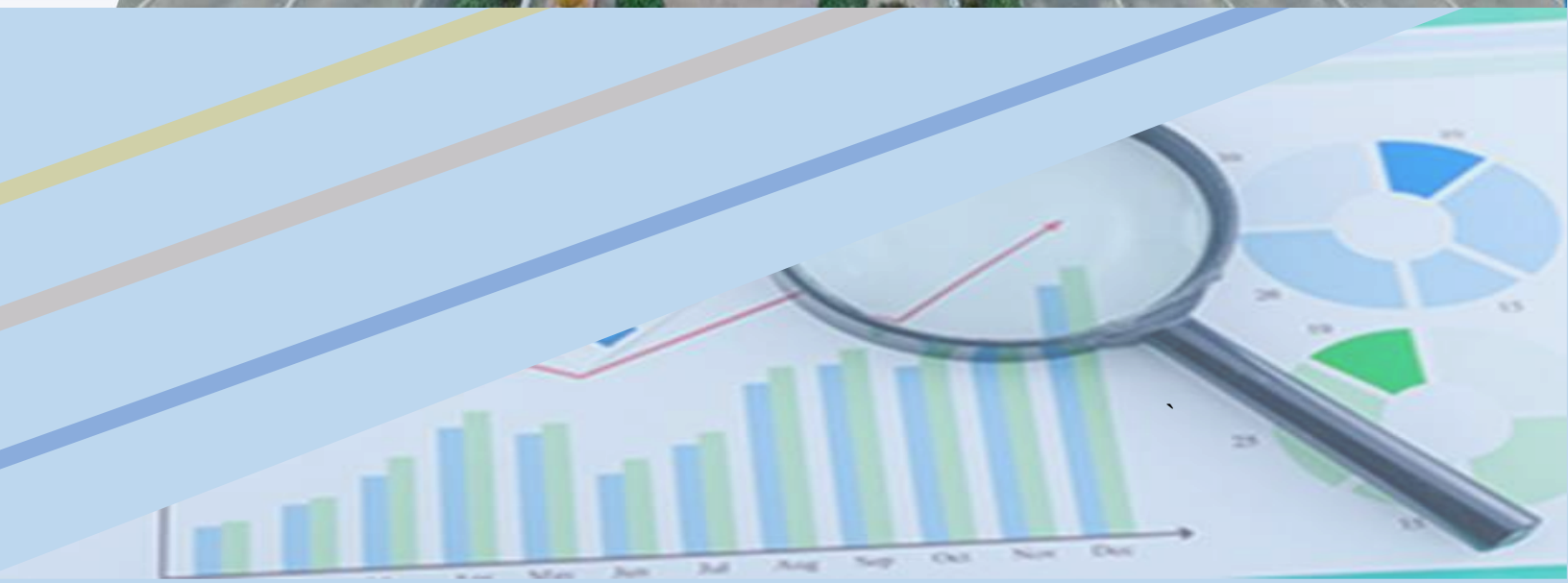
ANNUAL SUPERVISION REPORT

2021

Department of Financial Regulation and Supervision

June 2022



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Preface

To enhance transparency and inform on the stability and soundness of the financial sector, the Department of Financial Regulation and Supervision (DFRS), RMA publishes annual supervision report on the financial conditions and the Authority's supervisory and regulatory activities.

This report focuses on the five sections as follows:

The report consists of five sections:

- Structure of the Bhutanese financial sector;
- State of the financial sector and its associated risks;
- Supervisory priorities 2022-2023;
- Supervisory development; &
- Monetary measures and its impact.

Abbreviation & Acronyms

AASBB	Accounting & Auditing Standards Board of Bhutan
ALCO	Asset-Liability Committee
BCBS	Basel Committee on Banking Supervision
BDBL	Bhutan Development Bank Ltd.
BIL	Bhutan Insurance Ltd.
BNBL	Bhutan National Bank Ltd.
BoBL	Bank of Bhutan Ltd.
CAR	Capital Adequacy Ratio
CBS	Core Banking Solution
CCB	Capital Conservation Buffer
CEO	Chief Executive Officer
CG	Corporate Governance
CGRR	Corporate Governance Rules & Regulations
CIB	Credit Information Bureau
CRR	Cash Reserve Ratio
DRC	Department of Revenue & Customs
DFRS	Department of Financial Regulation & Supervision
DGRK	Druk Gyalpo's Relief Kidu
DPNBL	Druk PNB ltd.
ECL	Expected Credit Loss
FIs	Financial Institutions
FITI	Financial Institution Training Institute
FSPs	Financial Services Providers
GIC-BRL	GIC-Bhutan Reinsurance Ltd.
ICCAP	Internal Capital Control Assessment Process
ICT	Information & Communication Technology
IPS	Interest Payment Support
LTV	Loan to Value
MFIs	Micro Finance Institutions
MIS	Management Information System
MM	Monetary Measure
MoF	Ministry of Finance
NCSIDBL	National Cottage & Small Industries Development Bank Ltd.
NLC	National Land Commission
NPL	Non-Performing Loan
NPPF	National Pension & Provident Fund
OREO	Other Real Estate Owned
RAA	Royal Audit Authority
RBS	Risk-Based Supervision
RICBL	Royal Insurance Corporation of Bhutan Ltd.
RMA	Royal Monetary Authority
RSEBL	Royal Securities Exchange of Bhutan Ltd.
SLR	Statutory Liquidity Ratio

Executive Summary

The Bhutanese financial sector plays an important role in the economy, as Financial Services Providers (FSPs) are the main providers of essential financial services. The Royal Monetary Authority (RMA) of Bhutan ensures that the FSPs in Bhutan operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, comply with applicable laws and regulations. The RMA is, therefore, the preeminent prudential supervisor that adds value through proactive regulations and risk-based supervision.

As of December 2021, 28 FSPs, including banks, insurance companies, pension and provident fund, fund manager, microfinance institutions, insurance and securities brokers, credit information bureau and other financial infrastructure providers, have been providing varied financial services.

The COVID-19 pandemic has brought huge social disruptions and economic challenges. However, with the unprecedented and timely monetary measures (Phase I, II & III) issued by the RMA, the sector remained resilient and safe as indicated by the key financial stability and soundness indicators as of December 2021- Capital Adequacy Ratio (CAR) was 15 percent, Statutory Liquidity Ratio (SLR) was 33 percent, non-performing loans (NPLs) reduced to Nu. 15.8 billion from Nu. 24.8 billion in the previous year, deposits increased from Nu. 165.7 billion in 2020 to Nu. 185.8 billion in December 2021. The bold and timely intervention by the Royal Monetary Authority has continued to address and mitigate the implication on the Bhutanese financial sector and serve the needs of businesses and households through this period of uncertainty. In addition, to provide temporary reliefs to both the FSPs and the borrowers, as of December 2021, IPS amounting to Nu. 16,109.51 million was granted to 139,096 loan accounts. Further, loan amounting to Nu. 4.7 billion at concessional interest rate under the monetary measures was extended by the FSPs.

However, given the uncertainty of the extent and duration of the pandemic, the financial sector is still vulnerable and continues to face challenges posed by the pandemic. To understand the resilience of the FSPs and assess the impact of COVID-19 pandemic, the RMA has carried out the risk assessment of the financial institutions.

This **Risk Assessment** outlines RMA's assessment of the performance and key risks facing the financial sector, the resilience of financial sector to adverse shocks, and recommendations to ensure financial stability. The assessment is for the period ending fourth quarter, 2021 and includes five banks, two insurance companies and National Pension and Provident Fund.

The **Liquidity Position** of the financial sector is expected to remain relatively stable with the implementation of Domestic Liquidity Management Framework to help financial institution with liquidity support. The domestic financial system has already played a significant role in supporting liquidity needs of businesses so far during the pandemic. Deposit structure has remained stable and largely unaffected since December 2020. Financial institutions'(FIs)[1] Statutory Liquidity Ratio (SLR) as of December 2021 was 33 percent.

[1] FIs includes- 5 banks, 2 insurance companies (excluding GIC-BRL), and NPPF

Non-performing loans in the financial sector decreased from 15 percent (Nu. 24.3 billion) in December 2020 to 9 percent (Nu. 15.6 billion) in December 2021. Extensive monetary measures including the temporary deferment facility in place have helped in mitigating the immediate liquidity shock to the affected sectors/businesses and prevented further build-up of NPLs in the FIs. However, the impact of pandemic on FIs' Asset Quality (non-performing loans) is expected to be a key challenge going forward. If the pandemic's economic effects prove to be acute and persistent in medium to long term, FIs would be under stress and a significant portion of destressed loans may ultimately require restructuring. Considering such risks, the RMA has issued regulatory measures- rules and regulations on loan restructuring by the FSPs, guideline on the reclassification of old NPLs, and prompt corrective action framework. The FIs also have significant loan exposures amounting to Nu. 109.3 billion (62 percent of total loan outstanding) as of December 2021 to the sectors most affected by the pandemic (tourism, trade, manufacturing, commercial transport and commercial housing loans).

Weak **profitability** presents a challenge to future capital resilience as profit is an important element of capital growth. As of December 2021, FIs have made profit mainly on account of decrease in NPLs. The profitability (before tax) as of December 2021 stood at Nu. 4.6 billion as compared to a profit of Nu. 1.9 billion in December 2020.

The capital fund stood at Nu. 27.3 billion in December 2021 as compared to Nu. 23.3 billion in December 2020. The **Capital Adequacy Ratio** stood at 15.5 percent in December 2021 as compared to 13 percent in December 2020. However, the risk of dispersion/distribution of capital levels among the FIs remains high and some FIs that have entered the pandemic with relatively low capital and riskier exposures may face challenge. The release of the Capital Conservation Buffer (CCB) built prior to the pandemic have allowed financial institutions to cover for increase in non-performing loans and maintain their financing activities to the economy. The CCB release made available Nu. 2.6 billion across the financial sector, with the potential to support additional lending between Nu. 20 billion to Nu. 25 billion. However, given the overall uncertainty of the scale and duration of the crisis, it is important that the financial sector remains well-capitalized. Financial institutions should ensure that the assessment of their capital positions is forward-looking and that it takes into account current uncertainties.

Operational risk particularly ICT system and cyber risk may increase as a result of increase in digital dependency and remote working arrangements. So far, critical functions of financial institutions have continued to operate largely unaffected, as part of their business continuity plans. No major incident of business disruption attributable to the pandemic has been reported.

As we go forward, reactive to the changing economic situation, the RMA would prioritize its effort towards further reinforcing the stability and soundness of the financial sector by focusing on credit risk management practices, internal control and governance, risk management practices, internal capital adequacy assessment process of the FSPs, strengthening end-to-end credit ecosystem.

Part I: Structure of the Bhutanese financial sector

The Bhutanese financial sector plays an important role in the economy, as FSPs are the main providers of essential financial services. The RMA ensures that the FSPs in Bhutan operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, comply with applicable laws and regulations. The RMA is, therefore, the preeminent prudential supervisor that adds value through proactive and risk-based supervision.

The DFRS *(refer Chart 1)*, RMA regulates and supervises the FSPs *(refer Table 1)* through the formulation of rules and regulations, prudential standards, off-site monitoring, and onsite inspections. Some of the key functions of the DFRS, but not limited to, are as follows:

- Formulation and implementation of policies and prudential regulations;
- Assessing licence application of FSPs
- Conducting on-site inspection and off-site surveillance of FSPs

Chart 1: The chart shows the set-up of the Department of Financial Regulation & Supervision, RMA

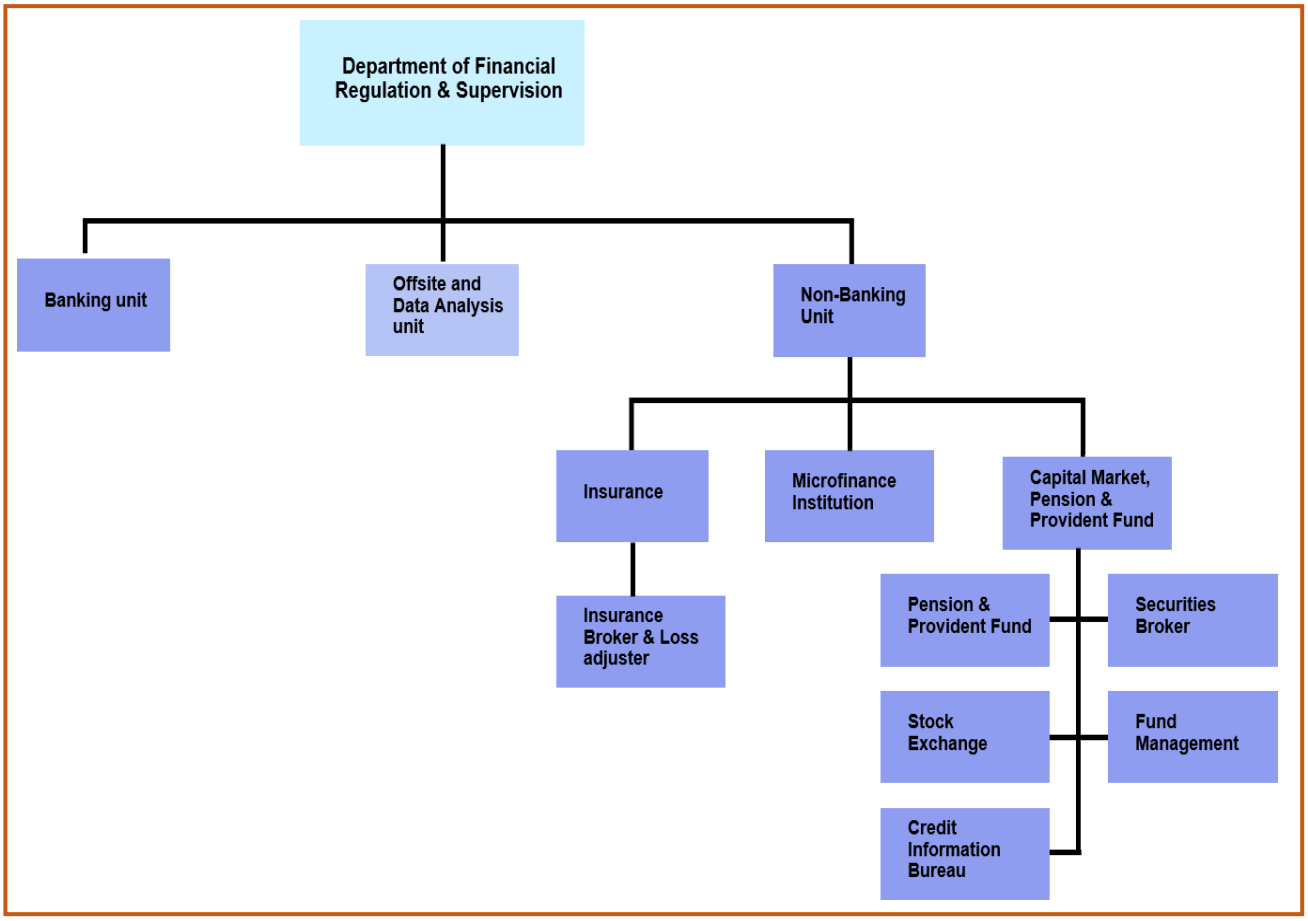
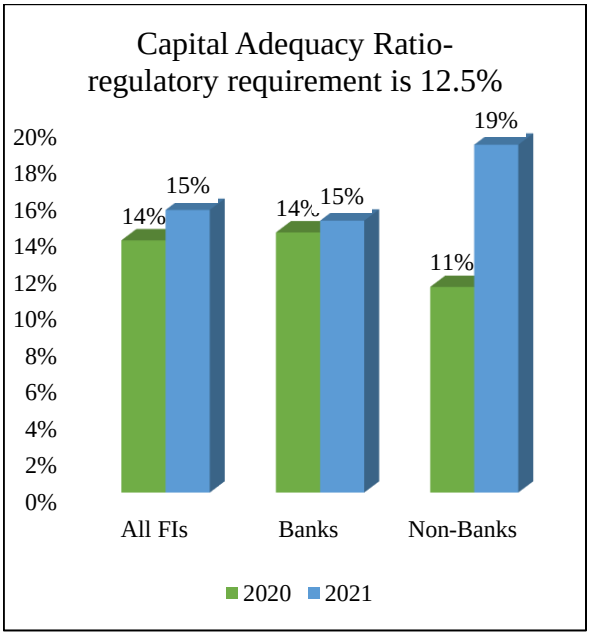


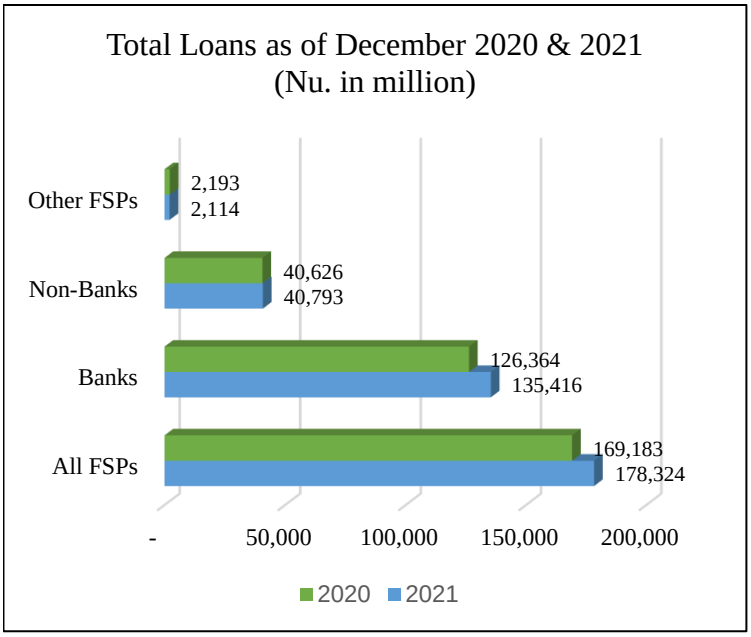
Table 1: List of banks, insurance and reinsurance companies, pension and provident fund, fund manager, microfinance institutions, securities exchange, insurance and securities brokers, and credit bureau, which are being regulated and supervised by the RMA.

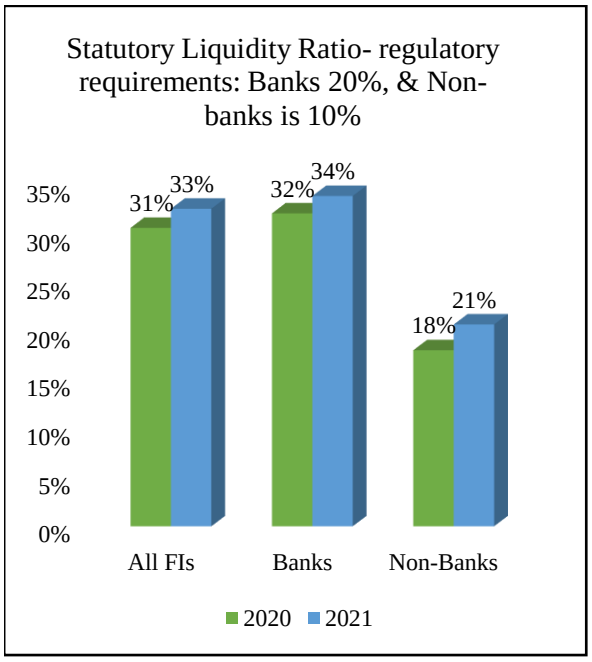
Sl. No.	FSPs	Establishment date
Bank		
1	Bank of Bhutan Ltd.	1968
2	Bhutan National Bank Ltd.	1980
3	Bhutan Development Bank Ltd.	1988
4	Druk PNB Ltd.	2009
5	T Bank Ltd.	2010
Non-Bank		
6	Royal Insurance Corporation of Bhutan Ltd.	1975
7	Bhutan Insurance Ltd.	2010
8	GIC-Bhutan Reinsurance Ltd.	2013
9	National Pension & Provident Fund	1962
Cottage & Small Industries Bank		
10	National Cottage & Small Industries Development Bank Ltd.	2018
Microfinance Institution		
11	RENEW Microfinance Pvt. Ltd	2016
12	Tarayana Microfinance Pvt. Ltd.	2017
13	BAOWE Microfinance Pvt. Ltd.	2018
14	Bhutan Credit Care Ltd.	2018
15	Microfinance Bhutan Pvt. Ltd	2019
Fund Manager		
16	Nubri Capital Pvt. Ltd.	2012
Securities Broker		
17	RICBL Securities	1994
18	BNBL Securities	1994
19	BDBL Securities	1994
20	BoBL Securities	1996
21	Drukyul Securities Broker Pvt. Ltd.	2015
22	Lekpay Dolma Securities Broker Pvt. Ltd	2019
23	Sershing Securities Broker Pvt Ltd	2020
24	Bhutan Post Securities Broker	2021
Insurance Broker		
25	Kubera Insurance Broker Pvt. Ltd.	2013
26	Lhojong Insurance Broker Pvt. Ltd.	2017
Infrastructure		
27	Royal Securities Exchange of Bhutan Ltd.	1993
28	Credit Information Bureau of Bhutan	2011

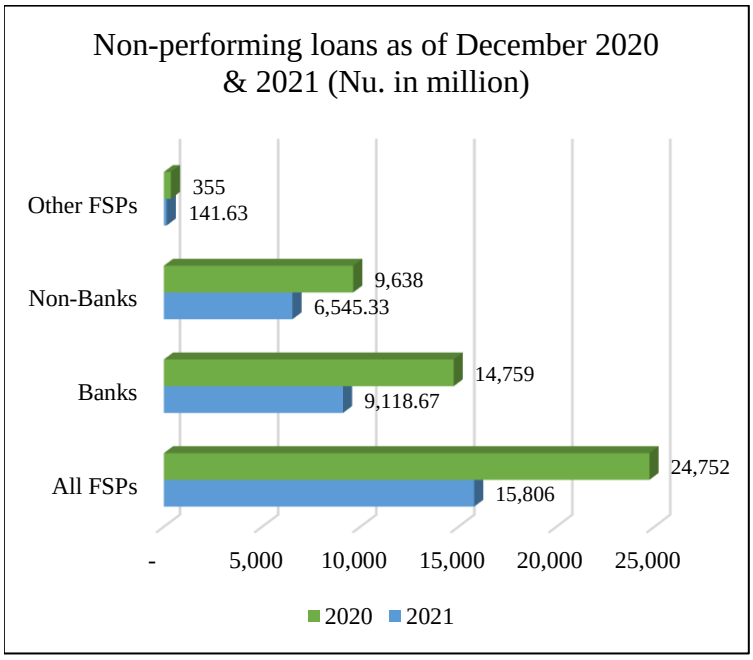
Part II: State of the financial sector and its associated risks

1. Key Financial Stability and Soundness Indicators at a glance[2]:

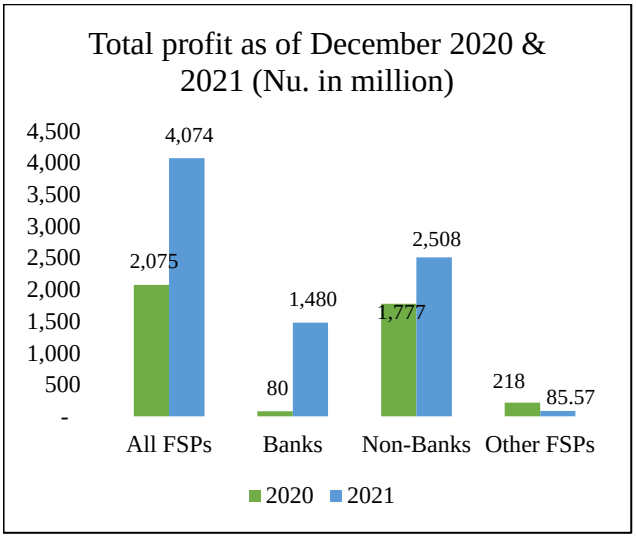


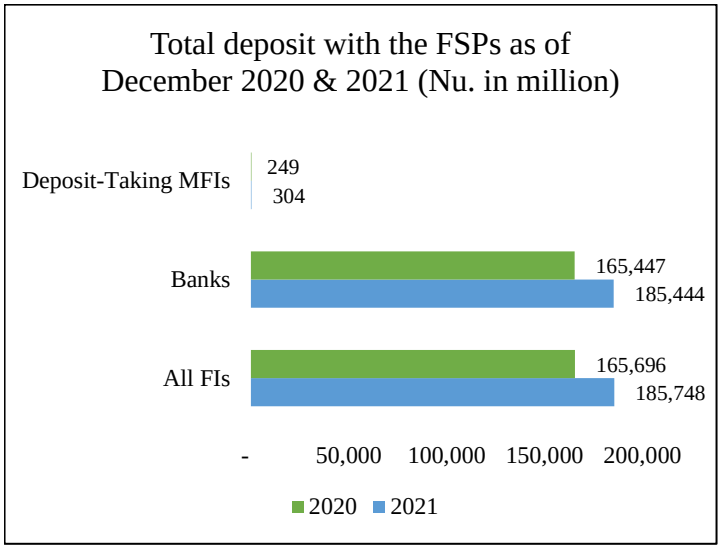




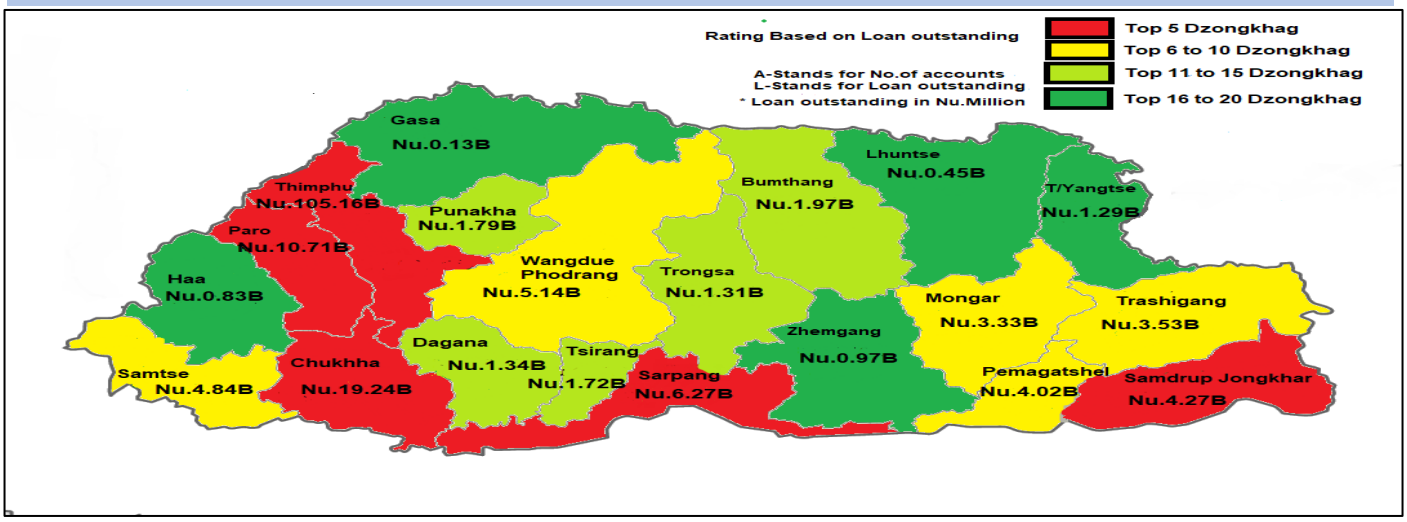


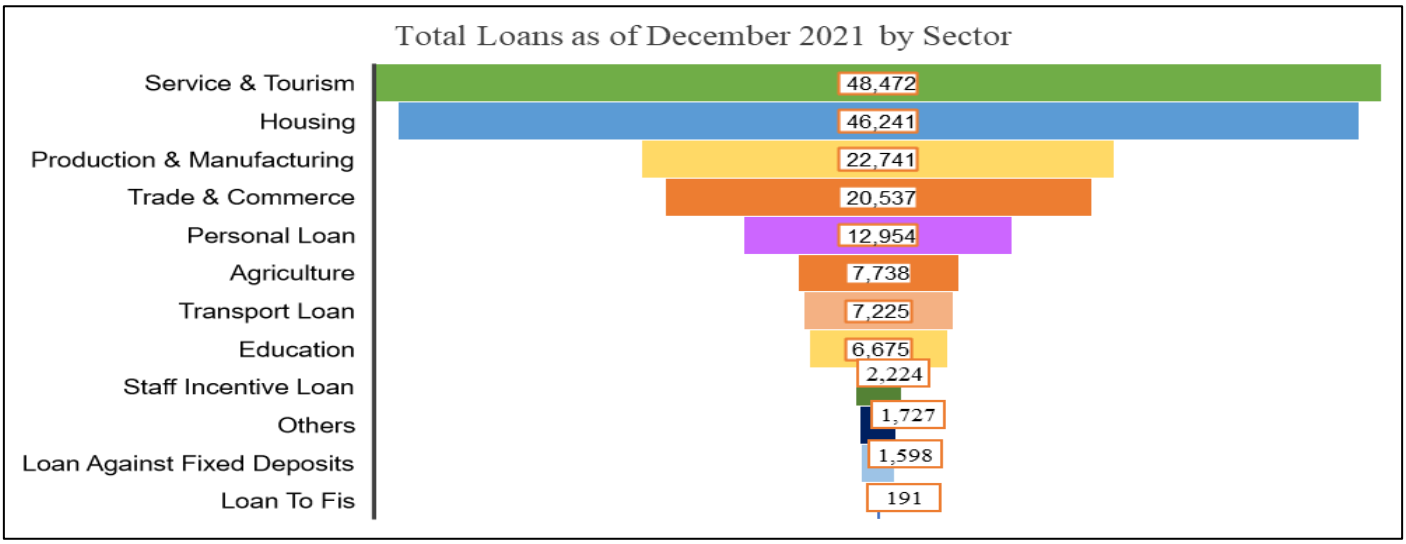
[2] Banks includes BoBL, BNBL, BDBL, DPNBL & T Bank Ltd.; Non-bank includes RICBL, BIL & NPPF, and other FSPs includes microfinance institutions, GIC-BRL & NCSIDBL





Dzongkhag-wise concentration of loans (Nu. in million)





2. Risk assessment

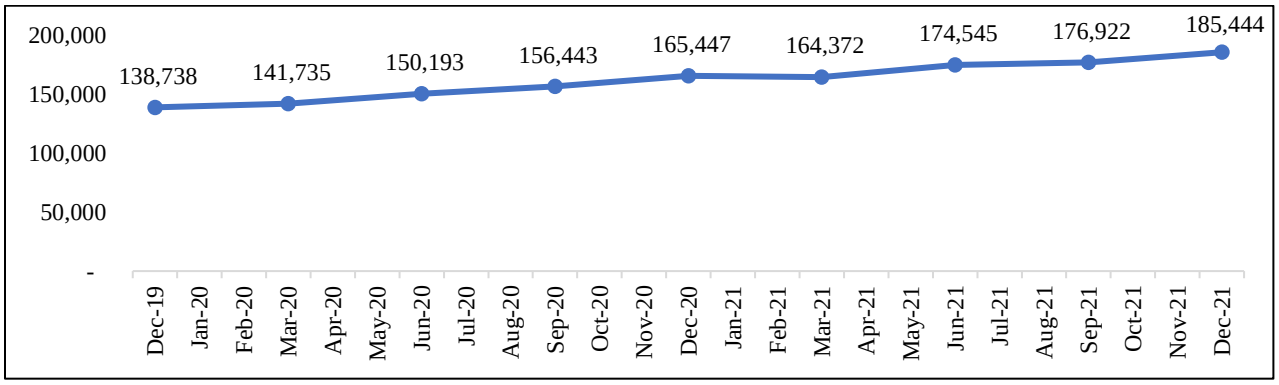
The RMA carried out the risk assessment of the financial sector to measure the impact of COVID-19 pandemic. The assessment report outlines the RMA's assessment of the performance and key risks facing the FIs, its resilience to adverse shocks, and recommendations to maintain financial stability. The assessment is for the year ending 2021 and includes five banks, two insurance companies and National Pension and Provident Fund. The state of the financial sector is determined based on the liquidity position, capital adequacy, profitability and asset quality of the FIs as follows:

2.1. Liquidity and funding risk assessment

2.1.1. Deposits have remained stable and unaffected

Since the outbreak of the COVID-19 pandemic, funding structure in terms of deposits have been stable and the deposit volume has been largely unaffected. The total deposits with the banks grew by 12 precent from Nu. 165 billion in December 2020 to Nu. 185 billion in December 2021.

Figure 1: Deposit composition in the banking sector



In terms of deposit composition as of December 2021, 60 precent (Nu. 111 billion) comprises of retail deposits and 40 percent comprises of corporate deposits (Nu. 73 billion).

Table 2: Quarterly retail and corporate deposit trend (Nu. in million)

Deposits Type	Dec (2019)	March (2020)	June (2020)	Sep (2020)	Dec (2020)	March (2021)	June (2021)	Sep (2021)	Dec (2021)
Corporate Deposits	66,449	67,143	68,323	66,760	68,053	66,795	69,696	65,764	73,806
Retail Deposits	72,288	74,592	81,870	89,683	97,393	97,577	104,849	111,158	111,638
Total Deposits	138,738	141,735	150,193	156,443	165,447	164,372	174,545	176,922	185,444

Table 3 shows the deposit by account type for the period ending December 2021. As indicated in the given table, 48 percent of total deposits are in the form of term deposits *(46 percent in fixed*

deposits and 2 percent in recurring deposits) indicating stable deposits in the banking sector. Remaining 52 percent of total deposits are in the form of demand deposits *(33 percent in saving deposits and 19 percent in current deposits)* which may be volatile in nature as this type of deposits can be withdrawn any time.

Table 3: Deposits by type as of December 2021

Deposit Type	Dec (2021) (Nu. in million)	% share against total deposits
Current Deposits	35,252	19%
Savings Deposits	61,232	33%
Fixed Deposits	84,734	46%
Recurring Deposits	4,226	2%
Total	185,444	100%

2.1.2. Financial Sector continue to maintain SLR above the regulatory requirement

FIs' SLR as of December 2021 are above the minimum regulatory requirement of 20 percent for banks and 10 percent for non-banks. Stable liquidity position has enabled the financial institutions to meet demand for new loans and committed funds. Table 4 shows the SLR position as of December 2021.

Table 4: SLR position as of December 2021

SLR (%)	BOBL	BNBL	DPNBL	BDBL	T Bank Ltd.	RICBL	BIL
	37%	26%	31%	29%	22%	21%	17%

2.1.3. Liquidity Position of the financial sector is expected to remain relatively stable in the medium term

Ensuring undisrupted flow of liquidity in the economy at all times is important to revitalize the economy and promote lending to productive sectors. Currently, one of the key challenges faced by the banking sector is the variation in liquidity holdings amongst banks, in particular due to its varying size and coverage. In order to promote easy access to liquidity in the financial sector, the RMA formulated a forward-looking Domestic Liquidity Management Framework (DLMF). The main objectives of this Framework are (i) to ensure and provide undisrupted and optimal level of liquidity in the financial system (ii) to encourage financial institutions to proactively carry out their liquidity management function based on the need and priority of the economy and (iii) to support the development of interbank lending operations and also develop the domestic money market.

2.2. Credit risk assessment

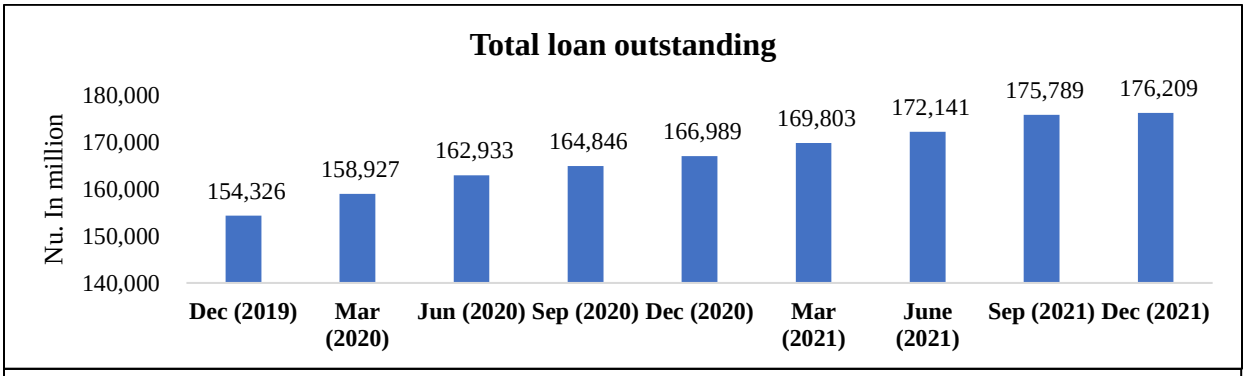
2.2.1. Loan outstanding and NPL trend in the financial sector

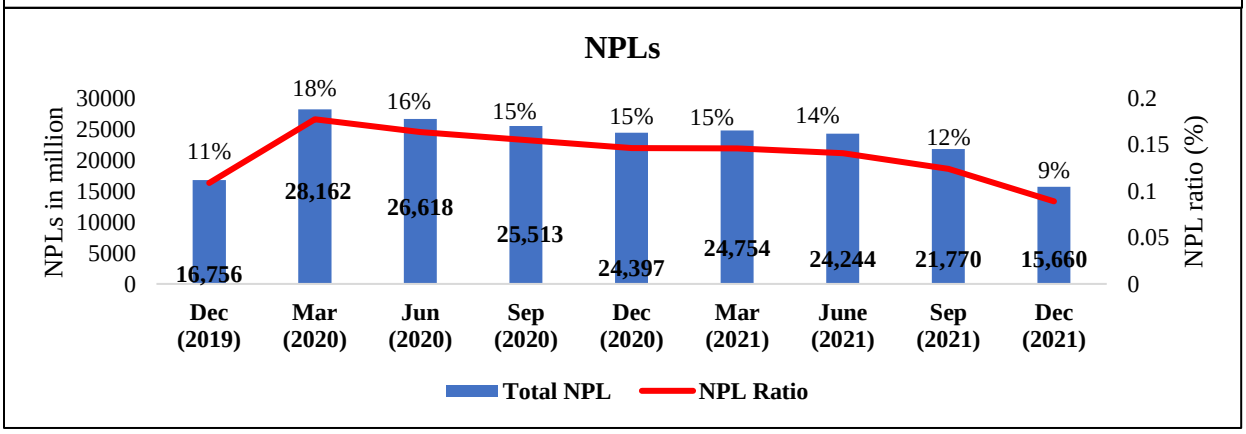
Total loans and advances have increased by 6 percent from December 2020 to December 2021 (from Nu. 167 billion to Nu. 176 billion). NPLs of the FIs has decreased from Nu. 24.4 billion in

December 2020 to Nu. 15.7 billion in December 2021 as a result of exceptional levels of policy support, the role of loan deferment facility and Interest Payment Support (IPS) *Kidu*, and also loan follow-up and recovery initiative undertaken by the financial institutions.

The loan deferment facility and the IPS *Kidu* are some of the key responses to the crisis, providing temporary relief from loan repayments to affected borrowers. This system-wide response which ran through for almost all loan portfolios provided relief regardless of whether the income-shock was short-term or potentially more permanent.

Figure 2: Shows quarterly loans and NPLs of the FIs (Nu. in million)





While NPLs ratio stood at 9 percent in December 2021, NPLs could rise significantly if the pandemic's economic effects prove to be acute and persistent in the medium to long term. The asset quality is expected to be a key challenge for financial institutions moving forward. As loan deferment facility expires, there will be borrowers who cannot return to full repayments and will require supports to address the specific issues they are experiencing.

2.2.2. Loan classification movements

The key indicator for credit quality of the institutions is movement of loans to a worse loan buckets/category as this indicates whether the loan book has undergone a significant increase in terms of credit risk. Table 5 shows the bucket wise loan comparison in the financial sector from December 2020 to December 2021.

Table 5: FIs' loan classification category (Nu. in million)

	Loan category	Dec (2020)	Dec (2021)
Regular loans	Standard (0-30 days)	128,151	151,809
	Watch (31-90 days)	14,442	8,736.75
NPLs	Sub-standard (91-180 days)	8,863	3,709.80
	Doubtful (181-365 days)	1,911	1,166.67
	Loss (> 365 days)	13,623	10,787.53

- NPLs: The loans under Sub-standard category (NPLs) have decreased from Nu. 8.8 billion in December 2020 to Nu. 3.7 billion in December 2021. Loans under Doubtful and Loss category have also decreased from December 2020 to December 2021.

- Performing loans: The loans under Standard category have increased from Nu. 128.2 billion in December 2020 to Nu. 151.8 billion in December 2021.

Table 6: FIs' loan classification status by bank and non-bank as of December 2021 (Nu. in million)

Loan category	All FIs	Bank	Non-bank
Standard (0 to 30 days)	151,809	121,631	30,177
Watch (31 to 90 days)	8,737	4,666	4,071
Sub-standard (91 to 180 days)	3,709.80	2,103	1,606
Doubtful (181 to 365 days)	1,166.67	888	279
Loss (more than 365 days)	10,788	6,127	4,660
(1) Total loans	176,209	135,416	40,793.40
(2) NPL ratio (%)	9%	7%	16%

2.2.3. Sectoral loan classification status of FIs as of December 2021

FIs' loan composition is expected to determine the extent to which they will be affected by the pandemic. Some loan sectors are expected to be hit harder than others, though predictions on the intensity of the impact on different sectors are difficult. Table 7 shows the sectoral loan classification status:

Table 7: Sectoral loan classification status as of December 2021 (Nu. in million)

Sectors	(A) Sectoral Loans and NPL (Nu. In million)							(B) Percentage Holding	
	Standard (0 to 30 days overdue)	Watch (31 to 90 days overdue)	Sub-standard (91 to 180 days overdue)	Doubtful (181 to 365 days overdue)	Loss (more than 365 days overdue)	(A.1) Total Loan O/S	(A.2) NPLS	(B.1) Setoral loan % against total loans	(B.2) NPL % against respective sector
Agriculture/Animal Husbandry	5,234	296	124	151	486	6,290	760	4%	12%
Production/Manufacturing	18,732	955	1,358	24	1,439	22,508	2,821	13%	13%
Tourism Related	23,489	1,376	683	83	767	26,399	1,533	15%	6%
Contract (construction based)	2,751	971	258	76	2,090	6,146	2,424	3%	39%
Others: Service	14,083	681	71	90	800	15,726	961	9%	6%
Trade/Commerce	15,924	1,608	427	98	2,306	20,363	2,831	12%	14%
Loans to FIs	191					191	-	0%	0%
Home loans	8,631	300	96	61	283	9,370	440	5%	5%
Commercial Housing loans	34,183	1,001	182	131	1,358	36,854	1,671	21%	5%
Commercial Transport	4,292	728	267	282	407	5,976	956	3%	16%
Non-commercial Transport	1,091	90	20	6	43	1,249	69	1%	5%
Personal Loan	11,667	393	90	73	717	12,940	880	7%	7%
Staff loan	2,163	21	4	4	10	2,201	17	1%	1%
Education loan	6,298	175	129	56	17	6,675	202	4%	3%
Loan Against Fixed Deposit	1,554	43		0	1	1,598	1	1%	0%
Loans to Government						-	-	-	-
Others	1,526	99	2	33	63	1,723	98	1%	6%
Total	**151,809**	**8,737**	**3,710**	**1,167**	**10,788**	**176,209**	**15,664**	**100%**	**9%**

(Hardest-hit sectors by the pandemic: (1) Tourism related (2) Manufacturing (3) Trade (4) Commercial Transport and (5) Commercial Housing)

The following are the sectors most at risk posed by COVID-19 pandemic:

(a) **Tourism related loans:** with exposure of 15 percent of total loans in the financial sector as of December 2021.
(b) **Manufacturing/Production sector loans:** with exposure of 13 percent of total loans in the financial sector as of December 2021.
(c) **Trade/Commerce sector loans:** with exposure of 12 percent of total loans in the financial sector as of December 2021.
(d) **Commercial Transport loans**: with 3 percent of total loans in financial sector as of December 2021.
(e) **Commercial Housing loans**: with a share of 21 percent of total loans in financial sector as of December 2021.

Sectors that are most at risk are those which are more exposed to the COVID-19 pandemic and those impacted by supply chain disruptions.

The total loan exposure of financial institutions towards the most-hit sectors makes around 62 percent of total loans as of December 2021 amounting to Nu. 109.3 billion.

- As of December 2021, 91 percent of total loans are performing loans (standard and watch category) amounting to Nu. 160.5 billion and remaining 9 percent are NPLs (sub-standard, doubtful and loss bucket) amounting to Nu. 15.7 billion.

- Out of regular loans of Nu. 160.5 billion, 64 percent are the loans provided towards the most-hit sectors (tourism, production/manufacturing, trade/commerce, commercial transport and commercial housing loans) amounting to Nu. 102 billion.

- Out of the total tourism sector loans of Nu.26 billion, 6 percent were NPLs amounting to Nu. 1.5 billion as of December 2021. In the worst-case scenario, the entire tourism portfolio of Nu.26 billion could be at risk of becoming NPL.

- The pace of recovery in the manufacturing sector depends on how quickly the industries can resume production at normal levels and how severely the pandemic has disrupted supply chains including the availability of labour. Total loans to the manufacturing sector stood at Nu.22 billion as of December 2021, out of which, Nu. 2.8 billion or 13 percent were NPLs.

- Personal loans, particularly consumer loans that were given to private sector employees may also likely see an increase in NPLs as a result of job losses.

Table 8 shows the financial institution's sectoral loan outstanding and exposure towards the most-hit sectors as of December 2021. The total loan outstanding as of December 2021 amounted to Nu. 176.2 billion, of which 77 percent are provided by the banking sector and remaining 23 percent by the non-banks.

Table 8: FIs' loan composition as of December 2021 (Nu. in million)

Sectors	All FIs	Bank	Non-bank
Agriculture/Animal Husbandry	6,290	6,233	57
Production/Manufacturing	22,508	15,806	6,702
Tourism Related	26,399	21,267	5,132
Contract (construction based)	6,146	2,565	3,581
Others: Service	15,726	10,809	4,916
Trade/Commerce	20,363	16,206	4,156
Loans to FIs	191	16	175
Home loans	9,370	8,771	599
Commercial Housing loans	36,854	31,229	5,625
Commercial Transport	5,976	4,847	1,129
Non-commercial Transport	1,249	1,032	217
Personal Loan	12,940	10,776	2,164
Staff loan	2,201	1,751	450
Education loan	6,675	1,209	5,466
Loan Against Fixed Deposit	1,598	1,598	-
Loans to Government	-		-
Others	1,723	1,299	424
Total	176,209	135,416	40,793
Exposure to most-hit sectors (%)	64%	66%	56%

- Among the loan sectors, the highest loan outstanding can be seen under commercial housing loan with Nu. 36.85 billion or 21 percent of total loans followed by tourism related loans with Nu. 26.40 billion or 15 percent of total loans and production/manufacturing loans with Nu. 22 billion or 13 percent of total loans as of December 2021.

- Financial institutions with High Exposure to most-hit sectors by COVID-19 could be vulnerable if COVID-19 pandemic continues.

Table 9: Sectoral NPL composition in the financial sector as of December 2021 (Nu. in million)

Sectors	All FIs	Bank	Non-bank
Agriculture/Animal Husbandry	760	760	1
Production/Manufacturing	2,821	1,622	1,199
Tourism Related	1,533	784	749
Contract (construction based)	2,424	634	1,790
Others: Service	961	618	343
Trade/Commerce	2,831	1,981	850
Loans to FIs	-	-	-
Home loans	440	410	29
Commercial Housing loans	1,671	846	825
Commercial Transport	956	810	146
Non-commercial Transport	69	47	21
Personal Loan	880	444	436
Staff loan	17	13	4
Education loan	202	116	87
Loan Against Fixed Deposit	1	1	-
Loans to Government	-	-	-
Others	98	31	67
Total	15,664	9,119	6,545
NPL ratio	9%	7%	16%

- The highest NPL can be seen under production/manufacturing and trade/commerce sectors with Nu. 2.82 billion and Nu. 2.83 billion respectively followed by contract (construction based) loans with Nu. 2.4 billion as of December 2021.

Table 10 shows financial institutions loan loss provision (NPL coverage ratio) set aside for NPLs as of December 2021. The Specific-Provision to NPL ratio in the financial sector stood at 77 percent as of December 2021.

Table 10: Loan Loss Provision (NPL Coverage Ratio) as of December 2021 (Nu. in million)

Particulars	All FIs	Bank	Non-bank
Specific Provision charged	*12,109.0*	*7,177.0*	4,932.0
Total NPLs	*15,660.0*	*9,118.0*	6,541.0
Specific provision to NPL coverage ratio	77%	79%	75%

2.3. Profitability assessment

2.3.1. The COVID-19 pandemic is expected to have significant adverse impact on profitability

Weak profitability presents a challenge to future capital resilience as profits are an important element of capital growth. As of December 2021, financial institutions have made profit mainly on account of decrease in NPLs. Table 11 shows the financial institution's profitability as of December 2021:

Table 11: Quarterly FIs' profit (Nu. in million)

Particulars	Period	All FIs	Bank	Non-bank
Profit before tax	December, 2019	3,494	1,838	1,657.00
	March, 2020	5	-1,911	1,915.00
	June, 2020	-622	-2,628	2,006.00
	September, 2020	-1,084	-1,713	628.00
	December, 2020	1,928	205	1,723.00
	March, 2021	2,344	-313	2,656.00
	June, 2021	3,616	103	3,513.00
	September, 2021	3,177	1,610	1,568.00
	December, 2021	4,672	2,091	2,579.00

2.3.2. Positive impact of profitability contributed by loan deferment and interest payment support *Kidu*

The loan deferment facility and interest payment support *Kidu* has helped financial institutions to prevent from further build-up of NPLs and huge negative net interest income (difference between interest income and interest expenses). Without these stimulus package, COVID-19 pandemic might have caused a decline in financial institutions' interest income, and potentially impacting the capital and earning of financial institutions. Table 12 shows the financial institution's profitability status as of December 2021.

Table 12: FIs' profit as of December 2021 (Nu. in million)

Particulars	All FIs	Bank	Non-bank
Interest Income (A)	17,237	13,013	4,225
Interest expenses (B)	10,833	9,106	1,726
Net Interest Margin (C) = (A) -(B)	6,405	3,906	2,498
Operating Income (D)	1,941	1,114	827
Operating Expense (E)	3,438	2,760	678
Net Income (F)= (C) + (D) - (E)	4,907	2,260	2,647
Additional provision charged	236	167	68
Profit before tax (after adjusting provision)	4,672	2,091	2,579
Profit after tax	3,783	1,274	2,508

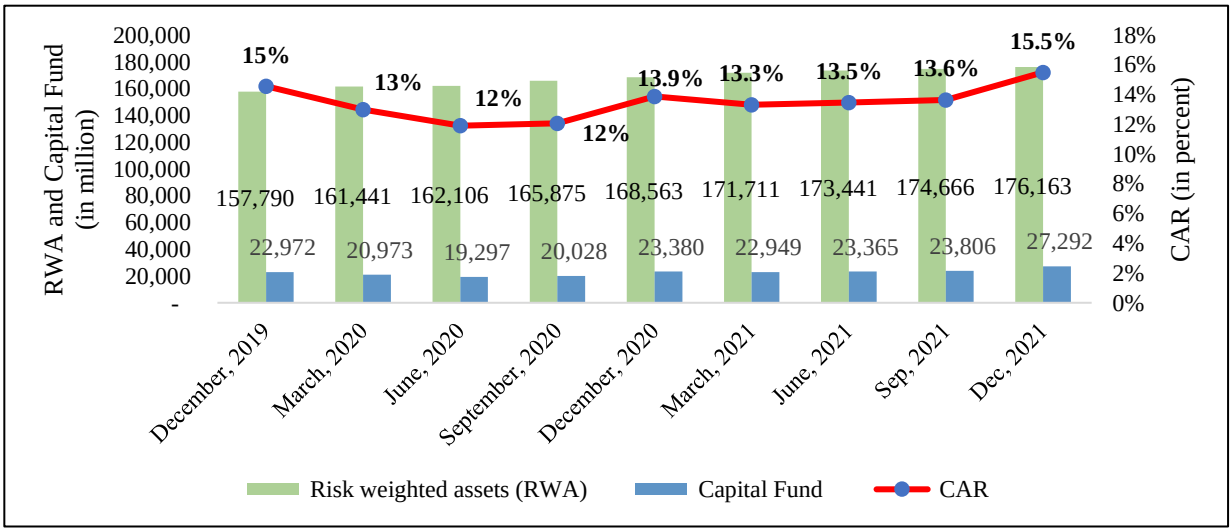
The financial sector made a profit of Nu. 3.7 billion (after tax) as of December 2021. If the current economic conditions persist over the medium term and borrowers are not able to repay their loans, the financial institutions would be under pressure and need to recognize the losses on the loans by writing down the value of their capital.

2.4. Capital risk assessment

2.4.1. Capital adequacy analysis

Financial sector entered the COVID-19 pandemic with the capital adequacy ratio (CAR) of 15 percent as of December 2019 including the requirement of capital conservation buffer (CCB)[3] of 2.5 percent which will allow the financial sector to cover potential credit losses. As reflected in figure 3, the CAR of financial sector as of December 2021 stood at 15.5 percent (against the minimum requirement of 10 percent) as compared to 13.9 percent in December 2020. The decrease in NPLs in most financial institutions from December 2020 to December 2021 has led to the improvement in CAR of the FIs.

Figure 3: Risk-weighted assets and capital adequacy ratio of FIs



[3]CCB ensures that financial institutions build up capital buffers outside periods of stress which can be drawn down as losses are incurred in order to avoid breaches of minimum capital requirements:

Capital buffers built prior to the pandemic and the regulatory relief provided by the RMA has allowed financial institutions to increase their lending to the economy, particularly to those sectors most in need of liquidity, and help financial institutions to withstand the impact of forthcoming expected credit risk losses stemming from the crisis. The CCB release makes available Nu. 2.6 billion of capital across the financial sector, with the potential to support additional lending between Nu. 20 billion to Nu. 25 billion. However, the dispersion of capital levels among financial institutions remains high, and some financial institutions having entered the COVID-19 crisis with relatively lower capital levels and riskier exposures may face challenges.

2.4.2. Financial institution's CAR position

The extent to which financial institutions will be affected by the crisis is expected to differ widely, depending on how the crisis evolves and the starting capital level of each financial institution and the magnitude of their exposure to the most affected sectors.

2.5. Operational risk assessment

With the outbreak of the COVID-19 pandemic and unprecedented containment measures introduced, the most urgent concern of the financial institutions was to ensure to operate unimpeded and provide their essential services. Most of the financial institutions have switched their business to online through the internet, mobile phone and apps exposing to various types of risk such as cyber risk (fraud, remote working), information technology (IT) risk, employees and reputational impacts.

So far, critical functions of financial institutions have continued to operate largely unaffected, as part of their business continuity plans. No major incident of business disruption attributable to the pandemic has been reported. Nonetheless, digitalization of financial services and the use of IT solutions might considerably contribute to alleviation of the pressure and the impact of the pandemic on financial institutions' operations. Therefore, financial institutions should ensure that their IT infrastructure is strong and remain vigilant to address data integrity, business continuity and to address cyber threats.

3. Measuring financial system resilience: Stress-test

The COVID-19 pandemic will continue to have significant adverse effects on Bhutanese economy, whereby exposing the FIs to the economic effects of the pandemic. In addition, uncertainty remains over macro-financial outlook, borrowers' repayment capacity, and opportunities for income generation through new lending. Therefore, to understand the risks to financial stability and assess resilience of FIs, stress-testing is done under different hypothetical scenarios.

3.1. Stress-test scenarios and assumptions

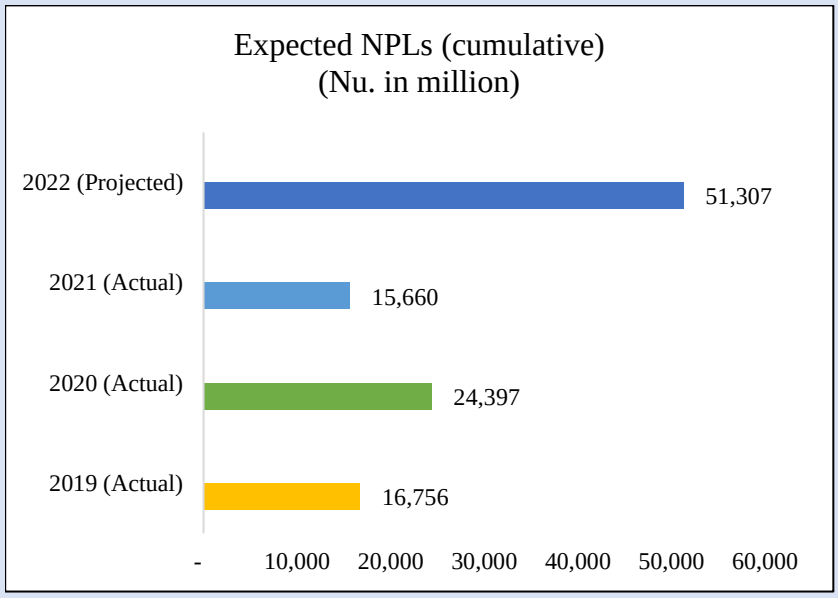
The following scenario has been developed taking into consideration the current slowdown in economic activities (macro-economic outlook) and uncertainty posed by the COVID-19 pandemic: The stress-test exercise has been conducted without taking into consideration the existing monetary measures (deferment facility as well as interest payment support Kidu).

3.2. Key assumption for stress test

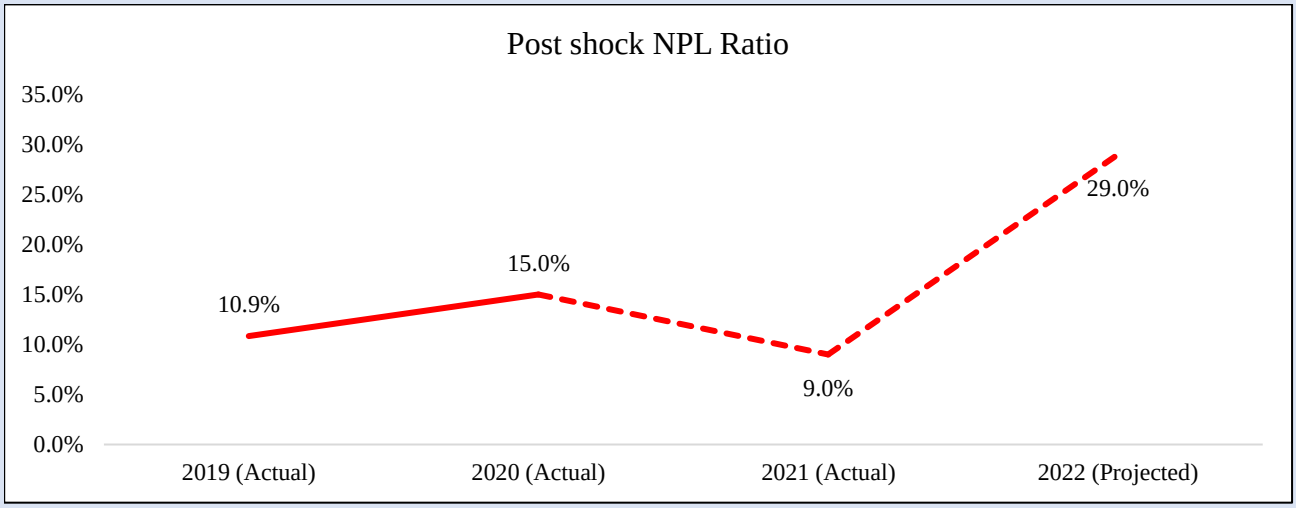
1. Discontinuation of interest payment support kidu and loan deferment facility from July 2022
2. Scenario analysis
   a. Sectoral NPL ratio of the most-hit sectors by the pandemic doubles in December 2022 from December 2021
      i. Production/manufacturing: 13% in December 2021 to 26% in December 2022;
      ii. Commercial transport: 21% in December 2021 to 42% in December 2022;
      iii. Trade/commerce: 14% in December 2021 to 28% in December 2022;
      iv. Commercial housing loans: 5% in December 2021 to 10 % in December 2022
   b. Tourism related loans at risk: 60% of regular loans turning into NPLs

3.3. Stress-test (What-if scenario analysis) results:

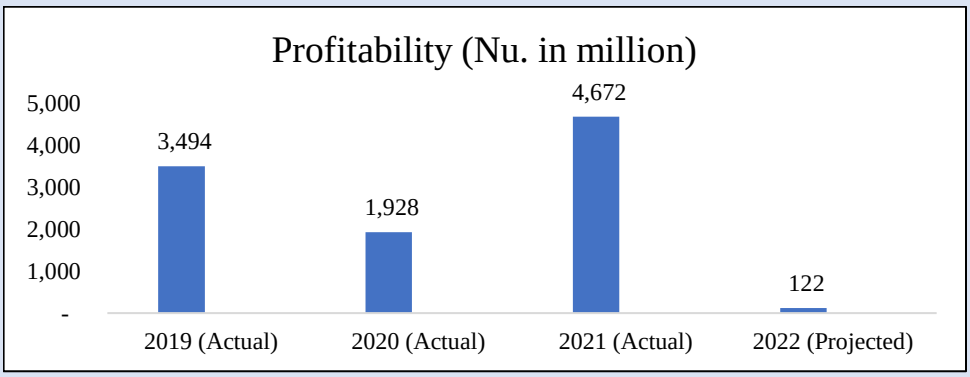
a) Expected NPL ratio in the FIs



- The financial sector is expected to have a new NPLs of Nu. 35 billion for the period ending 2022 taking the total cumulative NPLs to Nu. 51 billion.
- The cumulative NPL ratio in 2022 will stand at 29 percent in 2022 as compared to 9 percent as of December 2021.

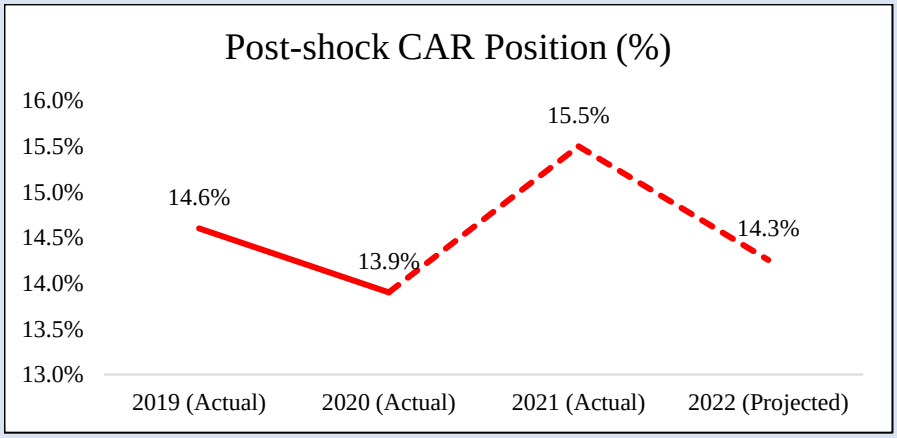


(b) Expected losses in the financial sector



- The financial sector is expected to make a profit of Nu. 122 million for the period ending 2022.

(c) Stability concerns: Impact on Capital Adequacy Ratio (CAR) of FIs



- The CAR of the financial sector is expected to stand at 14.3 percent for the period ending 2022 (which is above the minimum CAR requirement of 10 percent) compared to 15.5 percent as of December 2021.

Part III: Supervisory priorities 2022-2023

The RMA has defined the following supervisory priorities by drawing on an assessment of the main risks and vulnerabilities of the financial sector

1. Credit risks management practices

Since credit risk continues to be the leading source of problems in the financial sector, the supervisory focus will be on improving the FSPs'credit risk management policies and procedures to ensure that credit risks are identified, assessed, monitored and controlled.

To prevent or minimize new NPLs, FSPs should improve the loan underwriting and granting process at the loan origination stage followed by effective monitoring framework to ensure that the FSPs manage and monitor credit risk exposures at the portfolio level as well as at the individual exposure levels. For existing NPLs, the FSPs should resolve the NPLs through improved recovery plans and follow-up process.

2. Internal control and governance

Weak internal controls have impacted the performance of the FSPs in the past, which could have been substantially lessened or avoided if the FSPs had established strong internal control and culture.

Sound governance arrangements and robust internal controls are essential to fostering adequate decision-making and mitigating excessive risk-taking both in normal and crisis times.

The supervisory focus will be on improving the internal control processes of the FSPs particularly the functioning and oversight of management bodies and ensure effective implementation of three lines of defense model (improve the efficiency of risk management function, compliance function and internal audit function).

3. Risk management practices

Inadequate risk recognition and assessment has impacted the performance of the FSPs in the past. The supervisory focus will be on the requirement of an effective risk management system to ensure that all the material risks that could adversely affect the achievement of the FSPs' goals are being recognized and continually assessed.

The risk identification, monitoring, quantification and measurement processes are of the utmost importance, as they are the foundations for risk management processes. Based on the identification and understanding of their material risks, the FSPs quantify and address those risks by adding capital sufficient to cover risks or by applying other mitigating factors.

4. Capital adequacy and ICAAP (Internal capital adequacy assessment process)

As credit risk impairments directly affects FSPs capital ratios, there is a concern on meeting the capital adequacy requirements. The ICAAP process and stress testing is an ongoing risk

management practice that supports the FSPs' forward-looking assessment of risks and better equips them to address a range of adverse outcomes.

The supervisory focus will be on the review of the FSPs' internal processes (internal capital adequacy assessment process) rather than on the establishment of minimum regulatory requirements to be met by FSPs. It is intended to ensure that FSPs not only have adequate capital to support all the risks in their business but also develop and use better risk management techniques in monitoring and managing these risks.

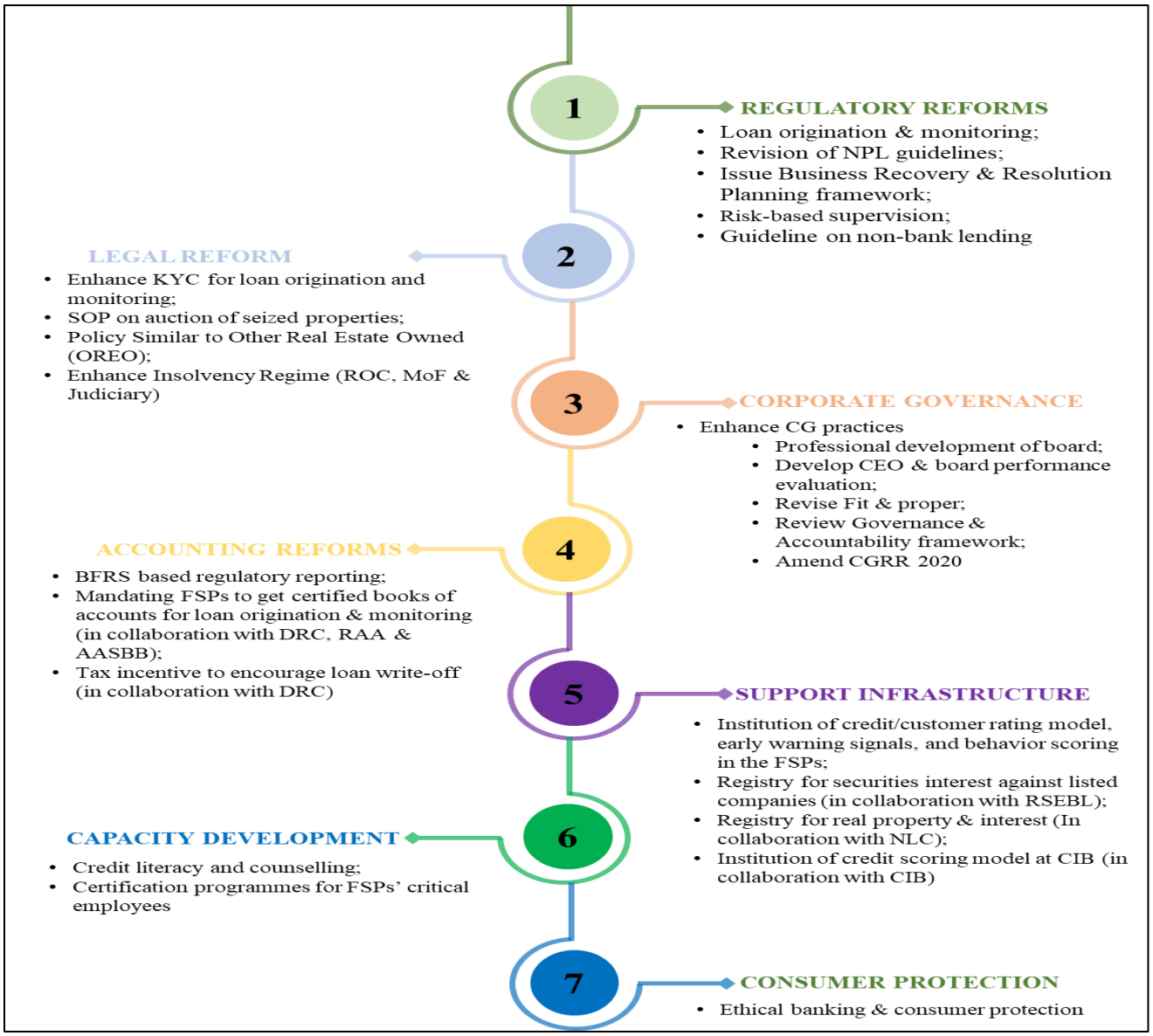
Part IV: Supervisory development

1. Supervisory developments

1.1. Strengthening end-to-end credit ecosystem

To promote responsible credit culture and maintain continued financial stability, the RMA in partnership with the FSPs and other relevant stakeholders is introducing Credit Policy Reforms – through following seven broad thematic areas – including reforms in regulatory areas to consumer protections as depicted in the Chart 2

Chart 2: Activities undertaken to strengthen end-to-end credit eco-system



1.2. Adoption of Bhutanese Financial Reporting Standards (BFRS) underway

To promote fairness, transparency and accountability in the financial sector, the RMA has commenced aligning its prudential regulations requirements with standards and practices which are widely accepted.

In this light, the RMA has issued guidelines governing the adoption of the Bhutanese Financial Reporting Standard 9 (BFRS 9)-financial instruments, following numerous consultations with the FSPs. This is aimed at ensuring consistency of application and comparability of financial reports across the financial sector. The areas covered are as follows:

- Issuance of guidelines governing the adoption of the Bhutanese Financial Reporting Standard 9 including the Expected Credit Loss model (ECL);
- Harmonizing the RMA's existing Prudential Regulation 2017 and Bhutanese Financial Reporting Standard 9;
- Develop Expected Credit Loss model and the regulatory reporting based on the Bhutanese Financial Reporting Standards; and develop and conduct capacity building training programs for supervisors and financial sector for implementation of BFRS 9 in collaboration with Financial Institution Training Institute (FITI)

1.3. Facilitating Green finance

As the world is grappling with the impact of global warming, and more so, that the developing countries like Bhutan are more vulnerable to the adverse impact of the climate change, therefore, the RMA, believing in the prospect of investment in the green sectors by the private and government sectors in mitigating and adapting to the climate change, intends to facilitate investments in the green sector. To do so, the RMA has designed a Green Finance Roadmap. The roadmap aspires a robust and resilient financial sector that can deliver both investable returns and environmentally positive outcomes.

Following the development of roadmap, the most important prerequisite for the successful mobilization of fund to the green sector is regarded to be green taxonomy. The taxonomy defines which investment and sectors should be considered as green, and would help in detecting and preventing green washing.

The RMA will continue its effort of prioritizing and promoting green finance through the following activities:

- Adoption of green taxonomy;
- Assisting the FSPs in targeted lending using the fund mobilized through green finance funding sources and credit lines;
- Facilitate the design of innovative green finance instruments; &
- Create an enabling environment for the FSPs to smoothly adopt the ESRM framework.

Taking into consideration of the instrumentality of the green taxonomy, the RMA has formulated a green taxonomy which is intended to identify green sector and prevent green washing by the

players. This taxonomy would be available for adoption after the completion of final refinement and addition.

While the RMA regard mitigation and adaptation of climate change as urgent and necessary, it is also important to rally FSPs and investors along the same line. In order to do this, the RMA is also considering mobilization of fund towards the green sector through incentivization and rewards. Further, there must be a concerted effort from all the relevant stakeholders in advancing the development of green finance in Bhutan.

1.4. Risk-based supervision (RBS) of the FSPs has already begun

In response to the deficiencies of the compliance-based supervision in maintaining financial stability and soundness, the RMA, consistent with regulators around the world, has developed and adopted forward-looking risk-based supervision approach in 2019. It is expected to be relevant, reliable and effective in supervising the growing complexity of the financial sector.

RBS employs a forward-looking supervisory approach where control weaknesses or other risk management conditions or problems are assessed early, and when necessary, corrected, in order to prevent or mitigate serious problems to an institution's financial condition in the future. With the adoption of RBS framework, the RMA is bringing its supervisory practices closer to the recommendations of the Basel Committee for Banking Supervision (BCBS). The main objective of the RBS is to evaluate the safety and soundness of the financial institution by assessing its risk management systems, financial condition, and compliance with applicable laws and regulations, while focusing on the institution's highest risks. The risk supervision process seeks to strike and appropriate balance between evaluating the condition of an institution at a certain point in time and evaluating the soundness of the institution's processes for managing risk in all phases of the economic cycle. By evaluating an institution's risk management practices, supervisors look beyond the financial condition of an institution at a point in time, to how well it can respond to changing market conditions given its particular risk profile.

2. Regulatory development

The RMA seeks to establish sound rules and regulations of a high standard that allows well-managed risk taking and innovation in pursuance of promoting the stability and soundness of the Bhutanese financial system, safe and sound financial intermediaries, and safe and efficient financial infrastructures. In response to the pressing circumstances, among others, the RMA has issued the following rules and regulations, guideline, directive and framework:

2.1. Rules and Regulations on Loan Restructuring by FSPs 2022

Addressing asset quality issues is one of the key priorities for the RMA. The RMA's focus on this issue began with the comprehensive assessment of current NPLs of the Bhutanese financial sector. The credit risk and the heightened levels of NPLs are being considered as one of the main risks facing the FSPs.

Therefore, to address the existing stock of NPLs as well as to prevent the emergence and accumulation of new NPLs on FSPs' balance sheets, the RMA has issued the Rules and Regulations on Loan Restructuring by FSPs. The rules and regulations sets out a number of best practices on loan restructuring, to ensure that the FSPs effectively address and manage the NPLs.

2.2. Rules & Regulations on Foreclosure and Write-off of Non-Performing Loans 2022

Considering the abortive and costly conventional NPLs recovery measures, as the FSPs often face time-consuming and costly litigations, resolution of NPLs through restructuring, foreclosure and write-off are regarded as some of the effective solutions to the problems owing to immediate availability of liquidity for re-utilization, which otherwise is blocked. Therefore, with the objectives to reach amicable settlements by protecting the interest of the FSPs and borrowers through timely actions/interventions, and to decongest the books of accounts of the FSPs by foreclosing and/or writing of NPLs, the RMA has adopted the Rules and Regulations on Foreclosure and Write-off of Non-Performing Loans to provide a regulatory framework to the FSPs.

2.3. Directive on housing loans (commercial and home) 2021

With an objective to make housing affordable through possible policy interventions at our level and also to reduce the burden of loan repayment during the pandemic, the RMA, considering the regional practices and recommendations of the Basel Framework, has issued housing loan directive to the FSPs.

Through the directives, the regulatory requirements - LTV, LTI, tenure and risk weight on the housing loans have been relaxed. The relaxation is expected to incentivize the FSPs in financing housing loans, particularly home loans, and promoting home ownership in Bhutan.

2.4. Guidelines on Reclassification of Old NPLs 2022

In response to high NPLs during COVID-19 pandemic, the RMA issued a counter-cyclical policy response to COVID-19 pandemic, as an interim measure, with an objective to provide a one-time facility for reclassifications of NPLs as other assets to provide temporary relief to both borrowers and FSPs during the pandemic.

2.5. Prompt Corrective Action (PCA) Framework

As a central bank, the RMA plays a key role in building a reliable and robust financial system that facilitates access to domestic credit schemes of suitable quality and quantity to promote financial inclusion and support economic development. Financial intermediation, however, is vulnerable to credit risk i.e. the risk of loans becoming NPLs. The risk of increasing NPLs will threaten the viability of the FSPs and if not contained, the problem could also threaten the viability of the financial system.

Therefore, the RMA has designed a Prompt Corrective Action (PCA) Framework to enable early supervisory intervention to mitigate any risk that could threaten viability of financial service providers and financial system as a whole. The PCA will enable supervisory intervention at an

appropriate time and require the FSPs to implement remedial measures in a timely manner, so as to restore its financial strength.

Under this framework, considering the amount of NPLs and the governance practices of the three FSPs- RICBL, BDBL and NCSIDBL, the RMA has indefinitely frozen lending of new loans by these three institutions.

Part V: Monetary measures and its status

In response to the COVID-19 pandemic, the RMA has issued the monetary measures as follows:

1. Monetary Measure: Phase I (April to June 2020)

i. Deferment of loan repayment;
ii. 100 percent interest payment support- 50 percent each by the government and FSPs;
iii. Extension of gestation period for projects under construction;
iv. Term based soft working capital facility for tourism, industries, & wholesale distributers; &
v. Loans to cottage and small industries at a concessional interest rate.

2. Monetary Measures: Phase II (July 2020 to March 2021)

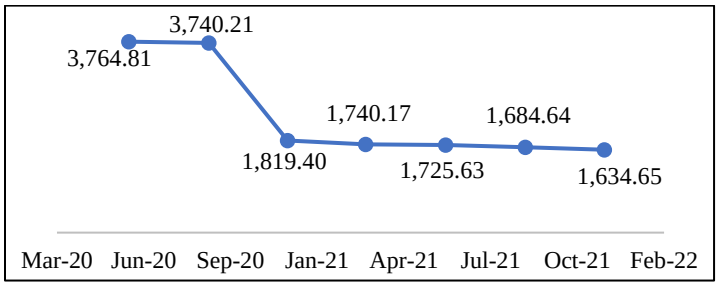
i. Deferment of loan repayment;
ii. 100 percent interest payment support was granted as DGRK for three months (July to September 2020);
iii. 50 percent interest payment support was granted as DGRK for six months from October 2020 to March 2021 (extended until June 2022);
iv. Incentive for regular repayment of loans- one percent interest rate reduction for the clients who repay their loans fully and regularly;
v. Extension of gestation period for projects under construction:
vi. Term based soft working capital facility at concessional interest rates; &
vii. Loans to cottage and small industries at concessional interest rate.

3. Monetary Measures: Phase III (July 2021 to June 2022)

i. Deferment of loan repayment until June 2022;
ii. Loan tenure extension up to five years for term loans;
iii. Incentive for regular repayment of loans- one percent interest rate reduction for the clients who repay their loans fully and regularly; &
iv. Enhancement of loan-to-value limits for project financing/business loans;

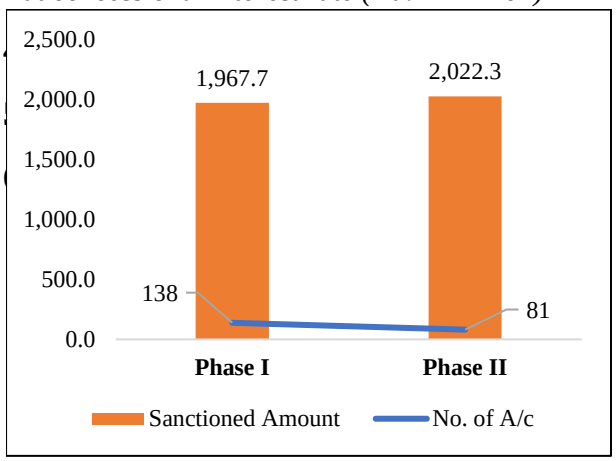
4. Implementation status of the monetary measures

Interest Payment Support Kidu: *the chart below reflects the quarterly IPS provided to the eligible loan accounts (Nu. In million)*

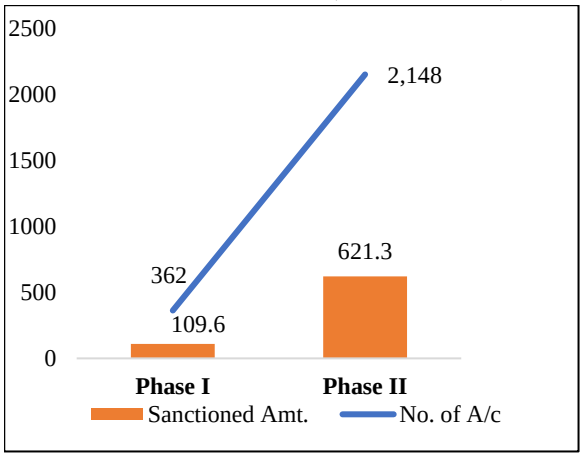


- As of December 2021, 139,096 loan accounts received IPS amounting to Nu. 16,109.51 million, of which Nu. 14,227.11 million was granted as Kidu from the DGRK and the remainder of Nu. 1,882.41 million was born by the FSPs

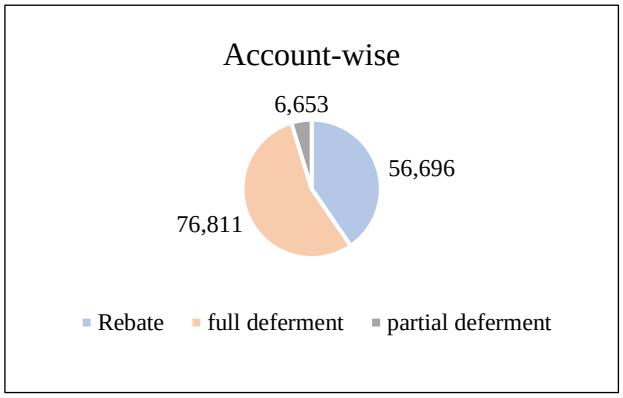
Loans under Monetary Measures: *shows loans extended by the FSPs (excluding NCSIDBL) at concessional interest rate (Nu. in million)*

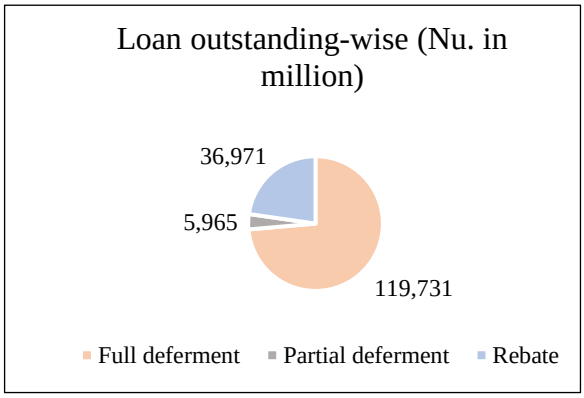


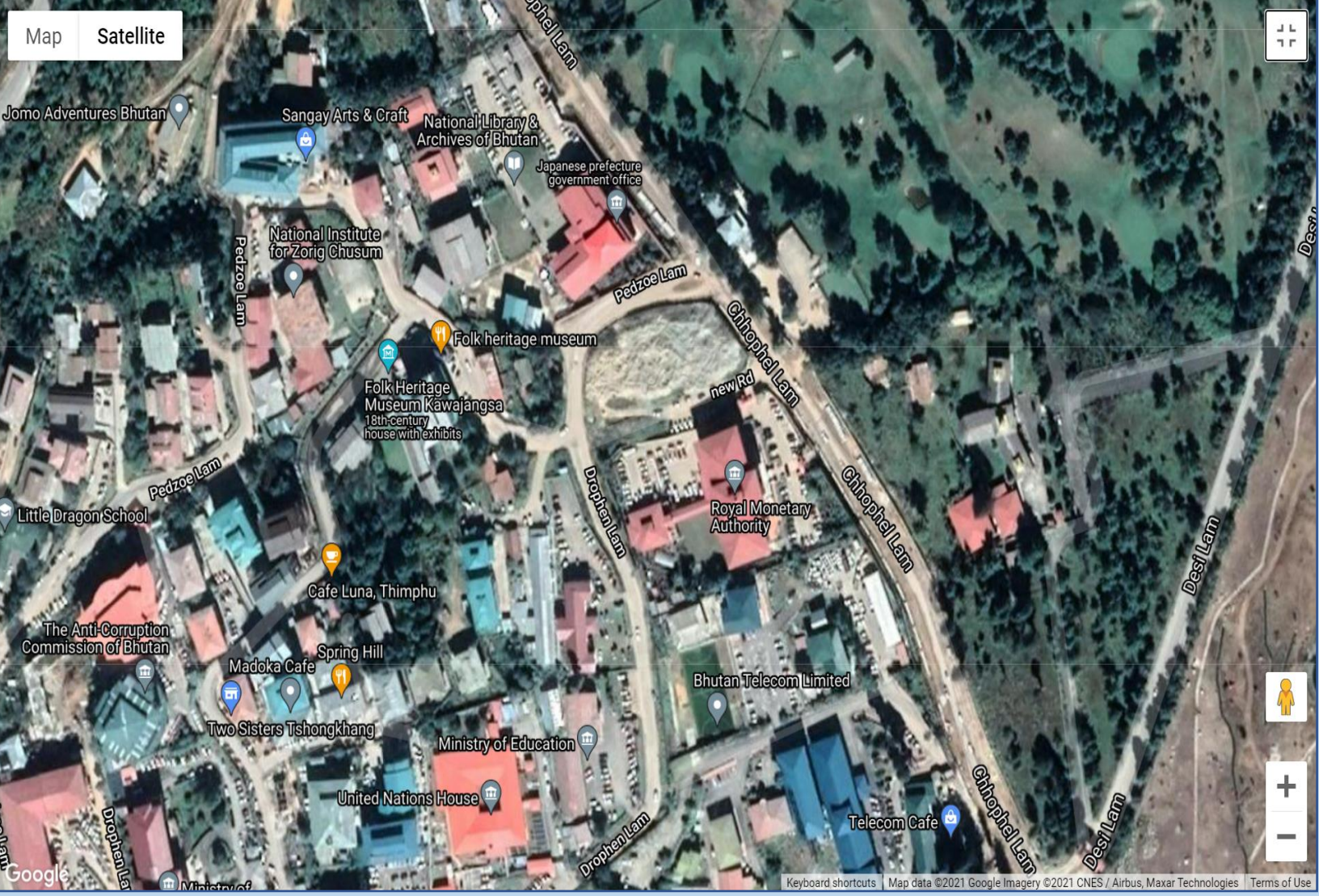
Loans under Monetary Measures: *shows loans extended by the NCSIDBL at concessional interest rate (Nu. in million)*



Subsequent to the issuance of the monetary measures- the borrowers have opted for deferment and rebate as shown in the charts below:







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