



SAARCFINANCE Seminar on  
**“The Strategies of Lending for Priority Finance in the SAARC Region”**

February 22, 2019

Dhaka, Bangladesh

**Country Paper for Bhutan**

Royal Monetary Authority of Bhutan

## **Priority Sector Lending: Country Paper for Bhutan**

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### **Abstract**

Priority Sector Lending (PSL) was implemented in Bhutan in January 2018 as an integrated platform to coordinate the interventions of the Government with improved access to finance from the financial institutions to stimulate the SME sector, locally called the Cottage and Small Industries (CSI) sector, as an important driver of Bhutan’s economic diversification. The PSL is a national program with the active involvement of both government agencies and the financial institutions, with both parties involved in assessing and monitoring the projects. The PSL Guidelines was crafted after extensive consultations with various stakeholders. The experience from implementing the PSL over the last one year is being used to improve the Guidelines for 2019. The smallness of Bhutan’s size is an advantage that allows active participation of many stakeholders and regular joint monitoring while social media has also been leveraged to enable efficient sharing of information and awareness.

### **1. Rationale and Preparations for Priority Sector Lending**

The cottage and small industries (CSI) sector is extremely important for the Bhutanese economy as a potential source of domestic production and employment, especially for our growing youth population while also addressing challenges in the agriculture sector and challenges related to rural-urban migration. Economic growth has been driven largely by the hydropower sector, while agriculture remains the largest economic sector, providing employment to more than half of the country’s labor force. The sector is faced with several challenges, associated with the extant practice of subsistence farming and resulting rural poverty and rural-urban migration. However, rising demand from the growing urban populace and Bhutan’s environmental policies and subsequent brand image present numerous opportunities especially in the organic and niche food market to transform

agriculture into a more enterprising and commercially-oriented CSI business that can also engage our youth in productive and meaningful employment.

Recognizing the potential of the CSI sector to diversify and promote inclusive growth, boost employment and reduce inequality, and the need to improve access to finance to the sector, a directed lending strategy that identifies various activities under the CSI sector as priority activities and that leverages various Government support schemes, was implemented in the form of the ***Priority Sector Lending Guidelines*** (attached as Annex).

The CSI sector is divided into agricultural CSI and non-agricultural CSI activities. Agricultural CSI includes primary production and value-added activities such as processing, packaging, marketing and sales. Non-agricultural CSI comprises production and manufacturing, and services. The Ministry of Economic Affairs defines the CSI sector in terms of employment size and investment size, with investment size taking precedence in case of conflict. Accordingly, the PSL Guidelines define the CSI sector by investment size, with investment up to Nu. 1 million defined as “cottage” and investment size above Nu. 1 million and up to Nu. 10 million defined as “small” industry.

However, Bhutan’s PSL initiative is more than just a directed lending program requiring banks to lend to the priority sector. The PSL was designed and implemented as an integrated platform to coordinate the interventions of the Government with improved access to finance from the financial institutions to stimulate the CSI sector as an important driver of Bhutan’s economic diversification.

Successive Governments have made huge investments in basic infrastructure such as road connectivity, water supply, electricity and telecommunications. Combined with improved access to finance, the PSL initiative is expected to complement the Government’s efforts for more inclusive growth and enable the beneficiaries to take advantage of existing infrastructure to boost their incomes and improve their livelihoods through engagement in the CSI sector. In addition, the Government also provides numerous support schemes to the CSI sector through a dedicated Department of Cottage and Small Industry under the Ministry of Economic Affairs, as well as through youth-focused entrepreneurship development

programs funded by the Ministry of Labour and Human Resources, while the Ministry of Agriculture and Forests provides several subsidies and support schemes to the agriculture sector (*please see the PSL Guidelines for various incentives and support schemes being provided*).

The former Government recognized the CSI sector as one of the five economic jewels of Bhutan. Numerous support schemes and incentives are already in place to promote the CSI sector, through the Ministry of Agriculture and Forests and the Ministry of Economic Affairs. In addition, the Government's Fiscal Incentives Act of Bhutan 2017 provides many fiscal incentives to the CSI sector. In particular, financial institutions that lend to the CSI sector at preferential interest rates (defined in the Act as rates that are below the commercial borrowing rates) are exempt from paying taxes on the income from such lending while the Royal Monetary Authority of Bhutan (RMA) Act 2010 empowers the RMA to prescribe the lending terms and conditions for the financial institutions towards the Government's priority sectors.

The PSL Guidelines leveraged on existing incentives and support schemes from the government to stimulate the CSI sector as an important driver of Bhutan's economic diversification through improved access to finance. The PSL was thus designed as an integrated platform because of the recognition that while access to finance is an important challenge, addressing this challenge needs to be complemented with other interventions from the government. Integrating government support and interventions with collective commitment from the financial sector for better financing is expected to catalyze the CSI sector into a growth driver that will contribute to achieving Bhutan's overarching national goal of sustainable and inclusive socio-economic development.

Preparatory works for the PSL initiative therefore involved extensive and frequent consultations and collaboration with several government agencies and the financial institutions over a period of one year before the PSL Guidelines was finally launched on 13 December 2017 for implementation with effect from 1 January 2018.

Collective ownership and commitment by the stakeholders were crucial in ensuring a successful launch and implementation over the last one year and will remain key in ensuring continued success going forward. Leadership and a shared vision were instrumental in spurring collective action and commitment. Bhutan has been fortunate to have leadership in the form of welfare-oriented and progressive hereditary monarchs, with each successive king working tirelessly for the benefit of the Bhutanese people. Bhutan's kings in turn inspire and motivate the Bhutanese people. The PSL too derived its inspiration from the king and was the outcome of His Majesty King Jigme Khesar Namgyel Wangchuck's national day address on 17 December 2016. His Majesty reminded the financial sector of the opportunities that the financial sector can create for Bhutan's youths and farmers in entrepreneurship and commercial farming. The national day address galvanized support for the Priority Sector Lending initiative and brought together the government and the financial sector towards a common national objective.

While the Royal Monetary Authority of Bhutan played a crucial role in initiating the PSL and facilitating stakeholder coordination, the PSL is viewed as a national program with the active involvement of many partners. As central bank, the RMA was best placed to bring on board the participation of the financial institutions in the PSL initiative. In addition, as an institution outside the government bureaucracy, the RMA was also able to bring together various relevant government departments and agencies to facilitate better coordination.

During the preparatory phase of the PSL Guidelines in 2017, the RMA sought technical assistance from the Reserve Bank of India to learn from the RBI's experiences, and later broadened internal consultations to the financial institutions and the government. In addition to consultations with the financial institutions, the RMA met with various government agencies at a bilateral level and hosted several joint meetings to better understand, streamline and coordinate the various interventions, regulatory clearances and processes.

In particular, the RMA held several meetings with the following government agencies: Ministry of Agriculture and Forests; the Department of Cottage and Small Industry, Ministry of Economic Affairs; National Environment Commission; National Land Commission; Bhutan Agriculture and Food Regulatory Authority; Ministry of Finance; and the Ministry of Labour

and Human Resources. The PSL Guidelines was also presented to the Cabinet and the National Council of Bhutan (Bhutan's Upper House).

The early engagement of key partners has resulted into broad-based ownership of and support for the initiative, which is crucial for its implementation and success.

## **2. Institutional Setup for Implementing the PSL**

Three institutional mechanisms were established for operationalizing the implementation of the PSL: (i) Dzongkhag PSL Committees (ii) Special credit delivery channels in the financial institutions, and (iii) the PSL Council.

Bhutan is divided into twenty administrative districts (Dzongkhag), each headed by a Governor (Dzongdag) who is a civil servant. All districts have officials from various ministries to assist the Governor such as the District Agriculture Officer, District Livestock Officer, District Planning Officer, District Environment Officer and so on. In partnership with the RMA's financial literacy program, an officer from each district also serves as the District Financial Literacy focal. For the PSL, the Prime Minister of Bhutan issued an executive order constituting and empowering the Dzongkhag PSL Committee to carry out the technical assessments and feasibility of PSL proposals and provide the regulatory clearances. The Dzongkhag PSL Committee is chaired by the Dzongdag/Governor and comprises of representatives from all relevant government agencies. The Committee selects one officer as the PSL Secretary who also serves as the contact point for the RMA. For a prospective PSL client, the Dzongkhag PSL Committee is the first point of contact.

Once a PSL client obtains clearance from the Dzongkhag PSL Committee, the client approaches a financial institution of his/her choice for a separate and independent credit appraisal. Clearance from the Dzongkhag PSL Committee does not guarantee a loan approval. Under the special PSL credit delivery channels of the financial institutions, all financial institutions have PSL focals who coordinate with their respective branch level staff to ensure that clients are provided with all the requisite information and support.

Finally, the PSL Council monitors and evaluates the implementation of the PSL Guidelines and provides recommendation to improve the Guidelines, in consultation with the Dzongkhags. The Council is chaired by the RMA and comprise of senior representatives from all government and financial sector partners.

Within the RMA itself, a broad spectrum of employees are involved in PSL related activities in addition to their regular responsibilities. Twenty employees from different departments and categories (officers as well as support level) volunteer as the Financial Literacy Focals for the twenty districts. With the introduction of the PSL, these focals have also taken on the role of PSL focals for their respective districts, responsible for coordinating with their district counterparts for data collection and other information sharing. A core PSL working team was also formed from among these focals to work on data compilation and analysis, awareness building and joint monitoring as well as liaising with other partners. The RMA's focals work in close coordination with their government and financial sector counterparts.

Social media applications have been leveraged extensively to create awareness, share information and to bring together the various stakeholders on a common platform. All twenty district governors or Dzongdags are on a common WhatsApp group along with the Governor and Deputy Governors of the RMA. The group regularly shares information and updates related to PSL activities and serves as an important tool to sustain the commitment and momentum for the PSL. Similarly, common chat groups have also been formed for the PSL Council as well as for the PSL focals.

Considering the importance of implementing the policy on the ground, the RMA also focused on awareness and capacity building especially for representatives from the government agencies. PSL focals from the financial sector along with government officials responsible for implementing the PSL were also trained through a trainers' program in priority sector lending at the Financial Institutions Training Institute (FITI) fully sponsored by the RMA prior to the launch of the PSL. Immediately following the launch of the PSL, three regional familiarization workshops were held in January 2018 for all the district governors who were accompanied by their PSL and Financial Literacy Focals. A follow up workshop was organized in May 2018 for the PSL focals from all the twenty districts of Bhutan.

### **3. Key Features of the PSL**

The PSL used a positive listing approach to identify products and activities within the broad definition of the Cottage and Small Industries sector. The Ministry of Agriculture and Forests and the Department of Cottage and Small Industries under the Ministry of Economic Affairs provided the main inputs in defining the priority list.

An important barrier in accessing finance was the lack of collateral. In order to break away from the traditional collateral- and guarantor-based lending, the PSL introduced insurance-based lending. 100 percent loan financing is available for primary production backed by two mandatory insurance – product insurance and loan protection for risk coverage from death and permanent disability of the policy holder. Given the high risks in agriculture and in order to promote groups and cooperatives, the loan limit for individuals in primary production was capped at Nu.500,000. Loans for all other activities are based on cash-flow or project financing along with fire and theft insurance with a debt-to-equity ratio of 70:30. The option of additional insurance are left to the borrower.

The two insurance companies worked with the RMA in designing insurance products for the PSL, introducing crop insurance and several livestock insurance products while coming together as co-insurers for the PSL. Crop insurance was introduced with a reasonable premium of 2.9 percent on the sum insured, while the existing premium on cattle insurance was reduced by half to 10 percent and other livestock insurance products were introduced with premiums ranging from 3 to 10 percent.

Indicative targets for lending were set for the financial institutions. As of June 2017, lending to agriculture constituted only 5 percent of the total portfolio of the five commercial banks, led by one of the development banks established with the mandate for rural lending. The remaining four commercial banks had either no lending or less than 1 percent of their portfolio in agriculture. On the other hand, there was a wide range in the lending to non-agricultural CSIs among the banks. In consultation with the financial institutions, a relatively straightforward target was set for 2018 as follows:

*1 percent of total loan portfolio for lending to Agricultural CSIs for all banks except the development bank (Bhutan Development Bank Limited)*

*Additional 1 percentage point on the exposure as of end-June 2017 for lending to Non-Agricultural CSIs for all banks and insurance companies (Insurance companies in Bhutan have also historically been involved in lending).*

However, in line with the spirit of collaboration and partnership that is the foundation of the PSL, the targets for 2018 were non-binding based on the request of the financial institutions who expressed their full commitment to the PSL but had reservations on the level of demand.

On-lending by the financial institutions to microfinance institutions and the Bhutan Development Bank Limited were allowed but not activated in 2018 since the targets were non-binding.

The government's Fiscal Incentives 2017 provided for the waiver of income tax on interest earned by the financial institutions through preferential lending to CSIs. In order to leverage this incentive, the RMA prescribed a ceiling Preferential Interest Rate linked to the Minimum Lending Rate (MLR) for loans to priority sector activities. The preferential interest rate ceiling was set at 8 percent for lending to Primary Production under Agricultural CSI and at 8.5 percent for non-agricultural CSI and value addition in Agricultural CSI for 2018, subject to periodic reviews. Financial institutions were free to compete on interest rates within the prescribed ceiling and be eligible for the fiscal incentives.

#### **4. PSL Performance in 2018**

All twenty districts participated in the PSL with the districts collectively receiving 1,274 PSL applications, out of which 1,009 projects were approved. The capital, Thimphu, received the highest number of applications. The majority of the projects (78%) were agriculture-related projects with the highest concentration in primary production. Projects were clustered around similar ideas while proponents were all individuals with only a handful of groups.

The financial institutions collectively assessed 779 projects in 2018, out of which 316 projects were approved. More than half the projects rejected by the financial institutions were on account of poor credit history of the clients. The financial institutions collectively sanctioned Nu. 305.8 million out of which Nu. 229.8 million were disbursed by the end of 2018.

While there were no NPLs as of December 2018, current updates reveal that repayment on 8 accounts were overdue by more than 45 days.

## **5. Compliance and Monitoring**

Compliance to the PSL guidelines is checked through the collection of detailed reports from both the districts as well as the financial institutions. The information from the two sources are crosschecked and used to compile the quarterly PSL reports. The status of projects with the financial institutions (whether approved or rejected, disbursements for successful projects and reasons for rejection) are shared with the districts.

An online system to process the PSL applications that is accessible to both the districts and the financial institutions has been developed by the Department of Cottage and Small Industries and is currently being tested by the users.

A key feature of the PSL initiative is the shared responsibility between the government and the financial sector. Since the Dzongkhag PSL Committee plays an important role in assessing and approving projects from a technical stance, the committee members are also expected to be actively involved in monitoring the projects. Information on overdue loans are reported by the financial institutions and shared with the respective districts for follow ups. In addition to the financial institutions and the districts, the RMA team is also involved in contacting and following up with PSL clients.

Since 2018 was introduced as a pilot year for the PSL, the RMA has been mindful of maintaining close contacts with all relevant stakeholders while also engaging with PSL clients and entrepreneurs in general to gain first-hand information on experiences from the implementation of the PSL to guide improvements for 2019. The RMA team visited the

districts, interacted with the PSL committee members and also visited PSL clients in each district. The visits were used to gather insights on how to improve the PSL and also as a joint monitoring event. The RMA team was accompanied by representatives from the PSL committees as well as branch level officers of the financial institutions. The visits were also used to spread awareness among the clients to institute a “culture of responsible borrowers.” During all its interactions with PSL clients and entrepreneurs in general, the RMA emphasized four key messages related to being responsible borrowers:

- i. Youths and farmers should take advantage of the PSL opportunity to productively engage themselves
- ii. Loans should be used for the intended purpose
- iii. Save a portion of the profit generated by the business
- iv. Invest back into the business to make it grow

The smallness of Bhutan’s size is an advantage that allows stakeholders to be actively involved in the monitoring process while social media has also enabled efficient sharing of information. Both mainstream and social media outlets have also been used to publicize positive stories to create awareness and continued enthusiasm for the PSL. The PSL’s first client was a young farmer who discontinued his undergraduate studies to take up farming on his ancestral land and was also the first client to successfully repay his loan after making a decent profit because of hard work and financial discipline. His story was widely covered by mainstream media and actively shared in order to promote PSL role models and youth in agriculture.

## **6. Challenges and Way Forward**

Capacity building continues to be an important area that needs sustained focus and investment. The Dzongkhag PSL Committees shoulder a key responsibility in assessing PSL proposals. While the government officials have good experience in the crop and livestock sectors, there is limited capacity in assessing non-agricultural proposals. There is also a general requirement for capacity building in business proposal assessments. Most clients also lack capacity in aspects such as accounting and book-keeping while ideas have not been very innovative so far.

While the level of commitment and due diligence of the Dzongkhag PSL Committees during assessment of PSL proposals have been commendable, there is a need to institute a formal accountability mechanism to incentivize efficiency and performance and ensure sustained efforts in monitoring and due diligence.

The most common feedback from prospective clients have been related to long turn-around-times in processing applications especially by the financial institutions. For some financial institutions, the branch level staff do not have any authority to recommend or approve loans and their responsibility has been limited to collecting the PSL applications and forwarding it to headquarters. Delegation of some authority to branch level staff along with accountability may increase the efficiency of the assessment process while on the other hand financial institutions have expressed concern on the ability to fix accountability.

Another possible reason for the delay may be tied to the fact that targets for the financial institutions are non-binding. Consultations are underway to explore how all the financial institutions can participate in a fair manner in PSL lending. For 2018, two banks accounted for over 80 percent of the approved PSL projects. While these two banks are the oldest banks and have better presence in the districts, there is room for all the financial institutions to improve their participation. Targets expressed as a ratio of the financial institution's capital fund are being explored.

While mandatory insurance was introduced to substitute for collateral or guarantor requirements, clients have found the insurance premiums, especially for livestock, to be high and adding to the cost of funds. On the other hand, the insurance companies are exposed to high risk with premiums collected disproportionately lower than the sum insured. The insurance companies are exploring expansion of insurance products beyond the PSL while some form of cost-sharing with the government have also been suggested to reduce the cost for PSL clients. Alternative means to de-risk lending to the CSI such as alternate credit scoring models and credit guarantees need to be explored.

Many entrepreneurs, especially young entrepreneurs and startups are unable to produce the 30% equity required to access the PSL loans. While the PSL was a crucial step to encourage more inclusive participation of the financial institutions in lending to Bhutan's CSI sector, there is a need for product diversification and alternate financing mechanisms such as supply-chain financing, crowdfunding, venture capital and other forms of risk capital.

Finally, related to the institution of a culture of responsible borrowers, more work is needed on the possible identification and segregation of clients into willful defaulters, fund diverters and genuine failures with differentiated responses, ranging from efficient and timely punitive action to rehabilitation through mentoring, debt restructuring etc. Further, since PSL lending is not backed by mortgage, risks to the financial institutions and avenues for recourse need to be further clarified.

The PSL initiative has gained immense momentum in the first year of implementation itself with participation of all stakeholders and good awareness among the general public. Going forward, we remain optimistic about the success of the PSL given the collective support from the various partners. Capacity building will be a key focus area for 2019 along with the continuation of joint monitoring programs. The implementation has not been without its challenges while many unforeseen issues have cropped up over the year. However, the approach of viewing the PSL Guidelines as a dynamic and live document that will be subject to a continuous process of evaluation and evolution ensures improvement and relevance.

The focus on the CSI sector is timely and relevant while economic and moral arguments to strengthen Bhutan's CSI sector have only become more pressing today. Bhutan's Gross National Happiness (GNH) led approach to development has always emphasized inclusive and sustainable development while His Majesty the King's aspirations for the creation of a "just and harmonious society" has further crystallized the expected outcomes of this GNH-led development process.

From an economic lens, societies are just and harmonious when there is equitable and inclusive distribution of the gains from development, when there is shared prosperity, and when citizens who are willing to engage themselves productively have the means to do so.

Bhutan has reached a critical demographic juncture. Our young working age population has been steadily increasing, with the highest concentration in the 25-29 and 20-25 age groups, closely followed by the 15-19 and 10-14 age groups. The 2017 Population and Housing Census of Bhutan refers to the increasing size of the young working population and suggests the presence of an accelerated demographic transition with opportunities for a demographic dividend through reduced dependency ratios.

However, taking advantage of this opportunity for a demographic dividend means that the young population must first have the opportunities to productively engage themselves. And it is the CSI sector that holds the most potential to productively engage our youth.

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