Annual Supervision Report 2022

Department of Financial Regulation and Supervision

Royal Monetary Authority of Bhutan

Preface

The Royal Monetary Authority of Bhutan promotes the safety and soundness of financial institutions and monitors their impact on the financial system. It is responsible for supervising monitoring, inspecting, and examining financial institutions to ensure that they comply with rules and regulations and that they operate in a safe and sound manner.

The RMA publishes an annual supervision report on the financial conditions to inform the public and provide transparency about its supervisory and regulatory policies and actions as well as current banking conditions.

This report focuses on the five sections as follows:

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

Abbreviations

BDBL	Bhutan Development Bank Ltd.
BIL	Bhutan Insurance Ltd.
BNBL	Bhutan National Bank Ltd.
BOBL	Bank of Bhutan Ltd.
BCP	Business Continuity Plans
BCBS	Basel Committee on Banking Supervision
CAR	Capital Adequacy Ratio
CCB	Capital Conservation Buffer
CD	Credit-to-Deposit
CG	Corporate Governance
CRM	Credit Rating Model
CGRR	Corporate Governance Rules & Regulations
CRR	Cash Reserve Ratio
DFRS	Department of Financial Regulation & Supervision
DPNBL	Druk PNB ltd.
ECL	Expected Credit Loss
E & Y	Ernst & Young Global Limited
FIs	Financial Institutions
FITI	Financial Institution Training Institute
FSPs	Financial Services Providers
GIC-BRL	GIC-Bhutan Reinsurance Ltd.
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
NCSIBL	National Cottage & Small Industries Development Bank Ltd.
NLC	National Land Commission
NPL	Non-Performing Loans
NPPF	National Pension & Provident Fund
OREO	Other Real Estate Owned
PCA	Prompt Corrective Action
RBS	Risk-Based Supervision
RICBL	Royal Insurance Corporation Ltd.
RMA	Royal Monetary Authority
RSEBL	Royal Securities Exchange of Bhutan Ltd.
SLR	Statutory Liquidity Ratio

Executive Summary

As we gradually recover from the pandemic, the financial sector faces a new massive challenge brought on by growing geopolitical unrest, escalating inflationary pressure, and tightening financial conditions globally, which have an influence on several financial institutions worldwide. Bhutan's financial sector has not yet been significantly impacted by the external shock, and the country's financial system has shown to be incredibly resilient to the ensuing macroeconomic shock. Through this period of uncertainty, the courageous and timely involvement has continued to address and reduce the impact on the Bhutanese financial sector and meet the demands of businesses and households.

In 2022, the Royal Monetary Authority (RMA) began preparing for the likelihood of a significant increase in non-performing loans (NPLs) and took proactive steps to address this challenge. Given the unprecedented growth of NPLs across financial institutions, the RMA continued its focus on monitoring and resolving these problematic loans. In response to various regulatory initiatives and interventions, a Framework for Charge-off and Transfer of NPLs to Off-Balance Sheet was introduced in June 2022. This framework aimed to assist financial institutions in cleaning up their financial records and effectively managing persistent NPLs. Additionally, a PCA Framework was developed to facilitate early supervisory actions to mitigate any risks that could threaten the profitability of financial service providers and the overall stability of the financial system.

The financial sector in Bhutan has exhibited resilience and remained stable with strong capital and liquidity positions, providing adequate resources to support domestic lending to the economy. The Core Capital Ratio and Capital Adequacy Ratio (CAR) stood at 11.88 percent and 16.47 percent, well above the minimum regulatory of 7.5 and 12.5 percent respectively. Driven by the increased cash balances and marketable securities, the statutory liquidity ratio (SLR) of the bank and non-banks remained comfortable at 29.75 percent for banks and 23.84 percent for non-banks. Meanwhile the higher growth in deposits during the FY 22 resulted in marginally increase credit-to-deposit (CD) ratio with the ratio reported at 75.38 percent. In comparison to the previous year, there has been a net increase of Nu. 292.01 million in non-performing loans (NPLs) in absolute terms. However, the NPL ratio has actually decreased by Nu. 1.01 percent. This decrease can be attributed to the rise in the total loans and advances amounting to Nu. 26,174.01 million.

The RMA undertook an assessment of financial institutions to better understand

the resilience of financial service providers (FSPs) and gauge the effects of the post-COVID-19 pandemic period.

The assessment covered five banks, two insurance firms, one reinsurance company, the National Pension and Provident Fund, and microfinance institutions, spanning until the fourth quarter of 2022. The favorable liquidity position continued to be a result of the monetary policy measures implemented in 2020 and 2021. The introduction of the Domestic Liquidity Management Framework was expected to maintain the stability of the financial sector's liquidity position with minimal changes. By December 2022, the Statutory Liquidity Ratio (SLR) for financial institutions (FIs) had decreased to 29.22%, which was lower than the level recorded at the end of 2021 but remained comfortably above the minimum regulatory requirements.

Non-performing loans in the financial sector marginally increased from Nu.15.6 billion in December 2021 to Nu. 15.90 billion in December 2022, while the ratio has declined from 9 percent to 8 percent. Nevertheless, with the creation of a high-level committee to address non-performing loans (NPLs), and the Prompt Corrective Action Framework 2022 along with extensive monetary measures in place have helped in mitigating the immediate liquidity shock to the affected sectors/businesses and prevented the further build-up of NPLs in the FIs. However, the impact of a pandemic on FIs' Asset Quality (non-performing loans) is still expected to be a key challenge going forward and main factor for the rise of NPL. The profitability of the financial sectors has increased, driven by decreased in loan provisioning and interest income. The profitability (after tax) as of December 2022 stood at Nu.5.10 billion as compared to a profit of Nu. 4.60 billion in December 2021.

The capital fund stood at Nu.30.42 billion in December 2022 as compared to Nu. 27.3 billion in December 2021. The Capital Adequacy Ratio stood at 16.5 percent in December 2022 as compared to 15.5 percent in December 2021. 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 challenges. The release of the Capital Conservation Buffer (CCB) built prior to the pandemic has allowed financial institutions to cover for an increase in non-performing loans and maintain their financing activities to the economy. 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.

There was no significant incident of business disruption reported in the past year. If the FSPs don't exercise caution, the adoption of online commerce through the internet, mobile devices, and applications exposes the FSPs to a variety of risks, including cyber risk, IT risk, employee and reputational consequences. FSPs should therefore make sure that their IT infrastructure is reliable while maintaining close tabs on issues like data integrity, business continuity, and online threats.

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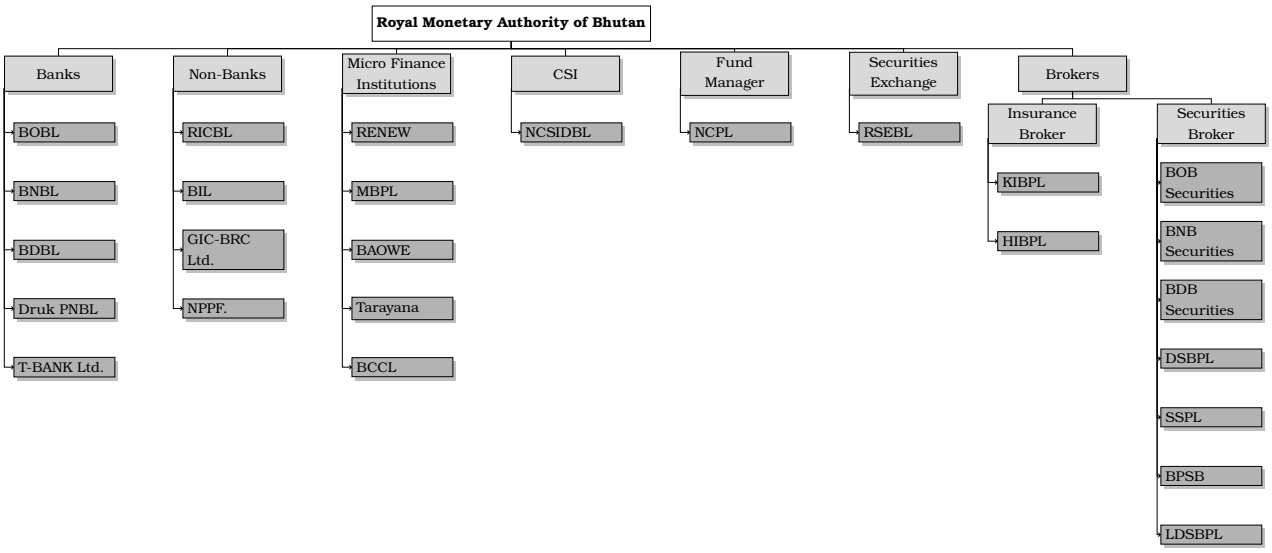
Chapter 1

Structure of the Bhutanese Financial Sector

The Bhutanese financial sector is essential for Bhutan's economic development and stability, as it plays a critical role in mobilizing capital, facilitating economic transactions, promoting savings and investment, managing risks, fostering entrepreneurship and innovation, enhancing financial inclusion, and ensuring regulatory oversight. It contributes to economic growth, stability, and prosperity.

The Royal Monetary Authority of Bhutan ensure that Bhutan's FSPs operate in a safe and sound manner, that clients are treated fairly, and that all applicable laws and regulations are followed. As a result, the RMA is the dominant prudential regulator that offers value through proactive and risk-based supervision.
The Chart below shows the list of banks, insurance and reinsurance companies, pension and provident funds, fund managers, microfinance institutions, securities exchange, insurance and securities brokers, and credit bureau, which are being regulated and supervised by the RMA.

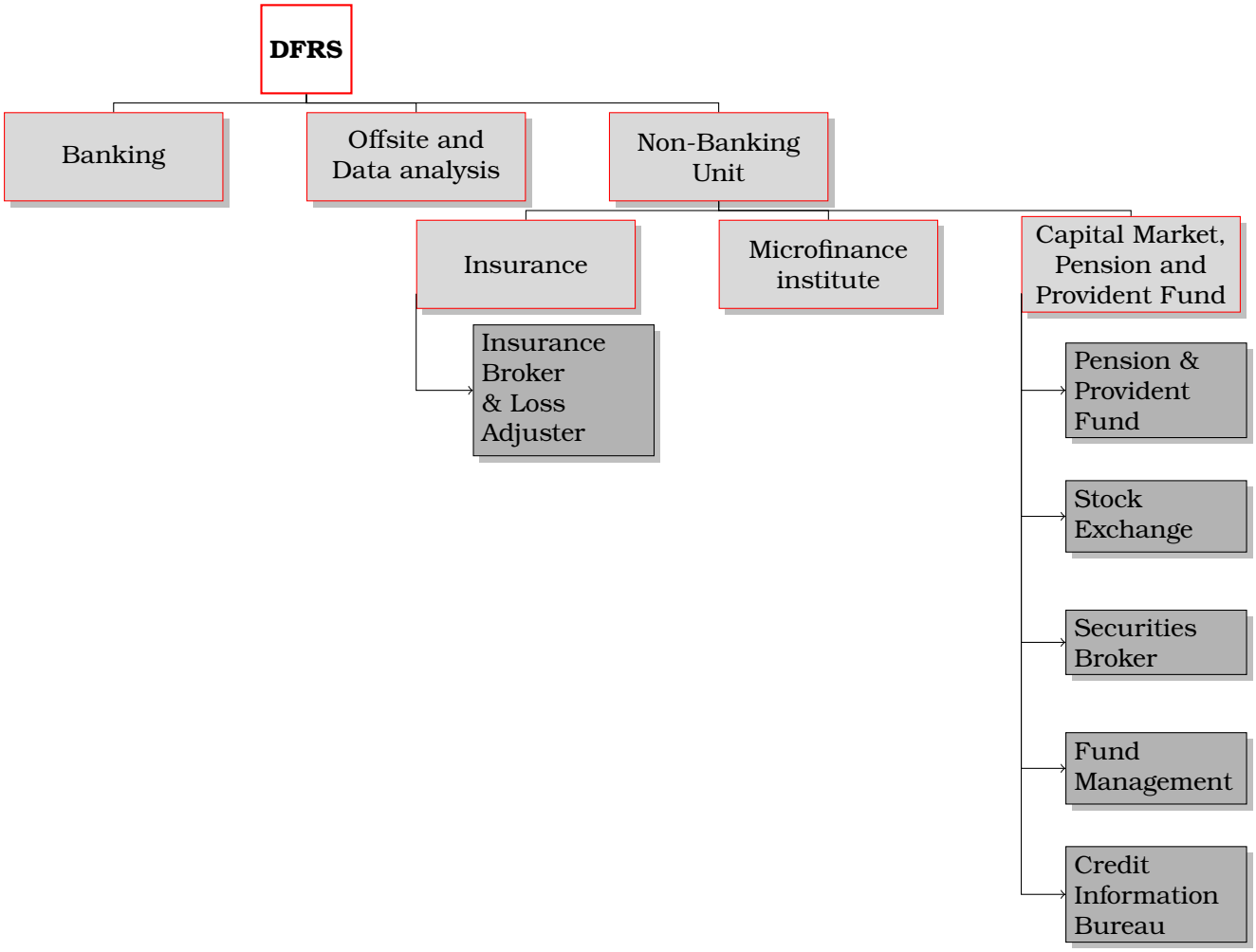


The Department of Financial Regulation and Supervision (DFRS) regulates and oversee the financial services providers through the formulation of rules and regulations, prudential standards, offsite monitoring, and onsite inspections.

Some of the key functions of DFRS are as follows:

- Formulation and implementation of policies and prudential regulations;
- Assessing licence application of FSPs
- Conducting onsite evaluation of the financial conditions and compliance with statutory and prudential requirements of the FSPs; and
- Conducting on-site inspection and off-site surveillance of FSPs.

The chart below shows Organogram of the DFRS in RMA:



Chapter 2

State of the financial sector and its associated risks

2.1 Core Indicators of Financial Institutions

Table 2.1: Core Indicators

Particulars	Regulatory Ratio	Dec-2022	Dec-2021
Capital	Capital Adequacy	16.47%	15.49%
	Core Capital	11.88%	11.82%
	Leverage	7.64%	8.02%
Asset Quality	Gross NPL Ratio	2.96%	8.77%
	Provision to NPL	71.06%	78.27%
	Total NPL	5,678.43	15,471.38
	Total Loan	192,105.71	176,493.68
Earning	Return On Assets (ROA)	1.00%	1.25%
	Return On Equity (ROE)	9.31%	11.92%
	Profit after Tax	2,527.49	2,788.72
Liquidity	Credit to Deposit	92.56%	95.17%
	Statutory Liquidity Requirement Ratio:		
	i. Bank	29.75%	33.95%
	ii.Non-Bank	23.84%	20.74%
	Liquidity Position	50,212.14	55,245.70

[1]

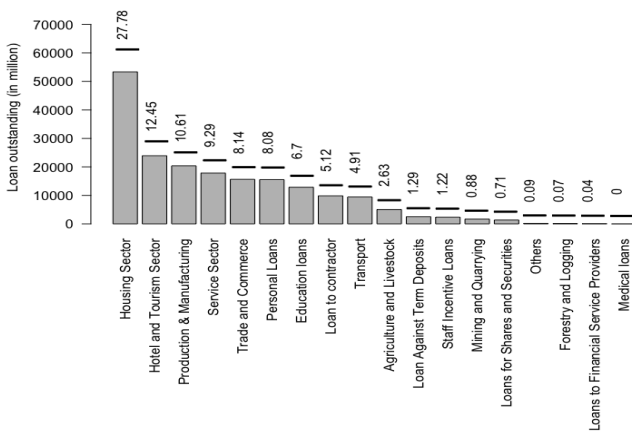


Figure 2.1: Credit exposures

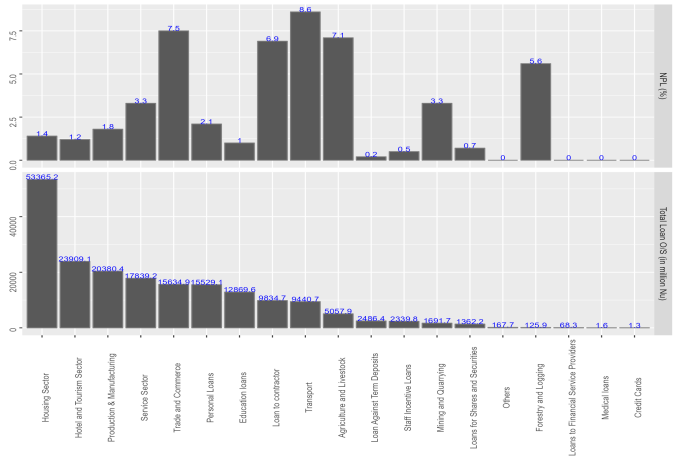


Figure 2.2: Sector-wise NPL

[1]Banks includes BoBL, BNBL,BDBL,DPNBL & T-Bank; Non-bank includes RICBL,BIL,NPPF, and others FSPs includes micro-finance institution,GIC-BRL & NCSIDBL

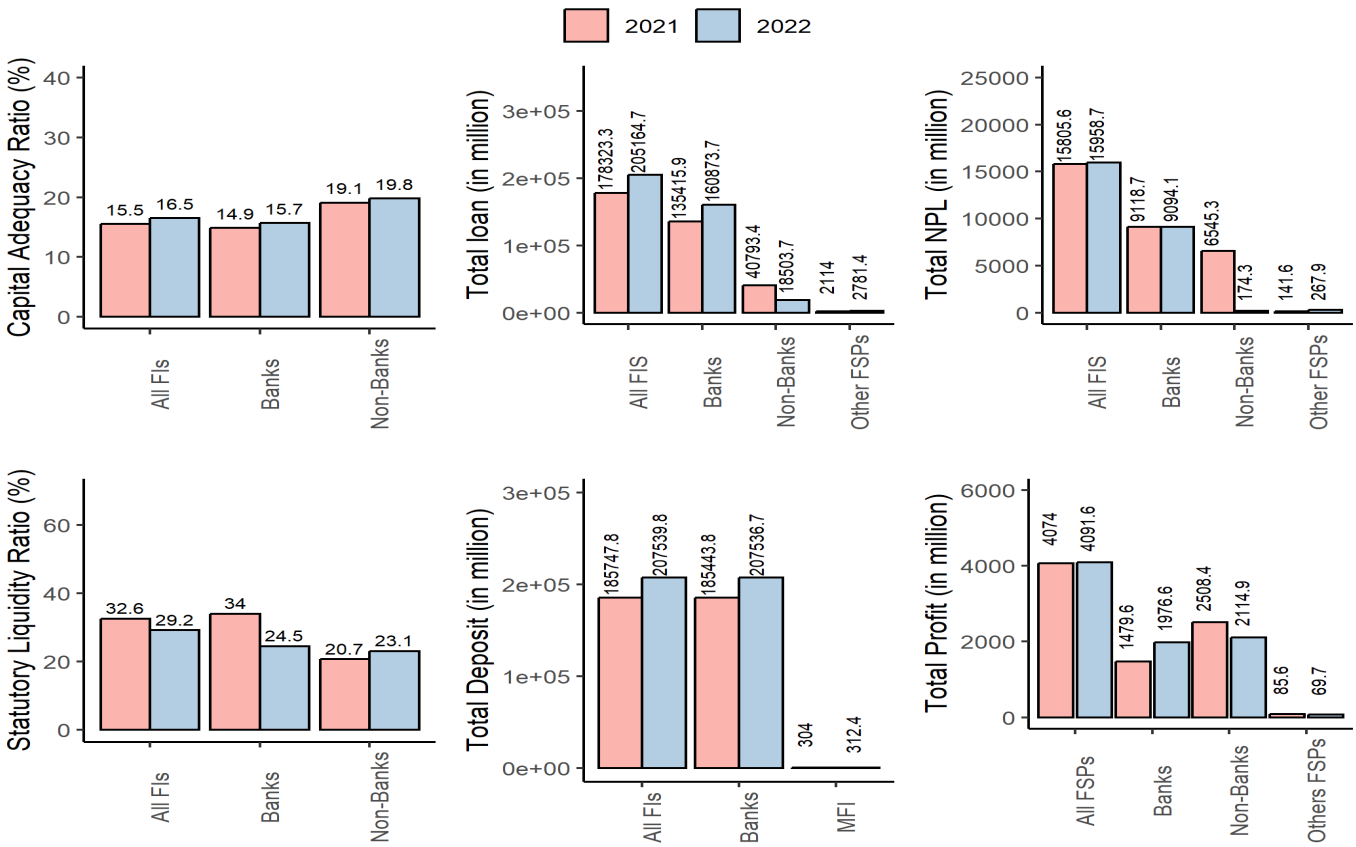


Figure 2.3: Financial Soundness indicators

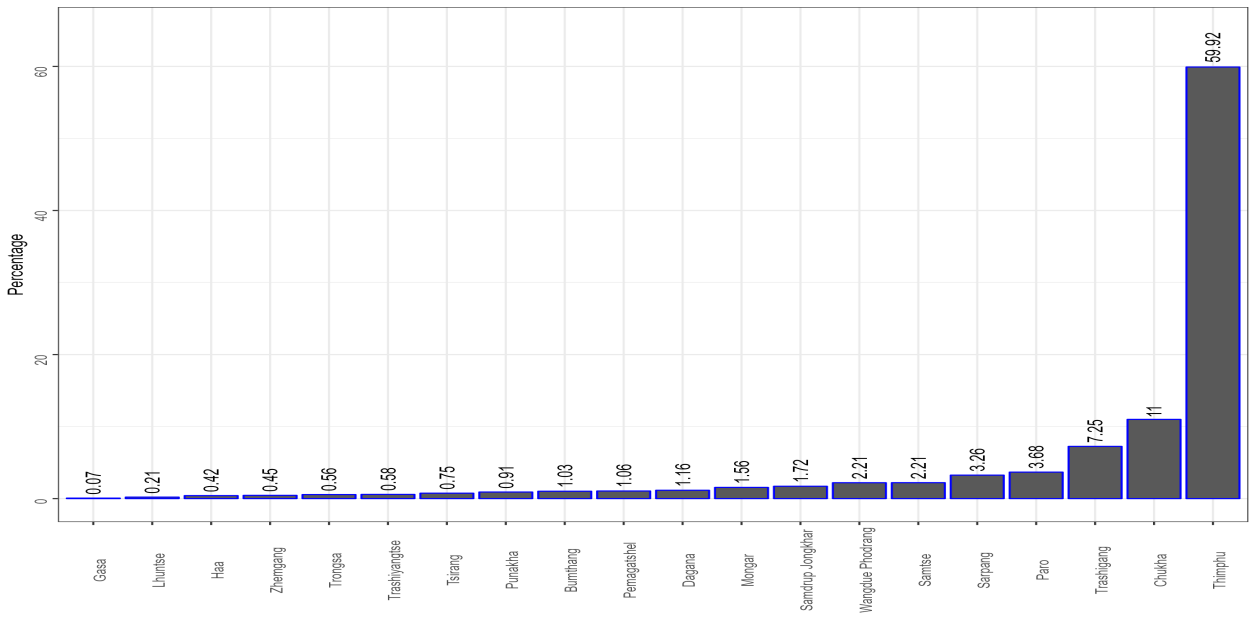


Figure 2.4: Distribution of credits by project site

2.2 Risk assessment

The RMA conducted a risk assessment of the financial sector to monitor and manage risk in the financial system and ensure the stability of the financial institution. It entails carefully evaluating the areas of inherent hazards, internal control, and governance, risk management policies, compliance with directives, rules, and guidelines, the effectiveness of internal audit function, compliance, and risk function. This assessment was for the year ending 2022 and includes five banks, two insurance companies, one re-insurance company, and National Pension & 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:

2.2.1 Liquidity and funding risk assessment

Deposits have remained stable and unaffected

Since December 2022, the liquidity situation within the financial sectors has stayed consistent and unaltered. Financial institutions observed a notable uptick in deposits both during and after the COVID-19 pandemic, possibly due to limited opportunities for spending or investment, as illustrated in Figure 1. This increase is reflected in the total bank deposits, which grew by 11.19 percent, escalating from Nu. 185.44 billion in December 2021 to Nu. 207.54 billion in December 2022. This trend suggests a greater dependence on deposits for lending and other operational activities.

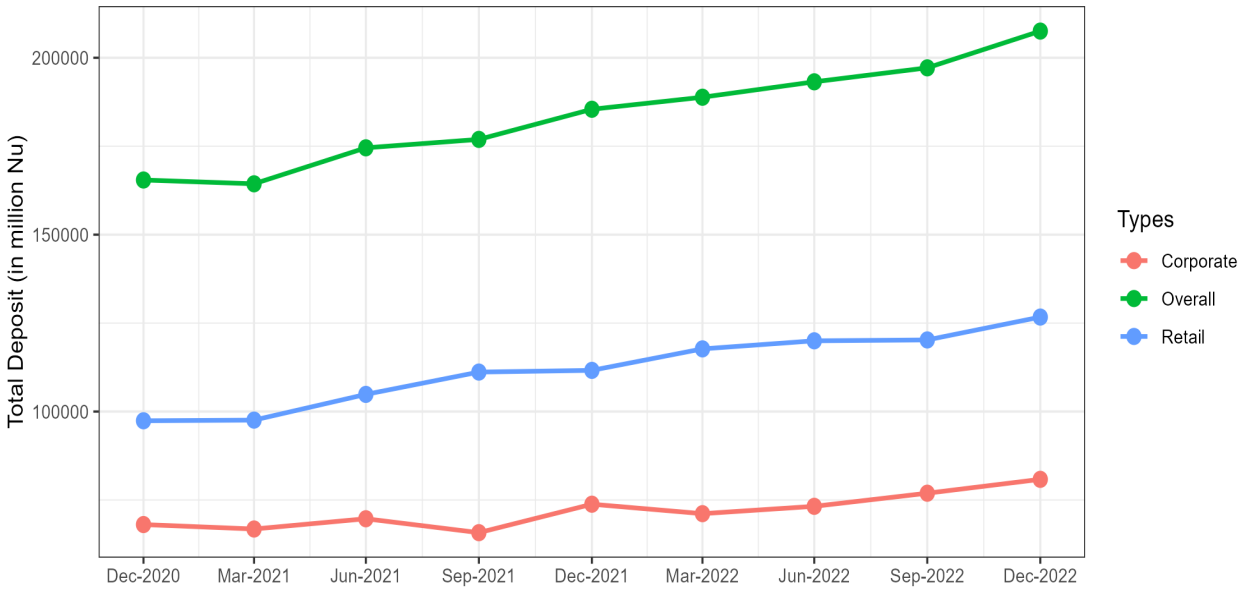


Figure 2.5: Deposit composition in the banking sector

By December 2022, the total bank deposits amounted to Nu. 207.54 billion, with 61.05 percent attributed to retail deposits and 38.95 percent to corporate deposits. Retail deposits with the banks increased by 13.49 percent, rising from Nu. 111.64 billion in December 2021 to Nu. 126.70 billion in December 2022. Corporate deposits with the banks also experienced growth of 9.51 percent, going from Nu. 73.81 billion in December 2021 to Nu. 80.83 billion in December 2022. The surge in bank deposits in both the corporate and retail sectors in 2022 may have been influenced by various factors. These include the elevated level of uncertainty related to the pandemic and the economic outlook, which has encouraged people to save cautiously, while simultaneously discouraging investment and the purchase of durable goods. This trend mirrors patterns seen in many developing countries worldwide.

Table 2.2: Quarterly retail and corporate deposit trend (Nu. in million)

Deposits Type	Dec (2020)	March (2021)	June (2021)	Sep (2021)	Dec (2021)	March (2022)	June (2022)	Sep (2022)	Dec (2022)
Corporate Deposits	68,053.00	66,795.00	69,696.00	65,764.00	73,806.00	71,133.66	73,207.12	76,915.00	80,832.67
Retail Deposits	97,393.00	97,577.00	104,849.00	111,158.00	111,638.00	117,711.83	119,991.82	120,239.32	126,704.01
Total Deposits	**165,447.00**	**164,372.00**	**174,545.00**	**176,922.00**	**185,444.00**	**188,845.48**	**193,198.94**	**197,154.32**	**207,536.67**

Table 2.2 shows the deposit by account type for the period ending December 2022. As indicated in the given Table 2.3; 47.99 percent of total deposits are in the form of term deposits (45.96 percent in fixed deposits and 2.03 percent in recurring deposits) indicating stable deposits in the banking sector. The remaining 52.01 percent of total deposits are in the form of demand deposits (30.95 percent in saving deposits and 21.06 percent in current deposits) which are considered to be volatile in nature as this type of deposit can be withdrawn at any time.

Table 2.3: Deposits by type as of December 2022

Deposits Type	Dec (2022) (Nu, in million)	% share
Current Deposits	43,705.54	21.06%
Savings Deposits	64,236.66	30.95%
Fixed Deposits	95,385.77	45.96%
Recurring Deposits	4,208.71	2.03%
Total	**207,536.67**	**100.00%**

2.2.2 Financial Sector continues to maintain SLR above the regulatory requirement

The FIs have remained to be highly liquid, with SLR well above the regulatory minimum requirement threshold of 20% for banks and 10% for non-banks. As shown in the Figure 2.6, SLR reaches its highest levels of nearly 33.95% for bank in 2021 and 23.84% for non-bank in 2022, primarily driven by the rise in bank deposits and marketable securities. Thus, a stable liquidity position has enabled FIs to meet the demand for new loans and committed funds. Therefore, the stronger SLR entails the FIs ability in meeting the obligation and also to pump more funds into the economy.

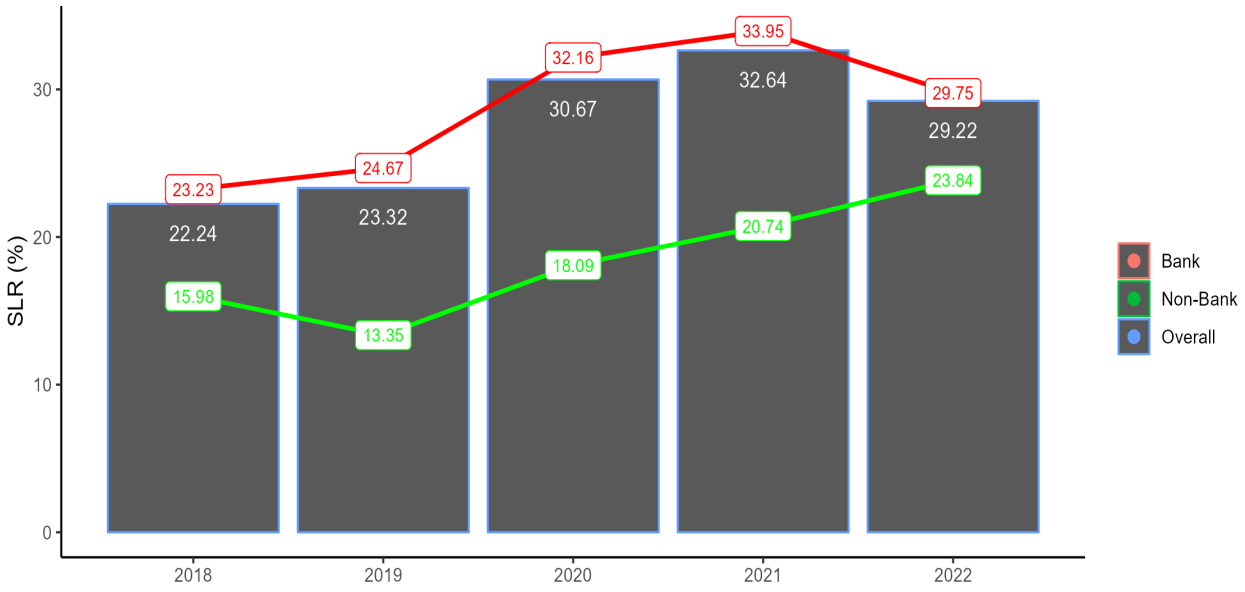


Figure 2.6: Financial Institutions SLR position over five years (2018 to 2022 December)

2.3 Credit risk assessment

2.3.1 Loan outstanding and NPL trend in the financial sector

The solvency and profitability of FSPs will be jeopardized due to the rising NPLs, and if not managed prudently, the soundness and stability of the financial sector will be affected. As per the figure 2.7, there is an increasing trend in the total loans outstanding over the quarters, thus a slight fall from September 2022 to December 2022 (0.21 percent). Total NPL, however, are showing a declining trend starting from March 2021. This is due to the support measures extended to the borrowers, including loan deferment facilities, interest payment support and assiduous recovery efforts from both RMA and FSPs. Likewise, with the

implementation of the charged-off framework, FIs have also been writing off the bad debts that they have been unable to recover over the years. Further, pursuant to Prompt Corrective Action (PCA) framework, FIs are required to maintain NPL below 7.5 percent of their total loan portfolio. Based on this, BDBL, NCSIDBL and RICBL were placed under the PCA framework through the imposition of credit moratorium in May 2022.

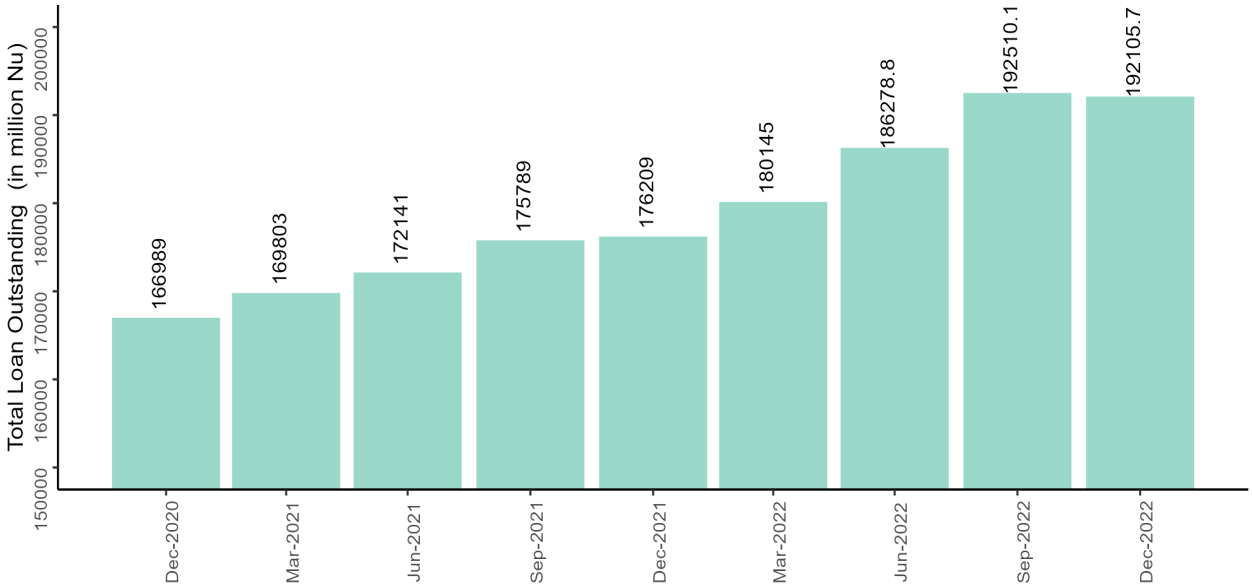


Figure 2.7: Quarterly loan growth of the FIs

The loan deferment period under Monetary Measures Phase IV will finally come to an end by June 2023 for those loans category falling under moderate and low-risk sectors. Nevertheless, its likely that most of the distressed loans may seek repayment extension beyond June 2023 impacting the cash flow of financial institutions and their ability to extend new loans in the economy. Further, against the backdrop of slag economic growth, businesses are still trying to recover from the pandemic, NPLs would probably increase by the time the deferment period comes to an end if prompt corrective action is not taken on time.

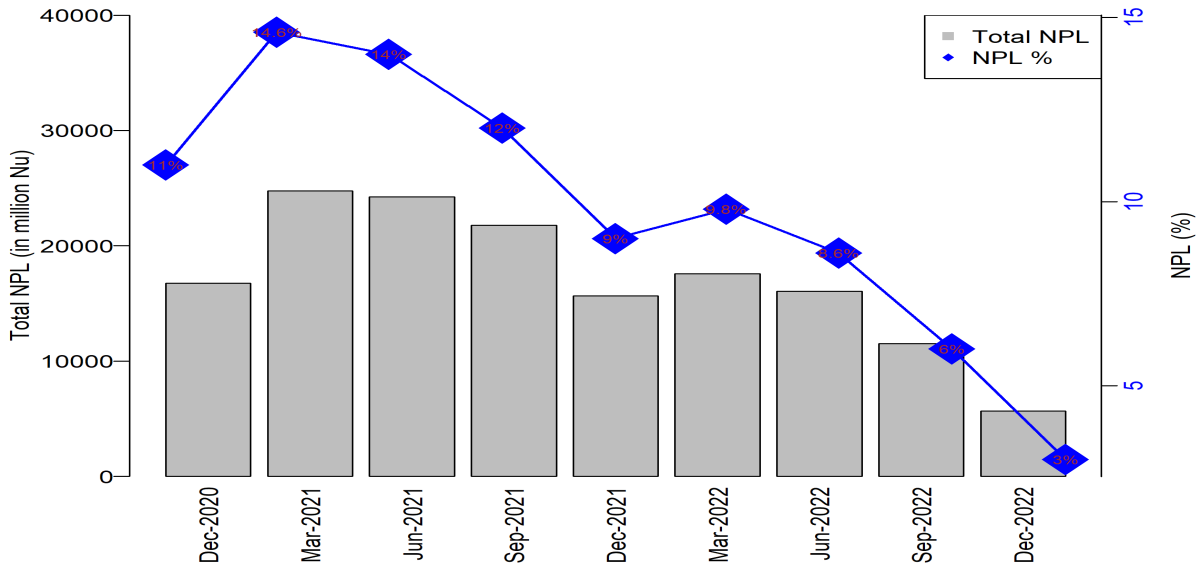


Figure 2.8: Quarterly NPL and NPL growth rate of the FIs

2.3.2 Loan classification movements

One of the indicator for the credit quality of the institutions is determined by the movement of loans to a worse loan bucket/category as this indicates whether the loan book has undergone a significant increase in terms of credit risk. Therefore, a declining trend in NPL also signifies a declining loan outstanding in the sub-standard, doubtful, and loss buckets. Owing to the implementation of various policy measures and intervention undertaken in 2022, NPL has declined in the financial sector.

The reduction in NPL resulted from the movement of loan from sub-standard category from Nu.3.7 billion in December 2021 to Nu.1.2 billion in December 2022 (65.29 percent). Similarly, loans under doubtful and loss categories have significantly dropped from December 2021 to December 2022 with 0.33 percent and 0.67 percent respectively. The loan under the standard category have increased from Nu. 151.81 billion in December 2021 to Nu 178.49 billion in December 2022.

Table 2.4: FIs' loan classification category (Nu. in million)

	Loan Category	**Dec (2021)**	**Dec(2022)**
Regular Loan	Standard (0-30 days)	151,809.00	178,486.73
	Watch (31-90 days)	8,736.75	7,939.67
NPLs	Sub-Standard (91-180 days)	3709.8	1,287.60
	Doubtful (181-365 days)	1,166.67	783.98
	Loss (>365 days)	10,787.53	3,606.85

Table 2.5: FIs' loan classification status by bank and non-bank as of December 2022 (Nu. in million)

Loan Category	**All FIs**	**Bank**	**Non-Bank**
Standard (0-30 days)	178,486.73	147,812.10	30,674.62
Watch (31-90 days)	7,939.67	3,967.56	3,972.12
Sub-Standard (91-180 days)	1,287.60	740.06	547.54
Doubtful (181-365 days)	783.98	660.72	123.27
Loss (more than 365 days)	3,606.85	3,264.14	342.71
(1) Total Loans	192,105	156,444.57	35,660.26
(2) NPL Ratio (%)	2.96%	2.98%	2.84%

2.3.3 Sectoral loan classification status of FIs as of December 2022

As of December 2022, housing sector continues to be the highest exposure sector with 27.78 percent followed by hotel and tourism sector and production and manufacturing with 12.45 percent and 10.61 percent respectively.

Table 2.6: Sectoral loan classification status as of December 2022 (Nu. In Million)

SL No.	Sectors	(A) Sectoral Loans and NPL (NU. In million)							(B) Percentage Holding	
		STD	WCH	SUB	DBT	Loss	Total Loan O/S	NPL	Exposure	NPL %
1	Housing Sector	51,478.21	1,137.55	185.70	215.82	347.96	53,365.25	749.49	27.78%	1.40%
2	Hotel and Tourism Sector	22,744.93	879.23	16.92	27.49	240.51	23,909.08	284.91	12.45%	1.19%
3	Production & Manufacturing	19,189.23	817.85	16.37	2.81	354.28	20,380.53	373.45	10.61%	1.83%
4	Service Sector	16,640.37	614.63	193.37	58.06	332.82	17,839.24	584.25	9.29%	3.28%
5	Trade and Commerce	13,339.29	1,124.22	291.14	56.48	824.78	15,635.90	1,172.40	8.14%	7.50%
6	Personal Loans	14,766.65	439.80	112.70	76.00	133.95	15,529.11	322.66	8.08%	2.1%
7	Education loans	12,665.74	72.51	62.47	54.12	14.76	12,869.61	131.36	6.70%	1.02%
8	Loan to contractor	7,876.00	1,280.74	52.42	5.43	620.11	9,834.69	677.96	5.12%	6.89%
9	Transport	7,739.40	885.96	146.95	103.61	564.74	9,440.66	815.30	4.91%	8.64%
10	Agriculture and Livestock	4,443.46	256.02	116.59	179.94	61.86	5,057.88	358.39	2.63%	7.09%
11	Loan Against Term Deposits	2,443.45	38.02	0.69	0.34	3.87	2,486.38	4.90	1.29%	0.20%
12	Staff Incentive Loans	2,269.33	58.45	8.14	-	3.93	2,339.85	12.07	1.22%	0.52%
13	Mining and Quarrying	1,398.56	238.93	16.62	1.55	37.35	1,693.00	55.51	0.88%	3.28%
14	Loans for Shares and Securities	1,273.57	79.14	9.11	-	0.39	1,362.20	9.50	0.71%	0.70%
15	Others	1.64	-	-	-	1.27	168.11	118.80	0.09%	70.67%
16	Forestry and Logging	102.27	16.61	0.76	2.33	3.97	125.94	7.06	0.07%	5.60%
17	Loans to Financial Service Providers	68.26	-	-	-	-	68.26	-	0.04%	-
	Total	**178,440.36**	**7,939.67**	**1,229.94**	**783.98**	**3,546.55**	**192,105.71**	**5,678.00**	**100%**	**2.96%**

In terms of the subsectors, the commercial housing and home loans within the housing sector were found to have a high concentration, followed by the hotels, travel agencies, restaurants, and bars under the hotel & tourist sector. Similarly, Hardware, textiles, handicrafts, food, and other related commodities under the production & manufacturing sector are found to have high loan concentration. As of December 2022, trade and commerce and transport sectors recorded highest NPL with Nu. 1.17 billion and Nu. 0.8 billion respectively followed by housing sector with Nu. 0.75 billion. However, the overall NPL ratio has decreased in the year 2022 due to deferment facilities offered under MMIV measures and NPL resolution measures including the charged-off of NPLs.

The total loan outstanding as of December 2022 amounted to Nu. 192.10 billion of which 81.47 percent is provided by the banking sector and the remaining 18.53 percent by the non-banks as shown in the Table 2.7.

Table 2.7: FIs loan composition as of December 2022 (Nu. In Million)

Sectors	All FIs	Bank	Non-Bank
Housing Sector	53,365.25	48,214.75	5,150.50
Hotel and Tourism Sector	23,909.08	21,898.14	2,010.93
Production & Manufacturing	20,380.53	14,587.03	5,793.50
Service Sector	17,839.24	10,349.77	7,489.47
Trade and Commerce	15,635.90	12,818.61	2,817.30
Personal Loans	15,529.11	10,938.64	4,590.46
Education loans	12,869.61	10,045.51	2,824.11
Loan to contractor	9,834.69	7,439.02	2,395.67
Transport	9,440.66	7,924.07	1,516.60
Agriculture and Livestock	5,057.88	5,029.17	28.71
Loan Against Term Deposits	2,486.38	2,486.38	-
Staff Incentive Loans	2,339.85	1,950.90	388.95
Mining and Quarrying	1,693.00	1,279.12	413.88
Loans for Shares and Securities	1,362.20	1,248.49	113.71
Others	168.11	168.11	-
Forestry and Logging	125.94	116.29	9.65
Loans to Financial Service Providers	68.26	10.88	57.38
Total	**192,105.71**	**156,504.87**	**35,600.83**

Table 2.8 shows the financial institution's loan loss provision (provisioning coverage ratio) set aside for NPLs as of December 2022. The Specific-Provision to NPL ratio in the financial sector stood at 72.57 percent as of December 2022 as compared to 77 percent in December 2021.

Table 2.8: Loan Loss Provision (NPL Coverage ratio) as of December 2022 (Nu. in Million)

Particulars	All FIs	Bank	Non-Bank
Specific Provision Charged	4,034.85	3,444.81	590.04
Total NPLs	5,560.47	4,618.70	941.77
Specific Provision to NPL coverage ratio	72.56%	74.58%	62.65%

2.4 Profitability Assessment

As of December 2022, the overall profitability of FIs has decreased by 9.37 percent. The declined in the overall profitability of the financial sector was mainly contributed by decreased in the profit in the non-banking sector by 57.92 percent. However, the banking sector's profits had increased marginally by Nu. 497.00 million. Similarly, the net interest income has decreased to Nu. 4413.19 million in 2022 from Nu. 4996.23 million in 2021 mainly because of loan deferment facilities and other MMIV measures.

Table 2.9: FI's profit as of December 2022 (Nu.in million)

Particular	2021			2022		
	All FIs	Bank	Non-Bank	All FIs	Bank	Non-Bank
Interest Income	17,237.39	13,012.66	4,224.73	17,767.60	14,040.05	3,727.55
Net Interest Income	4,996.23	3,906.17	1,090.06	4,413.91	4,175.84	238.07
Gross Operating Profit	6,859.73	5,020.27	1,839.46	7,576.90	5,589.48	1,987.42
Profit after tax	2,788.72	1,479.64	1,309.08	2527.49	1,976.64	550.85

2.5 Capital Risk Assessment

2.5.1 Capital adequacy analysis

Capital Adequacy Ratio (CAR) has increased from 15.50 percent in 2021 to 18.30 percent 2022 including the Capital Conservation Buffer (CCB), of 2.5%, factored by the increased in capital fund of 11.57 percent (Nu. 3,156.00 million) which outweighed the growth of Risk Weighted Asset of 4.89 percent (Nu. 8,618.76 million).

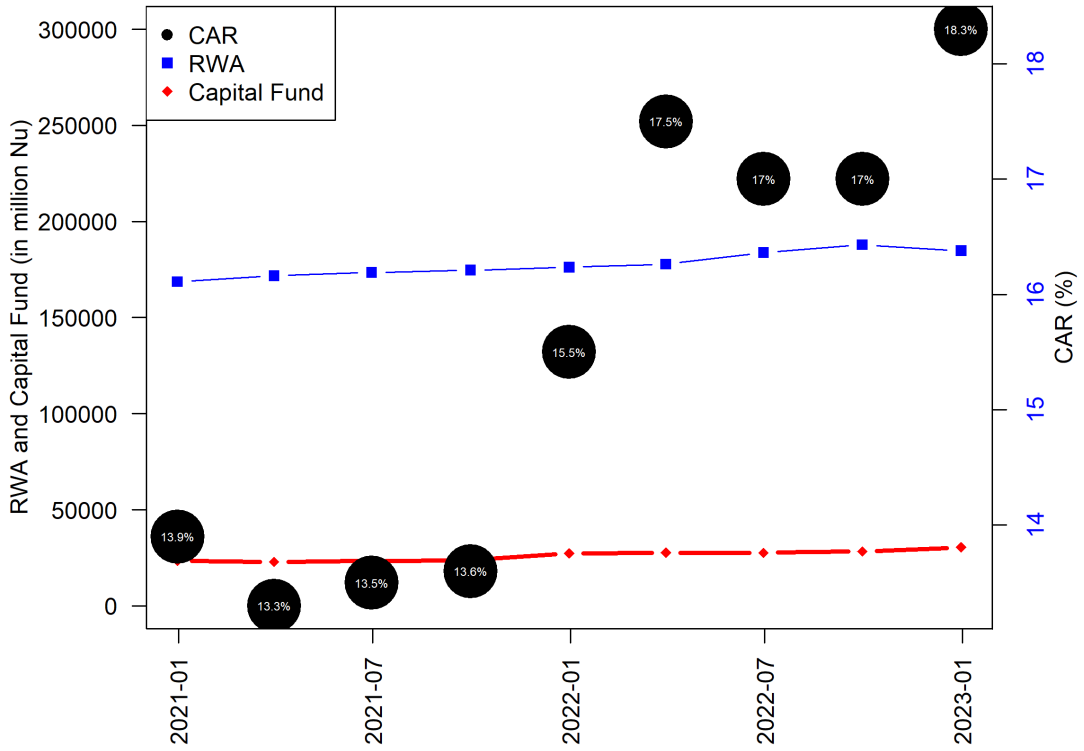


Figure 2.9: Risk-Weighted Assets (RWA) and Capital Adequacy Ratio (CAR) in the financial sector

2.6 Operational Risk Assessment

During the first half of the year 2022, the FIs continued the operations mostly with the containment mode as designed in 2020-2021, where the operations were carried primarily from the tech-driven online and automated model. The risk during the period was much lower compared to 2021 as the tech-driven models were much more matured by then. However, the second half of the year was fully back to its normal physical operations model as the intensity and the severity of the pandemic were substantially low. The mix-mode of physical operations along with the matured tech-driven platforms was much more effective with very low risks. The transition from an online to a physical model has helped the FIs to operate its business in a much more efficient manner. As mandated by the RMA, FIs have developed and adopted the Business Continuity Plans (BCP).

Chapter 3

SUPERVISORY PRIORITIES 2022

In order to enhance effective supervision of FIs, the RMA has introduced numerous supervisory and assessment frameworks as follows:

1. Risk-Based Supervision (RBS)

   To have prudent supervision of the regulated entities, RMA in collaboration with E & Y, Sri Lanka incepted the RBS framework in line with the Principle 8 of the Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision (BCBS). As per the Basel Principle, "An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address risks stemming from banks and the banking system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable."

   The main objective of the RBS framework adopted by RMA is to provide a dynamic, efficient, structured, and risk-oriented supervisory framework. With the adoption of the RBS framework, the RMA could timely detect systemic risk and provide necessary interventions in a timely manner.

2. Credit Rating Model (CRM)

   In a move to standardize the assessment of the creditworthiness of individuals prior to the sanctioning of the loan facility, RMA in collaboration with E & Y, Sri Lanka developed the internal CRM model for the benefit of the financial institutions. The model evaluates various factors and assigns a credit rating or score that indicates the likelihood of default or credit risk associated with the borrower. The model consists of two evaluation scorecards as follows:

   (a) Application: The scorecard assesses the applicant's financial information, credit history, income, debt-to-income ratio, and other relevant factors to determine the likelihood of the applicant repaying the borrowed funds. It assigns a numerical score or rating to the application, indicating the level of risk associated with extending credit to that particular applicant.

(b) Behavior: focuses on assessing and measuring an individual's behavior, habits, or performance in a particular context. The scorecard is designed to capture and analyze data related to specific behaviors or actions, which can vary depending on the intended purpose.

In both cases, the scorecards serve as quantitative tools to evaluate and compare individuals or entities based on predefined criteria.

Not limited to the above supervisory priorities, RMA is also in the process of developing various frameworks like the Green Finance, Valuation.

Chapter 4

Supervisory & Regulatory Development

The COVID-19 pandemic led to economic hardships for individuals and businesses, affecting debt repayment and the financial health of individuals and businesses. Considering the urgency of addressing the high non-performing loans (NPLs), the RMA issued a comprehensive framework to support and rehabilitate viable NPLs through loan restructuring measures while resolving non-viable ones through various foreclosures such as court/out-of-court settlements. The RMA issued the following rules and regulations as part of the NPL management framework:

1. **Rules and Regulations for Loan Restructuring 2022**

   The credit risk and the heightened levels of NPLs are being considered as one of the main risks facing the Bhutanese financial service providers (FSP). A comprehensive approach, consisting of different policy actions, is needed with the objective to address the existing stock of NPLs as well as to prevent the emergence and accumulation of new NPLs on FSP's balance sheets. In this regard, RMA issued the rules and regulations for loan restructuring 2022, which has identified a number of best practices on loan restructuring such as extension of loan tenure, providing credit moratoriums etc. which is set out in these Rules and Regulations. These rules and regulations outline the framework for implementing these best practices to ensure that FSPs effectively address and manage NPLs. FSPs are required to exercise due diligence when implementing loan restructuring measures. There are eight different forms of loan restructuring measures that FSPs can provide, which should be chosen based on the targeted support framework and the affordability of the borrowers. While these rules and regulations are written from a prudential perspective to safeguard the financial stability of FSPs, it also takes into account the need to treat borrowers fairly throughout the entire life cycle of the loan.

2. **Guideline on the reclassification of old Non-Performing Loans, 2022**

   In response to the impact of high NPLs and loan provisions, financial institutions will not be in a position to lend which might lead to a credit crunch if it's not addressed in a timely manner. Therefore, this guideline was issued as a counter-cyclical policy response to the pandemic as an interim measure with the objective to provide a one-time facility for the reclassification of NPLs as other assets to provide temporary relief to both borrowers and FIs during the pandemic.

3. **Requirements related to Credit Reports issued by CIB**

   All financial institutions are required to generate credit reports or perform credit assessments before issuing loans to clients. The primary purpose of conducting credit checks is to assess the creditworthiness of potential borrowers and minimize the risk of Non-Performing Loans (NPLs). While credit reports and credit assessments play a crucial role in reducing NPLs, it's essential for banks to adopt comprehensive risk management practices and continually monitor their loan portfolios. Therefore, considering the importance of credit reports, on 18th July 2022, RMA issued a directive related to the credit report issued by Credit Information Bureau. As per this directive, financial institutions are required to obtain a credit report issued by the Credit Information Bureau of Bhutan for prospective and existing borrowers not only prior to sanctioning of loans (section 218 of FSA 2011) but also during the renewal of any loan facility (24 hours before approval/disbursement of loans). These measures will help the financial institution to monitor, minimize the impact of NPLs and maintain a healthy lending environment.

4. **Guidelines for Implementation of Bhutanese Financial Reporting Standard (BFRS – 9)**

   The RMA has initiated a process to align its prudential regulations, particularly those related to asset classification and provisioning, with internationally accepted financial reporting standards. The adoption of Bhutanese Financial Reporting Standards (BFRS 9) is a significant step in this direction, aimed at promoting consistency and comparability in financial reporting practices across the Bhutanese financial industry. In March 2022, the RMA issued guidelines governing the adoption of the Bhutanese Financial Reporting Standards (BFRS 9) with the following objectives:

   (a) To align Section 4 of its Prudential Regulations from 2017, on asset classification and provisioning, with internationally accepted standards and practices.

   (b) To bring its prudential regulations in line with standards and practices that are widely recognized and accepted and to ensure that Bhutan's financial sector operates in accordance with international best practices.

   (c) To achieve consistency in the application of financial reporting standards for easier comparisons of financial reports among different financial institutions within Bhutan.

5. **Rules and regulations on loan origination and monitoring 2022**

The NPL Resolution Framework formed under the Comprehensive National Response to the Challenges of the COVID-19 Pandemic has brought multiple stakeholders together to address the risk and challenges of NPLs through diagnostic studies and designing the remedial measures. The diagnostic review of NPLs highlighted the importance of standardizing basic prudent requirements for credit sanctioning, monitoring, and follow-up of NPLs with the objective to ensure consistency and effectiveness in addressing NPL risks.

In response to the need for standardization and prudent credit practices, the RMA issued rules and regulations on loan origination and monitoring in 2022. These rules and regulations serve two main objectives:

(a) Guidance for Financial Service Providers: To provide guidance to financial service providers on prudent credit risk-taking and management which is crucial for ensuring that FSPs make sound credit decisions and manage risks effectively.

(b) Prudent Credit Origination: To establish basic prudent requirements for credit origination and sanctioning. FSPs are required to adhere to certain standards and procedures during loan origination and approving.

FSPs are required to strictly comply with these rules and regulations regarding loan origination and monitoring in order to manage the NPL risks.

6. **Treatments of Non-Performing Loans (NPLs)**

One of the key concerns in the management of NPLs is the practice of evergreening, where new loans are issued to borrowers to pay off existing NPLs which can lead to a cycle of debt and further deterioration of the financial health of borrowers. The RMA issued 6-month observation period directive for borrowers who have regularized their NPLs. During this period, financial institutions are prohibited from granting new loans. The directive aims to promote financial discipline, discourage evergreening practices, and ultimately lower the level of NPLs in the financial sector as detailed below:

(a) The primary rationale behind this directive is to instil financial discipline among borrowers who have previously regularized their NPLs. The goal is to encourage these borrowers to make regular loan repayments and prevent the practice of regularizing NPL loan accounts through the sanctioning of new loans, often referred to as "evergreening loans."

(b) The directive also aims to motivate borrowers to establish a consistent and timely repayment schedule for their loans, thereby reducing the risk of loans becoming non-performing again in the future.

(c) The overarching objective of the directive is to contribute to the reduction of NPLs within the financial sector.

7. **Rules and Regulations for Accountability of Key Responsible Persons of Regulated Entities, 2022**

   RMA has issued the Rules and Regulations for Accountability of Key Responsible Persons of Regulated Entities, 2022, in recognition of the significance of strengthening the regulatory framework to improve the responsibility and accountability of individuals in key responsible positions within the regulated entities. The regulation mandates the identification of key responsible persons, the allocation of responsibilities, and the fixation of accountability for breaches of duties and responsibilities. The main aim of the issuance of the regulation is to promote the responsibility and accountability of critical individuals and strengthen corporate governance for financial integrity and stability.

8. **Fit and Proper Guidelines for Key Responsible Persons of Regulated Entities, 2022**

   The RMA has issued the Fit and Proper Guidelines for Key Responsible Persons of Regulated Entities 2022. With the issuance of this guideline, financial institutions are required to obtain no objection letter (regulatory clearance from the RMA) for other key responsible persons in addition to the Board of Directors, before the appointment. The objective of this guideline is to ensure that these persons identified as "Key Responsible Persons" are fit and proper to carry out their duties and responsibilities as the Guideline ensures that the regulated entities prudently appoint fit and proper persons in key responsible positions.

Chapter 5

Monetary Measures Phase III and IV

In response to the COVID-19 pandemic, the RMA issued various monetary measures such as loan deferment, soft working capital at concessional rate of interest for the affected businesses. As per the monetary measures phase III issued in 2021, the deferment of loan repayment for eligible loan account was extended by another year from July 2021 to June 2022. Further, the payment of a one percent rebate for the clients whose repayment is regular during the deferment was also continued as an incentive for making regular repayment until June 2022.

Additionally, in continuation to the phase III monetary measure, RMA has further extended the monetary measures as monetary measure phase IV (MM IV). Under the MM IV, the sectors and subsectors are classified into three different risk categories viz., High, Moderate, and Low. Based on these risk classifications and the affordability of the borrowers, the FSPs are allowed to provide loan deferment until June 2024 for sectors under the high-risk category, and for moderate risk category deferment was extended until June 2023. *Targeted Support Measures Matrix for the risk classification of sectors/subsectors and their eligibility for various forms of loan restructuring measures*. There are 8 forms of loan restructuring measures under this targeted support framework. Further, the maximum loan term for the construction or setting-up of hotels and restaurants for both existing and new loans was also increased up to 30 years from 20 years.

In order to reduce the interest payment burden and also to avoid capitalization of accrued interest, the FSPs were prohibited from capitalization of the interest accrued during the loans deferment. At the end of the deferment period, FSPs were directed to convert the total accumulated interest for the entire deferred period provided from monetary measures Phase I to Phase lV into 'Fixed Equated Installment Facility (FEIF)' payable in equal installments for a period up to five years. Since the FEIF account is created out of the accumulated interest during the deferment period, the FSPs are not allowed to charge interest on the FEIF account.