

**SAARCFINANCE Governors' Symposium 2011:
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**Financial Stability in Bhutan: Overview
and Policy Initiatives**

Background on Global Financial Crisis

While the vulnerabilities that created the potential for crisis were years in making, it was the collapse of the housing bubble – fueled by low interest rates, easy and available credit, scant regulation, and toxic mortgages- that was the spark that ignited a string of events, which led to a full blown crisis in the fall of 2008. Trillions of dollars in risky mortgages had become embedded throughout the financial system, as mortgage-related securities were packaged, repackaged, and sold to investors around the world. When the bubble burst, hundred of billions of dollars in losses in mortgages and mortgage related securities shook market as well as financial institutions that has significant exposures to those mortgages and had borrowed heavily against them. This happened not just in United States but around the world. The losses were magnified by derivatives such as synthetic securities.

The crisis reached seismic proportion in September 2008 with the failure of Lehman Brothers and the impending collapse of the insurance giant AIG (American International Group). Panic fanned by a lack of transparency of the balance sheets of major financial institutions, coupled with a tangle of interconnections among institutions perceived “too big to fail”, caused credit markets to seize up. Trading ground to a halt. The Stock market plummeted. The economy plunged into a deep recessions.

Source: The Financial Crisis Inquiry Report

Then followed the currency war, also known as competitive devaluation, a condition in international affairs where countries compete against each other to achieve a relatively low exchange rate for their home currency, so as to help their domestic industry. The global recession also affected Japanese Yen which tripped to 83 per USD and the Southern European countries with a single currency faced huge sovereign debt problems.

The most influential economy, the US, got into double recession, resulting into huge global disparity and imbalance and loss of confidence in paper currency, which affected the emerging economies like China, India, Brazil, Russia and Korea. These economic problems even more focused on the need to have a stronger capital regime with risk assessment particularly on liquidity, credit, market and operational risk.

Bhutan and the Global Financial and Economic Crisis

Bhutan was largely insulated from the full-on effects of the financial crisis in part due to sound macroeconomic management and the underdeveloped nature of its financial markets with limited exposure to international markets. There was some evidence that Bhutan had been affected through prices; inflation in Bhutan hit an all time high of 8.8 percent mid-2008. Meanwhile, interest on earnings from deposits and investments abroad were adversely impacted during 2008/09, with the US Fed Reserve reductions in its interest rates; the Central Bank’s interest income for the year decreased that year by 61percent.

During FY 2008/09, the nation's Central Bank, the Royal Monetary Authority (RMA), resorted to several measures to safeguard the soundness of the financial sector. In August 2008, the RMA tightened monetary conditions by raising the CRR to 17 percent (the CRR had been increased from 13 percent to 15 percent, effective from September 2007). Under prudential measures, provisioning requirements of sub-standard and doubtful loans of financial institutions were also raised from 20 percent to 30 percent and from 50 percent to 60 percent respectively, for the highest exposed sectors. Similarly, the capital base of banks was increased to Nu.300 million (USD 6.7 million) and that of NBFIs were increased to Nu.100 million (USD 2.2 million) with effect from January 2008.

Bhutan's Recent Macroeconomic Developments¹

Real GDP growth in Bhutan remained robust at 6.7 percent during 2009. The electricity and construction sectors continued to dominate output, with share of 19.3 percent and 12.3 percent to GDP respectively. Improved performance in these sectors reflects ongoing pre-construction as well as construction works on new hydropower projects. Similarly, performance of Bhutan's second largest sector at 18.2 percent of GDP, the agricultural sector, remained consistent since 2007. On the whole, growth prospects appear favorable for Bhutan, and growth is expected to stay strong for the remainder of the 10th Five Year Plan (2008-2013), growing on average by approximately 9 percent per year for the remaining years of the Plan period, propelled by continuing developments in the hydropower sector.

Bhutan's hydropower potential is currently estimated at 30,000 megawatts (MW), of which around 23,760 MW has been estimated as being techno-economically feasible. Presently, a little over 1,480 MW or about 5 percent of that potential has been harnessed. The RGOB aims to achieve a total installed capacity of 10,000 MW of hydropower by the year 2020. To that end, foundation stones were laid for the Punatsangchhu II (990MW) and Mangdechhu (720MW) hydropower projects on May 1, 2010 and pre-construction works are currently underway. Meanwhile, construction works on the Punatsangchhu I (1200 MW) hydropower project continues on track and is scheduled for completion by the end of 2015, while that for the Dagachhu project (114 MW) commenced October 2009, and targets completion by 2013. The Punatsangchhu II and Mangdechhu projects are due for completion the following year in 2016. Once commissioned, the operation of all four power plants is estimated to augment Bhutan's hydropower generating capacity more than four-fold.

Corresponding to overall growth, **money supply** (M2) expanded significantly by 26.7 percent as at the end of November 2010, driven mainly by the growth in Net Foreign Assets (4.2 percent) and expansion in domestic credit by 66.5 percent, against 44.2 percent in June 2010. Similarly, growth in credit to the private sector remains accelerated at 42.4 percent, against 38.6 percent in June 2010. In particular, the lendings of the

¹ Please see Annex 1 for a summary of Bhutan's Key Economic Indicators.

financial institutions concentrated mostly in the building and construction (26.3 percent), trade and commerce (16.7 percent), and manufacturing (15.9 percent) sectors.

Inflationary conditions in Bhutan worsened during the year due to a considerable increase in both food and non-food prices, and annual inflation rose to 9.1 percent during the last quarter of 2010, against lower rate of inflation of 4.05 percent during the same period last year.

Developments in Bhutan's external sector as indicated by the **balance of payments statistics** were characterized by a widening in the current account deficit to 14.3 percent of GDP during FY 2009/10 (deficit of USD 187.7 million) from 1.7 percent of GDP in 2008/09. This has been underpinned by a substantial widening of the trade deficit due to rapid growth in merchandise imports. India remains Bhutan's largest trading partner, accounting for 92 percent of exports and 72 percent of imports during FY 2009/10. Hydropower exports to India are still the most important export, accounting for 39 percent of total exports during the fiscal year. Bhutan's balance of payments flows continue to be dominated by developments in the hydropower sector and flows of official aid in grants and loans. Net inflows of capital grants (largely associated with the Punatsangchhu I hydropower project) and concessional publicly guaranteed loans to the tune of USD 127.2 million were a large factor in building the surplus in the capital and financial account balance which totaled USD 150.4 million at the end of June 2010. These capital and financial flows helped finance Bhutan's current account deficit, with a final overall surplus in the balance of payments of USD 94.3 million.

Corresponding to the surplus in the balance of payments, Bhutan's **official international reserves** grew to USD 868.1 million for the year ending June 2010, sufficient to finance 12.3 months of commodity imports. International reserve levels have now risen to USD 988.6 million as of November 2010 and are adequate to finance 13.4 months of commodity imports. Entrusted with managing the nation's international reserves, this responsibility has become immensely challenging for the RMA, due to the need to ensure adequate Rupee reserves to safeguard the integrity of the exchange rate peg with India. And with the nation's widening current account deficit with India, the Ngultrum's fixed peg to the Indian Rupee has placed additional pressure to ensure adequate Rupees to meet the economy's requirements.

At the end of the fourth quarter of 2010, Bhutan's **external debt** outstanding totaled USD 837.7 million, or 61.8 percent of GDP (as compared to 63.5 percent of GDP at the end of FY 2009/10). Indian Rupee denominated debt constitutes 56 percent of Bhutan's external debt and Rupee denominated debt expanded substantially during the year on account of borrowings from the Government of India towards the construction of the Punatsangchhu I hydropower project and for Rupee reserve management purposes². Corresponding to the expansion in both public and private external debt, Bhutan's debt service ratio

² Bhutanese authorities continue to avail of the short-term overdraft facility from the State Bank of India at an interest rate of 8.5 percent per annum.

continues to remain elevated at 37.2 percent for the quarter ending December 2010 up from 29.5 percent at the end of FY 2009/10.

Bhutan's **fiscal policy** remained accommodative during the recent year with the national budget deficit expanding to 6.7 percent of GDP for the FY 2009/10 (revised budget) from a surplus of 2 percent of GDP as of FY2008/09. Total expenditure grew from 38.5 percent of GDP during 2008/09 to 46.3 percent of GDP, attributed to the incorporation of additional budget allocations for both capital and current expenditures during the financial year. Fiscal spending continues to drive overall growth in Bhutan and is an underlying factor behind mounting pressures on external debt and the government deficit. On the other hand, total revenue including grants, marginally decreased from 40.4 percent of GDP to 40.1 percent of GDP during 2009/10. Current expenditure was estimated at USD 296.6 million, and was completely financed by domestic revenue amounting to USD 341.6 million, while capital expenditure was estimated at USD 356.1 million. Grant support helped finance 34.2 percent of total expenditure. Of the total deficit, 16 percent was financed through external concessional borrowing and the remaining through domestic sources.

RMA's Monetary Policy

In accordance with the RMA Act of Bhutan 2010, commencing 2011, the RMA shall formulate and publicly present the **Annual Monetary Policy Statement** in Parliament, as the central function of the RMA is to initiate appropriate policies with the objective of maintaining price stability, and external and financial sector stability to facilitate sustained economic growth in the country.

The cornerstone of Bhutan's Monetary Policy continues to be that of **Exchange Rate Targeting**, supporting the peg arrangement with the Indian Rupee and anchoring inflationary expectations to more stable conditions in India. A major aspect of Bhutan's monetary policy framework is to manage overall banking sector liquidity to smooth out sharp and undesirable liquidity fluctuations in the financial system. This is carried out through the use of indirect instruments including the Cash Reserve Ratio (CRR), Statutory Liquidity Ratio, Royal Government of Bhutan (RGOB) Treasury Bills, and prudent management of Bhutan's foreign exchange balances. In recent years, the RMA has continued to tighten monetary conditions by maintaining the CRR at 17 percent (the CRR was revised from 15 percent to 17 percent in August 2008). Under prudential measures, provisioning requirements of sub-standard and doubtful loans of financial institutions have also been maintained at 30 percent and 60 percent respectively, for the highest exposed sectors.

Pursuing Exchange Rate Targeting as a policy measure has not only contributed to low volatility in the bilateral real exchange rate with India, it has greatly facilitated smooth trade integration between India and Bhutan, while safeguarding competitiveness, which is critical to avoid unwarranted pressures on net reserves. Moreover, the peg arrangement has been instrumental in maintaining confidence in the local currency, while tying Bhutan to relatively stable economic and monetary conditions in India.

Overview of the Bhutanese Financial Sector

FY 2009/10 has been a year of **sustained growth and positive institutional transformation**, particularly for the nation's Central Bank. Just as the nation and Government have strived to strengthen its footing in the new dynamics of democracy, so also the RMA has endeavored to consolidate its position and powers through the new Royal Monetary Authority of Bhutan Act of Bhutan 2010, to enhance its capacity to effectively steer financial sector and macroeconomic growth for national socio-economic welfare. In addition, the Financial Services Bill 2010 was drafted and endorsed by the National Assembly of Bhutan and the Bill is currently under the Joint Sitting of the Parliament. The Financial Services Act (FSA) will repeal the Financial Institutions Act 1992 and strengthen the RMA's role as the integrated financial regulator in Bhutan.

In the year 2009/2010 Bhutanese financial system has seen almost 100 percent growth in the number of banks and insurance companies in the country, with the licensing of two new commercial banks and one insurance company. The only development bank in the country was also issued a deposit taking license to extend domestic banking services to the urban centre. At present, the Bhutanese financial sector consists of five banks (Bank of Bhutan Ltd., Bhutan National Bank Ltd., Druk PNBL and T-Bank Ltd.) including one development bank (Bhutan Development Finance Corporation Ltd.), two insurance companies (Royal Insurance Corporation of Bhutan Ltd. and Bhutan Insurance Ltd.), a pension and provident fund (National Pension & Provident Fund) and one stock exchange (Royal Securities Exchange of Bhutan).

The entry of new banks and non-banking institution has injected much needed competition and has improved financial intermediation in the financial system. However, with more players in the market and in light of the rapid credit growth, the nation's Central Bank, the Royal Monetary Authority (RMA) is aware of the necessity to enhance supervision over banks' risk management practices and financial disclosure to safeguard and maintain desirable asset quality and financial sector stability. Therefore, in relation to the establishment of basic regulatory framework for the supervision of banks, much has been achieved: PR 2002 was updated, restructured, expanded and implemented in order to ensure financial stability and consistency with the international best practices. However, in relation to the establishment of regulatory framework for insurance companies, although the regulations have been drafted, it hasn't yet been implemented due to limited knowledge in this field. For securities business supervision, adequate regulations (for Stock Exchange, Brokerage firms, Listing Rules, etc) are in place. Once the RMA's Financial Services Act is formally endorsed in the coming fiscal year, this will empower the RMA to further introduce new avenues and opportunities for innovative financial market providers that will meet the diverse financial needs of private sector and general public.

Impact of GFC on the Bhutanese financial sector

The global financial turmoil has not had systemic implications as Bhutan's financial linkages with the rest of the world are limited. However, it had some spill-over effects on the manufacturing and industry sector due to decrease in the demand, which resulted in loan repayment problems or high level of non-performing loans in this sector in 2008. The manufacturing and industry sector experienced the highest non-performing loans for the first time with about 30 percent (USD 12.89 million) share in the total NPLs, surpassing all-time high portfolio at risk, the housing loans. As a result, the Central Bank revisited the provisioning requirements for the financial institutions and asked the financial institutions to provide an additional 10 percent for the highest exposed sector. In 2009/2010, the demand for industrial products picked up with the recovery of Indian market and once again the Housing sector became the sector with highest non-performing loans.

Despite the tampering impacts of global financial crisis, performance of the Bhutanese financial sector was robust during 2010 and financial stability indicators are comfortable. As of November 2010, the combined assets of the financial sector grew by 37.4 percent to USD 1.4 billion (Nu.64.9 billion), of which over 90 percent belonged to the commercial banks and less than 10 percent to non-bank financial institutions. Bhutan's banking sector assets grew by 32.6 percent to USD 1.3 billion (Nu.59 billion), while that of the non-bank financial institutions increased by 117 percent to USD 130.5 million (Nu.5.9 billion), mostly due to the re-categorization of the Bhutan Development Finance Corporation Limited as a banking institution after receiving its license in March 2010. The financial sector's capital remains at a comfortable position despite an enhancement in the minimum paid-up capital and capital adequacy ratio (from 8 to 10 percent) requirements in March 2008. However, stress testing on credit risk faced by the financial institution demonstrates a considerable impairment in the capital (private banks running below the minimum capital requirement) in case the portfolio at risks increases especially in the Housing sector. In order to enhance the capital of the FIs, the RMA did not approve the full declaration of dividend as proposed by the FIs.

Total lending of the financial institutions continues to grow aggressively to nearly 23 percent y-o-y, driven by the demand for housing and construction credit as well as manufacturing and industrial loans. In the third quarter of 2010, the total lending of the financial institutions grew by almost 7 percent from the second quarter of same year to USD 708.52 million with highest concentration being in the Housing sector (almost 27 percent of total loans). On the other hand, the financial system's non-performing loan ratio has also improved, dropping to 8.6 percent from 10.3 percent during FY 2009/10³, as compared to 18.3 percent as of the FY 2008/09.

The business of financial sector remains profitable. However, the returns on assets and return on capital of the banking system are low at 0.7 percent and 6.3 percent as of September 2010. This, however, do not provide a true picture as this ratio are usually high towards the end of the year. Short term interest rates are broadly stable at 2 percent

³ Bhutan's Fiscal Year runs from July to June-end.

(negative in real terms) and excess liquidity in the banking system remains high at about 40 percent of reserve money.

Policy responses/ initiatives/ tools to ensure financial stability

The Financial Regulation and Supervision Department (FRSD) of the RMA conducts regular monitoring of the financial institutions through off-site surveillance, on-site inspection and special on-site inspection (only if required). The main objective of off-site surveillance is to serve as an 'early warning device' to detect emerging problems before these potentially leads to an open crisis threatening the viability of an individual financial institution or systematically within the financial sector as a whole. This detection is accompanied by analyzing key financial ratios and other financial data that are generated from periodic reports submitted to the RMA and producing of quarterly performance reports (a copy of the latest report annexed herewith). Further, in order to closely monitor and supervise the financial institution, a Relationship Manager for each institution has been appointed. During the on-site inspection, the team looks thoroughly into the operations of the institution, focusing more on credit and operational risks. The teams assess the competency of the Board and the management to run the institutions smoothly.

Besides, the RMA has for the first time submitted financial soundness indicators to the IMF for their assessment and this now forms a part of the RMA's regular reporting (annexed herewith).

RMA has brought about a lot of policy reforms. Some of them include:

1. Launching of CIB: On September 9, 2009, the RMA launched Bhutan's first Credit Information Bureau. The main objective was to "promote credit and exchange conditions and a sound financial structure conducive to the balanced growth of the economy." The establishment of the country's first Credit Information Bureau was one of many ways in which the RMA steps in to fill institutional gaps to strengthen the financial sector. At present, CIB has captured almost 90 percent of financial data of the financial institutions.
2. Financial Literacy Campaign: RMA, collaboration with the financial institutions has carried out financial literacy campaign in the western region of the country from March 15-24, 2010. The main intention was to educate and familiarize the public at large on the products and services provided by financial institutions.
3. Development of System: With the financial assistance from the Asian Development Bank under Financial Sector Development Project, a website for the RSEBL was developed and launched. Besides, an expert on securities business (international consultant) gave one month long training to the staff of RSEBL, FIs (brokerage firms) and the RMA on the regulations, supervisions and role and functions of a Stock Exchange.
4. Up gradation of Prudential Norms: One most important development in PR 2002 was that of Asset Classifications. The provisioning requirements for non-performing loans

were made stringent. This has a positive impact on the financial institutions' overall soundness. The other up-gradations pertain to Sections on Related Party Transactions, Share Ownership and Equity Investment (requiring all FIs to be a public limited company), Consortium Financing, interest calculation, etc.

5. Setting up of EFTCS: The RMA celebrated the historic inauguration of the Electronic Fund Transfer and Clearing System in June 2010. Furthermore, the RMA in collaboration with other financial institutions conducted another round of the Financial Literacy Program early 2010 in six key districts. It is the RMA's hope that these efforts will go a long way to promote and enhance the general public's understanding of the financial sector to enable them to make sound financial decisions and to avoid predatory lending and credit schemes.

6. Other initiatives: During the year, the RMA initiated the drafting of **several key policies for the financial** sector including the Microfinance Regulations, Branchless Banking Regulations, Corporate Governance Regulations, Anti-Money Laundering Regulations, and the Establishment of Re-insurance companies in Bhutan. The Authority has also declared a moratorium on the issue of commercial bank licenses till 2015 in line with economic market survey

With the rapid development of telecommunication technologies in the country as well worldwide, the financial system has integrated its operational and service functions and came up with various products to meet the increasing demands. The products include internet banking, SMS banking, personal banking, anywhere banking (BNBL), Health Insurance Scheme (by RICBL), etc.

Under FSDP/ADB –

- **Strengthen the legal and regulatory framework for the whole financial sector-** Drafted Financial Services Bill (covering Banking, Insurance, Securities, AML/CFT and other financial services).
- **Improve the Corporate Governance Structure and Operations of Financial Institutions-** Corporate Governance Regulations and Fit and Proper guidelines were prepared in 2010.
- **Establishing an AML/CFT frame work for Bhutan-** AML/CFT regulations, guidelines, reporting formats were prepared by the international consultant in 2010-2011. FIU was set up within the RMA in 2010, which will fully operate after the enactment of the FSA.
- **Developing Bhutanese accounting and auditing standards**
 1. established an accounting standards committee with representation of relevant agencies to take care of accounting and auditing reforms.
 2. The committee created the Bhutanese AASB on 26th July 2010.

- **Establishment of Central Registry:** To promote secured transaction and ease collateral requirements security interests in movable and immovable property of the borrower.