* Manila.

[3] The Bhutan National Bank, the Bhutan Development Finance Corporation, the Royal Insurance Corporation of Bhutan, the Royal Securities Exchange of Bhutan Ltd. and the National Pension and Provident Fund.

[4] The Royal Monetary Authority, the Ministry of Finance, the Royal Audit Office, the Ministry of Economic Affairs, and the National Statistics Bureau.

[5] In addition to 15 private companies supported by FSIF funds, the evaluation team interviewed the Secretary General of the Bhutan Chamber of Commerce and Industry; the CEO of Bhutan Insurance Ltd. (a newly licensed insurance company); and the CEO designate of Tashi Bank (a commercial bank with in-principle approval for a license).

touched, partly because of time constraints, and partly because many external factors over the past decade have affected the outcomes.

B. Program Objectives

5. The development goal of the FSIF was to (i) promote an efficient and competitive financial sector; and (ii) encourage private sector development. Immediate project objectives included: (i) the removal of policy impediments to private sector development; (ii) improvements in the efficiency of resource allocation; (iii) the establishment of an enabling legal framework for the financial sector and for private business activities; and (iv) enhancements in private entrepreneurship and management skills, and access to market information (see Appendix 1 for the Design and Monitoring Framework of the FSIF).

II. DESIGN AND IMPLEMENTATION

A. Rationale

6. At the time of Program formulation, the contributions of the private sector to economic growth were limited, which was mainly due to stringent Government control over private sector business acitivities, lack of access to credit, an inadequate legal framework for private sector activities, limited entrepreneurial skills, and an inefficient Government-controlled financial system that does not meet private sector credit needs. Also, in the mid-1990s Bhutan's financial system was heavily burdened with nonperforming loans (NPLs) that, on average across all financial institutions, were close to 40%. It was therefore imperative to strengthen the financial institutions in many basic ways, to move toward a market-based system as distinct from a centrally administered system, to privatize financial institutions, and establish an effective banking supervision system. The FSIF was to (i) address key problems in the financial sector, including lack of competition and market-orientation, limited institutional capacities, and limited access by SMEs to credit, especially in rural areas; (ii) support effective policies and institutional frameworks promoting private sector development and investment; and (iii) alleviate a critical shortage of long-term foreign currency resources for private investment.

B. Formulation

7. When ADB analyzed the potential benefits of a second credit line to BDFC in 1997, it became clear that several structural issues could only be satisfactorily addressed by a broad financial sector development program. Therefore, the FSIF was designed with four components:

- (i) A policy-based program loan to RGoB (Loan 1565-BHU[SF]) to support policy reforms in the financial sector and the private sector, and to support the privatization of BNB.
- (ii) A development finance loan (Loan 1566-BHU[SF]) to RGoB. The Ministry of Finance administered this loan as a credit facility for participating financial institutions, of which there was only one, BDFC. BDFC in turn provided 281 loans to SMEs.
- (iii) An equity investment in the common shares of BNB (EI 7139-BHU).
- (iv) A technical assistance (TA) grant to upgrade the institutional capacities of financial institutions in Bhutan (TA 2902-BHU).

8. There was no preparatory technical assistance for the design of the FSIF. However, several TA projects that were concurrent with the FSIF supported implementation of FSIF policy

conditions. These included two TAs to assist the Royal Monetary Authority (RMA) in strengthening its regulatory functions (TA 3212,[6] 1999–2002; TA 3905,[7] 2002–2005); and a general review of the financial sector in Bhutan (TA 3687,[8] 2001–2005). Thus, ADB staff relied on ongoing dialogue to inform the design of the Facility (see Appendix 2 for an overview of ADB interventions in the financial sector in Bhutan).

C. Cost, Financing, and Executing Arrangements

9. ADB approved $4 million for the FSIF program loan, $4 million for a development finance loan, up to $790,000 as an equity investment in BNB, and $500,000 as a TA grant. The equity investment was recovered with profit, and the loans will be reduced by eventual repayment. The RMA was the Executing Agency responsible for financial policy reforms and institutional strengthening. The Ministry of Finance coordinated the work of the ministries and agencies on the reforms and led a steering committee that provided guidance on policy. The FSIF development finance loan was relent by the Borrower, who bore the foreign exchange risk, to BDFC at an interest rate of 7% per annum. BDFC used the funds to make loans to SMEs at interest rates that varied from 12% to 15% per annum, with interest charged quarterly on the declining balance. BDFC loans were generally amortized over five years, and subborrowers report that collateral requirements were high and collateral valuations low.

D. Application of Counterpart Funds

10. The FSIF funds were contributed by ADB in convertible foreign currencies.[9] RGoB used the Ngultrum (Nu) equivalent funds for several purposes, including covering its costs to undertake reforms, buying NPLs from BNB,[10] and providing a line of credit to BDFC for lending to SMEs.

E. Consultants

11. Consultants were engaged under the FSIF to provide technical assistance. An assessment of that work is provided in paragraphs 49 to 54 of this report.

F. Outputs

12. The anticipated outputs of each of the four FSIF components were as follows:

(i) The expected outputs of the policy loan were the achievement of tranche release conditions (Appendix 3), including cleaning up NPLs amounting to about 10% of BNB's portfolio of loans. At the time, about 37% of BNB's loans were non-performing (see paragraphs 34 to 35).

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[6] ADB. 1999. *Technical Assistance to the Kingdom of Bhutan for Strengthening the Banking Supervision Function of the Royal Monetary Authority.* Manila.

[7] ADB. 2002. *Technical Assistance to the Kingdom of Bhutan for Strengthening the Capacity of the Royal Monetary Authority and Royal Securities Exchange of Bhutan*. Manila.

[8] ADB. 2001. *Technical Assistance to the Kingdom of Bhutan for Financial Sector Review.* Manila.

[9] There were no FSIF "counterpart funds" in the sense of matching funds contributed by RGoB or funds generated through mechanisms such as the sale of commodities.

[10] In the case of the policy-based program loan, the main constraint on RGoB's use of the funds was that it must use part of the loan from ADB to "clean up" BNB's non-performing loans. In the event, approximately $1.2 million out of $3.9 million was used to transfer ownership of about one-third of BNB's nonperforming assets to the government. How this level of "clean-up" was decided, and why ADB thought it was satisfactory rather than insisting on a full "bad bank" approach to taking all non-performing assets off BNB books, is unknown.

(ii) The outputs of the development finance loan were to be the incremental loans made by BDFC to SMEs.

(iii) The expected outputs of the equity investment were (i) the privatization of BNB (the unrealized target for private holdings was 66% of all common shares); and (ii) successful internal reforms to strengthen the BNB’s systems and practices.

(iv) The TA was expected to provide analysis, advice, and training, leading to the improved capabilities of financial institutions in Bhutan, primarily the RMA and the Royal Securities and Exchange Commission.

III. ASSESSMENT OF THE PERFORMANCE OF THE FSIF

A. Policy-Based Program Loan

1. Relevance

13. IED rates the FSIF policy-based program loan as *relevant* (Table 1). The project completion report (PCR)[11] rated it *highly relevant*.

14. The program loan’s objectives and many of the supported policy measures were relevant to the development of Bhutan's financial sector and in line with RGoB’s strategy for it, and ADB’s country strategy for Bhutan. Nevertheless, the relevance of the FSIF program loan was somewhat reduced by insufficient depth in the analysis of underlying problems, and the absence of a cohesive sector strategy based on the best options to address financial sector structural problems. Reforms were piecemeal. Fewer conditions with more analytical depth would have produced a better focus on the substance of policies. Stronger analysis of Bhutan’s financial sector issues should have preceded the design of the policy reform program to avoid a number of design weaknesses and subsequent delays.[12]

2. Effectiveness

15. The PCR rated the program loan as *effective* arguing that it was able to introduce several significant policy measures, which included cleaning up BNB’s loan portfolio, revising foreign exchange regulations, improving the industrial and trade licensing systems, liberalizing interest rates, removing government subsidies to the Government Employees Provident Fund (GEPF), and issuing policies and regulations on foreign direct investment (FDI). However, this report finds that a number of expected outputs, mainly pertaining to the approval of effective commercial legislation, were not achieved. IED likewise assessed that outputs have not always translated into meaningful outcomes. For instance, despite the liberalization of interest rates and the removal of administered sectoral interest rate controls, there has not been any real change in interest rate levels or any competition in the setting of rates. IED therefore rates the FSIF program loan as *less effective*. The effectiveness of selected tranche release conditions is discussed in Appendix 4.

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[11] ADB. 2003. *Completion Report: Financial Sector Intermediation Facility in Bhutan*. Manila.

[12] IED noted that ADB commissioned a review of Bhutan's financial sector four years after the approval of the FSIF. This review could have provided valuable material to the reform agenda if it had preceded the program loan.

3. Efficiency

16. IED rates the FSIF program loan *less efficient*. The release of the second tranche was delayed three years because of RGoB's delay in complying with the condition relating to an FDI policy. [13]

4. Sustainability

17. IED rates the FSIF program loan as *less likely sustainable* because some of the tranche release policy conditions were met only in a formal way rather than as deep-rooted substantive changes. Second, the financial sustainability of BDFC continues to be in question because of comparatively high and volatile NPL rates and high concentration in their loan portfolios (although both conditions are less severe at present than in the mid-1990s). The FDI Policy (2002) and regulations (2005) were in place for only three years before the RGoB initiated a major review and revision (2008), which was still underway in late 2009 when the ADB evaluation mission for the FSIF visited Bhutan.[14]

5. Impact

18. The institutional development impact of the FSIF program loan is rated *moderate*. It did not succeed in liberalizing interest rates, nor in achieving majority privatization of BNB, and it achieved only minimal improvements in credit information. It encouraged the RGoB to give RMA powers to enforce compliance with prudential guidelines, but they were not used. It supported a regional system of payments and clearances that, in several locations, was impractical. Nevertheless, the FSIF pointed in the right direction even if it did not fully achieve the impact expected.

6. Overall Assessment

19. Overall, IED rates the FSIF program loan as *partly successful*. It was timely and served to initiate significant changes in the financial sector. The rationale for engagement in the financial sector was strong; and the direction in which it encouraged Bhutan to go was sound. However, it was not sufficiently selective. The many diverse initiatives bundled into it resulted in a lack of focus. The analytical underpinnings of the policy conditions should have been stronger, such as the conditions relating to FDI, industry and import licensing, capital market infrastructure, and the liberalization of interest rates.[15] In the absence of in-depth analysis of policy options, ADB appears to have accepted formal compliance in some instances where a stronger push for substantive reforms to ensure intended outcomes would have been more appropriate.[16]

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[13] The first tranche was released in June 1998 and the second tranche, which was planned to be released in October 1999, was actually released in December 2002.

[14] The Ministry of Economic Affairs commented that "Policies and regulations are being reviewed to make it contextual and relevant to changes that have taken place in sectors and overall development. The FDI Policy review initiated in 2008 is to improve on the FDI Policy 2002 and not restart the process from scratch."

[15] With regard to the FDI policy, the Ministry of Economic Affairs commented that "many lessons have been learnt and adopting a gradual approach is better than rushing to pursue very liberal policies."

[16] An example of the danger of formalistic compliance is the FDI regulations. Three years after the original target date for second tranche release, an ADB Review Mission concluded that RGoB had complied with all the tranche release conditions. The reality was that it took another three years (until 2005) for RGoB to formulate regulations to make the FDI Policy effective.

Table 1: Performance of the FSIF Policy-Based Program Loan

	Rating Values	Weights	Weighted Rating
Relevance	2	0.2	0.4
Effectiveness	1	0.3	0.3
Efficiency	1	0.3	0.3
Sustainability	1	0.2	0.2
Overall Assessment	Partly successful		1.2
Impact	Partly satisfactory		

Rating scale: 0, 1, 2, 3
Overall ratings: Highly successful if weighted score is equal to or greater than 2.7; Successful if weighted score is equal to or greater than 1.6 but less than 2.7; Partly successful if weighted score is equal to or greater than 0.8 but less than 1.6; and Unsuccessful if weighted score is less than 0.8.
Source: Independent Evaluation Mission.

B. Development Finance Loan

20. As part of the FSIF, ADB gave RGoB a loan of SDR 2.939 million (about $4.0 million). With this funding, the Ministry of Finance extended a line of credit to BDFC for on-lending to SMEs.[17] Two hundred and eighty-one urban small business loans were made by BDFC and allocated to the ADB credit line (see Appendix 5 for data on subborrowers).[18]

1. Relevance

21. The development finance loan to RGoB and the consequent credit line to BDFC are rated *partly relevant*. The loan was partly relevant because improving SME access to credit in Bhutan was a high priority for the RGoB, there was a clear need,[19] and it was consistent with ADB's Bhutan strategy. However, its relevance was limited in two ways. First, the evidence that BDFC would not have received a credit line from the Ministry of Finance without the FSIF is mixed. BDFC's ability to obtain funds for on-lending was not its main challenge. Its problem was not liquidity but a disastrous level of NPLs.[20] Second, although the approval documents for the loan specifically mentioned lending for rural and agriculture-related enterprises (footnote 1), the credit line contributed nothing to this core mandate of BDFC (unless one assumes that there was a fungibility effect whereby increased funding by RGoB for the urban sector freed up money for BDFC to lend to rural clients, but this effect is unstudied and unlikely).[21] The credit line was used to fund SMEs concentrated in and around the three main towns. The rural enterprise and agricultural part of the whole BDFC portfolio, by value, declined, and in 2007 was approximately 15%, compared with 24% for housing loans and 28% for loans to service industries.[22] In 2009-2010, BDFC is pursuing an amendment to its banking license to enable it to take deposits in

[17] ADB intended the line of credit to provide funds for SMEs in private industry and agriculture. It expected that both BNB and BDFC would participate equally. In fact only BDFC participated, and only in industry not agriculture. The reason for the concentration in industry was that the Kuwait Fund made funds available to BDFC for the support of agricultural loans, with less reporting than would have been required by ADB.
[18] Procurement carried out under the subprojects followed ADB's procurement guidelines.
[19] RGoB relies on aid flows for about half its national budget, especially for its capital investment budget.
[20] This situation continues. In 2006, for instance, the BDFC Business Plan, 2008-2012, reported that BDFC has "the potential to increase its loan portfolio substantially without having to call up an additional equity infusion by shareholders," page 10.
[21] Until 2005, BDFC operated two distinct businesses, urban industrial credit and rural credit. The rural credit operations were supported by the United Nations Capital Development Fund, the International Fund for Agricultural Development, and RGoB. Urban industrial credit was supported by ADB and the Kuwait Fund. In 2005, the two operations were merged.
[22] BDFC. *Business Plan 2008-2012*. Thimphu.

urban areas, which seems to indicate a strategy that will converge with the commercial banks. In response to BDFC's relative neglect of rural lending, there was discussion of RGoB founding an agricultural bank, although that has not yet happened. The relevance of the credit line was also limited by the fact that it did not significantly improve the constraints on SME access to finance. For example, it was intended to fund long-term loans, but in fact supported loans that were typically amortized over five years as is traditional in Bhutan, and it had no effect on other factors limiting access to credit, such as interest rates and collateral requirements.

2. Effectiveness

22. The credit line is rated *less effective.* The main metric of effectiveness was the number of jobs created and SMEs expanded. There has been no measurement of the degree of expansion of the SMEs that received loans, but IED observed limited expansion among the 15 businesses visited in Bhutan in 2009—most were stable, small, and often family businesses. The PCR stated that 1,830 incremental jobs were created by the SMEs that received loans.[23] Several points need to be highlighted. First, the PCR states that six subprojects were visited and that five of those subprojects had 75 staff in total. In 2009, six years later, IED visited the same five enterprises and found staff to be about half the number claimed in the PCR. Second, the data are biased because of selection. In essence, BDFC selected the best cases from its applicant flow to allocate to the ADB credit line, and also selected cases as a sample for ADB teams to visit subsequently. This type of selectivity is likely to mask the true incremental effect of the credit line. Third, the data are based upon unverified claims by the borrowers as reported by BDFC officers. Fourth, the simple idea of a "job created" does not always fit the Bhutanese reality. During site visits, IED observed, for example, that some of the labor used by some SMEs is temporary or seasonal, and, in part, comprises Indian workers provided by labor agents and working without security for low wages and sometimes in unsafe conditions.

23. BDFC staff received on-the-job training in loan appraisal by a consultant funded by ADB. However, BDFC reports that it did not apply ADB procedures to the analysis of other loan applications, since the methods were regarded as unnecessarily complex. The PCR agreed with this view, and suggested reconsidering the requirement for calculating an economic internal rate of return (EIRR) on subloans, even for those few that were larger than the free limit of $50,000.[24] This suggestion was made because BDFC had difficulty calculating the EIRR and because an EIRR was not needed as an input to the lending decision.[25] IED agrees with these points as it is clearly impractical to estimate the EIRR for single small loans. Nevertheless, there is a need to assess whether subprojects benefit from tax incentives and subsidies that distort their underlying economic feasibility and/or would result in financial performance problems if removed. The analysis would also depend on the type of labor, the shadow price of labor in Bhutan, and on estimates of some important external costs of the subloan enterprises, including the costs of environmental and safety problems observed by the IED team in some instances.

3. Efficiency

24. The credit line is rated *less efficient*. The procedural and logistical efficiency of the development finance loan was adequate, with some qualifications. On the positive side, loan

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[23] ADB. 2003. *Completion Report: Financial Sector Intermediation Facility in Bhutan*. Manila. Page 10, para. 44.

[24] Project Agreement, 20 April 1998, Section 2.02.

[25] ADB. 2003. *Completion Report: Financial Sector Intermediation Facility in Bhutan.* Manila. Page 14, para. 60. "Considering BDFC's difficulty in computing subprojects' economic internal rate of return, it may be worth examining the need for such a covenant in future financial intermediation loans as this data is difficult to compile and is not needed for credit decisions."

disbursement was not significantly delayed, the targeted completion date being July 2002 while the actual completion was in December 2002. However, efficiency was compromised in three main ways: (i) the line of credit required loan appraisal procedures that BDFC believes were too complex for the sizes and types of loans;[26] (ii) approval and reimbursement from ADB HQ were slow in the opinion of the present BDFC senior management; and (iii) BDFC application procedures were themselves slow, partly because of the lack of a credit information bureau.

25. The PCR should have presented an estimate of the EIRR of the FSIF as a whole, since data at that time would have supported this analysis. It would have been possible to select a stratified random sample of FSIF subloans as the basis of an estimate of its economic impacts including labor effects and externalities, although this would have involved substantial research. A much larger sample of subborrowers would have had to be examined more rigorously.[27] IED attempted to study a random sample of subborrowers in 2009, but found this impossible because BDFC records of the subborrowers had deteriorated, partly because of changes to its systems and software.

4. Sustainability

26. BDFC claims that the loans provided with ADB support had very low nonperformance rates. However, those rates are not a plausible measure of sustainability because of the strong selection bias in the data. The strongest loan applications were notionally allocated by BDFC to the FSIF credit line. The true marginal effect of the FSIF funds on BDFC's portfolio is, therefore, unknown.[28] Assuming that FSIF funds were fully fungible, the best measure of loan performance and sustainability would be BDFC's overall performance and sustainability. The BDFC's sustainability is low, because it has a very high ratio of nonperforming to performing loans. In 2009 its NPL ratio was about 19%. This rate of NPLs is much higher than could be sustained by BDFC's gross margin (before loan loss provisions). BDFC's sustainability appears to be dependent on indirect government subsidies, with periodic infusions of new capital to cover write-offs. Open and transparent subsidies of the interest rates or terms and conditions of micro, small and medium enterprise (MSME) loans, with rigorous loan application assessment and repayment collection procedures, would have been preferable. Without better evidence of the specific incremental effect of the FSIF, the overall low sustainability of BDFC operations must stand as a proxy for the FSIF as well. On this basis, the development finance loan is rated *less likely sustainable*.

27. The ADB-financed loans comprised about one-third of BDFC's industrial and urban loans between 1998 and 2002.[29] They were selected from the applicant flow to present to ADB because they were the most likely to fit the ADB criteria. As a result of this selectivity, the 281

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[26] IED Mission Contact Report 9: "The loan-by-loan approval procedures required by the ADB were time consuming and too complex for many borrowers (BDFC gave examples of agricultural borrowers, but, of course, ADB did not provide funds for agricultural loans). These appraisal procedures were not duplicated for the Kuwait Fund, the other line of credit utilized by BDFC at the time, nor carried on in detail by BDFC afterwards."

[27] The PCR team visited 6 subborrowers in 2002-2003, and, the IED PPER team visited 15 in 2009-2010 (including 5 of the 6 visited by the PCR team.)

[28] The loans nominally allocated to the FSIF funds are not a good indication of the true effect of the FSIF funds on BDFC's portfolio of loans. These loans would probably have been made anyway. New funds that enable a bank to expand its lending are best regarded as having produced the marginal loans that would not have been made without the new funding. Since there was no baseline study, one has no reliable measures of what these marginal loans were. Therefore, the most reasonable assumption may be that BDFC's overall average NPL ratio is the best available measure of the sustainability of the FSIF-funded activities as well.

[29] See BTOR, December 2009, Contact Report Number 9, discussion with Managing Director, BDFC, Deputy Managing Director; and General Manager, Credit Division, BDFC.

loans under the FSIF had low NPLs by BDFC standards. The recovery rate reported by BDFC was greater than 90%. IED was told that about 70% of the loans were fully repaid and closed, and about 20% to 30% rolled over and retained as ongoing clients. BDFC's overall NPL ratio improved after 1997. It is unknown how much of the improvement was due to improved lending practices and how much to capital infusions and write-offs. In 2009, 19% of BDFC's loans, by value, were still nonperforming.[30] This was after a Nu100 million recapitalization by the government and write-offs of the most hopeless recovery cases. In 2009, BDFC promised the government, as part of its application for an amended banking license, that it would reduce its NPL rate to 13%. The government was asking for 10%. Even at 10% NPLs, BDFC would not be sustainable without government subsidies; but an appropriate system of transparent subsidies of BDFC's social mission[31] has not yet been put in place.

28. The Loan Agreement for the development finance loan states that each qualified subproject must meet certain criteria including a "minimum financial internal rate of return higher than the weighted cost of capital." IED understands this to mean that the loan must make sense from the point of view of both BDFC and the subborrower. BDFC has generally paid approximately 7% per year for funds from the Ministry of Finance. Therefore, to meet this condition, BDFC must lend funds at this rate plus a premium to cover all operating costs. The interest rate spread has been about 5% to 8%. Second, the subborrower's project must earn a financial return greater than the interest rate he or she pays to BDFC—that is, higher than the 12% to 14% rates being charged. This is a high rate and it is clear from the sample of 15 subborrowers whom IED visited that many struggle to achieve financial returns at this level and a significant number will not borrow again to invest further in their business because the interest cost is greater than the gross returns on their investment.

5. Impact

29. **Institutional Development**. The development finance loan had *negligible impact* on the institutional development of BDFC. BDFC learned about the subloan appraisal procedures that ADB required (with ADB training assistance under other TA projects); but these procedures were not adopted more broadly by BDFC.

30. **Impact on Access to Credit**. At the end of 2002, the FSIF funding was associated with approximately 17% of BDFC's loans outstanding.[32] However, the true incremental impact of the line of credit on the access of MSMEs to credit is difficult to judge. By and large, the Bhutanese financial institutions have had high liquidity. Access to credit appears to have been constrained more by high interest rates than by liquidity constraints, and the FSIF appears to have had no impact on interest rates. Scale is also relevant. At the national level, the line of credit funded by the FSIF was too small to have a significant impact. In January 2003, the total assets of the commercial banks in Bhutan stood at approximately Nu1.62 billion (approximately $360 million),[33] so the market-wide increment of credit resulting from the FSIF was small (about 1%). Lastly, there was little uniqueness about the BDFC loans. They were made on commercial terms to small and medium urban businesses and were similar to loans made by the commercial banks.

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[30] Interview with Deputy General Manager, BDFC, Finance and Accounts, 31 December 2009. See IED Mission Contact Report 9.
[31] BDFC has a public policy mandate in addition to its commercial objectives.
[32] BDFC. 2008. *Annual Report.* Page 33, figures for 2002.
[33] RMA data quoted by the IMF, April 4, 2007. *Liquidity Management and Money Market Development*. Table 1.

31. The availability of foreign exchange was not significantly affected.[34] At the small scale of the FSIF, there is no evidence of a shortage of foreign-currency funds for SMEs to import equipment for business investments in Bhutan between 1997 and 2003. In fact, ADB documents note the opposite—excessive liquidity in the financial system (in part created by development aid) and large holdings of Indian rupees by Bhutanese financial institutions. Ninety-seven percent of the equipment imports by FSIF-funded subprojects were from India.[35]

6. Overall Assessment

32. This development finance loan is rated *partly successful* (see Table 2). It achieved some of its objectives but not others. To the modest extent that the subloans may have made an incremental difference to SME access to credit, they made a contribution to the growth of the private sector in Bhutan. In the absence of a baseline study to establish the counter-factual volume of lending, it is impossible to tell what the incremental impact was. It is clear, however, that there was no effect on some key problems of SME access to credit, including limited reach outside the main towns, high interest rates that were not responsive to differences in the risk profiles of borrowers, short amortization periods, and high collateral requirements coupled with low valuations of collateral assets. This outcome is to be expected since the concessionary element of the ADB loan benefited RGoB but was not passed on to BDFC or to SMEs.

Table 2: Performance of the FSIF Development Finance Loan

	Rating	Weights	Weighted Ratings
Relevance	1	0.2	0.2
Effectiveness	1	0.3	0.3
Efficiency	1	0.3	0.3
Sustainability	1	0.2	0.2
Overall Assessment	Partly Successful		1.0
Impact	Negligible		

Rating scale: 0, 1, 2, 3
Overall Assessment: Highly successful if weighted score is equal to or greater than 2.7; Successful if weighted score is equal to or greater than 1.6 but less than 2.7; Partly successful if weighted score is equal to or greater than 0.8 but less than 1.6; and Unsuccessful if weighted score is less than 0.8.
Source: Independent Evaluation Mission

C. Equity Investment in BNB

33. In 1997, the ADB Board approved an equity investment in the common shares of Bhutan National Bank (BNB). Before purchasing shares, ADB conducted a search for other potential private investors who might facilitate privatization of BNB and strengthen its board. Consequently, Citicorp made an equity investment for about the same number of shares as ADB for 20.1% of the shares. ADB's objective was to move BNB into the private sector, with at least 66% of common shares held privately, but this was only partly realized.

34. As a precursor to its equity investment in BNB, ADB agreed to provide funds to RGoB to clean up BNB's portfolio of assets by purchasing about one-third of its NPLs. The clean-up was a first-tranche release condition of the FSIF policy-based program loan (footnote1). It was

[34] Foreign exchange holdings at December 2002 stood at Nu 5.3 billion.
[35] ADB. 2003. *Completion Report: Financial Sector Intermediation Facility in Bhutan*. Manila. Page 6, para. 26.

agreed that a substantial portion of ADB's program loan funds would be used by RGoB, the owner of BNB,[36] to purchase part of the NPL portfolio of that bank for the full value of the unpaid principal.

35. The clean-up process was as follows. RGoB purchased NPLs from BNB at full value. This reduced BNB's NPL ratio from 37.0% to 26.7%. The transfer of ownership of the NPLs was executed on 31 December 1997. RGoB left BNB with the responsibility of recovering as much as possible from these NPLs and remitting the proceeds annually to RGoB. Interest payments on the loans in the NPL portfolio were frozen (waived).

36. ADB's effective involvement as a shareholder of BNB lasted for about five years, from 1998 to 2003, although full divestiture was not completed until December 2006. In June 2003, ADB declined to participate in a rights offering by BNB and its allocation was offered to the public. ADB's holdings were thereby diluted to 10.05% of the outstanding common shares; and public shareholdings rose to 38.63%.[37] In June 2004, ADB approved the sale of its shares to the public, with an allocation of about 25% offered to the staff of BNB. The latter allocation was undersubscribed by a small amount[38] and the shares not purchased by staff were released to the public.

1. Rationale and Objectives

37. In 1995 and 1996, ADB had assisted in the conversion of the Unit Trust of Bhutan to bank status (Bhutan National Bank).[39] The rationale for further intervention in 1997 was to privatize BNB and to help put the new bank on a sound financial basis by cleaning up its NPLs. These were, in many cases, legacy assets from the Unit Trust of Bhutan. It was also hoped that ADB's and Citicorp's participation on the BNB board would help reform its structures, policies, and procedures, and thereby contribute to its long-term viability. The relevant[40] objective was to help establish the first private commercial bank in Bhutan on a sound basis. ADB's "aim (was) to increase the private sector's share in BNB to at least two-thirds."[41]

2. Development Impact

38. The development impact of ADB's investment in BNB was rated as *satisfactory*. The main development impact of ADB's investment in BNB was a structural change for the better in the credit market in Bhutan. On this criterion, the investment performed satisfactorily. For the first time, there was a commercial bank that was not wholly owned and controlled by RGoB and its agencies. This contributed to greater depth in the loans market and also led to a gradual change in banking culture towards more attention to customer service. However, the development impact objectives of the FSIF were not fully achieved because privatization remains partial.

[36] At the time, BNB was owned by RGoB, the National Pension and Provident Fund (NPPF), the Bhutan Trust Fund, and the Royal Insurance Corporation of Bhutan (RICB), all owned and/or controlled by RGoB.

[37] ADB. 2004. *Completion Report: Equity Investment in Bhutan National Bank.* Manila. Page 4, para. 18.

[38] A constraint on BNB staff buying shares was the government prohibition on any bank lending to its own staff for this purpose; and the impracticality of a BNB staff member borrowing from another financial institution to buy BNB shares.

[39] ADB. 1995. *Technical Assistance to Bhutan for Conversion of the Unit Trust of Bhutan to the Bhutan National Bank*. Manila.

[40] The stated objectives of ADB's investment in BNB common shares included supporting financial sector reforms, increasing competition, and promoting trade and exports. What the equity investment had to do with exports is not clear.

[41] MOU FSIF Fact Finding Mission, January 1997, page 1.

39. ADB's impact on the soundness of BNB's balance sheet and financial strategy is not clear. During the period in which the ADB had an ownership interest in BNB, the bank pursued growth rather than profitability, but at the same time paid high dividends to its shareholders, including ADB and Citicorp. These actions are somewhat inconsistent; and the results were mixed. On many measures, the performance of BNB declined in the five years following the ADB equity investment.[42] Return on average assets fell from 4.9% in FY1998 to 1.3% in FY2002. Return on average equity fell from 30.3% to 11.7%. The loans-to-deposits ratio fell from 65.9% to 40.7%. Nevertheless, BNB was growing rapidly, and its total assets increased from Nu1.4 billion in FY1998 to Nu 5.063 billion in FY2002.

40. ADB's efforts to increase the private sector's share in BNB to at least two-thirds[43] were only partly successful. Before ADB's intervention, RGoB held 67.2% of BNB shares.[44] In 2009, private shareholders still hold less than a majority (48.6%). The majority of shares are still held by RGoB and agencies that it controls;[45] and the BNB board is still dominated by government appointees.

41. Citicorp was ADB's partner in the attempted privatization of BNB. Therefore, its early divestiture of its shares in May 2001, selling to two state enterprises,[46] was a disappointment to ADB. Citicorp sold its shares without notifying ADB, although the shareholders' agreement specified that notification was required. This ended hopes of ongoing benefits to BNB from the expertise of Citicorp, although, to be clear, these hopes were not significantly born out during Citicorp's tenure as a minority shareholder because of its low level of involvement with the board and management. The capital gain to Citicorp was substantial and in part due to ADB's funding of the clean-up of BNB's NPLs. ADB did not take legal action to recover from Citicorp, but the PCR noted that in future ADB should endeavor to obtain stronger assurances from any private sector partner in similar circumstances. However, despite its expressed displeasure with Citicorp's early exit, ADB allowed its own shareholdings to be diluted by half barely two years later, setting the scene for full divestiture. There appears to have been some dissonance between ADB's desire for a high rate of return on its investment and its desire to influence development outcomes in Bhutan. By selling its shares and giving up its seat on the board of BNB, ADB may have lost a special window on the financial sector in Bhutan and a lever for reform that may now pass to the World Bank/International Finance Corporation.[47] Nevertheless, given its core objective of privatization, ADB deserves credit for insisting on divesting its shares to the public rather than to RGoB and public sector agencies.

42. An ADB staff member with good credentials to be a board member of a commercial bank was available in the Kathmandu office. She sat on the BNB board for ADB in the role of an independent director. As a result of ADB's investment[48] and participation, BNB developed a new credit manual, and strengthened the ethics policy for the board as well as the BNB's audit policies and procedures. However, BNB senior management, in 2009, did not think that ADB's

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[42] ADB. 2004. *Completion Report: Equity Investment in Bhutan National Bank.* Manila. Page 6, Table 1.
[43] MOU FSIF Fact Finding Mission (Jan. 1997). Page 1.
[44] MOU FSIF Fact Finding Mission (Jan. 1997) . Page 17, Table 6.
[45] At December 2009 shareholdings were as follows: the National Pension and Provident Fund (NPPF) 25.7%; RGoB 13.6%; the Bhutan Trust Fund (BTF) 10%; the Royal Insurance Corporation of Bhutan (RICB) 2.1%; public 48.6% (See Contact Report Number 11, 11 December 2009.
[46] NPPF and Bhutan Trust Fund.
[47] In 2009 the World Bank/IFC expressed interest in making an equity investment in BNB of 20% of the outstanding shares.
[48] ADB's interest in BNB initially represented 20% of the total company shareholdings. ADB's holding was diluted to 10% only on the third year.

participation had had a significant impact on BNB's strategy, policies or structures. This may have been partly due to the focus of the BNB board on loan application reviews rather than on strategic issues, thus limiting the opportunities available to ADB's nominee to influence reform.

3. The Profitability of ADB's Investment

43. The profitability of ADB's investment in BNB is rated *excellent.* IED computed a high financial internal rate of return (FIRR) on the investment.

44. The high level of dividends made a major contribution to ADB's profit but was costly for BNB.[49] From an interview with the ADB staff member who sat on the BNB board, IED understands that ADB argued against the high dividends but was outvoted, the majority opinion being that future small investors in BNB would not invest unless there was a history of high dividends. This does not seem a particularly strong argument since few BNB shares are traded.

4. ADB's Work Quality

45. The quality of ADB's work on its equity investment was *excellent*. The investment was well designed, well linked with the FSIF policy-based program loan, and well executed. The PCR noted that "for countries like Bhutan, relatively far from ADB headquarters, involvement of ADB's resident mission makes sense if its staff has relevant private sector experience."[50] ADB was fortunate in this instance since it was represented by a well-qualified staff member working at the Nepal Resident Mission who was available to take on the role at that time. ADB deserves particular credit for insisting on the ultimate divestiture of its shares to the public rather than to RGoB and its agencies. There are some minor qualifications. For instance, the attempt to involve Citicorp substantively was not successful and ADB was unaware of Citicorp's planned divestiture until it was a *fait accompli*.

5. ADB's Additionality

46. ADB's additionality was *satisfactory.* It helped clean up BNB's NPLs and added to the credibility of BNB through direct investment in shares and by participation on the BNB board.[51] These factors were important to the partial privatization of BNB. ADB's eventual divestiture of its shareholding to the public was also an important step. However, according to BNB officials, ADB generally had limited impact on BNB's business strategy and operations during the investment period, although it made contributions to its ethics, audit and credit policies.

47. In summary, ADB's equity investment in BNB was *successful* (see Table 3). Stabilization and partial privatization of BNB was a high policy priority and was achieved. It was important, from all points of view, that the first efforts to create a private commercial bank should succeed. From a purely investment standpoint, ADB's investment in BNB was excellent, with a high FIRR.

48. There are some caveats. Although BNB grew rapidly after ADB's investment, its financial condition deteriorated on several indicators. ADB's involvement on the BNB board had some positive influence, but did not lead to major reforms. Also, ADB involvement was not sustained, since it divested after about five years. The presence of a genuinely strategic investor might

[49] From the time of ADB's investment in BNB, 1997, until 2003, BNB was thinly capitalized. This was mainly because of the high dividends paid during that period, ranging from 50% of the net profit in 1999 to 37% in 2002.
[50] ADB. 2003. *Completion Report: Financial Sector Intermediation Facility in Bhutan*. Manila. Page 8, para. 33.
[51] BNB's initial public offering had been undersubscribed indicating a lack of pubic confidence in the bank before ADB's intervention.

have helped enhance BNB's commercial orientation, operations and systems. As it turned out ADB's co-investor acted more like a financial than a strategic investor in this particular transaction.

Table 3: Performance Rating Equity Investment in BNB

Evaluation Criteria	Criterion Rating
Criterion 1: Development Impact	Satisfactory
Criterion 2: ADB's Investment Profitability	Excellent
Criterion 3: ADB's Work Quality	Excellent
Criterion 4: ADB's Additionality	Satisfactory
Overall Rating of this Component of the FSIF	Successful

Note: The equity investment in Bhutan National Bank was assessed against ADB's non-sovereign investment performance criteria.

IV. OTHER ASSESSMENTS

A. Technical Assistance

49. As part of the FSIF, ADB approved a TA grant for $500,000, of which $400,729 was utilized. The objective was to upgrade the institutional capacities of the financial institutions involved in the FSIF. The TA letter of agreement was signed in December 1997 and the TA was active from August 1998 to January 2002. Its main product was a consultants' report presented in January 2000.[52] Since the budget was not fully utilized, the TA was amended to fund a study tour by RMA staff to central banks in three neighboring states. No evaluation of that study tour is available.

1. Relevance

50. The TA was rated as *relevant*. The main consultants' report was wide-ranging.[53] It had chapters, authored by different members of the nine-person consultant team on:

- (i) private sector development;
- (ii) central bank and financial institutions, including the organization of the central bank, monetary policy and management of reserves, financial institutions supervision, a clearinghouse interbank market and credit information bureau, a negotiable instruments law, and loan swaps from BNB to the government;
- (iii) the securities market, including regulation, a central depository, and participant disclosure; and
- (iv) training programs for credit officers and business people.

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[52] Private Enterprise Development Corporation of Asia (Philippines) and Aries Group (USA). 2000. *Bhutan: Capacity Upgrading of Financial Sector Infrastructure and Entrepreneurial Development Project*. The recruitment of consultants under the attached technical assistance was generally in line with ADB's Guidelines on the Use of Consultants.

[53] The recommendations of the technical assistance team touched on private sector development, operations of the RMA and financial institutions, the securities market, training programs and pension reform. Prudential guidelines were revised. The *Moveable and Immovable Property Act and Bankruptcy Act* were passed in 1999, and the *Negotiable Instruments Act* and *Amendments to Companies Act* in July 2000. A cheque clearinghouse was established in January 1997. Procedures were established to improve management of foreign exchange reserves and liquidity.

2. Effectiveness

51. The TA is rated *less effective* in achieving its intended objectives. The PCR concluded that the TA could be rated effective as it facilitated compliance with the related tranche release conditions under the policy-based program. However, "more thought should have been given to the expertise required"[54] before engaging consultants.

52. The TA should be assessed as part of a longer series of TA projects by the ADB that began in the late 1980s and is still continuing. In this wider context, it is clear from interviews that ADB was a trusted advisor to RGoB during a challenging period of rapid institutional change, and its advice on the financial sector was influential. Many of the recommendations of this TA indicated directions in which RGoB moved over the following decade. One example is the recommendation that a credit information bureau (CIB) be established. It took another decade but eventually, in 2010, CIB was operational. The consultants' report makes numerous recommendations for actions, both large and small, to be undertaken by many different actors and organizations. On the whole, the recommendations are well argued. However there is no clear focus and little sense of priorities, sequencing, institutional readiness or costs. The report is an unintegrated compendium of the observations and opinions of different consultants with various interests and views. Much of it is insightful; but some of it is a basic text on credit analysis. The recommendations are not listed in a summary and there is no management action plan recorded. Overall, the TA was a diffuse effort that, nevertheless, produced some good advice. The degree to which that advice was influential relative to other factors is impossible to tell a decade later.

3. Efficiency

53. The TA project was rated *less efficient* because some consultants had to be changed, completion was somewhat delayed, and 19.9% of the budget was unspent and diverted to another use.

4. Sustainability

54. The TA project's sustainability was rated *less likely* because some advice was accepted and acted upon, but some was not (for example, establishing a CIB) and some was not based on adequate analysis (clearinghouses and FDI policy, for example).

Table 4: Performance of FSIF Technical Assistance

	Rating	Weights	Weighted Ratings
Relevance	2	0.2	0.4
Effectiveness	1	0.3	0.3
Efficiency	1	0.3	0.3
Sustainability	1	0.2	0.2
Weighted Average Rating	Partly Successful		1.2
Impact	Modest		

Rating scale: 0, 1, 2, 3

Overall Assessment: Highly successful if weighted score is equal to or greater than 2.7; Successful if weighted score is equal to or greater than 1.6 but less than 2.7; Partly successful if weighted score is equal to or greater than 0.8 but less than 1.6; and Unsuccessful if weighted score is less than 0.8.

Source: Independent Evaluation Mission

[54] ADB. 2003. *Completion Report: Financial Sector Intermediation Facility in Bhutan*. Manila. Appendix 7, para. 6.

B. ADB Performance

55. ADB performance was assessed as *satisfactory* by the FSIF PCR. IED confirms this rating, with some qualifications. ADB focused on important issues, put a broad facility in place to address them, and conducted operations efficiently. However, it should have invested more in analysis and been more involved in the policy substance of its tranche release conditions. A resident mission in Thimphu might have improved ADB's performance.

V. OVERALL ASSESSMENT, ISSUES, LESSONS, AND FOLLOW-UP ACTIONS

A. Assessment of Achievement of Objectives

56. The ultimate objective of the FSIF was to help strengthen the private sector in Bhutan. Both the economy and credit to the private sector in Bhutan grew rapidly during the FSIF period and afterwards. However, growth was concentrated in hydro power, not SMEs. SMEs continue to believe that they are underserved by the financial sector, as demonstrated by poor ratings in the World Bank's *Doing Business* index.

57. The FSIF failed to improve access to long-term credit especially in rural areas. There was no impact on rural credit and no impact on the length of loan amortization. The increment of funds available to BDFC was useful, although on an annualized basis it was relatively small.

58. The FSIF helped create a supportive government policy environment for private business, as part of a longer series of interventions by ADB in Bhutan's financial sector. It supported the development and enactment of framework laws such as the Real and Personal Property Act, the Bankruptcy Act, the Negotiable Instruments Act, and the Companies Act, although a number of these have not been effective due to inherent weaknesses of the legislation, the lack of implementing regulations, or lack of capacity for implementation and enforcement. Also, there were some elements of policy related to the FSIF intervention that are difficult to interpret as "supportive" of private business, including the restrictive FDI Policy, and the import and industrial licensing schemes.

59. The FSIF helped improve the regulatory framework for the financial sector and for private business. However, it was not fully successful in achieving an effective FDI regime; interest rates were not significantly liberalized and the structural impediments to price competition in the financial sector remained largely unaddressed; a CIB was not established; and the underlying data problems with regard to the credit records in the financial institutions were not addressed. In addition, although the prudential guidelines for financial institutions were improved, as were the capabilities of the supervision division of the RMA (under a separate TA), enforcement continued to be weak.

60. The FSIF made very modest contributions to the management and technical skills of key financial institutions, and had no impact on entrepreneurial skills in SMEs. BDFC loans were not accompanied by entrepreneurial training.

61. The FSIF did not significantly improve the availability of credit history information. One of the tranche release conditions of the FSIF policy-based program loan was that a CIB be established. This was not done. The PCR stated that the TA had recommended that there was no need at that time for a CIB. This was not so, in fact quite the opposite. The report of the TA team said: "The establishment of a credit information bureau is a way to streamline the process and make it more efficient and effective. Furthermore, it is consistent with private sector

development that the financial institutions who will be users of the service have indicated a willingness to pay for the startup and the ongoing costs of the facility.[55] The development of the Credit Information Bureau in Bhutan should be viewed in a positive way."[56] The TA team advised caution about the risks of having RMA operate the CIB. Nevertheless, despite this endorsement of the need for a CIB, the PCR stated that Bhutan's financial institutions already had an "effective system for trading credit information".[57] This "system" put the onus on the borrower to provide a credit clearance letter from the other financial institutions in Bhutan. This was slow, its accuracy is unknown, and it did not address the likely data deficiencies in the financial institutions. A decade later, in early 2010, RMA established a CIB, but it was not fully functioning because the Bank of Bhutan (BoB) was not yet participating.[58]

62. An FDI policy and regulations were published much later than the FSIF deadline and have come under review again within three years. RGoB's guarantee of a set rate of return to the investment portfolio of the GEPF was discontinued. Regional clearinghouses for cheques were established, but there was inadequate analysis of demand as two locations were later found to be not viable (footnote 6). ADB provided continuing assistance in this area; but after 2007 RMA turned to the Reserve Bank of India to implement a system that will be integrated with India's system. The capabilities of RMA's supervision division were improved, partly through this TA and partly through another ADB TA (footnote 6). In particular, RMA was given powers to penalize noncompliance with prudential guidelines, but enforcement remains inadequate. Finally, the conditionality concerning the interbank market appears to have been premature at the time and too imprecise as a result of inadequate prior analysis.

1. Overview of Performance

63. In summary, the policy-based program loan, the development finance loan, and the TA were *partly successful,* while the equity investment was *successful*. The FSIF was a coherent part of ADB's long-term engagement with Bhutan. Its continuity with earlier as well as later programs was good. The rationale for engagement in the financial sector was strong; and the direction in which the FSIF encouraged Bhutan to go was sound. Nevertheless, several of the achievements that are listed in the PCR appear, in retrospect, to be optimistic.

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[55] ADB. 2000. *Technical Assistance to Bhutan for Capacity Upgrading of Financial Sector Infrastructure and Entrepreneurial Development Project.* Manila. (TA 2902-BHU). Page 78, para 458.

[56] Ibid. Para 464.

[57] ADB. 2003. *Completion Report: Financial Sector Intermediation Facility in Bhutan*. Manila. Appendix 1.

[58] The Credit Information Bureau is the responsibility of the Chief, Financial Institutions Supervision Division (FISD), of the RMA. A task force to establish the CIB was set up during the second half of 2004 with members from the RMA and financial institutions (BNB, BoB, BDFC, RICB, and NPPF). A memorandum of agreement was signed by five financial institutions on 1 November 2005, and it was announced that the project would commence shortly. The CIB "went live" in partial form four years later, on 3 December 2009. At that time the CIB did not yet contain BoB data, and so, at best, less than 40% of borrower data was being made available. The target for full availability was March 2010.

Table 5: Performance Ratings of Public Sector Components of the FSIF[59]

	Component					
	Policy-based Loan	**Develoment Finance Loan**	**Technical Assistance**	**Average Rating (Unweighted)**	**Weights**	**Overall Weighted Rating**
Relevance	2	1	2	1.7	0.2	0.34
Effectiveness	1	1	1	1.0	0.3	0.30
Efficiency	1	1	1	1.0	0.3	0.30
Sustainability	1	1	1	1.0	0.2	0.20
Average Rating	1.3	1	1.3	1.2		1.14
Performance Category	Partly successful	Partly successful	Partly successful			Partly successful

Rating scale: 0, 1, 2, 3
Overall Assessment: Highly successful if weighted score is equal to or greater than 2.7; Successful if weighted score is equal to or greater than 1.6 but less than 2.7; Partly successful if weighted score is equal to or greater than 0.8 but less than 1.6; and Unsuccessful if weighted score is less than 0.8.
Source: Independent Evaluation Mission

B. Issues

64. The FSIF was not sufficiently selective. The several diverse initiatives bundled into the FSIF offered some opportunities for synergy, but, on the whole, resulted in a lack of focus. This lack of focus was evidenced in the insufficient analysis of the substantive underlying problems, insufficient depth in ADB's assistance to some areas, as well as a lack of follow-through. Consequently, ADB may have accepted formal compliance, in some instances, where a stronger push for substantive reforms may have been more appropriate.

65. A stronger emphasis on business skills was needed. More opportunities could have been developed and pursued to work directly with the private sector to develop entrepreneurial skills, and lending to SMEs should have been better supported with skill development and safeguard monitoring.

66. Monitoring of costs and benefits should have been more rigorous. The reports of the review and reconnaissance missions, and the two completion reports, had a tendency to overstate the outcomes achieved. It seems clear, for example, that the excellent NPL ratios that were claimed for the ADB-supported subloans to SMEs were largely a result of selection bias; and the “job creation” estimates by BDFC were unreliable. Similarly, the high rate of return on ADB’s investment in the common shares of BNB ignored some significant investment costs related to cleaning up the NPLs prior to ADB’s purchase of shares; and divestiture of those shares had strategic costs for the ADB that might not have been sufficiently considered.

C. Lessons

67. Many lessons can be learned from the rich experience of the FSIF in Bhutan. The following are important.

[59] The Equity Investment in BNB, by far the best performing component of the FSIF, is not included in the rating because it is a non-sovereign operation. IED follows a different set of criteria in rating non-sovereign operations. The overall rating of partly successful will remain unchanged even with the inclusion of the equity investment’s performance since the latter accounted for only a small portion of the FSIF.

1. Lessons from the policy-based program loan

68. **Insufficient analytical underpinnings** led to formal rather than substantive compliance with tranche release conditions. Joint undertakings with other donors and RGoB might have strengthened the substantive analysis of policies and the robustness of the dialogue with RGoB.[60] For example, requiring that RGoB formulate an FDI policy, without engaging substantively on the substance of that policy, was not useful. A policy was written and adopted, but a new attempt was being made to formulate a workable policy in 2009. If ADB wishes to influence FDI policy in Bhutan, it needs to contribute to public and official awareness of the benefits of FDI, partly by supporting research on the experience in Bhutan to date and making known the lessons from other small economies. Other policy measures where underlying analysis was lacking included the approval of commercial legislation and interest rate liberalization.

69. **Delays in the establishment of a credit information bureau was also partly a failure of analysis.** Costs were underestimated and the problems were not fully understood. Founding a CIB in Bhutan is not only a problem of coordination among the lending institutions. The challenge is more fundamental, with the essential problem being the poor data systems and practices of the lending institutions. Substantive analysis at the design stage of the FSIF would probably have identified this issue and allowed ADB and RGoB to address it earlier. If the lending institutions do not have good records of the credit history of their own borrowers, then a joint CIB is unlikely to succeed.

70. **The failure of interest rate liberalization was also partly a failure of analysis**. Removing overt administrative control of interest rates may make little difference to prevailing rates and practices if there is little competition between lenders because of the sector's oligopolistic and closely held structure. Several factors made it unlikely that simple deregulation of rate setting would be conclusive. These included (i) the oligopolistic structure of the financial system where all financial institutions were largely government held; (ii) the close interconnections between the stakeholders of the financial institutions, resulting in a risk of informal collusive rate setting; and (iii) the 1-to-1 peg of the Ngultrum against the Rupee that complicates the relationship between Bhutanese and Indian interest rates. These factors made it likely that interest rates would be largely unchanged and price competition between financial institutions would be slow to emerge. This has in fact been the case.

2. Lessons from the development finance loan

71. The key problems and constraints of SME access to credit in Bhutan needed to be better understood. Problems included high interest rates, short loan amortization periods, and excessive collateral requirements. The FSIF loan had no effect on these.

3. Lessons from the Equity Investment in BNB

72. A small equity investment can have a large impact in the right circumstances, especially if it is supported by TA and policy reforms. Although ADB's equity investment in BNB was largely effective in achieving its aims, it illustrates that small investments are not easy for ADB to handle within its cost structure.

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[60] ADB was involved in the financial sector in Bhutan for many years before it commissioned a strategic review of the financial sector. ADB. 2001. *Technical Assistance to Bhutan for the Financial Sector Review*. Manila.

73. Another lesson is that if ADB brings a private partner into the deal with the aim of facilitating capacity development, it should only go with a strategic investor with relevant banking experience, who will remain as a shareholder for a long time and thus play an active role in the management and corporate governance of an institution. In this particular case, the investor was not actively involved in managing the institution and acted more like a financial than a strategic investor.

D. Follow-up Actions

74. About three years after the FSIF, ADB provided assistance for the Financial Sector Development Program and the Micro, Small and Medium Enterprises Sector Development Program, which are still ongoing. The findings of this evaluation of the FSIF should be considered when ADB conducts reviews of these programs and when the next phase of ADB's involvement in the financial sector in Bhutan is designed.

DESIGN AND MONITORING FRAMEWORK FOR THE FSIF

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

Hierarchy of Objectives	Program Targets	Monitoring Mechanism	Risks and Assumptions
and management skills, and access to information, and upgrade human resources base in financial institutions.			Lack of budget support from the Government on bank training.
Components and Outputs			
• Policy loan first tranche release conditions:			
- Liberalize the interest rate structure and remove administered sectoral interest rate controls.	Allow financial institutions to determine deposit and lending rates, while keeping their interest spreads initially at a maximum of 6 percent until sufficient competition between financial institutions is in place.	A letter from Government indicating that the condition was fulfilled with supporting documents, such as RMA's Circular on Interest rate liberalization.	Lack of Government commitment regarding interest rate liberalization for fear of capital outflow.
- Abolish requirement for Royal Insurance Corporation of Bhutan (RICB) to provide 10 percent fixed return on the GEPF.	A formal agreement is to be reached between Government and RICB.	Supporting documents include a copy of signed agreement.	Inadequate institutional capability in managing the GEPF.
- Clean up BNB's loan portfolio of nonperforming assets inherited from the Unit Trust of Bhutan	Cleaning up the loan portfolio should be done before the loan effectivity and Bank's equity investment.	Closely follow up with the Government before loan effectivity	Concerns that other financial institutions may require the same treatment from Government.
- Issue and publish policies and regulations regarding foreign exchange transactions as agreed with ADB.	Move toward current account convertibility for third country transactions as agreed with the IMF.	Supporting documents include a copy of issued regulation.	RMA's concern of losing control of foreign exchange reserves of the country.
- Make effective the Commercial Sales of Goods Regulation.	To be approved by the Government.	Supporting documents include a copy of issued regulation.	Slow progress of the legal approval process in the National Assembly.

Hierarchy of Objectives	Program Targets	Monitoring Mechanism	Risks and Assumptions
- Draft a set of policies and regulations regarding import licensing schemes as agreed with ADB.	Policies and regulations to be made public.	A letter from Government indicating that the condition was fulfilled with supporting documents.	Limited flexibility in trade reforms due to smuggling potential for goods from Bhutan to India.
- Review current case-by-case approach to foreign investment and move toward developing a set of transparent foreign investment policy and regulations.	Actions to be taken by the Government to initiate the policy review process.	A letter from Government indicating that the condition was fulfilled with supporting documents.	Concerns over foreign dominance of the economy.
- Improve the industrial licensing system and rationalize administrative requirements for industrial locations, pricing, and raw material supplies as agreed with ADB.	Issue and publish rules and regulations.	Supporting documents include a copy of issued regulation.	Government's concern on environment degradation and the depletion of natural resources.
• Policy loan second tranche release conditions:			
- Improve RMA's prudential guidelines and strengthen its banking supervision function.	Institute a system of fines and penalties for violations of prudential guidelines.	RMA banking supervision reports, Program progress reports, ADB review missions.	Difficulties in solving the problem of nonperforming debts.
- Build market infrastructure including a credit information bureau and an interbank market.	Credit information bureau and the interbank market to be operational and self sustaining.	Program progress reports, ADB review missions.	Dominating position of BOB may make it reluctant to participate in these activities.
- Make effective the Real and Personal Properties Act, Bankruptcy Act, Negotiable Instruments Act, and amendments to Companies Act.	Be approved by the National Assembly.	Program progress reports, ADB review missions.	Slow progress of the legal approval process in the National Assembly.
- Improve operational efficiency of the payments system.	Including branches of commercial banks outside of Thimphu in the clearing and	Program progress reports, ADB review missions.	Insufficient infrastructure may slow down the process.

Hierarchy of Objectives	Program Targets	Monitoring Mechanism	Risks and Assumptions
	settlement system.		
- Remove any form of Government subsidy to the GEPF.	Restructure the GEPF and make it independent	Program progress reports, ADB review missions.	Political implication may slow down the reform process.
- Issue and publish policies and regulations regarding foreign investment as agreed with ADB.	Regulation on foreign investment to be drafted and adopted.	Program progress reports, ADB review missions.	Concerns over lack of domestic entrepreneurial capacity and the foreign domination of the economy.
• Conditions for credit line utilization			
- Strengthen the PFIs' organizational structure for project financing and upgrade PFI staff in project finance and banking skills.	Project finance unit to be set up in each PFI and appropriate procedures to be adopted.	Program progress reports, ADB review missions.	Lack of qualified personnel.
- The PFIs are to maintain compliance with all eligibility criteria under the credit line.	Any noncompliance to be reported and corrective measure to be taken promptly. Eligibility criteria are the following: * maintain compliance with RMA prudential guidelines as amended from time to time. * Minimum annual collection ratio of 80 percent based on a consistent formula agreeable to ADB * Maximum infection ratio of 20 percent * Minimum debt service ratio of 1.25 times; and * Minimum return on average assets of 1	RMA banking supervision reports. Program progress reports, ADB review missions.	Difficulties in solving the problem of nonperforming debts.

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

ADB = Asian Development Bank, BNB = Bhutan National Bank, BOB = Bank of Bhutan, DPL = Development Policy Letter, GEPF = Government Employees Provident Fund, IMF = International Monetary Fund, PAU = project administration unit, PFI = participating financial institution, PSC = Policy Steering Committee, RICB = Royal Insurance Corporation of Bhutan, RMA = Royal Monetary Authority, the central bank, TA = technical assistance.

Source: Report and Recommendation of the President to the Board of Directors: Proposed Loans, Technical Assistance Grant and Equity Investment to Bhutan for the Financial Sector Intermediation Facility.

THE FSIF IN THE CONTEXT OF ALL ADB ASSISTANCE TO THE FINANCIAL SECTOR IN BHUTAN

ADB Assistance to the Financial Sector in Bhutan

Grant/Equity Investment/Loan/TA Number	Approved	Approval	Close[a]	1997–2011
(1) POLICY-BASED PROGRAM LOANS				
FSIF Loan 1565 BHU/SF	$4,000,000	23-Oct-97	23-Dec-02	Oct – Dec
FSDP Loan 2279 BHU/SF	$11,000,000	7-Dec-06	30-Jun-10	Dec – Jun
TOTAL	$15,000,000			
(2) DEVELOPMENT FINANCE				
Finance Loan 934 (BDFC)	$2,500,000	13-Dec-88	15-Nov-94	
FSIF Loan 1566 (BDFC)	$4,000,000	23-Oct-97	9-Jan-03	Oct – Jan
MSMESDP Grant 0089 (BDFC)[b]	$5,235,000	21-Nov-07	30-Jun-12	Nov
TOTAL	$11,735,000			
(3) EQUITY INVESTMENT				
EI 7139 (BNB) TOTAL	$509,063	23-Oct-97		ADB and Citicorp each buy 20% (May 1999) ? Citicorp sells (May 2001) ? ADB accepts dilution to 10%. (2003) ? ADB divest fully by Dec 2006
(4) TECHNICAL ASSISTANCE				
(A) BDFC				
TA 0614 Feasibility of a Dev. Financing Mechanism (TASF)	$230,000	13-Jul-84	31-Dec-98	
TA 1022 Inst. Dev. BDFC (TASF)	$270,000	4-Aug-88	30-Sep-92	
TA 1465 Inst. Dev. BDFC (TASF)	$431,400	11-Jan-91	30-Sep-94	
TA 3910 Inst. Dev. BDFC (JSF)	$200,000	27-Aug-02	31-Aug-03	Aug – Aug
TA 4837 Microenterprise finance (JSF)	$500,000	11-Sep-06	30-Sep-10	Sep – Sep
BDFC TA Sub-total	$1,631,400			
(B) BNB				
TA 2284 Convert Unit Trust to BNB (TASF)	$146,500	4-Jan-95	31-Mar-96	
TA 2532 Convert Unit Trust to BNB (JSF)	$590,000	13-Feb-96	28-Feb-98	
BNB TA Sub-total	$736,500			
(C) RMA and General Financial Sector				
TA 2902 Fin Sect Infra & Entrepreneur Dev (JSF)	$500,000	23-Oct-97	31-Aug-03	Oct – Aug
TA 3212 RMA Supervision Function (JSF)	$600,000	30-Jun-99	30-Jun-02	Jun – Jun
TA 3687 Fin Sector Review (TASF)	$300,000	23-Jul-01	22-Feb-05	Jul – Feb
TA 3905 Strengthen RMA/Securities Exchange (JSF)	$334,000	23-Aug-02	16-Feb-05	Aug – Feb
TA 4386 Payments and Settlements System (TASF)	$275,000	7-Sep-04	24-Mar-09	Sep – Mar
- TA 4386 Payments and Settlements System (Supplementary)	$300,000	15-Dec-05	24-Mar-09	
- TA 4386 Payments and Settlements System (Supplementary)	$30,000	13-Aug-07	24-Mar-09	
TA 4615 Non-bank FI Reform (TASF)	$500,000	17-Jul-05	31-Jul-08	Jul – Jul
TA 4885 Skills & Capacity Dev (TASF)	$250,000	7-Dec-06	30-Jun-11	Dec – Jun
FSDP Project TA Loan 2280	$2,000,000	7-Dec-06	30-Jun-10	Dec – Jun
RMA/General TA Sub-total	$5,089,000			
(D) Dept. of Finance, Aid and Debt Management				
TA 3893 Dept. Aid and Debt Management (JSF)	$116,000	4-Jul-02	16-Nov-04	July – Nov
TA 4398 Dept. Aid and Debt Management (TASF)	$225,000	28-Sep-04	29-Nov-07	Sept – Nov
TA 4871 Debt Management Unit (TASF)	$200,000	20-Nov-06	31-Jul-08	Nov – Jul
Dept. Finance/Debt Manage TA Sub-total	$541,000			
(E) Royal Securities Exchange				
TA 1699 Cap Market/Securities Exchange (TASF)	$224,250	15-May-92	30-Sep-96	
TA 2902 Fin Sect Infra & Entrepreneur Dev (JSF) (See RMA above)		23-Oct-97	31-Aug-03	Oct – Aug
TA 3905 RMA/Securities Exchange (JSF) (See RMA above)		23-Aug-02	16-Feb-05	Aug – Feb
Royal Securities Exchange TA Sub-total	$224,250	(PLUS PART OF TA 2902 AND TA 3905 COUNTED ABOVE)		
(F) Pensions				
TA 3111 RICB/Gov Emp Prov Fund (JSF)	$500,000	7-Dec-98	12-Aug-04	Dec – Aug
TA 3796 Nat Pension & Provident Fund (JSF)	$300,000	12-Dec-01	16-Nov-04	Dec – Nov
Pensions TA Sub-total	$800,000			
TOTAL TECHNICAL ASSISTANCE	$9,022,150			

Yellow box indicates that the loan/TA was complete before 2000.

BDFC = Bhutan Development Finance Corporation, BNB = Bhutan National Bank, EI = equity investment, FI = financial institution, FSDP = Financial Sector Development Program, FSIF = Financial Sector Intermediation Facility, JSF = Japan Special Fund, MSMESD = Micro, Small and Medium-Sized Enterprise Sector Development, RICB = Royal Insurance Corporation of Bhutan, RMA = Royal Monetary Authority of Bhutan, SF = special fund, TA = technical assistance, TASF = technical assistance special fund

[a] This refers to the actual financial completion date for completed projects; or the expected financial completion date for current projects.

[b] The total grant amounted to $9.0 million to finance a project estimated to cost $10.6 million. Of the total project cost, $5.235 million was a credit line for BDFC.

Sources of data: Lotus Notes database on Loan, TA, Grant, and Equity Approvals; Loan Financial Information System; TA Information System; Program Completion reports; TA Completion reports

SUMMARY OF STATUS OF THE TRANCHE RELEASE CONDITIONS (POLICY MATRIX)[1]

A. STATUS OF REFORM IMPLEMENTATION AS OF PCR DATE (with additional column for comments from Evaluators)

Policy Measures under the Program Components and Outputs	Program Targets	Status of Implementation as of Completion Date	IED's Comments and PPER Evaluation on Status
1. Policy Loan First Tranche Release Conditions			
Liberalize the interest rate structure and remove administered sectoral interest rate controls	Allow financial institutions to determine deposit and lending rates, while keeping their interest spreads initially at a maximum of 6% until sufficient competition exists between financial institutions	Complied with. Interest rates on deposits and advances were fully liberalized effective April 1999. However, Section 10.11.1 of Royal Monetary Authority (RMA) Prudential Regulations of 2002, which took effect 1 July 2002, provides that the deposit and lending rates may be revised from time to time with the approval of the Board of Directors of the financial institution and subsequent RMA approval.	Removing interest rate controls made little difference to rates in the short and medium term. A study of the factors involved in the setting of interest rates in Bhutan would probably have identified other constraints that had to be addressed at the same time to promote price competition among financial institutions. Almost ten years after compliance, there was neither any real change in the interest rates nor any competition in the setting of rates.

[1] ADB. 2003. *Completion Report: Financial Sector Intermediation Facility in Bhutan*. Manila.

Policy Measures under the Program Components and Outputs	Program Targets	Status of Implementation as of Completion Date	IED's Comments and PPER Evaluation on Status
Abolish the requirement for Royal Insurance Corporation of Bhutan (RICB) to provide 10% fixed return on the Government Employees Provident Fund (GEPF)	A formal agreement is to be reached between Government and RICB	Complied. The Government subsidized GEPF to cover the difference as follows: 1998 Nu 15,964,202.04 (08/14/88) 1999 Nu 8,181,088.52 (10/05/99) 2000/01 Nu 54,342,227.00 (09/25/01) Total Nu 78,487,567.56 ($1,763,021.16 equivalent) • RMA justified the subsidy until 2001 as part of adjustment costs On 30 March 2000, the National Pension and Provident Fund Bureau (NPPFB) was established with assistance under an Asian Development Bank (ADB) technical assistance (TA) grant. On 3 July 2000, it took over the GEPF operation from RICB.	ADB was correct that it was conceptually inconsistent for RGoB to provide a guaranteed rate of return to its 'defined contribution' employee provident fund. It made the fund more like a defined benefit plan. However, it is unclear why ADB would involve itself in this matter. A government "subsidy" (contribution) to its employee provident fund is not unusual and has minimal effect on the broader financial sector.
		• On 8 April 2002, the Government allowed NPPF and the Armed Forces Pension and Provident Fund (AFPPF) to undertake limited financing activities such as loans to the Government and public limited companies, as well as housing loans to the members. The Government promotes both the NPPF Plan and AFPPF.	It is not clear how or why ADB became involved in this matter or, once involved, why it thought retail lending to be a good strategy for a national pension fund.
Clean up Bhutan National Bank's (BNB) nonperforming assets, inherited from the Unit Trust of Bhutan	Cleaning up the loan portfolio should be complete before loan effectivity and ADB's equity investment	Complied with. The Government and BNB signed an agreement on 1 September 1997 and the Government disbursed cash to BNB for Nu52 million in nonperforming assets of BNB.	The NPLs were reduced from about 37% to 27% through the "clean-up". BNB's NPL-levels were subsequently reduced further to about 5% as of December 2009.

Policy Measures under the Program Components and Outputs	Program Targets	Status of Implementation as of Completion Date	IED's Comments and PPER Evaluation on Status
Issue and publish policies and regulations regarding foreign exchange transactions–as agreed with ADB.	Move toward current account convertibility for third-country transactions, as agreed with the International Monetary Fund (IMF)	Complied with	The value added by including a condition already agreed with the IMF is unclear. Also, if ADB were to involve itself, there should have been more focus on the desirable substance of the policy and regulations as distinct from mere publication.
Make effective the Commercial Sales of Goods Regulation	To be approved by the Government	Complied with	Again there seems to be insufficient focus on the desirable substance of the legislation as distinct from mere publication.
Draft a set of policies and regulations regarding import licensing schemes as agreed with ADB	Policies and regulations to be made public	Complied with. The responsibility for the issuance of licenses for import from third countries was transferred from the Ministry of Finance to the Ministry of Trade and Industry (MOTI) in July 2002. As of 31 July 2003, the following accomplishments were reported: (i) MOTI had issued 3,068 import licenses; (ii) MOTI had registered 390 importers all of which were domestic companies; and (iii) between July 2002 to July 2003, the MOTI had authorized imports worth Nu4.57 billion (roughly $30 million equivalent), representing an increase of almost 200% from prior period level.	The "status report" implies that publishing the import licensing regulations led to a large surge in imports. That is not plausible, unless perhaps informal imports were formalized. Without a baseline study, and some analysis of the economic dynamics, the impact of the new regulations is not known.
Review current case-by-case approach to foreign investment and move toward developing transparent foreign investment policy	Actions to be taken by the Government to initiate the policy review process	Complied with	Conditionality is so vague that compliance is not meaningful. There is a stronger statement of this condition in the second tranche release conditions.

Policy Measures under the Program Components and Outputs	Program Targets	Status of Implementation as of Completion Date	IED's Comments and PPER Evaluation on Status
Improve the industrial licensing system and rationalize administrative requirements for industrial locations, pricing, and raw materials as agreed with ADB.	Issue and publish rules and regulations	Complied. Based on available statistics, the total number of industrial licenses issued increased by 221% from 4,115 in June 1997 to 13,199 by June 2002. In addition, the number of trade licenses increased by 134% from 7,045 in June 1997 to 16,465 as of the end of December 2002	The "status report" implies that publishing the industrial licensing regulations led to a large surge in new business formation. That is not plausible unless perhaps informal businesses were formalized. Without a baseline study, and some analysis of the dynamics of the business sector, the answers to these questions are not known.
2. Policy Loan Second Tranche Release Conditions			
Improve RMA's Prudential Guidelines and strengthen its banking supervision function	Institute a system of fines and penalties for violating prudential guidelines	Complied with. Prudential guidelines were strengthened. A system of fines and penalty clause for violations was incorporated in April 1999. The guidelines were further strengthened with the issuance of RMA Guidelines of 2002, which took effect 1 June 2002. Major changes include a corporate governance framework, more stringent standards for bank supervision, increased provisioning requirement for bad debt, and others.	Prudential Guidelines were significantly strengthened. However, this is another case where formal compliance was not enough. Fines and penalties have not been levied despite noncompliance. The root problem stemmed from a lack of independence of RMA from RGoB.
Develop market infrastructure, including a credit information bureau and an interbank market	Credit information bureau and the interbank market to be operational and self-sustaining	Based on TA 2902 recommendations, there is no need at present to establish a sophisticated credit information bureau because Bhutan's financial institutions have developed an effective system for sharing credit information. Options for an automated credit bureau have been developed and are currently evaluated by RMA.	A credit information bureau was not established until December 2009. The previous informal system by banks was deemed ineffective.

Policy Measures under the Program Components and Outputs	Program Targets	Status of Implementation as of Completion Date	IED's Comments and PPER Evaluation on Status
		Because Bhutan's financial sector is thin and the system has excess liquidity, TA 2902 observed that an interbank market is not envisaged in the immediate future. RMA can cover liquidity shortfalls at financial institutions for a maximum of 3 days. RMA committed to develop the necessary market infrastructure and regulations for an interbank market, should a liquidity condition so demand. At the time of the Project Completion Review Mission, the financial institutions, except perhaps Bhutan Development Finance Corporation because of its increasing demand for industrial and agriculture loans, are still experiencing excess liquidity.	It is difficult to understand why “not being envisaged” was sufficient reason for noncompliance with the ‘inter-bank market’ condition. However, the condition may not have been well advised in the first place. The IMF has suggested that RMA should not be an intermediary nor directly control interbank lending, as distinct from monitoring flows. Lastly, it is not clear what “self-sustaining” has to do with interbank lending.
Make effective the Real and Personal Property Act, Bankruptcy Act, Negotiable Instruments Act, and amendments to the Companies Act	Being approved by the National Assembly	Complied with. The National Assembly approved in August 1999 the Real and Personal Moveable and Immovable Property Act. The Negotiable Instruments and Amendments to Companies Act were approved in July 2000.	As with conditions discussed above, there appears to be a focus on simply passing the Acts rather than engagement with RGoB on the substance of policy.
Improve operational efficiency of the payments system	Including branches of commercial banks outside of Thimphu in the clearing and settlement system	Complied with. Based on the recommendation under ADB TA 2902: Capacity Upgrading of Financial Sector Infrastructure and Entrepreneurial Development. Phuensholing clearinghouse established on 3 July 2000.	Four clearinghouses outside Thimphu were established, two at sites where there was insufficient volume to be sustainable. A thorough study of clearance and payments might have identified other options for payments and settlements.

Policy Measures under the Program Components and Outputs	Program Targets	Status of Implementation as of Completion Date	IED's Comments and PPER Evaluation on Status
Issue and publish a set of import licensing regulations as agreed with ADB	Import licensing regulations to be issued and made public	Complied with. The Government approved Rules and Procedures for Imports from Third Countries on 5 June 2001.	Since Bhutan essentially has a customs union with India, and almost all imports are from India, it is unclear why ADB promoted an import licensing system rather than an open market system. Were import licenses meant to be a rationing device? Without additional analysis that explains the underlying intention, it is difficult to say. Import licensing appears to be a retrograde step if the strategy favored by ADB is based on open markets and regional integration.
Remove any form of government subsidy to GEPF	Restructure GEPF and make it independent	Complied with. However, the Government provided subsidies to GEPF to cover the differences as follows: 1998 Nu 15,964,202.04 (08/14/88) 1999 Nu 8,181;088.52 (10/05/99) 2000/01 Nu 54,342,227.00 (09/25/01) Total Nu 78,487,567.56 ($1,763,021.16 equivalent) RMA justified the subsidy until 2001 as part of adjustment costs. The government subsidy covering the 10% return on GEPF was removed on 31 December 1999. On 30 March 2000, NPPFB was established with assistance under an ADB TA. On 3 July 2000, it took over the GEPF operation from RICB.	There are two points: (1) have the GEPF administered by a new NPPFB rather than by the RICB; and (2) end all government subsidies for the GEPF. ADB spent $800,000 on technical assistance to the GEPF (TA 3111, 1998-2004) and the NPPF (TA 3796, 2001-2004). This technical assistance, outside the FSIF, may have been the genesis of the particular forms of restructuring noted here.

Policy Measures under the Program Components and Outputs	Program Targets	Status of Implementation as of Completion Date	IED's Comments and PPER Evaluation on Status
		On 8 April 2002, the Government allowed NPPF and the AFPPF to undertake limited financing activities such as loans to the Government and public limited companies, as well as housing loans to members. The Government promoted and supported both NPPF and AFPPF.	
Issue and publish policies and regulations regarding foreign direct investment (FDI) as agreed with ADB	Regulation on FDI to be drafted and adopted	Complied with. Council of Ministers approved the FDI policy on 3 December 2002, and the executive order to treat the policy as regulations until it is legislated was also issued on that day. Rules and regulations to operationalize the policy have already been drafted and will be issued soon. MOTI has received some 10 proposals, particularly from India, as a result of the FDI policy. MOTI is currently reviewing the proposals.	The regulations were not issued "soon". In fact they were not issued until 2005. The policy is being revised to make it more conducive to attracting FDI. Analysis by ADB of the options and recommended strategy for FDI in Bhutan would have been a valuable addition to the debate.
3. Conditions for DFI Loan 1566 utilization			
Strengthen the participating financial institutions' (PFIs) organizational structure for project financing and upgrade PFI staff capability in project finance and banking skills	Project finance unit to be set up in each PFI and appropriate procedures to be adopted	Complied with. Only BDFC participated, and it was able to utilize the entire proceeds of the development finance loan (about $3.82 million equivalent) to finance 281 subprojects, of which 4 were above the free limit. BNB did not utilize the loan as it is still experiencing excess liquidity, and chose to utilize its own funds to finance lending operations.	BDFC did benefit from training in loan appraisal, although from a separate ADB TA more than from the FSIF. However, BDFC reported to the evaluators in 2009 that it regarded the ADB methods as unnecessarily complex and has not continued to use them.

Policy Measures under the Program Components and Outputs	Program Targets	Status of Implementation as of Completion Date	IED's Comments and PPER Evaluation on Status
PFIs are to maintain compliance with all eligibility criteria under the credit line	Any noncompliance to be reported and corrective measure to be taken promptly. Eligibility criteria are the following: • Maintain compliance with RMA prudential guidelines as amended from time to time; • Maximum infection ratio of 20%; • Minimum debt service ratio of 1.25 times; and • Minimum return on average assets of 1%.	• Complied with • Partly complied with. Full compliance occurred in 2001 and 2002 • Complied with • Complied with	RMA told the evaluators in 2009 that BDFC has at times been noncompliant with various provisions of RMA's prudential guidelines, without penalties being imposed by RMA or ADB. The reports of ADB Review Missions did not monitor these metrics in particular. In fact, other performance indicators were reported.

EFFECTIVENESS OF SELECTED TRANCHE RELEASE CONDITIONS

The FSIF policy-based program loan included the following important tranche release conditions.

a. "Liberalize the interest rate structure and remove administered interest rate controls."

1. Asian Development Bank (ADB) was correct to push for price competition among lenders in Bhutan. Only through competition are the problems of access to credit likely to be solved. However, the removal of administered interest rate setting by the Royal Monetary Authority (RMA) made little immediate difference to interest rates in Bhutan (within the time frame of the program loan). Rates continued to be high, unresponsive to differences in risk ratings among borrowers, and virtually identical across financial institutions. The reason was probably the high level of direct and indirect government control in an oligopolistic market. However, the direction of reform was correct and some rate competition began to emerge a decade later. For example, Bhutan National Bank (BNB) increased its interest rates on short-term large deposits in the second half of 2007, with the result that many large enterprises shifted their business from Bank of Bhutan (BoB) to BNB. Price competition may be given additional impetus by the licensing of new commercial banks in 2009-2010 and by the possible expansion of the banking license of Bhutan Development Finance Corporation (BDFC) to enable it to take deposits in urban areas. A thorough study of interest rate setting in Bhutan was needed, including the constraints imposed by the Ngultrum-Rupee peg and an analysis of policy options with recommendations, and this is still needed.

b. "Abolish the requirement for Royal Insurance Corporation of Bhutan (RICB) to provide a 10% fixed rate of return on the Government Employees Provident Fund." "Remove any form of government subsidy to the GEPF."

2. Like other governments, the Royal Government of Bhutan (RGoB) can legitimately subsidize its employee provident fund if it wishes to do so and can afford to do so. In hindsight, it is unlikely that RICB's guaranteed 10% return on the Government Employees Provident Fund (GEPF) investment could have distorted interest rates in Bhutan. However, the guarantee was seen to have adverse implications for RICB's financial sustainability. For this reason, it was probably correct in principle for RGoB to abolish the fixed rate of return on its defined contribution to the GEPF. The removal, however, of the fixed rate did not in any way affect the industry-wide rates either positively or negatively. In the end, it is not clear why ADB interested itself in the matter for purposes of financial sector reform. In any case, the 10% fixed rate of return was removed and ADB provided technical assistance outside the FSIF for actuarial analysis to address the sustainability of the defined benefit part of the national pension scheme.[1]

c. "Issue and Publish Policies and Regulations Regarding FDI."

3. Three years past the original deadline for compliance, an ADB Review Mission concluded that RGoB had complied with the second tranche release condition related to foreign direct investment (FDI). However, in reality it took another three years (till 2005) for RGoB to

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[1] *ADB. 1997. Report and Recommendation of the President to the Board of Directors: Proposed Loans and Technical Assistance Grant and Proposed Equity Investment to Bhutan for Financial Sector Intermediation Facility.* Manila.

formulate FDI regulations under the new Policy. However, the FDI policy and regulations were ineffective as investment promoters. The Policy allowed no foreign investment except in a limited list of subsectors. It placed constraints on the size of investments as well as on the number of expatriate workers and managers and their tenure, and restraints on closing the business and/or repatriating profits.[2] In total, it was not a package likely to attract many investors. Little was done to monitor the effectiveness of the policy.[3] To date, 10 years after ADB's FDI condition was to be met, few foreign investments have been approved under the FDI Policy.[4] Foreign investment in small and medium enterprises (SMEs) does not appear to have contributed significantly to economic growth or job generation, although ADB's Independent Evaluation Department (IED) knows of no study of the topic. The major foreign investments in Bhutan have been Indian investments in hydro power generation. They were negotiated under the energy policy, not, as IED understands, under the FDI policy. In 2009, RGoB proposed a reformulation of the FDI policy to reorient it more towards investment promotion, although with significant opposition from some business and government interests. The draft Policy in circulation in 2009 maintains many impediments to foreign investment. In retrospect, ADB may have been too quick to accept compliance with the formality of a written FDI policy rather than push for more openness to foreign investment, especially in SMEs.

d. "Improve RMA's Prudential Guidelines and strengthen its banking supervision function."

4. One of the second tranche release conditions was that RMA should strengthen its prudential guidelines and its banking supervision function, and should institute a system of fines and other penalties for violating the prudential guidelines. A penalty clause was incorporated in the Guidelines in April 1999, and strengthened in June 2002 (after the TA on Strengthening the Banking Supervision Function of the Royal Monetary Authority).[5] RMA's prudential guidelines and its supervision function were reorganized and substantially strengthened in 2002, partly as a result of the TA for the Financial Sector Intermediation Facility (FSIF), which made extensive recommendations in that regard, and partly as a result of the TA for Strengthening the Supervision Function of the RMA. The Guidelines were redrafted to give RMA greater powers and to clarify its mandate, mission, and supervision procedures. Manuals for on-site and off-site examinations were introduced. At the same time, the TA for Strengthening the Supervision Function of the RMA supported training of RMA staff in supervision and examination skills and funded a study tour of other central banks and financial supervisors in the region. However, enforcement of compliance was limited, partly by limited powers to penalize noncompliance and partly by the lack of independence of the RMA, stemming from an implicit conflict of interest involving RGoB as owner of financial institutions and regulator of those same institutions.

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[2] Bhutan has been the recipient of very large FDI by India in hydro-power generation; but this has not been handled under the FDI policies and regulations.

[3] Available: http://www.bhutantimes.bt/index.php?option=com_content&task=view&id=1233&Itemid=79

[4] Between the effective date of the FDI policy, 1 July 2005, and 8 May 2008, eleven projects worth US$ 57.595 million (Nu 2,298.41 million), mostly in the manufacturing sector, were approved. It is unknown how many of these were in fact implemented subsequent to approval. According to records maintained by the Ministry of Economic Affairs, the overall shareholding pattern is 67.48 percent by foreign partners and 32.52 percent by local companies. Bhutan's FDI policy allows a maximum of 70 percent holdings by foreign companies, a minimum investment for manufacturing of $1 million, and $0.5 million for services.

[5] ADB. 1999. *Technical Assistance to Bhutan for Strengthening the Banking Supervision Function of the Royal Monetary Authority of Bhutan*. Manila.

Although instances of noncompliance with the Guidelines were common, it appears no penalties have actually been levied.[6]

e. "Develop market infrastructure, including a CIB and an interbank market."

5. Neither a credit information bureau (CIB) nor an "interbank market" (second tranche release conditions in the program loan) was created. A CIB would have improved access to credit histories by instituting a central record of loan clearance information. Instead of insisting on the establishment of a CIB, ADB accepted the existing system of Loan Clearance Certificates that left the onus on the borrower to provide a certificate of assurance of loan clearance. There has been no study of how much this system delayed loan applications, or how accurate it was in providing good information about credit history. Ten years later, in December 2009, the RMA launched a CIB that was expected to be fully functional by March 2010 provided BoB was participating by then.[7] A decade was lost in lagged implementation of this improvement to credit efficiency in Bhutan. Even in 2010, the effectiveness of the CIB may be compromised if it is found that the financial institutions have poor records of the credit history of their borrowers. IED found it difficult in the present study to compile reliable information about BDFC borrowers from the BDFC records, and its discussions with the senior managers of BNB also indicate that borrower records in general may be poor. All in all, it is clear that the original tranche-release condition was not met within the timeframe of the program loan and, given the importance of the matter, the ADB Board's waiver of compliance should have been sought before the second tranche payment was released.

6. The second condition on "market infrastructure" (interbank market making) was also not met, but this failure was perhaps less important because it may not have been necessary in the first place. In recent years, financial institutions in Bhutan have lent to each other without the intervention of RMA. A recent study by the International Monetary Fund (IMF)[8] throws doubt on the idea that RMA should actively control interbank lending (as distinct from maintaining good records of financial flows) or act as an intermediary for interbank loans. Referring back to the matter of relevance, this point is illustrative of the lack of sufficient analytical underpinnings for the reforms proposed as tranche release conditions.

f. "Improve operational efficiency of the payments system."

7. ADB provided technical assistance to help construct a payments and settlement system. First, four regional clearinghouses for cheques were established outside Thimphu.[9] However, there was little demand at two sites. A subsequent TA project developed a truncation system for communicating payments information among financial institutions. After 2007, RMA opted for an Indian system (Electronic Fund Transfer and Clearing System [EFTCS]) to be installed and supported by the Reserve Bank of India (RBI), with promised support from the World Bank for the IT investments needed. This raises questions about the sustainability of ADB's investments

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[6] According to the South Asia Department, "under ADB's Financial Sector Development Program (FSDP) (2006), RMA's authority and power to regulate the whole financial sector has been strengthened by the recently passed RMA Act (2010), especially in terms of giving power to enforce the conflict of interest rules and qualifications of the board of directors at FIs. In addition, there was no explicit penalty clause before the new Financial Service Act (2010) discussing the penalty actions for charges in a circumstance of noncompliance."

[7] On 16 July 2010, the South Asia Department informed IED that the CIB is fully operational and all banks, including BoB, have participated. Apparently, a total of 80% of loan history data has been completed (by all banks).

[8] IMF. 2007. *Liquidity Management and Money Market Development in Bhutan*. Washington.

[9] ADB. 2004. T*echnical Assistance to Bhutan for Strengthening of the Payment and Settlement System*. Manila (TA 4386–BHU).

in the payments and settlement system. No evaluation of this experience is available, so it is not clear how much the new system (RBI/World Bank) will build upon the foundations established with ADB's technical assistance and how much it will go in a new direction. The TA did not address underlying issues related to the use of checks including lack of public awareness and lack of enforcement of regulations that require banks to charge penalties with regard to bounced checks.

8. The program loan was clearly less effective in addressing some of the objectives stated in the logical framework.[10] There continued to be constraints on foreign investment as well as regulatory hurdles for importers and industry licensing. Interest rates did not change, and the market infrastructure for credit facilitation continued to be inadequate. There was also no clear improvement in the entrepreneurial skills or borrowing behavior of the private sector, as shown by the continuing high rate of NPLs and by the lack of real growth in the sample of SMEs visited during the present study. Although there have been subsequent implementation issues, legislation was passed on basic commercial laws such as the Real and Personal Properties Act, Bankruptcy Act, Negotiable Instruments Act, and amendments to Companies Act. Work on these laws had already begun before the FSIF. Finally, RMA's supervisory skills and capacity appeared to have improved with the establishment of a supervisory unit and ongoing training under other ADB TA projects. RMA, however, has not imposed any penalties for noncompliance although they were called for.[11]

[10] The logical framework objectives included removing policy impediments to private sector development by rationalizing Government control over private sector business activities; improving efficiency of resource allocation by liberalizing the interest rate structure and adopting transparent foreign exchange policies; improving RMA's banking supervision capabilities, and building an adequate market infrastructure; setting up an enabling legal framework for operation of the financial system and private sector business activities; and improving private sector entrepreneurship and management skills, access to information, and human resources in financial institutions.

[11] The South Asia Department commented that the newly passed Financial Services Act (2010) incorporates the penalty section with regard to noncompliance.

DATA ON SUBBORROWERS UNDER THE DEVELOPMENT FINANCE LOAN

1. Number of Subloans 281
2. Sectoral Distribution of Subloans

Criteria	Amount ($ million)	Percent
Agriculture	0.01	0.34
Food and Beverages	0.10	2.65
Textiles, Apparel and Leather	0.18	4.79
Wood and Wood Products	0.35	9.18
Paper, Printing, and Publications	0.07	1.74
Chemicals, Petroleum, Coal, Rubber, and Plastics	0.05	1.24
Basic Metals	0.02	0.53
Nonmetallic Minerals	0.67	17.64
Fabricated Metals, Machinery, and Equipment	0.00	0.00
Construction	0.65	16.97
Wholesale, Retail, Restaurants, and Hotels	1.02	26.84
Transport, Storage, and Communication	0.02	0.50
Financing and Business Services	0.00	0.11
Community, Social, and Personal Services	0.43	11.19
Tourism	0.24	6.29
Other Industries	0.00	0.00
Total	**3.82**	**100.00**

3. Size of subloans (actual) (SDR2,932,248.23)

Range	Number of Accounts	%	Aggregate Amount ($million)	Percent
Up to $5,000	94	33.45	0.32	8.38
Over $ 5,001 to $10,000	77	27.40	0.59	15.45
Over $10,001 to $20,000	63	22.42	0.85	22.25
Over $20,001 to $30,000	19	6.76	0.43	11.26
Over $30,001 to $40,000	13	4.63	0.44	11.52
Over $40,001 to $50,000	11	3.91	0.51	13.35
Over $50,000	4	1.42	0.68	17.80
Total	**281**	**100.00**	**3.82**	**100.00**

4. Other Breakdown of Subloans

Range	Number of Accounts	%	Aggregate Amount ($million)	%
A. Purpose				
New	251	89.32	3.54	92.67
Expansion	30	10.68	0.28	7.33
Balancing, Modernization and Replacement	0	0.00	0.00	0.00
Total	**281**	**100.00**	**3.82**	**100.00**

Range	Number of Accounts	%	Aggregate Amount ($million)	%
B. Maturity				
Accounts Closed	21	7.47	0.26	6.84
Up to 5 years	217	77.22	2.27	59.44
Over 5 to 10 years	39	13.88	1.08	28.30
Over 10 years to 15 years	4	1.42	0.21	5.42
Total	**281**	**100.00**	**3.82**	**100.00**
C. Location				
Central	37	13.17	0.35	9.19
East	9	3.20	0.41	10.84
West	235	83.63	3.06	79.97
Total	**281**	**100.00**	**3.82**	**100.00**
D. Procurement Procedures				
Reasonable Competition	281	100.00	3.82	100.00
International Shopping	0	0.00	0.00	0.00
Proprietary Basis	0	0.00	0.00	0.00
Total	**281**	**100.00**	**3.82**	**100.00**
E. Procurement by Country				
Germany	0	0.00	0.00	0.00
Denmark	2	0.71	0.11	2.96
India	270	96.09	3.33	87.17
Italy	0	0.00	0.00	0.00
Japan	1	0.36	0.01	0.16
Singapore	6	2.14	0.33	8.74
Sri Lanka	0	0.00	0.00	0.00
Switzerland	0	0.00	0.00	0.00
Taipei, China	0	0.00	0.00	0.00
Thailand	2	0.71	0.04	0.97
United Kingdom	0	0.00	0.00	0.00
Total	**281**	**100.00**	**3.82**	**100.00**