ROYAL MONETARY AUTHORITY OF BHUTAN

FINANCIAL REGULATION AND SUPERVISION DEPARTMENT

PRUDENTIAL REGULATIONS

In exercise of the powers conferred by the Royal Monetary Authority of Bhutan Act, 2010 and the Financial Services Act of Bhutan 2011, the Royal Monetary Authority of Bhutan (RMA) hereby issues these regulations to the financial institutions in Bhutan. These regulations shall come into force [ ] and supersede the existing Prudential Regulations 2002. These regulations shall be amended in part or as a whole when the RMA feels the need to affect such changes.

Foreword

In exercise of the powers conferred by the Royal Monetary Authority of Bhutan Act, 2010 and Financial Services Act of Bhutan 2011, the Royal Monetary Authority hereby issues these regulations to the financial institutions in Bhutan. These regulations shall come into force from [ ] and supersede the existing Prudential Regulations 2002.

While these regulations provide a broad framework of quasi-judicial responsibilities that the financial institutions will have to adhere to and implement at the minimum, the financial institutions are allowed to have their own stringent policies and procedures that are approved by their respective Boards.

In developing these regulations, the RMA has incorporated certain minimum standards set out in 29 Core Principles for Effective Banking Supervision (version of September 2012) and other standards published by the Basel Committee for Banking Supervision, BIS. In doing so, while consideration has been given to achieve the minimum international best practices, the RMA has also taken into account the nature, scale and complexity of the financial sector in Bhutan. Additional requirements may be set out in separate Regulations and Directives that the RMA may issue at any time (current Regulations include the Corporate Governance Regulations 2011 and Macro prudential Rules and Regulations 2014).

The RMA expects that the Prudential Regulations [ ] will facilitate the implementation of prudent practices and effective risk management techniques amongst financial institutions. These regulations shall also promote a level of playing field for all market players, including transparency, accountability, corporate governance and fair competition. It is the RMA's expectation that all the financial institutions shall comply with and implement these regulations in an effective manner.

These regulations shall be amended in part or as a whole when the RMA feels the need to make such changes.

Thanking you,

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SECTION 1: REGULATIONS ON CAPITAL ADEQUACY REQUIREMENTS

1.1 INTRODUCTION

1.1.1 Capital

Capital serves as a reserve against unexpected losses and is the foundation of a sound financial system. The maintenance of adequate capital is most often the principal source of public confidence in any financial institution. Capital provides confidence and protection to depositors, creditors, the central bank, and ultimately to the government. Therefore, it is important to establish a legal framework governing the minimum capital requirements, as well as minimum capital standards to be observed by the financial institutions.

These regulations shall determine the minimum level, the structure, and the ratios of the capital base of a financial institution, to its balance-sheet assets and off balance-sheet items.

1.2 MINIMUM PAID-UP CAPITAL REQUIREMENT

The minimum paid-up capital for different types of financial institutions shall be in line with the relevant regulations issued by the RMA.

1.3 MEASUREMENT OF CAPITAL

The capital of a financial institution, for the purposes of these regulations, is composed of Tier 1 capital and Tier 2 capital as defined in these regulations.

1.3.1 Tier 1 Capital

Tier 1 capital, or Core capital, is formed as the sum of:

- Paid-up capital
- [1]General Reserves (Statutory Reserves)
- Share Premium Account
- Retained Earnings (Free Reserve)

Less:

- Loss for the current year
- Goodwill and other intangible assets
- Deferred tax assets that rely on the future profitability of the institution
- Buyback of the financial institution's own shares

[1] General Reserves and Reserve Fund mentioned in the Financial Services Act of Bhutan 2011 shall have a same meaning and should be used interchangeably for the purposes of these regulations.

Buying back of financial institution's own shares is tantamount to repayment of capital and therefore, it is necessary to take-off such investment from the institution's capital with a view to improving the institution's quality of capital. This deduction would remove the double counting of equity capital.

- Holdings of Tier 1 instruments issued by other financial institutions
  The investment of financial institutions in the capital instruments of other financial institutions contributes to the inter-connectedness amongst the financial institutions. In addition, these investments also amount to double counting of capital in the financial system. Therefore, these investments have been subjected to deduction from respective tier 1 capital.

1.3.2 Tier 2 Capital

Tier 2 capital, or Supplementary or Secondary capital, is formed as the sum of:

- Capital Reserve
- Fixed Assets Revaluation Reserve
- Exchange Fluctuation Reserve
- Investment Fluctuation Reserve
- Research and Development Fund
- *General Provisions to the extent that they do not exceed 1.25% of the sum of total risk weighted assets in respect of credit risk*
- Subordinated term debts with a minimum original maturity of at least 5 years. *(The debt must be fully paid; the repayment of the debt must not be guaranteed in any form by the financial institution; the debt may not be repaid ahead of term without the permission of the RMA in writing. In case of liquidation of the financial institution, the repayment of the debt is admissible after all other creditors' claims have been met. During the last 5 years to maturity, the amount of subordinated term debt shall be included and reported in Tier 2 Capital reduced by 20% for each year. After the debt has matured, it shall be entirely excluded from the capital base calculation).*
- Profit for the current year

1.4 MINIMUM CAPITAL ADEQUACY RATIOS

(i) Every financial institution shall maintain at all times a Capital Adequacy Ratio (CAR) of not less than 10%. For this purpose, CAR shall be computed as the ratio of the institution's capital as defined above to the sum of:

(a) its total risk weighted assets for credit risk, including off-balance sheet items calculated in accordance with the requirements of this section; and

(b) its risk-weighted assets for operational risk calculated in accordance with the requirements of this section.

(ii) Every financial institution shall in addition maintain at all times a core capital adequacy ratio of not less than 5%. For this purpose, the core capital adequacy ratio shall be computed as the ratio of the institution's total Tier 1 capital as defined above to its total risk weighted assets as calculated in (i) above.

(iii) The minimum capital adequacy ratios shall be observed by each financial institution and the financial institution's group as a whole.

1.5 LIMITS ON THE USE OF DIFFERENT FORMS OF CAPITAL FOR CAPITAL ADEQUACY RATIO PURPOSES

For purposes of computing capital adequacy ratios:-

(i) Total of subordinated term debts of a financial institution shall not exceed 50% of the Tier 1 capital.

(ii) Total Tier 2 capital shall be included in the capital fund, only up to the extent of 100% of the total Tier 1 capital.

(iii) All items that are deducted from capital are excluded from total assets in calculating the capital adequacy ratio.

1.6 CAPITAL CONSERVATION BUFFER

1.6.1 In addition to the above minimum capital adequacy ratios, financial institutions are required to hold a capital conservation buffer of 2.5% of total risk-weighted assets (RWAs) over and above the minimum ratios set out in Section 1.4 to enable the institutions to withstand future periods of stress without breaching the minimum capital ratios.

The capital conservation buffer must be met by Tier 1 capital.

The minimum capital requirement ratios including the Capital Conservation Buffer are as follows:

	Regulatory Capital	**As a % to RWA**
(i)	Core Capital Ratio (Tier 1)	5%
(ii)	Capital Conservation Buffer	2.5%
(iii)	Core Capital Ratio plus Capital Conservation Buffer [(i)+(ii)]	7.5%
(iv)	Tier 2 Capital	5%
(v)	Capital Adequacy Ratio (Tier 1 plus Tier 2 Capital) [(i)+(iv)]	10%
(vi)	Capital Adequacy Ratio Plus Capital Conservation Buffer [(v)+(ii)]	12.5%

Where a financial institution fails to meet in part or fully its capital conservation buffer requirement, it shall be prohibited from distributing capital and declaring or paying dividends, bonuses, salary incentives, severance packages (contractual arrangements entered into with, and involving payment of cash or benefits to directors or staff whose employment with the institution is to finish), management fees or other discretionary compensation to directors or officers.

1.7 ADJUSTMENT OF CAPITAL

(i) When a financial institution fails to meet any of the capital adequacy ratios set out in Section 1.4 above, including the Capital Conservation Buffer, it shall immediately notify the RMA of the circumstance and draw up a rehabilitation program, including deadlines for restoring the capital adequacy ratio. During the rehabilitation program, the financial institution is prohibited from paying out dividends to its shareholders, and must allocate the full amount of its profit to the statutory reserves.

(ii) In case of failure by the financial institution to abide with the rehabilitation program or to meet any deadlines, it shall be liable to such measures and penalties as may be imposed by the RMA, in accordance with the Financial Services Act of Bhutan 2011.

1.8 RISK WEIGHTED ASSETS

1.8.1 For the purpose of these regulations, risk-weighted assets will be calculated by applying to the value of assets and off-balance sheet items (as calculated under Section 1.9) risk weights as follows. The treatment of collateralized claims is set out in Section 1.11.

(i) Zero Risk-Weighted Assets

(a) Cash in hand;

(b) Precious metals;

(c) Balances with the RMA (Current Deposits and CRR);

(d) Bills issued by the RMA;

(a) Both fund based and non-fund based claims on the Royal Government of Bhutan.

(b) Royal Government of Bhutan's guaranteed claims.

(g) Reserves Repurchased by the RMA; and

(h) Claims, including fixed interest securities, and guarantees, with a remaining maturity of not more than one year, issued by or given to governments or central banks of "Zone A" countries.

(ii) 20% Risk-Weighted Assets

(a) Claims on financial institutions in Bhutan

(b) Claims on financial institutions incorporated in *"Zone A"* countries

(c) Claims and guarantees, including fixed interest securities, with remaining maturities of more than one year, issued by governments or central banks of *"Zone A"* countries.

(d) Claims and guarantees, including fixed interest securities, with a remaining maturity of not more than one year, issued by governments and central banks of *"Zone B"* countries.

(iii) 50% Risk-Weighted Assets

(a) Claims and guarantees, including fixed interest securities, with remaining maturities of more than one year, issued by governments and central banks of "*Zone B"* countries.

(b) Claims with remaining maturity of not more than one year, on financial institutions incorporated in *"Zone B"* countries, including deposits in India.

(iv) 100%Risk- Weighted Assets

(a) Equity investments *(net of specific provisions);*

(b) Investments in real estate *(net of specific provisions);*

(c) Loans and overdrafts to counterparties, which are overdue by 90 days and less *(net of specific provisions);*

(d) Claims* with remaining maturities of more than 1 year, on financial institutions incorporated in "Zone B" countries (including India);

(e) Fixed Assets; and

(f) Other Assets.

(v) 150%Risk- Weighted Assets

(a) Loans and overdrafts to counterparties, that are overdue by 91 days and more, *(net of specific provisions).*

1.9 OFF-BALANCE SHEET ITEMS

1.9.1 General

(i) The risk-weighted amount of an off-balance sheet item is generally calculated as follows:

(a) The amount of the off-balance sheet item is converted into a credit equivalent amount, by multiplying the amount by the specified Credit Conversion Factor[2]; and
(b) The resulting credit equivalent amount is multiplied by the risk weight applicable to the off-balance sheet item

1.9.2 All off-balance sheet items shall be assigned 100 percent risk weighting, except otherwise where these regulation provides an exemption.

1.9.3 The following off-balance sheet items should be assigned a Credit Conversion Factor (CCF) net of margin money before being subject to risk weighting. The factors to be used are:

(a) [3]Direct credit substitutes (including guarantees, stand-by letters of credit used as guarantees and bank acceptances): 100%
(b) [4]Transaction-related contingent items (e.g. performance bonds, bid bond/security): 50%
(c) Undrawn commitments with an original maturity of over one year: 50%
(d) Undrawn commitments with an original maturity of under one year: 20%
(e) Commitments under facilities where the financial institution is able to cancel the commitment at any time without prior notice may be given a CCF of 0%.

1.10 ZONES

For the purposes of these regulations, countries are divided into two zones as follows:-

(i) "Zone A" Countries

The term 'Zone A' covers full members of the Organization for Economic Co-operation and Development (OECD), as published by the OCED, and those

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[2] Credit Conversion Factor refers to the percentage by which a financial institution's off-balance sheet exposures are to be multiplied, as specified, in order to express them as credit-equivalent exposures.
[3] Direct credit substitutes means when a financial institution irrevocably undertakes to guarantee the repayment of a contractual financial obligation. It carries the same credit risk as a direct extension of credit i.e. the risk of loss is directly linked to the creditworthiness of the counterparty against whom a potential claim is acquired.
[4] Transaction-related contingent item involve an irrevocable undertaking by a financial institutions to pay a third party in the event the counterparty fails to fulfill or perform a contractual non-financial obligation. In such transactions, the risk of loss depends on the event which need not necessarily be related to the creditworthiness of the counterparty involved.

countries which have concluded special lending arrangements with the IMF associated with the IMF's General Agreement to Borrow (GAB), as published by the IMF, provided they have not rescheduled their external sovereign debt, to official or private sector creditors, in the previous five years.

(ii) "Zone B" Countries

All countries not included in "Zone A" are in "Zone B."

1.11 TREATMENT OF NETTING, COLLATERAL AND GUARANTEES (CREDIT RISK MITIGATION)

1.11.1 Financial institutions use a number of techniques to mitigate the credit risks to which they are exposed. For examples, exposures may be collateralized in whole or in part by cash or securities, deposits from the same counterparty etc. The approach to credit risk mitigation allows a wider range of credit risk mitigants to be recognized for regulatory capital purposes. Therefore, exposures may be assigned a risk weighting reduced from the weighting to be applied under Section 1.8 above in cases where the financial institutions hold cash or other forms of collateral, and appropriate arrangements with the counterparty as set out in this sub-section.

1.11.2 In respect of netting arrangements covering cash held by the financial institution on its own balance sheet, the institution may assign a reduced risk weighting as set out below where it has a netting agreement with the counterparty and:

(i) the agreement is legally effective and enforceable in all relevant jurisdictions, including in the event of the insolvency or bankruptcy of a counterparty;
(ii) the financial institution must be able to determine at any time those assets and liabilities that are subject to the on-balance sheet netting agreement;
(iii) the financial institution must monitor and control the risks associated with the termination of the credit protection; and
(iv) the financial institution must monitor and control the relevant exposures on a net basis.

1.11.3 In respect of cash held by a third party institution, the institution may assign a reduced risk weighting as set out below where it has an agreement with the counterparty and:

(i) the counterparty's claim against the third party institution is openly pledged or assigned to the lending institution and such pledge or assignment is legally effective and enforceable in all relevant jurisdictions;
(ii) the third party institution is notified of the pledge or assignment;

(iii) as a result of the notification, the third party institution is able to make payments solely to the lending institution; and
(iv) the pledge or assignment is unconditional and irrevocable.

1.11.4 In respect of financial collateral held by the financial institution, the institution may assign a reduced risk weighting as set out below where:

(i) the financial collateral takes the form of gold or securities issued by a government; and
(ii) the credit quality of the obligor and the value of the collateral do not have a material positive correlation; financial institutions shall also fulfill any contractual and statutory requirements in respect of, and take all steps necessary to ensure, the enforceability of the collateral arrangements under the applicable law; and shall have conducted sufficient legal review confirming the enforceability of the collateral arrangements in all relevant jurisdictions; and the collateral arrangements shall be properly documented, with clear and robust procedure for the timely liquidation of the collateral.

1.11.5 Where the financial institution meets the conditions for recognition of arrangements covered by this section, the risk weighting to be assigned shall be that of the collateral:

(i) Loans and deposits with the bank subject to on-balance sheet netting are to be treated as cash collateral and assigned a risk weight of 0%, except when a currency mismatch exists, where no reduction in risk weighting is permitted.
(ii) Cash held by a third party institution and financial collateral which meet the conditions set out above shall be assigned a value equal to its market value and the risk weight shall be applied as if the financial institution had a direct exposure to the financial collateral instrument; the reduced risk weight shall be assigned only to those portions of claims collateralized by the market value of collateral, except that risk weight of the collateralized portion shall be a minimum of 20%.

1.11.6 While the use of credit risk mitigation techniques reduces or transfers credit risk, it simultaneously may increase other risks (residual risks). Residual risks include legal, operational and liquidity risks. Therefore, it is imperative that financial institutions employ robust procedures and processes to control these risks, including strategy; consideration of the underlying credit; valuation; policies and procedures; systems; and management of concentration risk arising from the financial institution's use of credit risk mitigation techniques and its interaction with the financial institution's overall credit risk profile. Where these risks are not adequately controlled, RMA may impose additional capital charges or take other supervisory actions.

1.12 RISK WEIGHTED ASSETS – OPERATIONAL RISK

1.12.1 Financial institutions must calculate an amount of risk-weighted assets for operational risk as set out in this sub-section. Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events and includes legal risk, but excludes strategic and reputational risks. The Basel Capital Adequacy Framework outlines three methods for calculating operational risk capital charges in a continuum of increasing sophistication and risk sensitivity: (i) the Basic Indicator Approach (BIA); (ii) the Standardized Approach (SA) and (iii) the Advanced Measurement Approach (AMA). However, to begin with, financial institutions in Bhutan shall compute the capital requirements for operational risk under the Basic Indicator Approach.

1.12.2 Under the "Basic Indicator Approach", financial institutions must hold capital for operational risk equal to the average over the previous three years of a fixed percentage (denoted as alpha) of positive annual gross income. Figures for any year in which annual gross income is negative or zero, should be excluded from both the numerator and denominator when calculating the average. If negative gross income distorts a financial institution's capital charge, RMA will consider appropriate supervisory review and actions. The capital charge may be expressed as follows:

$$K_{BIA} = \left[\sum (GI_{1..n} \times \alpha)\right] / n$$

Where:

K_{BIA}= the capital charge under the Basic Indicator Approach
GI = annual gross income, where positive, over the previous three years
N = number of the previous three years for which gross income is positive
α = 15% as determined by Basel Committee

Gross income is defined as net interest income plus net non-interest income. It is intended that this measure should: (i) be gross of any provisions (e.g. for unpaid interest); (ii) be gross of operating expenses, including fees paid to outsourcing service providers; (iii) exclude realized profits/losses from the sale of securities in the banking book; and (iv) exclude extraordinary or irregular items as well as income derived from insurance.

1.12.3 The capital requirement derived from the calculation in Section 1.12.2 shall be converted into risk-weighted assets by multiplying the total capital requirement by 12.5 (i.e. the reciprocal of the minimum capital ratio of 8%). The risk-weighted assets thereby derived shall be added to credit risk-weighted assets as required under section 1.4 above.

1.13 MINIMUM LEVERAGE RATIO

1.13.1 In order to avoid building-up excessive on and off-balance sheet leverage in the financial sector, a simple, transparent and non-risk based Leverage Ratio is being introduced with the following objectives:

(i) constrain the build-up of leverage in the financial sector which can damage the broader financial system and the economy; and

(ii) reinforce the risk based requirements with a simple, non-risk based measure

1.13.2 All financial institutions shall meet the minimum leverage ratio requirement on a quarterly basis. The leverage ratio shall be calculated as the bank's core capital divided by the bank's total exposure measure and shall be expressed as a percentage.

The leverage ratio shall be calculated using the following approach:

(i) The capital measure for the leverage ratio is the Tier 1 capital as specified under Section 1.3.1 of these Regulations.

(ii) The denominator for the calculation of the leverage ratio shall be the sum of all (a) on-balance sheet exposures, and all (b) off-balance sheet exposures of the financial institution.

(iii) All items listed on the assets side of the balance sheet shall be included in the exposure measure for the leverage ratio on an un-weighted basis (i.e. without the application of risk weights as set out in Section 1.8 above). On balance sheet exposures shall be included net of specific provisions.

(iv) However, to ensure consistency, balance sheet assets deducted from Tier 1 capital (as set out in Section 1.3.1) may be deducted from the exposure measure.

(v) Treatment of off-balance sheet exposures: financial institutions should calculate the off balance sheet items (net of margin money) for the purposes of the leverage ratio by applying a uniform 100% credit conversion factor (CCF).

1.13.3 Financial institutions in Bhutan shall maintain a minimum leverage ratio of 5%.

1.13.4 The RMA shall vary the minimum leverage ratio requirement specified above, if it is necessitated by macro-economic developments or by other information.

1.14 ADDITIONAL CAPITAL

1.14.1 Since the capital adequacy ratio prescribed under this regulation is only the regulatory **minimum** level addressing only the two specified risk (credit and

operational risks), holding additional capital might be necessary for financial institutions, on account of both – the possibility of some under-estimation of risks under the prescribed framework and the actual risk exposure of a financial institution vis-à-vis the quality of its risk management architecture. Illustratively, some of the risks but not limited to, that financial institutions are generally exposed to but which are not captured or not fully captured in the regulatory CAR would include:

(a) Credit concentration risk
(b) Liquidity risk
(c) Reputational risk
(d) Market risk

1.14.2 It is therefore, appropriate that the financial institutions make their own assessment of their various risk exposures through a well-defined internal process, and maintain an adequate capital cushion for such risks.

1.14.3 The RMA generally expects financial institutions to hold capital above their minimum regulatory capital levels, commensurate with their individual risk profiles, to account for all material risk. To this end, RMA will assess the overall capital adequacy of a financial institution and may determine the extent to which financial institutions should hold capital in excess of the regulatory minimum

1.15 REPORTING OF CAPITAL ADEQUACY

1.15.1 Report on the Risk Component and Capital Adequacy

(a) The RMA will prescribe the forms and issue mandatory instructions on the manner of drawing up and submitting the report on the risk components and the capital adequacy by the institutions.

(b) Based on the balance sheet for the last day of each quarter, every financial institution shall draw up a report on the risk component and its capital adequacy ratio. The report must be submitted to the RMA before the end of the first month following the quarter.

(c) Each financial institution shall draw up and submit to the RMA an annual report on the risk component and its capital adequacy ratio. The report must be submitted within the first three months following the end of a financial year.

1.16 ADDITIONAL INFORMATION

The RMA may require from financial institutions additional information and analytical breakdowns on each item on the risk component and capital adequacy, with each determinant of accounting included.

1.17 CONTROL OVER THE VERACITY OF DATA

The RMA may conduct an examination on the veracity of data in the reports and for compliance with the rules for establishment of the risk weighted assets. This may include on-site inspections and comparison between the data in the report and the accounts of the financial institutions. The external auditors will conduct verification, reflect in the report and give an opinion on the correct weighting of the risk weighted assets. Furthermore, the auditors' opinion shall contain an assessment of the capital adequacy of the financial institution.

SECTION 2: REGULATIONS ON RELATED PARTY TRANSACTIONS

2.1 INTRODUCTION

2.1.1 Misconduct and irregular practices by financial institutions typically occur through the extension of credit to related parties without proper appraisal thereby leading to a high degree of risk exposure to such parties, loss of credibility and public confidence, and subsequent losses by the institution. To prevent these abuses and irregular practices, Sections 77 to 81 of the Financial Services Act of Bhutan 2011 prohibit a financial institution from entering into related-party transactions other than in the ordinary course of business and on terms generally available to its customers and set out other requirements for doing business with related persons.

The regulations in this Section seeks to instill discipline and professionalism for financial institutions in extending credit and making investments in the ordinary course of business to/in connected parties which are of good credit standing, while ensuring that connected parties, by virtue of their position that could potentially exert influence over a financial institution, do not inappropriately benefit from such transactions to the detriment of the financial institution.

2.2 DEFINITION OF RELATED PARTY

2.2.1 For the purpose of these regulations, any natural or legal person is considered to be a related party if that person has a relationship with the financial institution, and includes the following:

(a) significant owner[5];

(b) a member of the Board of Directors

(c) employees of the financial institution;

(d) spouse and children of persons specified in (a) if it is a natural person and (b);

(e) spouse and children of persons specified in (c);

(f) any individual for whom a director or significant owner is a guarantor;

(g) any individual for whom a employee is a guarantor;

[5] Significant owner has the same meaning as defined in the Financial Services Act of Bhutan 2011

(h) any firm or company in which a significant owner and director has an interest as owner, partner, or has a direct or indirect equity interest equal to or exceeding 10 percent of the paid-up equity capital;

(i) any firm or company in which an employee has an interest as owner, partner, or has a direct or indirect equity interest equal to or exceeding 10 percent of the paid-up equity capital;

(j) parent/holding company of financial institution;

(k) subsidiary of the parent/holding company specified in (j);

(l) companies in which the parent/holding company specified in (j) has a direct or indirect equity interest equal to or exceeding 10 percent;

(m) subsidiary or associate company, fellow subsidiary or affiliate of the financial institution;

(n) another financial institution with cross-shareholding in, or a high degree of influence over the financial institution;

2.3 POLICY STATEMENT ON RELATED PARTY TRANSACTIONS

2.3.1 A financial institution must have a policy statement, approved by its board of directors, on transactions with related parties. The policy statement should include the institution's procedures for identifying related parties, for approving transactions with such parties, where permitted under these regulations and the Financial Services Act 2011, and for monitoring and managing transactions once approved. The policy should include the limits approved by the board on related party exposures.

2.4 RESTRICTIONS ON TRANSACTIONS WITH RELATED PARTIES

2.4.1 A financial institution shall not enter into a transaction with a related party where it would result in:-

(a) an exposure to any individual firm or company included in the definition of related party in Section 2.2.1, exceeding 10 percent of the institution's total capital;

(b) an exposure to any individual natural person specified in Section 2.2.1, exceeding 5 percent of the institution's total capital;

(c) aggregate exposure to all related persons of the financial institution, excluding those specified in (c), (e), (g) and (i) of Section 2.2.1, exceeding 30 percent of its total capital; and

(d) aggregate exposure to all those persons specified in (c), (e) (g) and (i) of Section 2.2.1 above, exceeding 10 percent of total capital.

2.4.2 For the purposes of the limits on exposure set out in Section 2.4.1 above, total capital shall be defined as in Section 1 (Capital requirements) of these regulations.

2.4.3 For the purpose of the application of the limits in Section 2.4.1 above, the following exposures shall be aggregated:-

(c) loans and advances granted to the related party;

(d) any exposures arising from off-balance sheet transactions, including undrawn commitments[6] and guarantees;

(e) loans and advances and off-balance sheet exposures to unrelated parties where a guarantee has been provided by the related party, and the financial institution is relying on the guarantee for repayment of the loan or settlement of the obligations of the unrelated party; and

(f) loans and advances and off-balance sheet exposures arising from consortium financing arrangements or equivalent arrangements for financial institutions to share risks, including syndicated lending; however, where the arrangement was entered into before the date on which these regulations take effect, the exposure will be exempt from the limits in this section, provided that the value of the exposure is not increased from its amount at that date.

2.4.4 Loans and advances should include outstanding amount in case of term loan and outstanding amount or sanctioned amount whichever is higher in case of overdraft/working capital facilities. Off-balance sheet transactions, including undrawn commitments and guarantees should be calculated in the same way as for the capital requirements in Section 1.

2.4.5 Where a default occurs in respect of any of the related parties specified in Section 2.2.1 above, that person shall not be eligible for any further loan until the loan account has been regularized.

2.4.6 A report of all outstanding exposures to related parties must be submitted to the Board at each meeting.

2.4.7 If a loan to a related party becomes a non performing loan, the financial institution shall deduct the total loan outstanding from its capital fund when assessing the capital adequacy ratio.

[6] For example: A loan of Nu. 100 million where the drawn portion is Nu. 60 million, the undrawn portion of Nu. 40 million is the undrawn commitment.

2.5 GRANTING OF FAVOURABLE TERMS PROHIBITED

2.5.1 All loans to, and other transactions with related persons (i) shall be on the same terms and conditions, including interest rates, fees, margins and security, as those applicable at the time of origination to similar loans to any other person who is not a related person of the financial institution; (ii) shall not involve more than the normal risk of repayment or any other unfavorable features, and (iii) the financial institution shall apply credit underwriting procedures that are no less stringent than those applied for comparable transactions with persons who are not related person.

2.5.2 Notwithstanding the requirement in Section 2.5.1 that loans and other transactions be made on the same terms and conditions as are offered to unrelated parties, financial institutions may make loans to their own staff under remuneration or incentive schemes on terms which are not offered to unrelated parties, provided such schemes are documented and approved by senior management and the board of directors and the same terms are offered to all staff or categories of staff.

2. 6 RESTRICTIONS ON THE PURCHASE OF GOODS AND PROPERTY OBTAINED BY THE INSTITUTION IN SATISFACTION OF DEBTS

2.6.1 The sale of goods or other property seized by a financial institution in satisfaction of a debt previously contracted must be carried out through public auction.

2.6.2 Directors, officers and employees are prohibited from purchasing such goods or property from the financial institution or any agent thereof, directly.

2.7 REPORTING OF RELATED PARTY TRANSACTIONS

In the context of this regulation, related party transactions shall be reported to the RMA as per the format prescribed by RMA. The report shall contain details of all loans, including overdraft facilities and other extensions of credit, and must be submitted to the RMA on a monthly basis, no later than last day of the following month.

SECTION 3: REGULATIONS ON CREDIT CONCENTRATION

3.1 CREDIT CONCENTRATION AND ITS RATIONALE

3.1.1 The excessive concentration of risk exposure to a single counterparty, or to persons connected to the single counterparty and to their related interests, industry or economic sector, country or activity, places a financial institution in a vulnerable position, as the business failure of the counterparty, or unfavorable developments in the sector or country could have an adverse effect on the financial position of the institution itself. Historically, financial institutions have been known to have failed because of excessive lending to a group of borrowers (connected persons), over-exposure to markets such as real-estate or stocks, or engaging in excessive speculative activities arising from high foreign exchange exposure, or maturity and interest-rate mismatches. These excessive exposures are normally generated by either technical misjudgment of sudden changes in the market, or as a result of mismanagement. Moreover, restricting aggregate credit to large borrowers may also have a beneficial effect in making credit available to a broader group of borrowers.

3.1.2 It is therefore, necessary that within the regulatory framework prescribed by the RMA, financial institutions should clearly define their credit policies in respect of limits and procedures for the granting of large credit facilities and other facilities giving rise to credit risk. Credit risk must be contained by ensuring that a financial institution's exposure is diversified, e.g. by customer, geographical spread or economic sector. Concentrations will also arise through the specialization of financial institutions for reasons of competitive advantage and expertise. For this reason, safeguarding against excessive concentration is one of the most important components in any financial system. The primary purpose of this regulation is to allocate and limit the loss, which a financial institution may suffer from concentration of exposures.

3.1.3 Therefore, the purpose of the regulations in this Section are to define the permissible limits of a financial institution's exposure to a single counterparty, or persons connected to single counterparty and their related interests. The regulations are not only designed to restrict the concentration of risk to a few borrowers, but the underlying philosophy or intention is to diversify risk among the institutions vis-à-vis their exposure to a few counterparties. Financial institutions could possibly consider large loans to big borrowers through consortium financing, or syndicated loans to reduce their respective exposures. Alternatively, a financial institution could also increase its capital base, and the size of its total loan portfolio to enable it to increase the size of its loan to large borrowers.

3.2 POLICY STATEMENT ON CREDIT CONCENTRATION

3.2.1 A financial institution must have a policy statement, approved by its board of directors, on credit concentration. The policy statement should include the institution's procedures for identifying concentrations, including groups of connected counterparties and for establishing and monitoring limits on such exposures. The policy should include the limits approved by the board on credit risk concentrations. The policy statement must cover exposures to single counterparty and persons connected to it, and concentrations of exposure to economic sectors, regions and countries, as appropriate to the nature of the financial institution's business.

3.3 RISK EXPOSURE

3.3.1 Risk exposure is the amount at risk arising from the aggregate of the financial institution's business, whether conducted on or off-balance sheet, the realization of which generates an unconditional claim in favor of the financial institution. These will comprise claims on a counterparty including actual claims and potential claims which would arise from the drawing down in full or un-drawn advised facilities (whether revocable, irrevocable, conditional or unconditional), which the financial institution has committed itself to provide, and claims which the financial institution has committed itself to purchase or underwrite.

3.3.2 Exposures shall be calculated for the purposes of these regulations in the same way as for the capital requirements in Section 1, before the application of risk weightings.

3.3.3 In the case of overdrafts and working capital advances, financial institutions must calculate the exposure, for the purpose of these regulations, as the sanctioned limit, or the outstanding balance, whichever is greater. Undrawn committed facilities are to be treated as in Section 1.9 above.

3.4 SINGLE COUNTERPARTY (CONNECTED PARTIES)

3.4.1 For purpose of these regulations, single counterparty is defined as:

(a) an individual, his/her spouse, persons who are economically dependent on the individual and a company or a firm in which he/she has a shareholding of more than 50%; and

(b) persons with common business or financial interests, whether incorporated or not, including:

(i) a partnership and its members;

(ii) an enterprise and participants in the enterprise who borrow for that enterprise;

(iii) a group of enterprises or companies with common ownership;

(iv) a company and its majority owned subsidiaries.

(c) Any persons who because of economic interdependence would both or all are likely to experience financial problems, particularly funding or repayment difficulties, at the same time.

3.4.2 For the purpose of this regulation, single largest counterparty shall not include related party of the financial institution as defined under Section 2.2. Separate limits on related party exposures are set out in that section.

3.5 LIMIT ON CREDIT TO A SINGLE COUNTERPARTY

3.5.1 No financial institution shall incur an exposure to a single counterparty or persons connected to single counterparty as defined in Section 3.4.1 above, exceeding the following limits:

Exposure limit as a % of Financial Institution's Capital Fund	
For Single Counterparty	For Group of Counterparties
25%	30%

3.5.2 Total capital shall consist of that amount based on previous year's final and audited balance sheet. For this purpose, financial institutions must use the definition of Total capital in Section 1 of these regulations. The limit on credit exposure to a single counterparty specified above shall not apply in the following cases:-

(a) inter-bank exposures with a maturity of three months or less;

(b) exposures fully covered by cash collateral;

(c) exposures covered by government guarantees;

(d) exposures to governments and the central banks

3.6 LIMIT ON CREDIT TO TEN LARGEST COUNTERPARTIES

The aggregate of the ten largest exposures of a financial institution to any counterparty or persons connected to counterparty, shall not at any time, exceed 30% of its total loans (including off-balance sheet exposure)

The determination of exposure for these purposes shall be the same as for the limits on individual exposures in Section 3.5.1 and the definition of exposure in Section 3.3 above.

3.7 CONSORTIUM FINANCING

Consortium financing (CF) of large value loans by two or more financial institutions is permitted in line with the following criteria:

(a) require a lead financer who shall maintain all the original records and files pertaining to the CF loan account.

(b) the amount of loans sanctioned shall not, in any way, exceed the 30% of total capital in this regulation, except that where the consortium financing arrangement was entered into before the commencement date of these regulations.

(c) In case of financing to any related party by the financial institution under consortium financing, the financial institution shall not be the lead financer.

(d) Asset classification of accounts under consortium should be based on the **record of recovery of the individual member financial institutions**. Where the remittances by the borrower under consortium financing arrangements are pooled with one financial institution and/or where the financial institution receiving remittances is not parting with the share of other member financial institutions, the account will be treated as not serviced in the books of the other member financial institutions and therefore, be treated as NPA. The financial institutions participating in the consortium should, therefore, arrange to get their share of recovery transferred from the lead financial institution or get an express consent from the lead financial institution for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

3.8 REPORTING OF LARGE EXPOSURES

3.8.1 By the last day of the following month, every financial institution shall submit to the RMA:-

(a) a statement of its ten largest exposures in Form prescribed by the RMA, together with a list of all exposures exceeding 10% of capital;

(b) if the exposure to ten largest borrowers of the financial institutions is less than 10% of the capital fund, the financial institutions should submit the statement of their top10 borrowers.

3.8.2 The RMA may require additional information in regard to each exposure and/or conduct examinations on the veracity of reports.

SECTION 4: REGULATIONS ON ASSET CLASSIFICATION AND PROVISIONING

4.1 INTRODUCTION

4.1.1 A realistic valuation of assets and prudent recognition of income and expense are critical factors in evaluating the financial condition and performance of financial institutions. Since most financial assets are loans and advances, the process of assessing the quality of credit and its impact on the financial institution's condition is critical. Financial institutions must therefore exert due care and diligence in maintaining stringent monitoring of loans and advances, both during approval and through their existence. Charging-off irrecoverable assets and provisioning against non-performing assets (NPA) must be done without regard to the potential impact on the Profit and Loss account of a particular year or period. Credit extensions, loan restructuring and simple renewals of problematic loans will not change the treatment or aging of past due loans unless new effective repayment guarantees are brought in. Financial institutions will therefore have to institute a proper monitoring and control system of assessing these credit risks and then classifying the loans into their appropriate categories. They must also include in their classification system exposures due to off-balance sheet transactions.

The regulation in this Section shall determine the criteria and manner of evaluating credit exposures of financial institutions; the conditions, amounts and procedures for the allocation of provisions to cover the risk related thereto; and the supervision exercised by the RMA on the compliance with these requirements.

4.2 CREDIT POLICIES AND PROCEDURES, AND CREDIT COMMITTEES

4.2.1 Each financial institution shall organize a Credit Committee and adopt internal policies and procedures for its credit activities and prepare a credit Manual.

4.2.2 Each financial institution shall also establish a Credit Review Unit (CRU) as a specialized internal body for monitoring, assessing, classification and provisioning of credit exposures.

4.2.3 The structure and powers of the Credit Review Unit, as well as the regular Credit Committee, shall be specified in the Credit Manual and Procedures. Persons directly responsible for the extension of the credits and for maintaining relations with borrowers shall not be eligible for participation in the Credit Review Unit.

4.2.4 The Credit Manual and Procedures shall be submitted to the Financial Regulation and Supervision Department of the RMA on a yearly basis or as and when it is amended.

4.3 GENERAL REQUIREMENTS

4.3.1 Financial institutions shall assess, classify and report their credit exposures at least on a quarterly basis in accordance with the principles and criteria provided for in this regulation.

4.3.2 Where a financial institution has more than one exposure to a single borrower under various account titles, if one or more of the accounts should experience repayment problems and the outstanding loan amount of these problematic accounts are equal to or more than 50% of the total exposure, then the total exposure shall be classified into the classification category with the highest risk level exposure. However, if the total outstanding amount of the NPL accounts is less than 50% of the total exposure, then under such a situation, the non-defaulting accounts may be classified where they need to be categorized based on the circumstances of each account.

4.3.3 Financial institutions shall keep, at any time, provisions which are allocated in the manner and amounts specified in this regulations.

4.3.4 The criteria for classification of credit and investment exposures, set out in these regulations are the minimum that the financial institutions are required to abide by, and they may adopt and apply more detailed and stringent criteria, as well as the measure of risk associated with a particular country, in their internal credit policies and procedures.

4.3.5 Financial institutions shall maintain comprehensive documentation for each exposure encompassing all material conditions and circumstances of the transaction, including financial and other credit information, as well as the amounts due by maturity.

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4.4 EVALUATION AND CLASSIFICATION OF CREDIT EXPOSURES

4.4.1 Within the meaning of these regulations, “credit exposure” shall mean:-

(a) all loans and other claims of a financial institution reported as balance-sheet items, for which there is a risk of reduction in their book value;

(b) contingent liabilities reflected as off-balance sheet items, including guarantees issued, commercial and standby letters of credit, performance bonds, acceptances and others, the realization of which generates an unconditional claim in favor of the financial institution.

4.4.2 The criteria for classification of credit exposures are based on some elements of objectivity that can be applied automatically, but for the most part, are based on the subjective judgments of evaluators. Credit exposures must be evaluated and

classified according to the level of potential risk, the period of delinquency of amounts due, assessment of the debtor's financial position, and the main sources for repayment of the debtor's obligations, which altogether constitute the classification factors of the credit exposure.

4.4.3 Assessment of the debtor's financial position must be based on the information required from, and made available by the debtor semi-annually, or more frequently as required by the financial institution, including his/her financial statements.

4.4.4 Where different classification criteria apply to one and the same risk exposure, the exposure shall be classified in the category that requires the allocation of higher provisions.

4.4.5 On the basis of risk exposure evaluation and classification matrix, credit exposures shall be classified into five categories: *Standard; Watch; Substandard; Doubtful; and Loss.* The first category includes loan assets, which are current in repayment, and no problems are foreseen. Assets possessing various degrees of well-defined credit weaknesses shall be placed in one of the latter four categories and collectively, these assets shall be referred to as *Classified Assets.*

4.4.6 ***Standard Exposure***

Standard credit exposures shall be those credit exposures which are serviced according to the terms of the credit agreement, and for which information on the debtor's financial position gives no ground to assume that that the debtor will not repay the debt (s) in full. A credit exposure shall be classified as Standard, provided that all of the following conditions exist:-

(i) Principal and interest are repaid according to the contractual agreement terms, or payments on them have been overdue up to 30 days, provided the delay is justified or accidental;

(ii) the debtor uses the loan for the purposes stipulated in the loan agreement;

(iii) the value, condition of and/or control over the collateral is perfect;

(iv) the debtor submits regular financial statements and other information as required by the financial institution, including annual accounting reports.

4.4.7 ***Watch Exposures***

Watch exposures shall be those credit exposures having potential weaknesses that deserve close attention, and which, if left uncorrected, may at some future date result in deterioration of the repayment prospects or where the available information points to a certain deterioration of the debtor's financial position. A risk exposure shall be classified as watch, if any one of the following conditions exists:

(i) principal or interest payments have been overdue 31 to 90 days;

(ii) questions exist regarding the value, condition of and/or control over the collateral;

(iii) the debtor uses the loan for purposes other than those specified in the loan agreement;

(iv) there is a declining trend in the borrower's operations or an imbalanced position in the balance sheet, but not yet to the point where repayment is jeopardized;

(v) the debtor has delayed the supply of information under 4.4.6 (iv) by more than 30 days following the reporting date or the quarter.

4.4.8 ***Sub-standard exposures***

Substandard exposures shall be those credit exposures where well-defined weaknesses exist with respect to debt servicing, or the available information points to the debtor's unstable financial position, indicating a condition insufficient for the full repayment of his debts to the financial institution and to other creditors. A risk exposure shall be classified as Substandard, if any one of the following conditions exists:

(i) principal or interest payments have been overdue 91to 180days;

(ii) the debtor's financial position has substantially worsened and may result in inability to repay his/her obligations, and uncertainty over control of collateral;

(iii) the debtor has delayed the supply of information under 4.4.6 (iv) by more than 60 days following the reporting date or such quarter.

4.4.9 ***Doubtful Exposures***

Doubtful exposures shall be those credit exposures where serious weaknesses exist with respect to their servicing, or the available information indicates a probability for the debtor to repay only part of his debts to the financial institution due to his deteriorated financial position. A risk exposure shall be classified as Doubtful, if any one of the following conditions exists:

(i) principal or interest payments have been overdue 181 to 365days;

(ii) the debtor suffers from a lasting shortage of working capital;

(iii) the financial position of the debtor has worsened to an extent which makes doubtful the full repayment of his obligations under the prevailing terms and circumstances;

(iv) the debtor has delayed the supply of information under 4.4.6 (iv) by more than 90 days following the reporting date or the quarter.

4.4.10 Loss *Exposures*

Loss exposures are those credit exposures which do not generate direct or indirect return to the financial institution, and are deemed un-collectible. A credit exposure shall be classified as Loss, if any one of the following conditions exists:-

(i) principal or interest payments have been overdue for more than 365 days;

(ii) the debtor has been, voluntarily or involuntarily, declared bankrupt;

(iii) the debtor is in a liquidation procedure, and there is a risk of leaving creditors unsatisfied.

Credit exposures which are term expired, suspended or under litigation cases are also classified under the Loss Exposure category.

4.5 NON-PERFORMING LOANS (NPL)

4.5.1 A credit exposure shall be classified as non-performing when any of the following conditions exist:

(a) *Term loan with pre-established repayment schedule* – an installment is due, but remains unpaid for 91 days or more from the first day of default.

(b) Overdrafts and working capital advances shall be classified as non-performing under following conditions:

i. the loan outstanding amount in the loan account exceeds the sanctioned limit continuously for 91 days or more;

ii. when the account has been dormant for 91 days or more, and the outstanding amount is in excess of the sanctioned limit;

iii. when the loan outstanding balance is less than the sanctioned limit, but there have been no payments in the account for 91 days or more, or the payments received are insufficient to cover the interest accrued during the period;

iv. the term of the overdraft facility or working capital advance has expired.

(c) *Bankers Acceptances, Trust Receipts, Bills of Exchange and other instruments of similar nature* – when the instrument is due but remains unpaid for 91 days or more after the maturity date.

(d) *Credit Cards* - when the cardholder fails to settle his minimum monthly repayment of 10% of the loan outstanding for 91 days or more, or when the payments received are insufficient to cover the interest accrued during the period.

(e) *Revolving credit facilities, lump-sum loans, leasing loans, hire-purchase loans and bullet loans* - when principal or interest is due, but remains unpaid for 91 days or more from the first day of default.

4.5.2 ***Treatment of credit with quarterly, semi-annual, annual, bullet or lump-sum repayments*** - Where repayments are scheduled at intervals of 3 months or longer, the credit is classified as non-performing when a repayment is due and remains unpaid for 91 days or more from the first day of default. A financial institution shall not, under any circumstances, fix a loan repayment schedule against any type of credit exceeding one year.

4.5.3 ***Treatment of partial repayments of loans*** **-** For the purposes of ascertaining the period in arrears, each repayment must be made in full. If the borrower settles his monthly repayment partially, the repayment is still deemed to be in arrears.

4.5.4 ***Reclassification of non-performing loans as performing*** **-** A non-performing loan can be reclassified as performing once the total installment in arrears falls below 91 days. When the loan is reclassified as performing, interest can be recognized as income on an accrual basis. If the loan remains at all times below 91 days in arrears, the loan can be classified as performing and interest can be accrued and recognized as income.

4.5.5 ***Granting of new loan for a non-performing account*** – The financial institution shall, under no circumstances, sanction new or additional loans to a borrower, in order to regularize a non-performing loan account. However, a financial institution trying to realize the collateral charged to it for the non-performing loan, could grant or transfer a loan to an independent party wishing to purchase the collateral. The loan to the third party shall be granted based on the normal credit evaluation criteria, including the credit-worthiness of the third party.

4.6 RESTRUCTURED, RESCHEDULED, RENEWED AND ENHANCED CREDIT EXPOSURES

4.6.1 ***Restructured Credit Facility*** – A restructured credit exposure is one whose original terms and conditions have been modified principally. This may include a change in the type or structure of facility, or changes to the existing terms and conditions to assist the borrower overcome its genuine shorter-term financial

difficulties -particularly where the longer term prospect of the business or project is still deemed to be viable. When the borrower enters into schemes of arrangement of this nature, the new facility will constitute a restructured facility. However, such a facility may be granted only in the case of credit exposures that have been regular and have genuine unforeseen financial constraints.

4.6.2 ***Rescheduled Credit Facility*** – A rescheduled credit facility is one whose repayment terms have been modified, but the principle terms and conditions of the contract have not changed significantly. Normally, rescheduling of loans and advances shall be permitted if all interest arrears have been fully paid by the borrower from primary sources other than through the creation of new loans from the same institution. However, rescheduling may also be permitted if the financial institution is satisfied that the borrower is unable to pay his installments due to circumstances beyond his control, and that the problem is of short-term nature. This includes, amongst others, lengthening the repayment tenor of the facility. A change in the form of the credit facility from a term loan to an overdraft facility or vice versa, does not constitute a rescheduled facility as the original terms of the contract have changed significantly.

(i) Financial institutions must reassess the borrower's financial position once again and make a full credit evaluation of the borrower's financial condition and prospects for repayments before the loan can be rescheduled to avoid "ever-greening" of the loan. In this regard, financial institutions are permitted to reschedule a loan once in two years only and not more than three times during the term of the loan.

(ii) Where rescheduling occurs before a loan account is classified as non-performing, the account will still be classified as performing. It will only be classified as non-performing when, in aggregate, the borrower fails to settle his repayments for 91 days or more from the first day of default.

(iii) Where rescheduling occurs after a loan account has been classified as non-performing, the account shall continue to be classified as non-performing. The rescheduled loan can only be classified as performing when repayments under the new terms have been complied with for a continuous period of 6 months or when the loan becomes well secured by cash or cash substitutes.

4.6.3 ***Renewed Credit facility*** – A renewed credit facility is normally provided in the case of working capital advances or overdraft facilities, whose tenor are usually for a period of one year. Renewal of overdraft and working capital advances could be carried out only at the maturity of the facility, provided that the account has been regular and actively operated. Overdraft facilities and working capital advances classified as non-performing cannot be renewed unless and until it is regularized.

4.6.4 ***Enhancement of Term Loans/Overdrafts/Working Capital Advances (additional loan)* –** Enhancement of loans may be considered, only if, the project or business under consideration is still under progress and yet to be completed. Financial institutions may grant such a facility, provided that the loan on the whole could be adequately serviced and sufficiently covered by collateral properties. However, in the case of overdrafts and working capital advances, enhancement of limits could be considered only if the account has been regular.

4.6.5 Financial institutions may restructure, reschedule, renew or enhance a credit facility only upon a written application from the borrower and based upon a written resolution of the Credit Committee. If extension of such credit facilities exceeds the sanctioning authority of the Managing Director/Credit Committee, then the approval must be sought from the Board of Directors.

4.7 ALLOCATION OF LOAN LOSS PROVISIONS

Financial institutions are required to review the adequacy of the general and specific provisions for all loans at all times to ensure that the provisions set aside are reflective of their potential losses.

4.7.1 General Provisions and Specific Provisions for loan losses shall constitute an element of accounting expense and an adjustment for the book value of balance-sheet assets.

4.7.2 *General Provisions* for Loan Losses shall be allocated against exposures classified as Standard and Watch.

4.7.3 *Specific Provisions* shall be allocated against exposures classified as Substandard, Doubtful, and Loss.

4.7.4 General and Specific Provisions for Loan Losses shall also be allocated to cover classifications of contingent liabilities recorded as off-balance-sheet items.

4.8 PROVISIONING REQUIREMENTS

Financial institutions shall allocate provisions as a percentage of the principal amount of each risk exposure as follows:-

	Category		***Provisioning Requirement***
i.	Standard	-	1 percent;
ii.	Watch	-	1.5 percent;
iii.	Substandard	-	20 percent; 30 percent for Sector with highest exposure
iv.	Doubtful	-	50 percent; 60 percent for Sector with highest exposure
v.	Loss/litigation/suspended	-	100 percent.

4.8.1 Provisions on credit extensions such as overdrafts, working capital advances and credit cards, which do not have pre-established repayment schedules, shall be allocated as follows:

i. Credit facilities on which no repayments have been received for 91 to 180 days shall be classified Substandard, requiring 20% provisioning.

ii. Credit facilities on which no repayments have been received for 181 to 365 days shall be classified Doubtful, requiring 50% provisioning.

iii. Credit facilities with no repayments for more than 365 days, or whose term has expired, shall be classified as Loss and require 100% provisioning.

4.8.2 Provisions against credit exposures secured by risk-free collateral shall be maintained in an amount being the net difference between the principal amount and the value of the risk-free collateral. For this purpose, precious metals, cash deposits in the banks, and securities issued by RMA or by the Royal Government of Bhutan shall be deemed to be “risk-free collateral.”

4.8.3 RMA may require financial institutions to allocate provisions in addition to the minimum provisioning requirement specified above.

4.9 SUPERVISION OVER AND REPORTING OF THE EVALUATION AND CLASSIFICATION OF RISK EXPOSURES AND PROVISIONING

4.9.1 Financial institutions shall disclose in their annual published reports the impact on its accounts of the general provisions and specific provisions maintained towards loan losses, as well as the aggregate amounts of classified credit exposures and restructured exposures in their portfolios.

4.9.2 Depending on the efficiency of credit and investment policies of a financial institution, the RMA may require the financial institution to enforce a stricter evaluation and classification of credit exposures.

4.9.3 The RMA may carry out a re-classification of risk exposures, if a financial institution has not evaluated and classified its exposures according to the provisions of these regulations. In such cases, financial institutions shall make corrective accounting entries.

4.10 INTEREST REGIME

4.10.1 Interest Rates

Financial institutions may determine the rate of interest on deposits and loans and advances. The deposit and lending rates may be revised from time to time with

the approval of the respective Board of Directors and subsequent notification to the RMA. The approved rates and any revisions thereof must be publicly announced and should be available on the website.

4.10.2 Method of Interest Calculation

All financial institutions shall follow the Simple Daily Product Method for computation of interest on loans and advances.

i. **Simple Daily Product Method**

Simple Daily Product method of calculating interest is the method of calculating interest on loans and advances on a daily basis. Interest is calculated on the number of days since the last payment date.

ii. **Compound Interest**

Compound interest arises when interest is added to the principal and the interest that has been added also earns interest.

iii. **Term Loan**

All financial institutions shall follow the following:

a. Simple Daily Product Method for computation of interest on loans and advances.
b. Compounding of interest and late fee shall not be allowed.
c. A late fee up to a maximum of 5% p.a. may be charged on the defaulted amount. The rate must be applied uniformly to all the defaulters. Henceforth, the late fee may be calculated and charged from the first day of default of an installment

iv. **Overdraft (OD)/working capital (WC)**

ODs are to be treated as two different products for banks and non-banking institutions. The treatment of ODs in these two institutions is as follows;

a. **Non-bank Financial Institutions**

(i) ODs are to be treated as a loan product

(ii) Capitalization of interest and late fee are not allowed

(iii) No compounding of interest and late fee

(iv) A late fee up to a maximum of 5% p.a. may be charged on the defaulted amount **ONLY**. The rate must be applied uniformly to all the defaulters. The late fee may be calculated and charged from the first day of default of an installment.

(v) Appropriation of repayment shall be made first towards the interest and the remaining balance towards the reduction of principal.

b. **<u>Banks (Deposit taking institutions).</u>**

(i) ODs to be treated as a CASA product

(ii) Banks are not allowed to charge any late fees on OD.

4.10.3 Interest during Project Gestation Period

(a) Financial institutions may give project gestation period in line with the Institution's credit policies approved by the Board, subject to a maximum limit as follows;

(i) Housing: Maximum 3 years
(ii) Hotel Construction: Maximum 5 years
(iii) Manufacturing and Service: Maximum 5 years

The gestation period for any other loans apart from the one specified above shall not exceed two years.

(b) Interest during gestation period shall be treated as follows:

(i) All financial institutions shall follow the Simple Daily Product Method for computation of interest.
(ii) Interest may be capitalized at the end of the gestation period **<u>only after full disclosure to and understanding by the client.</u>**
(iii) Interest may be serviced during the gestation period.
(iv) No compounding of interest shall be allowed during gestation period.

4.10.4 Suspension of Interest

Interest accrued on a credit exposure which is classified as a non-performing loan shall not be recognized as income, but shall be suspended and booked in a valuation reserve designated as "Interest-in-Suspense account." Thereafter, any payments received against the credit exposure must be first applied towards interest arrears, and the remaining balance, if any, towards the principal.

4.10.5 Reversal of Interest Income

When a loan is classified as non-performing, all interest on the loan must be suspended from the date of the first default. Thus, any accrued interest taken to income prior to the loan being classified as non-performing must be reversed out of income. Subsequently, interest on non-performing loan will be recognized as income on a cash basis.

4.10.6 Interest on account of Rescheduled Loans

When an account is rescheduled, all interest accrued and suspended shall be capitalized to principal. Interest-in-Suspense which has been capitalized should not be credited as interest income, but reversed only upon receipt of payment.

4.10.7 Commitment fee on overdraft limit

Financial institutions may charge a commitment fee on the unutilized portion of an overdraft or working capital advance. However, such a rate must be duly approved by their respective Board and applied uniformly to all the borrowers.

4.10.8 Accounts regularized near about the Balance Sheet date

The asset classification of borrower accounts where a single or a few credits are recorded before the balance sheet date should be handled with care and without scope for subjectivity. The financial institutions must furnish satisfactory evidence to the Statutory Auditors/Inspecting Officers about the manner of regularization of the account to eliminate doubts on their performing status.

SECTION 5: REGULATIONS ON LIQUIDITY MANAGEMENT

5.1 LIQUIDITY AND ITS RATIONALE

5.1.1 Liquidity is defined as a financial institution's ability to meet anticipated and contingent obligations as and when they fall due. A financial institution must, under any circumstances, maintain sufficient liquidity to fulfill all its contractual obligations in the normal course of business. A financial institution may have various obligations:-

(a) obligation to pay deposits or borrowings;

(b) obligation to provide committed funds; and

(c) obligation to make other payments such as cash flows in respect of off-balance sheet instruments, interest payments and other expenses.

5.1.2 A financial institution can meet such obligations in a number of ways:

(a) by holding sufficient immediately available cash or easily marketable securities;

(b) by securing an appropriately matching profile of cash flows from maturing assets and liabilities; and

(c) by borrowing.

5.1.3 Financial institutions are reluctant to hold a large stock of immediately available cash or marketable securities as these generate comparatively low or no yields. They, therefore, depend on future cash flows and their ability to raise funds in the market as and when the need arises. Thus, it is essential that a financial institution has ample funding capacity. This, in turn, depends on a variety of factors including strong liquidity management, market perception, earnings and asset quality.

5.2 REGULATIONS FOR LIQUIDITY MANAGEMENT

5.2.1 The management of a financial institution's liquidity should be based on future financial inflows and outflows (financial flows). Planning for financial flows is dependent on two fundamental conditions:-

(a) an adequate information system; and

(b) prompt recording of all transactions in books of accounts.

5.2.2 Within its information system, a financial institution is obliged to analyze its assets, liabilities, and off-balance sheet assets and liabilities according to:

(a) remaining period to maturity of its fixed term assets, liabilities, off-balance sheet assets and liabilities;

(b) anticipated developments in its fixed term liabilities, such as the probable volume of deposits rolled over by depositors on maturity date;

(c) experience with depositor behavior in respect of current and savings deposits, and time deposits under specific conditions;

(d) degree of liquidity of assets with respect to:

- their immediate availability to cover fund outflows;
- the possibility of their transfer into funds with the RMA;
- their tradability on the financial market whose size will allow the sale of a required volume of assets for a price corresponding to their market value, or for a price higher or equal to their book value;
- the possibility of a decrease in the value of the asset, concurrent with a decrease of relevant liabilities (reserve requirements)

(e) deposits of individual depositors or groups of connected depositors (*see below*);*

(f) type and degree of liability of off-balance sheet items issued or received by the financial institution;

(g) currencies in which assets, liabilities, and off-balance sheet items are expressed;

(h) legal status of a depositor in the country where he resides and according to the financial institution instrument used.

* *For the purposes of this Regulation, a group of connected depositors means two or more depositors (natural or legal persons), to whom a financial institution has a commitment following from deposits received, and who are mutually associated through either one of the depositors exercising control either directly or indirectly over the other depositors.*

5.3 METHODS OF ACHIEVING LIQUIDITY

In order to secure liquidity the financial institution shall concentrate its activities particularly on:

(a) financing firstly from stable sources within agreed terms;

(b) the diversification of sources of financing according to maturity, financial instruments and clientele;

(c) introducing organizational measures directed at effective liquidity management (e.g. entrusting a particular employee with liquidity management, introducing effective control and internal audit of the financial institution's liquid position);

(d) degree of the financial institution's integration in the money market and trading in the market;

(e) regular formulation of its liquidity policy together with planning to ensure sufficient resources for its business plans and to reduce any structural imbalance of its assets and liabilities following from differences between agreed and actual maturity dates;

(f) holding a sufficient volume of quick assets with respect to the repayment of short term deposits. (*For these purposes, quick assets are cash; gold and precious metals; balances with the RMA (excluding statutory reserves); demand deposits with banks in Bhutan and India; government and government-guaranteed securities; RMA securities; and time deposits with a remaining period to maturity not exceeding 30 days held with commercial banks in Bhutan);*

(g) regular compiling and updating of a contingency plan for unusual events which threaten the financial institution's liquidity. This will comprise the designation of responsible employees, identification and value (volume) of assets to promote and secure the financial institution's liquidity;

(h) each financial institution should appoint an Asset Liability Management Committee(ALM Committee) which will be responsible for formulating recommendations and implementing the financial institution's liquidity policy in accordance with the liquidity strategy, risk appetite, policies and limits agreed by the board of directors;

(i) the financial institution shall report to the RMA, the body responsible for supervising and controlling implementation of the approved liquidity policy.

5.4 POLICY STATEMENT ON LIQUIDITY

5.4.1 A financial institution must have a policy statement, approved by its board of directors, on liquidity risk and liquidity management. The policy statement should include the institution's liquidity strategy, risk appetite, policies and limits and policy on monitoring and managing liquidity. The policy should include the limits approved by the board on sourcing of liquidity in accordance with the methods and approaches set out in Section 5.3 above.

5.5 MINIMUM REQUIREMENTS AND REPORTING

5.5.1 Cash Reserve Ratio

Every bank is statutorily required to maintain a Cash Reserve Ratio (CRR) in the ratio as may be prescribed by the RMA from time to time. The CRR must be maintained in the form of a current account deposit with the RMA.

5.5.2 Statutory Liquidity Requirement Ratio

Every financial institution shall, at all times, maintain minimum liquidity in the form of quick assets, in a ratio not less than that set out below:-

(a) Banks - 20% of total liabilities excluding capital fund and liabilities to the RMA

(b) Non-bank financial institutions - 10% of total liabilities excluding capital fund and liabilities to the RMA

5.5.3 Reporting requirements

Every financial institution is required to submit to the Financial Regulation and Supervision Department, RMA, a monthly Liquidity Return in *Form* M5 - which sets out the maturity mismatch profile of the institution according to time bands of the remaining period to maturity of its assets and liabilities.

5.6 THE MATURITY MISMATCH APPROACH

5.6.1 The maturity mismatch approach measures a financial institution's liquidity by assessing the *mismatch* between its assets and liabilities within different time bands on a *maturity ladder*. The extent of the difference between the maturities of assets and liabilities is termed a mismatch. Assets and liabilities are slotted into time bands according to their maturity on a worst-case view i.e. assets (inflows) are put in at their latest maturity and liabilities (outflows) at their earliest maturity. This approach is adopted, because, what is needed is an assessment of a financial institution's liquidity in a situation when funding sources are unwilling to lend and depositors withdraw their money.

5.6.2 A net mismatch figure is obtained by subtracting liabilities from assets in each time band. Mismatches are then measured on a net cumulative basis. This is achieved by accumulating the net positions in each successive time band to arrive at a net cumulative mismatch figure.

5.6.3 A financial institution's liquidity position shall be assessed by the RMA by means of the net cumulative mismatch position expressed as a percentage of total deposit liabilities. Total deposit liabilities (the total of the deposits/borrowings) held by the financial institution is used because it represents a relatively stable approximation of the total external (or withdrawable) funding of the financial institution.

5.6.4 The RMA will set *benchmarks* for the maximum percentage for net cumulative mismatches as a percentage of total deposit liabilities. These are known as *mismatch benchmarks* and prevent financial institutions from operating with too large a negative mismatch, and thereby, running an excessive risk of not being able to raise sufficient funds to cover the mismatch at short notice. These benchmarks will be set for maximum mismatches only for the time bands of overnight -8 days, overnight -1 month and overnight –3 months. Mismatch regulations are not usually set for the longer time bands as in most cases, over a longer time period, financial institutions will have a greater opportunity to raise funds.

5.6.5 The maturity ladder serves to compare the volume of assets and liabilities of the same maturity across a number of time bands. The time bands included in the maturity mismatch ladder on the reporting forms are:

- Overnight;
- spot<1 week;
- 1 week<1 month;
- 1 month<3 months;
- 3 months<6 months;
- 6 months<1 year;
- 1 year<3 years;
- 3 years<5 years; and
- over 5 years

The information provided on the ladder is then assessed in the cumulative time bands of overnight-8 days; overnight-1 month; overnight-3 months, etc.

5.7 COMPONENTS OF THE MATURITY LADDER

5.7.1 Liabilities

Liabilities should be included in the maturity ladder according to their earliest maturity. Known firm commitments to make funds available on a particular date

are included in the appropriate time band at their full value. Contingent liabilities are not included in the maturity ladder, unless there is a reasonable likelihood that the conditions necessary to trigger them might be fulfilled.

5.7.2 Assets

(i) Assets are generally included in the maturity ladder according to their *final* maturity *net of provisions*. Assets known to be of doubtful value are excluded from the maturity ladder and treated on a case-by-case basis. Where assets have been pledged as collateral and are therefore no longer available to the financial institution to meet obligations, they should be excluded from the maturity ladder, as they are no longer available to provide the financial institution with liquidity.

(ii) In respect of overdue assets, if on any reporting date, an asset, or part of it, has passed the due date for repayment by *30* days or more, then the amount or principal which is in arrears should be entered in the overdue column. Assets having passed the due date by less than *30* days should be entered under 'next day'. Only that part of a loan or other asset actually overdue, and not any un-matured installments, should be reported in the overdue column unless the whole of the loan or asset has been formally declared to be in default within the terms of the contract.

(iii) Amounts overdue in respect of secured loans should be included unless the collateral has been realized. Amounts overdue without regard to whether a specific provision has been made should be included. Amounts written off, however, should not be included in any part of the form.

5.8 FACTORS CONSIDERED IN SETTING BENCHMARKS

Mismatch benchmarks will be set for each financial institution for the spot< 1 week and spot<1 month regulations. These are specific to the financial institution, taking account of a number of factors:

(i) General Factors

In setting mismatch benchmarks, the following factors are considered in all cases:

(a) the volatility, diversity and source of deposits; the volatility of deposits may be more closely related to a financial institution's perceived creditworthiness, to its position in the banking system or to current economic or financial conditions, than to the precise term of the deposits;

(b) the presence of concentrations in the deposit base, including single-source introductions;

(c) the degree of reliance on marketable assets, the depth of market in such assets and the price volatility of such assets;

(d) the degree of diversification in a financial institution's portfolio of marketable assets;

(e) the availability and reliability of un-drawn standby lines;

(f) the dependence on drawings of standby lines in order to maintain adequate liquidity, and in particular the possibility of calls for early repayment on lines which have already been drawn;

(g) the impact of other business such as off balance sheet obligations.

(ii) Qualitative Factors

In setting mismatch benchmarks, consideration should also be given to certain qualitative factors:

(a) the asset profile;

(b) the quality of management information systems;

(c) the market reputation, general ability of management and the particular skills of the treasury area;

(d) the ability and willingness of the parent/ head office to provide liquidity;

(e) the financial institution’s standing and reputation in the market.

SECTION 6: REGULATIONS ON SHARES TRADING

6.1 INTRODUCTION

6.1.1 The establishment of "brokerage firms" as subsidiary companies of the financial institutions could give rise to practices that may result in conflict of interest. As investment advisers and underwriters, the financial institutions and their staff could possibly obtain undue advantage to gain from shares trading businesses, especially when dealing in shares of companies in which they have privileged information. Such a situation could result in the abuse of general trading practices and create public concern. Therefore, in order to avoid any conflict of interest and to allay fears of unethical practices, it would be expedient for the financial institutions to strengthen their internal control procedures. Certain codes of conduct should be established and disciplinary actions taken on staff who abuses their positions.

6.1.2 The working relationship between the parent institution and its stock-broking subsidiary must be well established. A satisfactory and effective "Fire Wall" should exist between the stock-broking firm and its parent institution. Trading should always be on an arms-length basis and not on biased or favorable terms.

6.1.3 A financial institution may not deal in the securities of any company listed or pending listing on the stock exchange at any time when any of its staff is in possession of insider information, unless the staff is not involved in the decision to trade in those securities and the group has arrangements to ensure that such information is not communicated to the person making the decision to trade and it is not so communicated.

6.1.4 Staff and Directors shall not deal in the securities of any company listed or pending listing on the stock exchange at any time when he/she is in possession of information, obtained as a result of his employment by, or his connection with the financial institution which is generally not available to shareholders of that company and the public, and which, if it were so available, would likely bring about a material change in the market price of the shares or other securities of the company concerned.

6.1.5 Insider dealing by a financial institution (or its staff) has pervasive adverse effects on its integrity and credibility, and therefore viewed as very serious. Financial institutions may, therefore, establish comprehensive in-house rules which should require a minimum standard of conduct.

6.2 **In terms of Section 248 of the Financial Services Act of Bhutan 2011,** a bank/financial institution must not grant credit, give any guarantee or incur any other liability, against the security of:

(a) its own shares, the shares of a subsidiary, or the shares of a parent company;

or

(b) the shares of a subsidiary of a parent company.

6.3 LOANS AGAINST SHARES OR LOANS FOR THE PURCHASE OF SHARES

No financial institution shall grant loan against shares or for the purchase of shares exceeding 50 % of the existing market price.

SECTION 7: REGULATIONS ON SUBMISSION OF ANNUAL AUDITED ACCOUNTS

7.1 INTRODUCTION

7.1.1 As takers and custodians of public funds, financial institutions have a responsibility for the prompt finalization and publication of their annual financial results. A delay in the publication of final accounts usually indicates poor management of the financial institution concerned, which would reduce public confidence in the management of the institution. Chapter 6 of the Financial Services Act of Bhutan 2011 sets out requirements on financial institutions on audit and financial statements.

7.1.2 Every licensed financial institution is required, within three months after the close of each financial year to prepare a balance sheet and profit and loss account as of the last working day of that year.

7.1.4 All financial institutions must send to the RMA the auditor initialed balance sheet, profit and loss account and external auditor's report described in Chapter 6 of the Financial Services Act of Bhutan 2011. The submission of these final accounts to the RMA shall be within 14 days of its preparation by the statutory auditors. In addition, the financial institutions shall also submit two copies of their annual report to the Financial Regulation and Supervision Department of the RMA.

7.1.5 In terms of Section 96 of the Financial Services Act, a licensed financial institution must publish its annual audited accounts in a national newspaper. This requirement shall be satisfied where the financial institution publishes a summary of both its balance sheet and income statement. Financial institutions should make available copies of their audited annual accounts and half-yearly unaudited financial statements on their websites.

7.1.6 If a financial institution should have problems in finalizing its draft accounts early due to differences in opinion between its management and external auditors over income recognition and provisioning for bad and doubtful debts, the institution concerned and its external auditors should discuss and resolve these matters with the RMA to avoid delay in finalizing the accounts. Under such situation, it is mandatory for the external auditors and the financial institution to meet with the RMA examining officers to finalize the necessary provisions. If the auditors do not agree with the management, they may submit the draft accounts with a "subject to proviso" on the disputed items.

7.1.7 Financial institutions should ensure that the audit of their accounts by the external auditors is promptly carried out after the close of each financial year.

SECTION 8: REGULATIONS ON BORROWER INFORMATION

8.1 INTRODUCTION

8.1.1 This part of the regulation provides guidance on what disclosures and financial information that the borrowers are obliged to submit to the financial institutions, both in terms of initial application of loans and during the servicing of loans. An interactive role of enforcing market discipline between the lenders and borrowers is important. Therefore, both in the interest of the lending institutions and the borrowers, the submission of accurate and timely financial information is the basis for assessing, evaluating and monitoring the true business performance of the borrowers. As such, it is important that financial institutions seek periodic financial information from their clients on a regular basis. Predominantly, it is the financial information of the borrowers that reflect on the viability of the business and the borrowers' ability to repay loans through primary sources, other than relying too much on collateral requirements. The following are some of the requirements that the lending institutions must abide with.

8.2 BORROWER INFORMATION

Each financial institution shall maintain Credit Manual and Procedures, which shall establish information that will be required from the borrower during the application process and information that the borrower will be required to submit while the credit remains outstanding.

8.3 Each financial institution shall forthwith notify all of its existing clients having borrowing relationships, and, upon credit application, all of its new borrowing clients, of the requirements of this section.

8.4 Each financial institution shall maintain credit files on all borrowing relationships, regardless of size. A current credit file shall provide the Credit Committee, and internal and external reviewers with all information necessary to analyze the credit before it is granted and to monitor and evaluate the credit during its life.

8.5 ***Such information shall:***

(a) contain borrower's current and permanent address

(b) identify the borrower's business or occupation;

(c) document the borrower's past and current financial condition;

(d) state the purposes of all loans granted to the borrower, the sources of repayment, and the repayment programs; and

(e) identify the collateral and state its value and the source of the valuation

8.6 ***Credit files shall be subdivided and tabbed and must include:***

(a) loan application and all authorized approvals

(b) appraisal of project as well as collateral, memoranda and correspondences

(c) loan agreements

(d) certificates of insurance

(e) collateral-inspection documents

(f) credit reports & annual credit analyses

(g) restructuring, rescheduling and renewal documentation

(h) past loan applications

(i) all financial statements

(j) rental information for income-producing real estate credits

(k) in the case of term loans, i.e., loans maturing after one year, cash flow projections updated annually during and for the life of the loan

(l) valid identity card copy and passport-size photo

(m) valid license/registration certificates

(n) ownership certificate of land, vehicle or other collateral, and

(o) hypothecation of mortgage deed, signed by borrower and financial institution

8.7 A financial institution shall require all borrowers to submit periodic financial statements (with the exception of borrowers mentioned in 8.8 below), but not less frequently than semi-annually, and provide other information required to evaluate the quality of the credit exposure as determined by the RMA or by the financial institution.

8.8 For small borrowers with loans totaling not more than Nu.500,000/-, the borrowers' financial information shall be obtained at the time of loan application, and, if the respective debt is maintained current as to the contracted repayment program on a continuous basis, it need not be updated. However, the credit files

for these types of loans shall contain initial information and underwriting factors such as the borrower's income, job stability, credit history, debt load, and the loan-to-value requirements for collateral. For loans of any amount which are in default, and regular large loans of Nu.500,000 and above, the borrower's financial information must be obtained on a regular basis as stated in 8.7 above.

8.9 Sections 8.1 through 8.8 shall be implemented by all financial institutions in entirety.

8.10 INFORMATION TO CLIENTS

Every financial institution engaged in extensions of financial business is required to notify their customers of the terms and conditions associated with their deposits or loans and advances, including the annual rate of interest and charges, and the method of calculation used.

8.11 All financial institutions shall establish an appropriate customer grievance cell to address all kinds of grievances.

SECTION 9: REGULATIONS ON REVALUATION AND APPROPRIATION OF RESERVES

9.1 INTRODUCTION

9.1.1 Capital of an institution is one of the most important factor and indicator of strengths and weaknesses of a financial institution. Comfortable level of capital provides confidence to a financial institution and protects the interest of depositors and creditors. In general, it promotes a stable and strong financial system and provides positive incentives for prudent banking. In the light of the above, financial institutions must give proper and adequate attention to the need for stepping up their usual and necessary provisions and appropriations to reserves.

Likewise, prudent recognition of foreign exchange fluctuation gains and creation of a reserve to serve as a cushion to contain losses that may arise due to possible fluctuations in exchange rates is necessary. This regulation shall therefore prescribe the following.

9.2 TRANSFER TO GENERAL RESERVE/RESERVE FUND

Every financial institution shall, before declaring any dividend from its net profits of each year (after due provision made for taxation), transfer to its general reserve/reserve fund out of net profits of each year:

(i) a sum equal to not less than 50 percent of the net profits of that year, so long as the amount of the reserve fund is less than 50 percent of its paid up capital; or

(ii) a sum equal to not less than 25 percent of the net profits of that year once the reserve fund exceeds 50 percent of its paid up capital.

9.3 PROVISION FOR FOREIGN EXCHANGE FLUCTUATION RESERVE

Financial institutions which are authorized dealers in foreign exchange should keep in view the possible fluctuations in exchange rates, and therefore, create a Foreign Exchange Fluctuation Reserve to book one-fourth of the total gains on an annual basis from the profit after tax only.

SECTION 10: REGULATIONS ON DIVIDENDS AND RESERVES

10.1 INTRODUCTION

10.1.1 While declaration of high dividends may benefit the shareholders and enable them to recover their investments in a short span of time, it may deprive the concerned institution from strengthening its capital, which may adversely affect its balance sheet. The RMA would, therefore, envisage that in the long-term interest and growth of the financial institutions, the following regulations on dividend are observed strictly.

10.2 In the event of a financial institution making any withdrawals from General Reserves or Share Premium Account, it must seek the RMA's approval.

10.3 A financial institution must observe that any proposed total dividend, should be approved by its Board and subsequently by the RMA. Such approval shall be accorded only upon examination and verification of full compliance of prudential norms relating to proper recognition of income, asset classification and loan loss provisioning. Declaration of any dividends must be from the current year's profit only.

10.4 ELIGIBILITY CRITERIA FOR DECLARATION OF DIVIDEND

10.4.1 Only those financial institutions, which comply with the following criteria, would be eligible to declare dividends:

(1) The financial institutions shall have:
- (a) Capital Adequacy Ratio (CAR) of at least 12.5% (including capital conservation buffer) for preceding two completed years and the accounting year for which it proposes to declare dividend;
- (b) Core Capital ratio of 7.5% (including capital conservation buffer) for preceding two completed years and the accounting year for which it proposes to declare dividend;
- (c) Net NPL ratio of less than 5% for the accounting year for which it proposes to declare dividend.

(2) In case a financial institution is unable to meet the CAR and Core capital norms in the previous two completed years, it may declare up to 15% dividend as proportion of profit after tax provided in the accounting year for which dividend is being considered provided that:
- (a) CAR is at least 12.5% (including capital conservation buffer);
- (b) Core Capital ratio of 7.5% (including capital conservation buffer); and
- (b) Net NPL ratio is less than 5%.

10.4.2 The financial institution shall comply with the provisions of Sections 85 and 247 of The Financial Services Act of Bhutan 2011.

10.5 QUANTUM OF DIVIDEND PAYABLE

10.5.1 Financial institutions, which fulfill the eligibility criteria set out in Section 10.4 may declare and pay dividends, subject to the following:

(a) The dividend payout ratio (including any interim dividend) shall not exceed 65% of the profit after tax of the accounting year for which financial institution proposes to declare dividend and it shall be as per the norms mentioned in the following table;

	Net NPL Ratio			
	Up to 1%	More than 1% but less than 3%	3% and above but less than 5%	5% and above
	Minimum Capital Adequacy ratio of 12.5% and Core Capital ratio of 7.5% in past 3 completed years			
Maximum Dividend Payout Ratio	65%	55%	45%	NIL

Notes: Financial institutions should have a CAR of at least 12.5% and core capital of 7.5% for the preceding two years and the accounting year for which it proposes to declare dividend and Net NPL of 1% or less in the accounting year for which dividend is being declared to be eligible to pay dividend payout ratio at the rate of 65%.

SECTION 11: REGULATIONS ON COLLATERAL AND OTHERS

11.1 INTRODUCTION

11.1.1 While loan sanctioning and monitoring of financial institutions in industrialized countries are mainly based on the authenticity and regular submission of financial information by the borrowers, and the financial institution's careful assessment of the business viability and ability to repay loans; financial institutions in most of the developing countries lend based on collateral requirements. This situation of collateralized lending is primarily carried out in countries with low literacy rate, non-existence of proper and standard accounting system, weak legal framework and weak market discipline of borrowers. Under such circumstances, while financial institutions may continue using collateral as the basis for lending, the following regulations should be observed.

11.2 COLLATERAL

Until now most of the financial institutions have based their lending decisions mainly on the collateral provided by the borrower, without giving adequate consideration to the borrower's cash flow and financial discipline. Experience has shown that over-reliance on collateral is problematic because the collateral is often illiquid, difficult to value, and difficult to acquire through foreclosure and other legal means. While financial institutions may continue to make use of collateral for protection against loss, they should ensure that there are no pre-existing claims on the assets pledged as collateral and that the assets are of type which is readily marketable. Reliance on collateral should not, in any case, replace a careful assessment of the project's viability and the borrower's ability to repay through primary sources.

11.3 REGISTRATION OF MORTGAGES AND COLLATERAL

Financial institutions must ensure that their claims on assets provided as mortgage or collateral against their loans are registered with the appropriate authorities. While the institutions may, with the written consent of a third party, accept assets belonging to the third party as mortgage or collateral, they should ensure that the assets are the registered property of the third party, and that there are no outstanding claims on the assets. In addition, the financial institutions may, at their discretion, require the third party to guarantee the loan. Financial institutions should, as a matter of routine, require their borrowers to furnish a periodic written statement confirming that the assets mortgaged or pledged as collateral is still in his/her possession, or in the possession of the third party who agreed to place the assets as security against the loan.

11.4 INSURANCE OF COLLATERAL

Financial institutions must ensure that fixed assets pledged as collateral or mortgaged against loans are properly insured in the joint names of the borrower and the institution. The loan agreement must include a condition stipulating that

in the event of the borrower's failure to insure or to renew the insurance policy, the financial institution will insure or renew the insurance policy, as the case may be, and debit the cost of the insurance to the borrower's loan account or recover accordingly.

11.5 SUBSTITUTION OF COLLATERAL

In the case of regular loans, exchange of collateral may be permitted by the financial institutions, only if the value of the replacement collateral covers the loan outstanding amount. Financial institutions may also allow its clients to substitute their collateral incase of non-performing loans, provided that the value of collateral is better than the existing collateral and can cover the entire loan outstanding amount which has become non-performing loans.

11.6 THIRD PARTY GUARANTEES

While financial institutions may accept a guarantee issued by a third party for a loan, they should ensure that the guarantor does not have any record of loan defaults with any other financial institution, and that the guarantee is fully backed by the guarantor's unencumbered assets.

11.7 FINANCING LIMIT

Financial institutions shall not finance more than three fourths of the cost of the project, and the borrower should be required to meet the remaining one fourth of the project cost from primary sources. Subject to the maximum financing limit of three fourths of project cost, financial institutions may prescribe different financing limits for different types of loans and advances depending on the appraisal of the project, and the borrower's creditworthiness.

SECTION 12: RESTRICTIONS ON OWNERSHIP OF FINANCIAL INSTITUTION AND INVESTMENTS BY FINANCIAL INSTITUTIONS

12.1 No person shall hold more than the following percentage of interest in shares of a financial institution:
(a) In case of an individual, 20 percent,
(b) In the case of a company not being a financial institution, 30 percent,

12.2 In the case of a company being a financial institution:
No financial institution can have ownership in another financial institution exceeding 5 percent of the other financial institution's paid up capital.

12.3 For the purpose of Section 12.1
a) Individual is a natural person and includes spouse, dependent children or other dependents of a person being of the same household; and
b) Company means a parent company, its subsidiaries and affiliates, and it shall also include their significant owners.

12.4 A financial institution shall not, directly or indirectly, without written approval from the Authority, own shares in a company in excess of 20 percent of its capital fund.

12.5 The Authority shall, at no point of time permit the financial institution to invest in a company in excess of 25 percent of its capital fund.

12.6 Section 57 of the Financial Services Act, 2011 provides an exemption for financial institutions to have share ownership of a financial institution in Bhutan in excess of the limit specified above under the following circumstances:
(a) To rectify the financial institution's financial condition;
(b) Merger and acquisition; or
(c) To maintain the overall Bhutanese financial system stability.

12.7 The acquisition or merger of a financial institution shall require the prior authorization of the Authority.

SECTION 13: REGULATIONS ON ESTABLISHMENT OF BRANCHES, AGENCIES, AND OTHER SUCH OFFICES OF FINANCIAL INSTITUTIONS AND NEW PRODUCTS

13.1 ESTABLISHMENT OF BRANCHES, AGENCIES, AND OTHER SUCH OFFICES OF FINANCIAL INSTITUTIONS

13.1.1 The Royal Government of Bhutan (RGOB) has played a vital role in encouraging the financial institutions to establish their branches/agencies in the dzongkhags in order to promote balanced economic development and to address the financial services need of the general public. However, the policy and setting up of new branches/agencies should be decided and undertaken based on respective institution's yearly business growth and plans, potential for business at the new centers for opening of branches, profitability of the proposed branches, redeployment of staff where surplus manpower has been identified and for extending efficient and prompt customer service to the clientele of the institution. Additionally, while considering such expansions, regulatory aspects of promoting a fair and competitive financial sector development should be taken into account.

13.1.2 Therefore, in accordance with Chapter 7 of the Financial Services Act 2011, no financial institutions shall, without the prior permission of the RMA, establish branches, agencies, and other such offices.

13.2 LAUNCHING OF NEW PRODUCTS

All financial institutions must seek written approval from the RMA prior to the introduction of new products to the public. Further, the financial institutions are required to fulfill the prerequisite conditions listed below for the launching of the new products and furnish the details to RMA accordingly:-

i. Board's approval on launching of new products
ii. Adherence to principles on fair treatment of consumers which would include:
    a. Disclosure to customers on terms and conditions associated with the product
    b. An adequate and effective system for resolving and monitoring customer complaints
    c. Suitably trained staff to educate the customer on the product
iii. Required to put in place adequate policies and procedures designed to ensure that the customer has practical understanding of products so as to meet the client's objectives.

SECTION 14: REGULATIONS ON ON-SITE EXAMINATIONS OF FINANCIAL INSTITUTIONS

14.1 In terms of Chapter 8 of the Financial Services Act of Bhutan 2011, the Examining Officers of the Royal Monetary Authority shall conduct on-site examinations of each financial institution as and when found necessary.

14.2 The financial institutions are required to make available to the Examining Officers of RMA all records and documents to enable them to ascertain the overall financial condition of the institution. Furthermore, the employees and officers of the financial institution are required to provide such information concerning any aspects of the financial institution's operations, which the Examining Officers may reasonably request to determine its safety and soundness.

14.3 A copy of the Examining Officers' on-site report of examination shall be submitted to the Board of Directors and Executive Management of the financial institution and shall be discussed by the Board of Directors at its meeting immediately succeeding receipt of the report.

14.4 Each member of the Board of Directors shall acknowledge receipt and perusal of the report of examination on the form provided at the time of the Board Meeting.

14.5 Management of the financial institution is required to respond to the findings in the report within 14 working days of the meeting of the Board of Directors referenced in 14.3 above.

14.6 Management of the financial institution shall report to the RMA the necessary actions/measures/remedies taken by the Board based on the findings of the on-site inspection report, within 6 months from the date of submission of the on-site inspection report.

SECTION 15: REGULATIONS FOR COMPLIANCE OFFICERS

15.1 INTRODUCTION

15.1.1 The main objective of requiring each financial institution to appoint a Compliance Officer is to check the level of compliance of laws, regulations and rules within the institution and to streamline the present reporting system to the RMA. The concerned institution may appoint an officer ***of appropriate seniority in the management of the financial institution***. While the Compliance Officer may report to the Managing Director/Chief Executive Officer/Audit Committee on areas requiring compliance at intervals as may be specified by the institution, the issues pertaining to non-compliance should be reported to the RMA on a quarterly basis.

In addition to his/her normal discharge of duties and responsibilities, the Compliance Officer shall also be responsible for:

(i) implementing and complying with all matters relating to RGOB circulars, prudential regulation and directives issued by the Royal Monetary Authority from time to time;

(ii) acting as a focal point of contact between the financial institution concerned and the RMA;

(iii) instituting a system whereby he/she can collect any information requested by the RMA from various divisions/department of the respective financial institution;

(iv) monitoring and confirming from the officer-in-charge of the respective division/department with regard to effective compliance of legislations, regulations, directives and circulars on an on-going basis;

(v) undertaking measures when necessary to reflect the institution's compliance to Sl. No. (iv) above on an on-going basis;

(vi) collecting and compiling all information relating to RMA returns, and then submitting to the RMA;

(vii) checking the correctness and promptness of the reports being submitted to the RMA; and

(viii) dealing with any queries or problems concerning the RMA returns and compliance with the prudential norms.

15.2 Any change in the appointment of the Compliance Officer shall be notified immediately to the RMA.

SECTION 16: REGULATIONS ON INTERNAL AUDIT REQUIREMENTS

16.1 INTERNAL AUDIT

(a) It is mandatory for all the financial institutions to have an adequate team of internal auditors, who are competent, professionally trained and recruited as full time auditors.

(b) Each financial institution shall have adequate number of internal auditors, depending on the size of the institution.

(c) The objectives of having internal audit is to review internal control functions, check and verify that correct operational procedures are being followed, and monitor accuracy of the financial transactions and records in accordance with sound accounting principles, on a regular basis.

(d) An internal audit cell must prepare a detailed audit plan covering all auditable areas and should include a schedule of all audits each year. However, the audit program must be revised periodically during the year when circumstances change, and such changes should be clearly explained and presented to the Audit Committee or Board for approval.

(e) Internal auditors shall also keep a track of compliance level being followed by the management of the institution, specially relating to policies, resolutions and rules approved by the Board of Directors. It shall also ensure that the institution abide by the relevant laws, regulations and notifications issued by the RGOB and RMA, from time to time.

(f) Internal Auditors shall normally submit their reports and findings to the Audit Committee and the Board of Directors. However, on matters of great exigencies, if the auditors feel the need to present their findings to the shareholders, they may do so. Such reports shall also be made available to the RMA Examining Officers during the time of on-site inspections, and, when such reports are being called by the RMA.

SECTION 17: REPORTING REQUIREMENTS

17.1 REPORTING FORMAT AND PERIODICITY

For the purpose of off-site surveillance, the RMA requires all financial institutions to submit the following reports in the prescribed formats and as per the period indicated:

	Form No.	Function/Purpose	Frequency
i.	FIS - M1M2 - P1	Statement of Condition, Assets	Monthly
ii.	FIS - M1M2 - P2	Statement of Condition, Liabilities	Monthly
iii.	FIS - M1M2 - P3	Statement of Condition, Fixed Assets	Monthly
iv.	FIS - M1M2 - P4	Statement of Condition, Other Assets	Monthly
v.	FIS - M1M2 - P5	Statement of Condition, Other Liabilities	Monthly
vi.	FIS - M3	Income & Expenditure Statement	Monthly
vii.	FIS - M4	Foreign Currency Balances	Monthly
viii.	FIS - M5	Liquidity Return	Monthly
ix.	FIS - M6	Statement of Sectoral Investment	Monthly
x	RMA-PR	Monthly Prudential Ratios	Monthly
xi.	RMA-DH	Monthly Data History	Monthly
xii.	FIS – M7	Classification of Loans & Advances by Sector & Repayment Status	Monthly
xiii.	FIS – M8	Statement of Ten Largest Exposures & Exposures Exceeding 10% of Capital Funds	Monthly
xiv.	FIS – M9	Statement of Large Loans & Advances by Sector	Monthly
xv.	FIS – M10	Statement of New Loans Sanctioned During the Month	Monthly

	Form No.	Function/Purpose	Frequency
xvi.	FIS – M11	Term Loans/Overdrafts/Working Capital Advances Enhanced/Renewed During the Month	Monthly
xvii.	FIS – M12	Statement of Off-Balance Sheet Items	Monthly
xviii.	FIS – M13	Capital Adequacy	Monthly
xix.	FIS – M14	Related/Connected Lending	Monthly
xx.	FIS – M15	Statement of 30 Largest Non-Performing Loan	Monthly
xxi.	FIS – M16	Statement of 30 Largest Depositors (for banks only)	Monthly
xxii.		Audited Annual Accounts	Annually

17.2 REPORTING DATE AND DATE OF SUBMISSION

a) The reporting date for the reports is the last working day of the period to which it pertains. The head office of each financial institution must consolidate the branch accounts up to the reporting date, and submit correct consolidated report to the RMA on or before the last day of the following month.

b) All financial institution shall draw up and submit to the RMA a copy of the audited report.

SECTION 18: REGULATIONS ON PENALTY FOR NON-COMPLIANCE

18.1 PENALTY CLAUSE

A financial institution that fails to comply with any of these regulations, including the failure to submit reports, shall be liable to the penalties in line with the Financial Services Act of Bhutan, 2011. Henceforth, the RMA shall, in the event that it determines that there has been an infraction by a financial institution, by one or more of its officers or directors, or by any other person with respect to (i) the violation of a provision of the Financial Services Act, 2011 or of a regulation of the RMA pursuant thereto; (ii) the breach of a fiduciary duty in transactions covered by the Financial Services Act, 2011; or (iii) the unsafe or unsound operation of a financial institution, take the following actions or impose the following penalties:

(a) Issue warnings;

(b) Conclude written agreements for the company to undertake remedial measures, including those limiting the operations of the institution engaged in financial services;

(c) Issue orders to cease and desist from such infractions;

(d) Impose fines up to Nu.5000 per day for each day that the infraction continues;

(e) Suspend temporarily or permanently officers or directors from duties in the financial institutions;

(f) Order conservatorship in the case of institutions in accordance with provisions of the Chapter 12 of Financial Services Act, 2011;

(g) Revoke the license to operate.