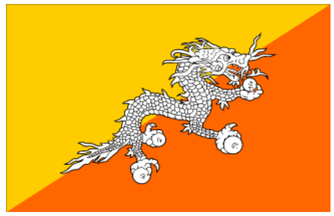

State of Microfinance in Bhutan

Prepared for

Institute of Microfinance (InM)

As part of the project on
State of Microfinance in SAARC Countries

By

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Disclaimer

Any opinions expressed and policy suggestions proposed in the document are the author's own and do not necessarily reflect the views of Institute of Microfinance (InM). The report also does not represent the official stand of the Government of the countries studied.

Currency and Equivalents

Currency Unit		Ngultrum (BTN) */
USD 1.00	=	BTN 48

*/ The Bhutan Ngultrum is equal to the India Rupee.

Fiscal Year

1 July to 30 June

Abbreviations and Acronyms

ADB	Asian Development Bank
AMEPP	Agriculture, Marketing and Enterprise Promotion Programme
AMS	Agricultural Marketing Service
BCCI	Bhutan Chamber of Commerce and Industries
BDFC	Bhutan Development Finance Corporation
BOB	Bank of Bhutan
BTN	Bhutan Ngultrum
FCB	Food Corporation of Bhutan
GDP	Gross Domestic Product
GGLS	Group Guarantee Lending Scheme
GNH	Gross National Happiness
IFAD	International Fund for Agricultural Development
M&E	Monitoring and Evaluation
MIS	Management Information System
MoA	Ministry of Agriculture
MTR	Mid-Term Review
RGOB	Royal Government of Bhutan
RNR	Renewable Natural Resources
SAARC	South Asian Association for Regional Co-operation
SIL	Small Individual Loan
SNV	Dutch Development Organisation (NGO)
UNDAF	United Nations Development Assistance Framework

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Chapter 1: Introduction and Objectives

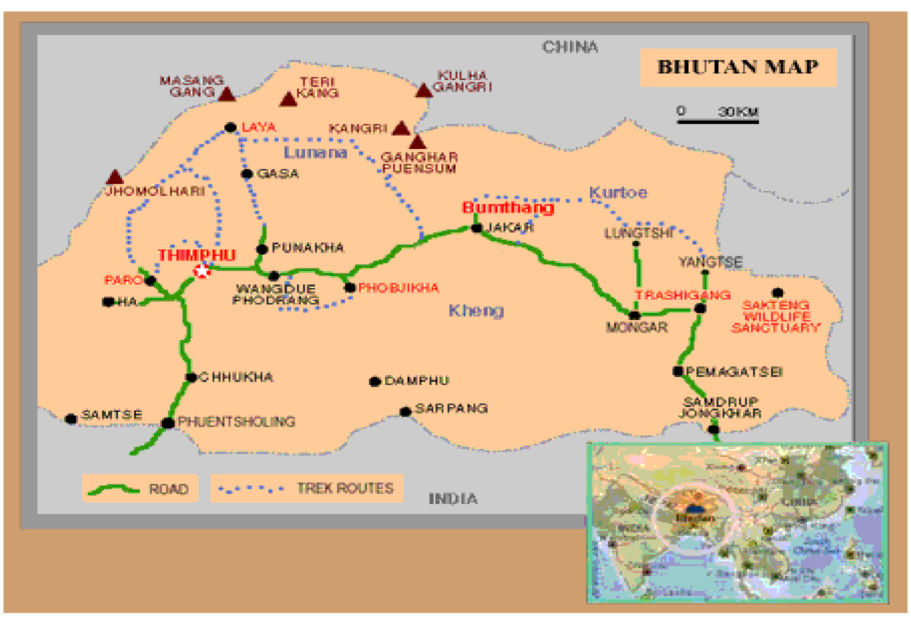
A. Overview

The Institute of Microfinance (InM) has undertaken the task of publishing reports on the state of microfinance in different regions. Each year, InM will prepare a document on the state of micro finance in different regions. In 2009, the Institute will publish a report on the State of Microfinance in the SAARC countries. This series will include seven country reports on each of the SAARC countries. This report on the state of the Microfinance Sector in Bhutan is part of this first series of reports. This report will attempt to provide an overview of the state of micro finance in Bhutan from both the demand and supply side. There is very little information available on Bhutan with reference to the microfinance sector. Bhutan does not appear on the Mix Market as there is no MFI which is registered with the Mix Market and there is little information on it on web. This report is primarily based on reports produced by the Asian Development Bank, World Bank, the International Fund for Agriculture Development and the United Nations Development Programme. Papers produced by the staff of the Bhutan Development Finance Corporation were also used to supplement the information from donor reports.

B. Country Background

The Kingdom of Bhutan is a landlocked country deep in the eastern Himalaya Mountains, bordering on India to the south and China to the north. Rugged mountains dominate the terrain and make the building of roads and other infrastructure difficult and expensive. Bhutan has a total land area of about 47,000 square kilometers. Forests cover more about 72 per cent of the land and estimates of arable land vary between 7 to 12 per cent of the total land area.

Figure 1: Map of Bhutan



Estimates of the population of Bhutan vary widely but current estimates put the population at around 700,000[1] and its growth rate is estimated to be 1.26 per cent per annum.[2] The population density is very low. The average annual growth rate of GDP is about 6 per cent. Gross national income (GNI) per capita was an estimated US$1,250 in 2005, up from US$720 in 2000[3] and was estimated to be $ 5600 (PPP) in 2008.[4] The economy one of the world's smallest and least developed countries is dominated by small-scale subsistence farming based on traditional technology and with relatively little economic interaction outside local communities. The country's main exports are electricity, timber, cement, agricultural products and handicrafts. Among the most economically active sectors are construction, manufacturing and transportation. Although subject to restrictions, tourism has considerable potential. Administratively, the country is divided into 20 dzongkhags or districts which are further divided into 202 Geogs.

Bhutan has successfully completed four decades of planned development. The development process in the Kingdom was initiated in 1961, the year it was first classified as the country with the lowest GDP per capita in the world at US$ 51. The economy then was basically a closed rural-based barter economy with its population fully dependent on subsistence agriculture and livestock rearing. Virtually no physical or social infrastructure existed and there was a complete absence of modern communication facilities. Additionally, an administrative system in the sense of a modern civil service was only just developing and the country suffered from a dire shortage of educated and trained personnel. The health and education system at that time comprised only 11 primary schools with 500 students and four small hospitals.[5] Health indicators were abysmal with life expectancies at less than 35 years and extremely high infant/maternal mortality rates, attributable largely to readily preventable and treatable diseases. And while no surveys had been done, literacy rates were probably among the lowest in the world with school enrollment figures equally dismal.[6]

The isolated, mountainous Kingdom of Bhutan began to open up to the outside world in the 1960s. It has adopted a policy of cautious modernization, moving away from a generally self-sufficient barter economy based on agriculture. The economy has developed rapidly since the country began to open up to external influences, and a stable macroeconomic environment has favoured growth. The Bhutanese economy is dominated by two contrasting sectors, the traditional sector comprising agriculture and forestry, and a fast growing modern sector comprised of energy and industries. The contribution of agriculture to GDP has come down from around 50% two decades ago to 22% in 2006. However agriculture is still important but does not enjoy its dominant status anymore. The export of hydropower which consists of about 45% of national revenues has become the major driving force of the economy.[7] The harnessing of hydropower and the development of power-allied industries are seen as the key to unlock Bhutan's future economic prospects and to serve as the engine of growth. There are fears though because of the excessive reliance on a single commodity exported to a single market as this increases the country's economic vulnerability. Furthermore, the current growth of the country's economy has not significantly benefited the rural population per se and largely bypassed other sectors.

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[1] CIA Fact Book. April 2009.
[2] Ibid. April 2009.
[3] International Fund for Agriculture Development. COSOP.
[4] CIA. Fact Book April 2009.
[5] Government of Bhutan.
[6] Country Presentation by The Royal Government of Bhutan. Third United Nations Conference on The Least Developed Countries. Brussels, 14-20 May 2001
[7] Asia Development Bank. December 2006. ADB. Grant Assistance Report. Project Number: 40172. December 2006. Proposed Grant Assistance. Kingdom of Bhutan: Rural Skills Development Project.

Rural settlements vary from single homesteads to a cluster of 30-40 dwellings and are scattered across Bhutan. Some of these settlements can be reached by road while many can only be reached by mule tracks or foot trails. Most people in rural areas are subsistence farmers. Although most of these farmers are self-sufficient in food production there is little trade of surplus production due to remoteness of suitable markets. Farming activities are diversified in most rural households that grow a range of cereals and horticulture crops while around 90 percent of these households own livestock. The average agricultural land holding is 1.5 hectare per rural household. Around 10 percent of the households have more than 5 hectares of land. Rural micro-enterprises are scant. Most economic opportunities are found in and around the few urbanized areas that have sufficient infrastructure.

Bhutan remains a poor country with a national poverty rate of 32%. Poverty is predominantly a rural phenomenon. The poor make up only 4.2% of the urban population, but 38.3% of the rural population.[8] The Bhutan national poverty line is 740.36 Ngultrum (Nu) per month, which is approximately US$17. According to the Bhutan Poverty Analysis Report of 2004, the current average per capita household income is US$0.80 per day. About a quarter of the population is living on less than US$0.46 a day, most of them in rural areas. Bhutan's poorest people include subsistence farmers, small traders and day labourers and their households. Some people work at more than one job in an attempt to earn enough to rise above the poverty level. Poverty in Bhutan has diverse causes, but most are linked to the nature of the land. Because villages are isolated and the terrain is extremely rugged, people lack access to social and health services and to education and markets. Among other factors that aggravate rural poverty in Bhutan are natural calamities such as floods and landslides, breakdowns in society that disrupt family and social support systems, increasing costs of goods and services, and illnesses such as malaria and tuberculosis. Women have equal legal status but are less mobile than men and less active in social and economic life outside of their own villages.

Opportunities for producing food and generating cash income are limited. There is little potential for expanding irrigation facilities, and much existing irrigation needs rehabilitation. External inputs and services are inadequate. Most rural households farm at a subsistence level and raise some livestock. Many subsistence farmers live outside the cash economy. There is little surplus for commercial purposes in their cultivation. Most rural people do not have a semi-annual cash crop that will allow them to farm throughout the year. The reason is that cash crops, such as oranges, cardamom, and potato, are adapted for cultivation mostly in the southern region. Also, farmers generally do not have other sources of income during off-farm seasons. They hardly have productive activities unless they have a crafts production tradition. Farmers have little or no access to credit and other financial services. Because of high illiteracy rates and lack of training, rural people do not have the productive skills and knowledge of technology they need to improve their living standards. They have few opportunities for off-farm employment and for otherwise generating income. During off-farm seasons, they stay in their villages and survive on their previous harvest. Thus, rural people are most financially vulnerable in off-farm periods, and lack of income opportunities outside of subsistence agriculture, especially during off-farm periods, is one of the causes of rural poverty.[9]

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[8] ADB. December 2006.

[9] Technical Assistance Report. Project Number: 39221. September 2006. Kingdom of Bhutan: Preparing the SME/Microenterprise Development Program. Financing Component. (Financed by the Japan Special Fund).

Chapter 2: History of the Microfinance Sector

A. Overview

In Bhutan the system of credit is a very young phenomenon and it did not gain much impetus until recently with the emergence of a strong monetary system. In the remote areas of the Kingdom, rural credit is still not a common feature and people prefer to continue with their old system of trading in kind.[10] Until the 1960s most financial transactions were carried out using barter arrangements. The payment system in Bhutan is characterized by the heavy use of cash and paper-based instruments for all types of payment transactions both in rural and in urban areas. This causes significant costs not only in the banking sector, but also in the private and government sector, to physically move these instruments from region to region. The distribution of cash in a country like Bhutan with extensive mountains and insufficiently developed transportation infrastructure is extremely cumbersome. With the introduction of privatization and the ever-increasing market economy, rural credit is becoming important in the country. Money is now a predominant feature of the rural economy as people realize that the purchasing power and convenience of money can guarantee the delivery of services and products. However financial markets are not developed and there are few financial intermediaries. Bhutan has a very weak financial sector which is considered a constraint to private sector growth: out of 175 countries in 2007, Bhutan ranked 159th on the ease of getting credit.[11]

Limited financial intermediation is a key constraint in Bhutan. In the Bhutanese economy many producers find themselves unable to finance highly profitable investment projects while, at the same time, the large majority of consumers have few opportunities to invest or cannot find suitable borrowers.[12] Bhutan's financial sector has a large liquidity reserve ratio and high Capital Adequacy Ratio.[13] The liquidity build up has not been matched by domestic private investment. This shows a clear lack of financial intermediation. The implication is that a more efficient system of financial intermediation could raise the overall level of economic activity as well as the ratio of investment and savings to GDP.[14] The loan market remains thin, and most of the liquidity is re-deposited in either non-interest bearing account with the Royal Monetary Authority (RMA) or, in high interest bearing deposits with commercial banking institutions in India. This weak intermediation function has led to high interest rate spread which is about 9.5%, higher than a regional average of 7% which was reported in 2005.[15]

B. Financial Institutions in Bhutan

The financial sector in Bhutan is very small and provides limited financial products and services. In Bhutan there are four major financial institutions. There are only two commercial banks—Bhutan National Bank (BNB) and Bank of Bhutan (BOB), and two non-bank financial institutions—Bhutan Development Finance

[10] Sonam Tashi and Sonam Dorji. A Brief Paper. Bhutan Development Finance Corporation. Paper for the SAARC Finance. Seminar on Microfinance. 21-23 December 2002, Dhaka, Bangladesh.
[11] Doing Business Report. World Bank 2007.
[12] Tashi and Sonam Dorji. A Brief Paper. Bhutan Development Finance Corporation. Paper for the SAARC Finance. Seminar on Microfinance. 21-23 December 2002, Dhaka, Bangladesh. December 2002.
[13] Project Appraisal Report. Private Sector Development.World Bank. May 2007.
[14] Ibid. December 2002.
[15] Project Appraisal Report. Private Sector Development. World Bank. May 2007.

Corporation (BDFC) and Royal Insurance Corporation of Bhutan (RICB). The two commercial banks dominate the financial sector with a market share of 88% in total assets and 76% in total lending. However, BOB lends mainly to government enterprises and BNB mainly to medium and large enterprises or individuals who meet collateral criteria. RICB and BDFC have a combined market share of 24% of total lending operations.

The Bank of Bhutan, the nation's commercial bank, was established in 1968 as a joint venture with the Chartered Bank of India, which owned 25 percent of the bank. In 1970 the State Bank of India took over the Bhutanese assets controlled by the Chartered Bank of India. Since its establishment, the Bank of Bhutan's Board of Directors has been composed of key officials from the economic ministries and departments and two officials from the Indian banks. The bank was restructured in 1971. To ensure that it would have sufficient funds at its disposal, government departments were required to deposit all of their accounts with the government-run bank until 1982, when the Royal Monetary Authority was established. Since 1982 the Bank of Bhutan has served as the retail banking agent for the Royal Monetary Authority. The Bank of Bhutan was able to give relatively large loans for capital programs, such as irrigation projects in the south-central region. Among its retail banking activities was the issuance of rupee-denomination travelers' cheques; this activity started in 1974. In 2002 the bank had a nationwide network of 25 branches and 3 extension centers that covered all districts of Bhutan. The Bhutan National Bank, formally the Unit Trust of Bhutan, was established in 1997 and has a network of four branches. The largest shareholders of the Bhutan National Bank are the Government and the Asian Development Bank. Both the Bank of Bhutan and the Bhutan National Bank operate as commercial banks.

Non-bank financial institutions also were set up as part of the economic modernization process. Insurance was offered by the Royal Insurance Corporation of Bhutan, which was established in 1975 with its headquarters in Phuntsholing. Starting in 1980, individuals could invest their savings in the newly established Unit Trust of Bhutan. The trust channelled invested funds for which it issued shares called units, into industrial and commercial development. The Royal Insurance Corporation of Bhutan operates as a non-bank financial institution. The Government owns 41 percent of this institution while the remaining share capital is owned by private sector entities. The Royal Insurance Corporation of Bhutan is the only financial institution that provides insurance products.

The Bhutan Development Finance Corporation **(**BDFC) was formed as an autonomous development organization in 1988 by merging the rural credit section and the industrial credit section of the RMA. BDFC was registered as a company under the Companies Act of 1989 and is governed by the Financial Institutions Act of 1992. BDFC has an authorized capital stock of Nu. 200 million with a paid-up capital of Nu. 100 million. The shareholders of BDFC are the RGOB (87 percent), the Bank of Bhutan (7.5 percent), the Royal Insurance Corporation (3 percent) and the Bhutan National Bank (2.5 percent). Although BDFC is officially supervised by the RMA, the RMA takes a flexible approach with respect to the financial services provided by BDFC especially because BDFC does not attract deposits from the public but also because the BDFC is considered a government owned development bank. BDFC does, however, adopt prudential banking requirements as set forth by the RMA. Its loan classification and provisioning policies are in line with the banking regulation.

The Royal Monetary Authority, since its establishment in 1982, has served as the central bank of Bhutan and maintained its headquarters in Thimphu. The authority is responsible for issuing currency, implementing monetary policy, coordinating financial institution activities, and holding the government's foreign exchange earnings. Among its initial duties was the administration of financial assistance to rural development. The Bhutan Development Finance Corporation, upon its establishment in 1988, took over the administration of rural financial assistance from the Royal Monetary Authority. Loans were granted for improving farmlands, acquiring livestock, and meeting short-term, seasonal requirements. At least some of the funding for the corporation came from the Asian Development Bank, including an initial US$2.5 million loan in 1988 for the expansion of small- and medium-sized, private-sector industrial development. By 1991 the corporation had been privatized.

C. Micro-Finance in Bhutan

Money Lenders

While informal arrangements for financial and credit services are reported to exist in some parts of the country, there is very little data available. In the informal market for credit, private moneylenders charge 3 to 5 percent per month for mostly short-term loans. In Thimpu some moneylenders charge up to 10 percent per month. The terms vary depending on the repayment capacity of the borrower. Much of the lending is done in kind as many villagers, especially in remote rural areas, cannot afford to borrow in cash.[16] It is reported that well to do families and individuals would loan out cash or grain or both to poor villagers to help them resolve their seasonal or emergent difficulties. These loans were usually repayable within a one year period at an interest rate of between 15% to 25%. Loans taken in kind had to be repaid with interest in kind also. It is believed that most villages had one or more such informal lenders who were the more enterprising individuals of the community. In its review f the sector IFAD reports that poor households do not have access to consumption loans from financial institutions and take loans from money-lenders at 2-5% interest per month. Access of poor households to small consumption loans is an important strategy to assist them in increasing their risk bearing ability and help them move up the development ladder.[17]

Monastic Body

The monastic institutions which had substantial revenue collection of its own also followed the practice of lending money, grains, and dairy produces to certain creditworthy individuals or families. The rate of interest ranged from 15% to 25% per annum.

Semi Formal Institutions

The National Women Association of Bhutan (NWAB), a nongovernmental organization which was established by the Government in 1981 was at one time providing skill training and group lending to women entrepreneurs. Its group lending methodology was based on the Grameen model. The interest rate was 14 percent per annum while loans were paid back in weekly instalments. The main objective of NWAB was to

[16] Peter Kooi And Hedwig Siewertsen Mid-Term Evaluation BHU BHU/98/CO1. Strengthening Capacities for Sustainable Microfinance Draft Evaluation Report. FACET BV For Netherlands Development Organization. Bhutan. United Nations Capital Development Fund. May 2002.

[17] IFAD. Appraisal Report. AMEPP.

create awareness and promote social mobilization of poor women. Microfinance was considered as a promotional instrument to reach this objective. The NWAB scheme was initiated in collaboration with BNB to cater to the women's requirement in Trashigang District between 1989 and 1991. The operation was finally launched in 1993. The mechanism used to guarantee the repayment of these loans was through peer pressure where people within each credit group ensured that no one defaulted on the repayment. The scheme was mainly targeting women clients but on a very small scale. Another scheme called "National Fodder Seed Production Centre" was initiated by Helvetas at Bumthang to cater to the agriculture-input requirements of the farmers in the beginning of 1990. Farmers formed groups in this association while each group was provided seed capital. The interest varied from 3 to 5 percent per month. The operation was later handed over to the BDFC in 1994 in view of logistics problem. The Integrated Sustainable Development programme Zhemgang supported by Save the Children provided rural credit in two Geogs. With the passage of the NGO act by the National Assembly, several NGOs and Associations have been established. However, none of them have any significant role in providing financial services. It is reported that even the limited provision of financial services by the informal sources is on the decline both in urban and rural areas.

Formal Sector Provision

Microfinance in Bhutan featured only in 1980. Unlike in other countries in South Asia microfinance in Bhutan is being managed by public sector institutions and not by NGOs. The Bank of Bhutan (BOB), which is mandated to give 20% of its loan portfolio as rural credit did not lend even 1% of its loan portfolio. The principal reason for this was that BoB's loans were highly secured. The farmers who needed credit were not able to meet the collateral and personal guarantor requirements for accessing these funds. Acknowledging the situation, the Royal Government of Bhutan (RGoB) decided that there had to be a separate institution to deal with rural lending and Food Corporation of Bhutan (FCB) was identified as the appropriate organization in 1980. The Corporation upon assuming the responsibility was faced with financial difficulties and had to resort to borrowing from the Royal Insurance Corporation of Bhutan (RICB) and BoB at commercial interest rate of 14% per annum. The FCB commenced its credit programmes with the following rates of interest with the understanding that the government would subsidize the difference in interest rates;

*	Loan amount less than Nu[18]. 5,000 -	6%
*	Loan amount between Nu. 5,000-Nu. 10,000 -	8%
*	Loan amount between Nu. 10,000- Nu. 50,000 -	10%

The FCB operation was short lived due to manpower and logistic problems in addition to having to borrow at high rates of interest and re-lend at lower rates. The Rural Credit Scheme under the FCB lasted only two years. The RGoB despite establishing the Bank of Bhutan and the Royal Insurance Corporation of Bhutan (RICB) for the purpose of general credit to business communities realized that lending was biased towards general trade, transport and real estate development. It was observed that these financial institutions insisted on high collateral requirements for its lending, which had made it impossible for rural farmers to avail any form of credit.

It was at this time that the need to establish a Development Bank, which would provide the much required credit facilities for accelerating rapid industrialization and rural development process was realised (5th Five

[18] The official currency is the Ngultrum (Nu) divided into 100 Chetrums.

Year Plan 1981-1987). The desired Development Bank was expected to provide loans for industrial and agriculture related activities including provision of credit in rural areas. In addition to the existing section for rural credit which was operational since 1982, another section to deal with industrial credit was set up under the Royal Monetary Authority (RMA) during the early part of the mid-eighties to ultimately create a new institution equivalent to a Development Finance Institute (DFI) like elsewhere in other South East Asian countries. The DFI, which was later separated from the RMA and established as an autonomous organization was called the Bhutan Development Finance Corporation. It was established with the signing of the Royal Charter (RC) on January 31, 1988. The Bhutan Development Finance Corporation (BDFC) was established with assistance from ADB, and equity participation from the Government. The RC was later renamed as Articles of Incorporation (AOI) of BDFC. The Corporation was, however, actually established only on March 13, 1988 when all the assets and liabilities of the Rural Credit Program and Industrial Program Sections were formally transferred to BDFC. The Corporation was later registered with the Company's Act of Bhutan which was enacted in 1989.

Lending Methodologies in Bhutan

The Bhutan microfinance sector uses both the individual and group lending methodology. However, it has not had much success with its group approach. The idea of using the group approach has mainly been inspired by the Grameen approach and has been introduced through donor support. When the National Women Association of Bhutan first started its small scale microfinance programme it was using the Grameen group formation methodology. Inspired by its approach, an attempt was made to use the NWAB to form groups for access to financial services from the formal sector. The intention was that a contract would be made between BDFC and NWAB, for NWAB to start social mobilization efforts and group formation in six eastern districts. The NWAB would apply its methodology of peer group formation and training of members. BCDF would collaborate with NWAB in preparing the group members to gain access to the group loan scheme of BDFC.[19] No contract materialized as BDFC management felt that their own in-house capacity was sufficient to take the task at hand. An evaluation of the program concluded that using its own staff was the right approach for BDFC as the mandates of NWAB and BDFC were not compatible to allow a fruitful collaboration. While BDFC's rational of forming groups was to reduce its credit risks and transaction costs. Furthermore, the management of BDFC believed that it was important for the credit assistants to establish a good relationship with its borrowers. These credit assistants should therefore work with their clients from the very start. Sub - contracting NWAB would prevent this to happen. Moreover, Group formation is a continuous effort that goes beyond the contract period with NWAB. By including group formation as an integral part of its product, ALD would be able to ensure technical sustainability. The group formation and meetings were a relatively new phenomenon in Bhutan.

[19] Peter Kooi And Hedwig Siewertsen Mid-Term Evaluation BHU BHU/98/CO1. Strengthening Capacities for Sustainable Microfinance Draft Evaluation Report. FACET BV For Netherlands Development Organization. Bhutan. United Nations Capital Development Fund. May 2002.

Credit Policies of BDFC

Eligibility Criteria:

To become eligible for a loan it is mandatory that a female client has a minimum age of 16 and a male client a minimum age of 18. The client should have sufficient formal education to carry out the business. No loan facility is to be extended to clients without national identity card. All borrowers need a guarantor or in case of GGLS, a group guarantee.

Loan Processing Methodology:

The Agricultural Lending Department has considerably improved its loan processing methodology. Before 1998, a loan applicant had to submit a loan application to an extension agent. The extension agent checked the forms and, after endorsement, submitted the forms to the Gup for verification. After endorsement of the Gup the forms were sent to the District Credit Officer. The District Credit Officer submitted the forms, after review, to the Branch Loan Committee meeting. The timing of the Branch Loan Committee meeting depended on the availability of the Dzongdag, District Agricultural and District Animal Husbandry Officer, the Planning Officer and District Credit Officer. Loan disbursements and repayments took place at the district branch.

At present, the loan processing methodology has been decentralized, removed from the local government administration at district level and the concept of mobile banking has been introduced in 55 Geogs. The District Credit Officer and/or District Credit Assistants are present on a fixed date and time to serve (potential) borrowers at their location. During this mobile banking day, loan appraisals, loan approvals for loans up to Nu. 5000 loan and deposit collections take place by the Geog Loan Committee. This Committee consists of the District Credit Officer, the District Credit Assistant, The Gup, Chipons /Tshogpa and a Mang Ap (village elder).

If the loan exceeds Nu. 5000 but is lower than Nu. 30,000, the loan application will first need endorsement by the Geog Loan Committee. Branch Loan Committee can approve the loan application. This Committee is comprised of the Regional Manager, the District Credit Officer and the District Credit Assistant. The presence of the Regional Manager is no longer required for the Branch Credit Committee to approve loans between 5,000 Nu and 30,000 Nu. This situation puts the senior credit officers in a situation whereby they have to approve the loans that they have endorsed earlier in the Geog Loan Committee. The newly appointed managing director of BDFC, who took office since the end of March 2002, is considering the possibilities of giving back and increasing the loan approval authority to the Regional Managers.

Loans between Nu. 30,000 and Nu. 50,000 have to be submitted by the Branch Loan Committee to Head Office for approval. These loans are verified by the ALD Program section and approved by the Executive Director. Commercial loans of over Nu. 50,000 are submitted to Commercial Agricultural Loan Committee at head office. This Committee is comprised of Project Officers from the ALD and ILD, the Executive Director and the Managing Director.

These changes have led to a considerable reduction in loan processing time from 3 to 6 months in the past to less than a month at present. Loans up to Nu. 5,000 are disbursed during the meeting or, if insufficient cash is available at the borrower's place, within a few days from the meeting. Loans higher than Nu. 5,000 will be disbursed at the branch office. Loans from Nu. 5,000 to Nu.50, 000 can be processed and disbursed between one and two weeks. Loans higher than 50,000 can be processed and disbursed in a month. The main difficulty to speed up the loan processing time stems from the inefficiency of the payment system in Bhutan. Check clearing and transfer are extraordinary slow and can take from 10 days to more than two weeks.

Default Management:

The branches are responsible for administration and loan collection. Credit officers have their own assigned blocks. In advance, borrowers are informed in writing when repayments are due. Borrowers that do not repay during the meeting are required to repay at the branch office. This provides a borrower with the incentive to repay in order to save cost from transportation and time. During the center meeting the names of defaulting members are read out in public by the chairperson of the Geog Loan Committee. Delinquent borrowers are notified that no subsequent loans can be obtained if they default on the loans.

If a borrower defaults on the loan, the District Credit Officer or District Credit Assistant will meet with the borrower to request repayment. The Gup plays an important role in reminding delinquent borrowers and applying social pressure. In case of larger loans sometimes collateral like livestock and machinery is seized. In a few cases of deliberate default, the case is brought to the court. However, from a legal point of view it is difficult and time consuming to seize property like land and houses.

Rescheduling Procedures:

The clients have to request rescheduling of the loans stating the reason of rescheduling. The Regional manager has the authority to reschedule loans with sizes below Nu. 30,000. Loans higher than Nu. 30,000 need approval of the Managing Director or Executive Director. The interest due can be capitalized in case the borrower is unable to pay the interest as well. Loans can only be rescheduled once and are for 100 percent provisioned. BDFC is careful with rescheduling of loans, which is commendable. In 2000, a total of 69 loans were rescheduled with a principal amount of Nu. 1,065,222.

Write off Procedures:

Write off is defined as "an amnesty, or pardon, from having to meet the debt obligation either in part or in full or being freed from the burden of debt"[16]. The concerned client, or the direct family members if the client died, should pass a petition for write-off of loans with full reasons as why repayment is not possible.

In addition, BDFC has an "off balance sheet" policy, which resembles a common write off policy to adjust the gross loan portfolio and loan provision for delinquent loans that are considered not collectable. In 2000, a total amount of Nu. 3,289,961 was written off and in 2001 a total amount of Nu. 3,502, 329. This results in a write off ratio of 1, 76 percent in 2000 and 1, 52 percent in 2001. These ratios seem small compared to the total arrears rates and the notional character of the pledged collateral. This write off policy does not have specific criteria but is decided on a case-by-case basis in a loan committee meeting at head office.

Loan loss provisioning

Provisioning for non-performing loans is made as per guidelines issued by the Royal Monetary Authority of Bhutan, at the following rate, except for loans under litigation against which a 100 percent provision is made:

Period in Default (months)	Provision on Outstanding principal Amount (%)
7-12	10
13-18	15
19-24	20
25-36	50
More than 36 and term expired	100

Chapter 3: Growth and Outreach

A. Overview

BDFC is the only development finance institution in Bhutan which is mandated to provide credit to small- and medium-scale industrial and agricultural activities — particularly in rural areas. While a few other small efforts were made to provide credit, these were never of significant scale and have not been able to sustain themselves. BDFC has a network of branch offices in all 20 districts and provides credit services to both women and men. In order to enhance credit accessibility and delivery, BDFC decentralised its credit system with the establishment of block loan committees and introduced schemes such as savings mobilisation and group guarantee lending. These measures have brought about wider participation by the rural population, especially women. A review of the finance provided in Bhutan shows that most lending by financial institutions is in the construction sector followed by the transport sector, manufacturing sector and trade sector. Only 5.4 percent went to agriculture of which 97.8 percent came from BDFC. Among the financial institutions, the Bank of Bhutan was the largest lender (37 percent of total loans disbursed), followed by the Bhutan National Bank (27.6 percent), the Royal Insurance Corporation of Bhutan (21 percent) and the BDFC (13.4 percent).[20]

B. Financial Products of BDFC

The bank offers a variety of loan products and is also engaged in the development of a system of distribution of Micro-credits through the Group Guarantee Lending Scheme, mobile banking, and simplification of the lending system and decentralization of the branch operations. BDFC provides term loans with different maximum maturities depending on the sector. Its loan periods are much larger than those offered by MFIs in other countries and can be anywhere from 5 to 10 years. Its average loan size at Ngultrum 100,000 or US$ 2010 does not classify as micro-lending. However, this average is biased upwards because of its commercial agriculture loans. Loans are primarily approved on the basis of collateral. The Agriculture Lending Division provides three financial products (i) The Small Individual Loan (SIL), (ii) Commercial Agricultural Loan (CAL) and the Group Guarantee Lending and Savings Scheme (GGLS). GGLS is tailor made to meet the credit needs of rural farmers who have no assets to mortgage. SIL targets those farmers requiring loans ranging from BTN 500 to BTN 100,000 with minimum collateral requirement of 100% and could be relaxed based on viability of the proposals. Commercial Agriculture Loan Scheme targets higher income bracket of both the rural and the urban populace whose loan requirement exceeds BTN 100,000. The collateral requirement is 150% of the loan amount. Annex Tables give details of the types of activities for which loans in each category are generally extended.

Small Individual Loans (SIL) are divided into seasonal loans and term loans. The maximum seasonal loan is Nu. 5,000 and has a maximum loan period of 6 months. The loan sizes for term loans vary between Nu. 5,000 and Nu. 50,000. The loan period for term loans vary between 1 to 7 years. The SIL loan has to be collateralized. In practice the collateral is land and/or premises owned by the borrowers. The collateral is

[20] Private Sector development Project. World Bank. 2001.

generally notional as it is difficult to seize the collateral if the borrower defaults on the loan. The minimum debt security ratio is 150 percent. Guidelines for valuation of security are detailed in the credit manual. Land valuation is based on the Governmental guidelines which are periodically reviewed to adjust for increase in land prices. Some BDFC staff members estimate that under the new land valuation rules, up to 90% of the Bhutanese households will be eligible for a small individual loan. The guidelines state that the client should finance the intended project for a minimum of 25 percent. The interest rate is 14 percent annually on a declining balance. The client is expected to submit a financing plan and a cash flow statement. The repayment period is on a quarterly, half yearly or yearly basis. Most of these loans are for agricultural purposes, animal husbandry and housing.

Commercial Agricultural Loans (CAL) have loan sizes beyond Nu. 50,000 or about US$ 1000 and the ceiling is well beyond what is generally described as microloans in the sector. The loan period varies from 5 to 10 years. Grace periods can be granted up to 1 year for loans sizes beyond Nu. 50,000. The CAL has to be collateralized. In practice the collateral is the land and/or premises of the clients. The collateral is also generally notional. The minimum debt security ratio is 150 percent. Guidelines for valuation of security are detailed in the credit manual. The client should finance the intended project for a minimum of 25 percent. The interest rate is 15 percent annually on a declining balance. The client should submit a financing plan and a cash flow statement. The repayment period is on a quarterly, half yearly or yearly basis. Most of these loans are for animal husbandry, agricultural machinery, land development (terracing and irrigation) and orchards.

The Group Guarantee Lending and Savings Scheme (GGLS) was initiated in 1998. On the basis of disappointing results of this first scheme, the management decided in the first quarter of 2001 to suspend the formation of new GGLS groups in all district branches and to suspend further disbursements to delinquent groups. A revised GGLS was piloted and at the end of 2002. The major differences between the old and the new schemes are the client selection, group training, means test, an increased discipline during center meetings and the strict application of procedures. The loan duration has been brought back to 6 months for the first cycle loan and repayments need to be made as frequently as possible, preferably on a monthly basis. The new GGLS is only to be introduced in geogs with sufficient population density and business opportunities. One difference between the two pilot schemes lies in the loan approval authority; in some geogs the center approves the loans, while in other geogs the geog loan committee (including the gups, extension workers and BDFC staff) approves the loans.

The procedures of the revised GGLS are as follows. In order to become eligible for a group loan, potential borrowers have to form a group of a minimum of 3 and a maximum of 7 members. The members will guarantee the repayment of loans and the payment of interest and savings for the whole group. The members will have to pass a means test[21] to ensure that they belong to the poor section of the society by having hardly any assets or a fixed income. After forming a group and passing the means test, the members are required to attend a two to three day group training designed to equip the members with the knowledge, skills and values necessary to run their group and projects successfully. A number of groups will have to form a group center

[21] The means test entails mainly a brief inspection from the credit officer to confirm that the applicant does not have sufficient collateral to qualify for an individual loan.

that consists of a maximum of 50 members. The members will elect a chairperson, secretary and supervisor. All group meetings take place on a monthly basis in the group center. The group center is responsible for deposits of savings and repayment of all group members.

The maximum amount is Nu. 5000 for the first loan, Nu. 10,000 for the second loan, Nu. 20.000 for the third loan, Nu. 30,000 for the fourth loan and Nu. 50,000 for the fifth loan. The manual describes that the loan period is fixed at 6 months for first cycle, 12 months for the second cycle, 18 months for the third cycle and 24 months for subsequent cycles. The repayment schedule is the same for all members of a group and can vary from monthly, quarterly or half yearly repayments. The loans carry no grace periods. The interest is 13 percent annually calculated on a declining basis. A penalty of 5 percent annually is levied on the defaulted amount. It should be noted that these are the formal terms.

The deposits requirements of the GGLS seem rather daunting and are likely to have discouraged many potential members. Members have to pay a compulsory deposit of 5 percent of the loan amount, which is deducted from the loan upfront. In addition, members have to pay a compulsory monthly deposit of Nu 50 per month, which is collected at the compulsory monthly group meetings or at the branch office. The savings represent collateral on the loan. The interest paid on deposits is 6 percent annually, compounded on a quarterly basis. Members will have to continue to deposit compulsory savings on a monthly basis after having paid back a loan even if they decide not take a subsequent loan. Withdrawal of deposits is not allowed except in case of death or death of a family member. In case of forced eviction from the group the evicted member is allowed to withdraw 75 percent of his/her deposits. In practice, BDFC allows some flexibility with this rule. There are some cases whereby members were allowed to withdraw savings amounts in cases of emergency, while keeping a minimal balance of Nu. 100.

In case a member leaves the group, the member is entitled to withdraw all savings and will loose his/her entitlement to join in a subsequent cycle. If such member wishes to obtain a loan at later stage, this member would have to start again at the first cycle. However, the branches also adopt these rules in a flexible manner. Due to the compulsory savings the effective annual interest rate hovers between 13.5 and 14 percent in the case the member does not have to pay part of the loan outstanding of a delinquent member. In addition, the group will have to open a Center Fund Account to deposit penalties, to be paid by members in case of late attendance and/or absence at group/center meetings or in case the loan has been used for other purposes than stipulated in the loan application. The penalty is 1 percent of the loan principle. The group center decides on when a penalty will be levied and the use of the penalties charged. In case not all members attend a group center meeting, no loan disbursements will take place and no new loan applications will be reviewed. In reality these rules are more flexible.

BDFC has established an innovative outreach mechanism in the form of mobile banking to offer service to far flung *Geogs*. The credit officers of BDFC visit *Geogs* once a month on an appointed day to sensitise the community on loan and savings products available, take applications for loans, process applications, obtain required documents and deliver loans. This reduces transaction costs of the borrowers but increases transaction costs of BDFC.

C. Growth of BDFC

The growth in the outstanding loan portfolio of BDFC from 1995 to 2004 is indicated in figure 2 below. The achievement of the Agriculture Lending Department has been much more modest as compared to its overall growth. From 1998 till the end of 2001 the number of borrowers has increased annually on an average by only 5.38 percent. The average loan outstanding per borrower increased with an average of 5.37 percent per year over the same period. At the end of December 2005, BDFC had 14,764 active clients in rural areas accounting for over 90% of rural lending in Bhutan. BDFC claimed that it provided coverage to 17% of the total rural households. The number of branches and Geogs remains more or less the same indicating that the BDFC is enhancing its depth of coverage rather than the breadth of coverage (see Table 1 below). An evaluation report of BDFC reports that Bhutan's political and economic decentralization process has enhanced the credit delivery process, thereby leading to a sharp decrease in transaction costs in terms of waiting time, travel expense, and missed business opportunities.[22]

Figure 2: Overall Growth of BDFC

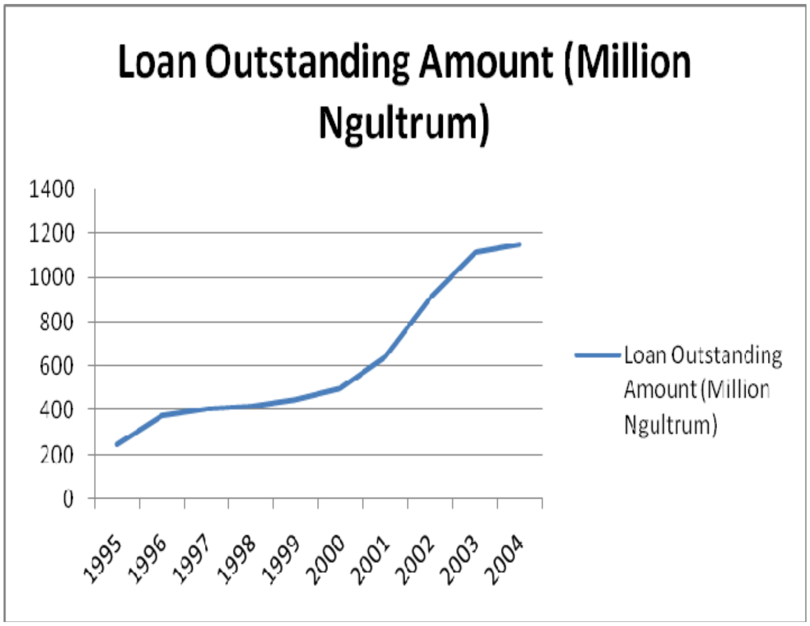


Table 1 below reports on the growth of the Agriculture Lending programme of BDFC. This table shows that while the growth in the number of loans over the last four years has increased by 17% the growth in the Gross Portfolio outstanding has been 37% indicating an increase in the loan size. The analysis of the data further reveals that after being more or less stagnant for a few years there was growth in loan portfolio in 2001.

[22] ADB.

Table 1: Growth in the Agriculture Lending Programme

Outreach	**1998**	**1999**	**2000**	**2001**
Gross Portfolio	165,774,882	165,591,798	183,378,222	226,966,256
Number of Loans	9.426	10,407	10,055	11,061
Number of Borrowers	9,345	10,286	9,948	10,937
Average Portfolio O/S per client[17]	17,739	16,099	18,434	20,752
Loan Disbursements	39,183,532	46,224,470	85,486,722	116,889,280
Number of new loans disbursed	NA	3,505	4,187	4,442
Average size of loans disbursed	NA	13,188	20,417	26,314
Total Deposits	0	0	7,896,257	7,896,257
Number of Savings Accounts	0	0	2,023	2,023
Average Deposit per Account	0	0	3,903	3,903
Number of Branches	19	20	20	20
Number of Districts	20	20	20	21
Number of Geogs	158	158	159	161

Data was obtained from BDFC for the last four years but they were unable to provide data which could indicate their microfinance clients separately. The only year for which this data was readily available was for 2008. As a result the micro-lending programme for the earlier years was calculated based on the proportion of loans and volume of loans derived from the 2008 figures. However, this method of calculation may overestimate the volume of lending given that when data is available for agriculture lending separately for earlier years it shows there has been stagnation both in the number of loans and the volume of lending under its microfinance programme.

Table 2: Growth in BDFC's Overall Programme

Particulars	**Year**			
	2008	**2007**	**2006**	**2005**
Gross Loan Outstanding (Ngultrum)	2,500,224,483	2,037,891,481	1,579,926,821	1,325,681,440
Number of Loans	18,627	17,596	17,667	16,341
Number of Staff	HO - BR -	HO - 78 BR - 107	HO - 57 BR - 114	HO - 62 BR - 90
Number of Branches	23	23	23	22
Number of Savers	9,728	7,011	5,425	3,381

Loans below Nu. 100,000 (US$ 1 = Nu. 49) are considered microloans. As of December 30, 2008 the micro-client number was about 13,887 with a portfolio of Nu. 332 million and NPL was 21%. OSS and FSS is difficult to calculate as there is no breakdown of cost as BDFC calculates these ratios on an overall basis. The most important micro loan product is the SIL (Small Individual Loan scheme) and is included within the above loans below Nu. 100,000. SIL loan is doing better than GGLS. Microsaving deposit is working well and amounts to about Nu. 137 million from about 9,728 savers. Historically the savings accounts were less than 20% of the total borrowers indicating that BDFC was unable to attract savers. The number of savers has picked up in recent years when total savers are included. However, the number of micro-savers has been stagnant for the years for which the data is available. The average savings account had a deposit of US$80 and the amount of funds in these accounts had not increased between 2000 and 2001. BDFCs Rural Savings Program, "Save to Grow", was launched in April 2005 to encourage savings in rural areas. The National Committee in Bhutan is supporting BDFCs current promotion of the credit plus savings services available in the rural areas.

Chapter 4: Sustainability

A. Overview

A review of the history of microfinance in Bhutan illustrates that the Government of Bhutan has considered the provision of microfinance as its responsibility and therefore it has considered it appropriate to subsidize the sector. While this pattern of thinking is not unique to Bhutan and is in evidence in other countries in the region as well where most public sector entities have subsidized the provision of microfinance. What is unique in Bhutan is that the public sector is the only provider of formal microfinance and the inclusion of NGOs which has really driven growth in other countries in the region is not in evidence in Bhutan. The Bhutan Development Finance Corporation is a non-bank financial institution. As a non-bank it cannot raise funds from the public and relies on government grants and external assistance. Those partners like UNDP who have worked closely with the BDFC maintain that the dual focus of commercial lending and subsidized lending within the same institution is problematic. The BDFC's rural credit programme has high operational costs and is sustained by its commercial and industrial lending operations.

Sustainability is a special problem in Bhutan for the one MFI operating in the sector. BDFC is managed as a bureaucratic, state-run, directed and subsidized credit delivery institution.[23] BDFC has provided subsidies on both interest rates and operational costs. The micro-finance products of BDFC were never structured with much regard to sustainability. Overall, loan maturities are too long, and not adapted to cash flow. There was limited feasibility analysis undertaken prior to initiating the microfinance products. This is true for both the group lending and the SIL products. The demand for both these products is not as high as was initially expected.[24] Sustainability in the sector is generally driven by appropriate pricing and growth. The sector in Bhutan suffers from both inappropriate pricing and inability to attract clients. As was evident from the analysis above, the number of clients has increased only slightly. Portfolio quality is another issue at BDFC. The portfolio performance of BDFC's entire credit operation has marginally deteriorated as PAR increased from 17% in December 2006 to 19% in December 2007 and 16% in December 2008. BDFC has improved the operational self-sufficiency of its microfinance programme but is still being subsidised by its mainstream programme.

Table 3: Performance Ratios of BDFC

Particulars	Year			
	2008	2007	2006	2005
Portfolio at Risk (PAR)	16.00	19.10	16.68	18.71
Operating Income (OI)	279,679,265	214,597,159	182,723,293	163,219,420
Operational Expenses (OE)	75,018,751	69,687,172	51,685,238	48,900,895
Financial Expenses (FE)	125,622,856	84,684,750	51,949,832	40,306,608
Operational Self Sufficiency (OSS) (OI / OE)	3.73	3.08	3.54	3.34
Financial Self Sufficiency (FSS) [OI / (OE + FE)]	1.39	1.39	1.76	1.83

23 Microfinance Evaluation Summaries Report. UNDP. 2002.
24 Ibid. 2002.

B. Financial Performance

Operational Self-Sufficiency

It is difficult to assess the financial performance of BDFC by using the normal standard benchmarks as its definition of some of the performance indicators does not conform with industry standards. The operational efficiency ratios provided by BDFC for the Agriculture Lending Department show an increasing trend from 1997. However, some caution has to be taken in analyzing these figures because the operating costs are not adjusted for subsidies. The Government subsidizes 50 percent of the operational costs in three branches and provides free premises for thirteen branches. The costs for salary and other expenses for the staff paid through project financing by donors are not included. The depreciation costs are not adjusted for equipment which has been received as grant. One evaluation study made these adjustments and found that the operational self-sufficiency of the ALD was 1.04 in 2001. The study further stated that if appropriate loan provisioning was made and no cross-subsidy from ILD to ALD was included, it is probable that the ALD had not yet reached operational self-sufficiency in 2001. Nevertheless, the financial income has increased due to an interest rate increase on loans, increasing loan portfolio and some reduction in operating expenses.

Table 4: Operational Self-Sufficiency Ratio of ALD-BDFCTab

Operational Self-Sufficiency[25]	1996	1997	1998	1999	2000	2001
Total financial income	18,734,195	18,407,406	18,549,945	23,870,924	30,539,831	31,106,576
Financial expenses	6,110	15,695			214,382	300,656
Provisioning	5,316,444	3,502,586	4,123,856	3,530,886	11,015,695	8,443,021
Operation/admin. exp.	11,274,706	14,710,303	13,720,528	18,551,591	16,735,211	16,773,189
Operational Self-Sufficiency	1.13	1.01	1.04	1.08	1.09	1.22

Portfolio Quality

The overall quality of the group loan portfolio is poor. The differences between the different branches however are large. The total number of loans in arrears as a percentage of total loans outstanding increased from 20 percent in 1999 to 25.6 percent in 2001. This is despite the fact that many borrowers had loans with a grace period of one year. Despite the declining quality of portfolio BDFC reports an increasing recovery rate from 72.16 percent in 1999 to 82.72 percent in 2001, which demonstrates that certain caution has to be taken with recovery rates that are formulated in cumulative terms.

[25] Operational self-sufficiency is defined as: financial income (interest income + i nterest on staff loans + interest on financial investments) divided by (actual financial costs + operating expenses + administrative costs + loan loss provisions).

Table 5: Quality of the Group Loan Portfolio

Quality of the Group Loan Portfolio	**1999**	**2000**	**2001**
Number of active group members	1,683	1,645	1,425
Total principal outstanding	10,559,034	12,991,890	11,124,917
Total arrears	880,452	833,629	1,274,962
Average arrears per active group member[26]	523	507	895
Total arrears rate	8.3%	6.4%	11.5%
Arrears rate by period			
0 - 3 months	5.0%	1.2%	2.4%
4 - 6 months	1.4%	1.4%	2.2%
7 - 12 months	1.9%	3.1%	3.4%
13 - 24 months	0.0%	0.7%	2.9%
> 24 months	0.0%	0.0%	0.6%
No. of loans in arrears	337	292	365
No. of loans in arrears/number of loans O/S	20%	17.8%	25.6%
Recovery rate[27]	72.16%	79.52%	82.72%
Loan loss provision	193,165	447,810	715,869

With respect to the portfolio quality of all loans outstanding of the Agriculture Lending Department, the recovery rate is also poor. The arrears rate is very high. The aging report shows that there is virtually no improvement in portfolio quality management over time for loans with arrears less than 12 months. The average arrears per borrower remains the same despite write offs and rescheduling. In the branches the recovery rates vary from a minimum of 38.93 percent to a maximum of 95.27 percent. Across the board one in three borrowers was in arrears in 2001. The figures show that both the arrears rate and the recovery rate obscure the true quality of the portfolio. In addition, both rates can be easily influenced by write off and rescheduling and also by providing loans with long maturities and/or grace periods. Sudden deterioration of the quality of a loan portfolio is hard to measure with recovery rates based on cumulative figures because of arithmetic reasons. BDFC is not yet able to produce aging reports of the portfolio at risk that reveals the principle balance of loans with arrears. The staff of BDFC reasoned that the recovery rates and loan arrears rates are still depressed by inferior loan processing methodologies applied before 1998, whereby the local government decided on loan approvals. Many of these loans are not collectable and few have been written off.

[26] Arrears rate is calculated as the total amount of arrears/principal balance of loans outstanding
[27] Recovery rate is calculated as the cumulative principal repayments/cumulative principal payments due

Table 6: Quality of the Total Loan Portfolio

Quality of Total Loan Portfolio	1998	1999	2000	2001
Number of loans outstanding	9,426	10,407	10,055	11,061
Total principal outstanding	165,200,406	165,591,798	183,378,222	226,966,256
Total arrears	29,730,109	28,690,259	24,118,941	27,027,748
Average arrears per borrower	3,154	2,757	2,399	2,444
Total arrears rate	18.0%	17.3%	13.2%	11.9%
Arrears rate by period				
0 - 3 months	2.10%	2.50%	1.59%	2.50%
4 - 6 months	1.59%	1.50%	1.22%	1.30%
7 - 12 months	2.92%	2.90%	2.16%	1.90%
13 - 24 months	3.84%	3.60%	2.32%	2.10%
> 24 months	7.55%	9.10%	5.85%	5.40%
Number of loans in arrears	4,447	4,561	3,442	3,634
No. of loans in arrears/total loans O/S	47.18%	43.83%	34.23%	32.85%
Principal balance of portfolio at risk	NA	NA	55,965,500	70,443,480
Portfolio at Risk	NA	NA	31%	31%
.Recovery rate	63%	71.55%	76.34%	77.33%
Loan loss provision	30,989,215	34,312,666	42,014,428	47,416,650
Loan loss provision/total principal O/S	18.76%	20.72%	22.91%	20.89%

Maturity Periods

The average maturity period remains long compared to international standards for similar loans. Of the total accounts outstanding in 2001, 4 percent has a loan period of less than one year, 38 percent between one to three years, and 48 percent between three years to 5 years and 10 percent of 5 years or more. The arrears rate was 12 percent for loans with loan periods of less than one year; 7 percent for loans with a loan period between one to three years; 13 percent for loans with a loan period between three years to 5 years while loans with a loan period longer than 5 year have an arrears rate of 22 percent. This indicates a positive correlation between maturity and arrears rate. It should be noted that loan periods are often pegged to loan size instead of cash flows. For instance, shopkeepers and traders with high cash flow turnover also received working capital loans with a five-year term. Credit officers prefer loans with a long maturity because it diminishes their workload in terms of loan processing and monitoring. These are the main reasons that only 4 percent of the loans have a loan period of less than one year, irrespective whether it concerns agricultural or non-agricultural loans.

Productivity

Over the three year period between 1999 -2001 a slight improvement was made in terms of number of clients per staff member. The liquid assets to total assets remained very high at 35.55 percent at the end of 2001. This ratio declined to 26 percent at the end of March 2002 due to high disbursements in the first quarter. These ratios indicate that BDFC remains with an excess liquidity which it apparently cannot on-lend. The administrative efficiency has considerably improved due to improved cost management, mobile banking and simplification of procedures. This has also led to a decline in average operational cost per client. The average amount outstanding per loan officer is increasing mainly because the average loan outstanding is increasing. The ratio of head office staff to field staff is very high.

Access to Capital

The equity base of ALD in 2001 consisted of share capital (33 percent), UNCDF contributions (38 percent), RGOB reserve (14 percent), retained earnings (11 percent) and other capital (4 percent). The liabilities consisted of a 10-year government bond (63 percent), and IFAD loan (18 percent) and current liabilities (19 percent). The 10-year government bond was received in 1998 when BDFC was experiencing liquidity problems. The balance sheet of ALD in 2001 looks very strong given a liquidity to assets ratio of 35.55 percent and an equity to total assets of 72 percent. Given the present growth rates and the relatively high penetration rates it is expected that ALD will have sufficient liquidity for the coming years, provided that the quality of its portfolio does not decrease further and the operational self-sufficiency is maintained.

Most growth in the portfolio has come from an increase in loan sizes. If such growth continues than, in time, additional capitalization might be required. Given the limited profitability and the low portfolio quality, among others, it does not seem likely that BDFC could obtain additional funding through commercial sources. The present legal and operational status of BDFC does not allow BDFC to collect deposits from the public. The profitability trend over the past years indicate that ALD is not expected to be able to afford market rates on loans from government or development agencies unless major changes occur in the productivity, portfolio quality and pricing policies of BDFC. It is therefore likely that the only source of funding in the future could come from grants or soft loans from government and development agencies. At present, BDFC has received the first series of a Rural Credit Bond financed by the Government. In addition, a credit line has been made available by IFAD under the AMEPP.

Monitoring System

BDFC has a monitoring system in place and generates several types of reports. However, there are several problems with its system. The reports on loan disbursements and loan repayments are made on a cumulative basis. It is not possible to know exactly what loan amount has been truly disbursed during a year and what amount of principal has been repaid. The management information system is not able to provide information on interest and principal due and received. When a repayment is made principle and interest are not separated. Hence, it is not possible to know the actual incoming cash flow from interest and principal. No overall systematic analysis is done of the quality of the portfolio to trace the causes of delinquency. Bad loans can be tracked by sector, product, purpose, branch, maturity, gender, size, credit officer, etc. which would provide information that could lead to improvement in product policies and methodologies, diversification of portfolio, human resource policies and management. At present the Regional Manager and the District Credit Officer review loans with arrears on a case-by-case basis.

No information is available on branches as fully-fledged profit centers. The branch reports do not include costs like depreciation, provisioning and (imputed) cost of capital. The balance sheet and income and expense account are not adjusted for (implicit) subsidies. Such information is vital in order to understand which branches are viable and which are not. Even after the BDFCs management introduced a profit center approach it did not put in place a system to actually assess the costs and profits of a branch and thus the introduction of the concept was meaningless.

BDFC does not prepare financial projections. The only projections available are related to loan disbursements, targets and recovery rates. No comprehensive balance sheet, income and expense accounts and cash flow projections are available. This seriously hampers any financial planning.

Institutional Strengthening

BDFC is being assisted with institutional strengthening by several donors such as the Asian Development Bank, the International Fund for Agriculture Development, the Netherlands and the German Government. ADB has provided technical assistance and IFAD has provided resources for revolving funds and for strengthening its management and implementation capabilities, especially in monitoring of its portfolio. The Asian Development Bank has supported BDFC in enhancing its governance, increasing operational efficiency, and raising institutional capacity. The Technical Assistance from ADB focus on improving its operations and business development, governance structure, new strategy and business plan (2007–2011), development of demand-oriented products, product pricing and policies regarding risk management, credit risk management, funding and asset liability management.[28] The TA was also expected to help BDFC with the expansion of its rural saving scheme partly to help it address the external funding issue. The Netherlands Development Organization (SNV) has also assisted with strengthening the capacity of the organization.[29] World Bank has not provided direct assistance to BDFC but is assisting the banking sector by helping to develop the information Technology Infrastructure.

[28] SME/Microenterprises Development Program. ADB.
[29] Report and Recommendation of the President to the Executive Board on proposed financial assistance to the Kingdom of Bhutan for the Agriculture, Marketing and Enterprise Promotion Programme. IFAD. 2005

Chapter 5: Demand Side of Microfinance

A. Demand for Microfinance

There have been few studies to assess the overall level of demand for credit. A few studies which have been undertaken are thought to underestimate the demand for credit. A rural credit demand assessment survey was conducted in April 2000 by a local consultancy bureau.[30] The survey provided an assessment of the market for rural credit. The objective of the study was to assess the scope for development of the rural credit program of ALD and the actual credit needs of the rural population. On potential credit demand for rural finance the survey report stated that there were an estimated 65,899 rural households. BDFC had already covered 10,799 of these households leaving a balance at the national level of 55,100 households. Of these 10,469 households are in the high-income districts, 24,244 are in the medium-income districts and 20,387 households are in the low- income districts. The survey reported that for the coming five years there was a demand from low-income households for 1,019 loans per year for an amount of Nu. 3,668,400 and a demand from medium-income households of 1,212 loans per year for a total amount of Nu. 7,272,000. Some feel that the findings of this study grossly underestimate the credit demand in the country.[31]

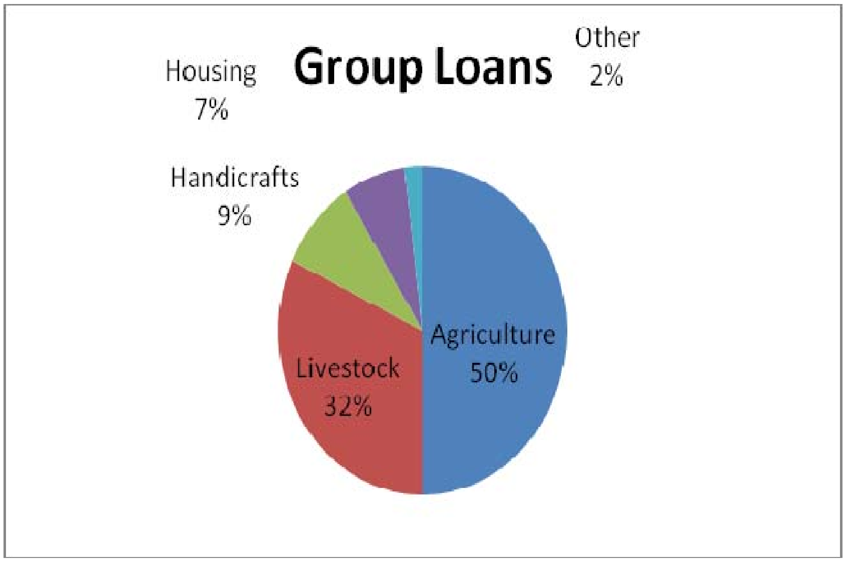
Donor appraisal reports maintain that the poorest households require loans to meet emergency needs. Poor households in remote areas resort to distress sale of their assets or borrow money from the moneylenders at rate of interest as high as 60% per annum severely reducing their ability to move up the development ladder.[32] For the purposes of estimating credit demand in Bhutan it was assumed that at any given time 50% of the rural households would require a loan. Thus around 43,000 households would require credit at any given time. BDFC was addressing the needs of 34% of the rural households demanding credit in 2005. CGAP estimates that only 16% of the people in Bhutan have access to financial services. If one estimates that the demand of each household is around Nu 20,000 then in 2005 BDFC was supplying around 26% of the total need in terms of the loan size. However, households are very selective about their borrowing. The demand for credit from BDFC is reported to be small The main reasons for this is said to be the (i) time lag between the need and the availability of loan; (ii) documentation requirements of BDFC; and (iii) collateral requirement of BDFC. [33]

B. Purpose of Loans

With respect to the sector diversification of the portfolio, 50 percent of the group loans were for agricultural purposes, 32 percent for animal husbandry, 9 percent for handicraft, 7 percent for housing, and the remaining 2 percent for other purposes.

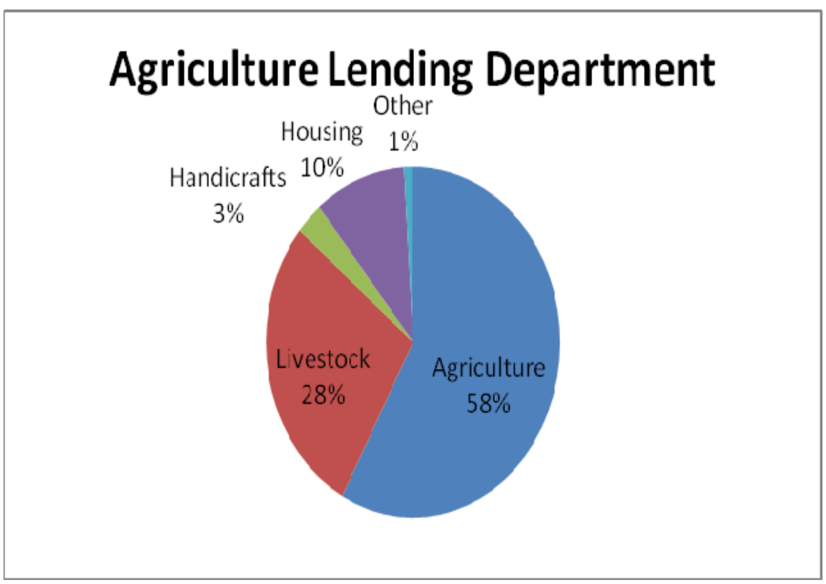
[30] Rural Credit Demand Assessment Study, April 2000, Kyingkhor Consultancy
[31] Mid Term Evaluation Bhu/98/Co1. Strengthening Capacities for Sustainable Microfinance. Draft Evaluation Report. Prepared by Peter Kooi and Hedwig Siewertsen, Facet Bv For Netherlands Development Organisation. United Nations Capital Development Fund New York, United States of America. 2002.
[32] IFAD. Mid-Term Review of the Agriculture Marketing and Enterprise Promotion Programme. 2007.
[33] IFAD. Mid-Term Review of the Agriculture Marketing and Enterprise Promotion Programme. 2007.

Figure 3: Purpose of Group Loans



The sector diversification for the total loan portfolio was as follows; 58 percent for agriculture, 28 percent for animal husbandry, 10 percent for housing, 3 percent for handicraft, and the remaining 6 percent for other purposes. Trend analysis indicates that ALD has been successful in further diversifying its portfolio in terms of sectors and also in terms of loan sizes, the latter mainly due to the GGLS loans.

Figure 4: Purpose of Agriculture Lending



C. Impact of MicroFinance

The principal goal of the Agricultural Lending Department of BDFC is to assist the small rural entrepreneurs to increase on-farm and off-farm production and income, thereby improving their standard of living. The increase in production on a nation wide basis will assist Bhutan to become self-sufficient in food, which is one of the major aims of the government.[34]

Rural financial services are an important instrument to help the target group build assets for sustainable development. The market environment in Bhutan is not as favorable for microfinance relative to many other developing countries. The transaction cost for both the microfinance operator and the clients are very high due to the rugged terrain, low population density, scattered nature of settlements which are often inhabited by only a small number of households, and inaccessibility of many locations, except by foot. In most areas there is a lack of markets while in the remote villages barter is prevalent and, consequently, the notion of credit is low. Most people are subsistence farmers with little incentive to produce a surplus to increase income due to lack of markets and infrastructure. Potential business opportunities are limited.

BDFC reports that the microfinance programme has made a significant difference in improving the income and quality of life of the rural farmers, directly or indirectly. Extension of credit facilities have not only enabled rural people to be more receptive to new technologies, improved practices of farming, utilization of new seeds/seedlings or plants, and applications of fertilizers and plant protection chemicals, but also made it possible for them to actually obtain and use the various new extension packages developed or improved varieties being promoted by organizations like the Ministry of Agriculture.[35] Without these credit facilities, efforts made by researchers, extension agents and district authorities would make little difference, as most farmers would not be able to afford to obtain seeds/plants of the promoted varieties. The credit component that plays a catalytic role in harnessing the benefits of research and extension.

D. Case Study of Some Groups

The Trashigang centre meeting regroups 9 groups consisting of between 3 to 6 women. The groups have a monthly meeting in Khaling which is a small trading centre situated between 0 to maximum 10 kilometres from the clients' homes. The groups were formed in October 2001 with the assistance of the village leaders and BDFC staff following public meetings and house-to-house promotion visits during which the group scheme was explained. The groups were formed for the purpose of getting a loan but all the members know each other well because they live near to each other. None of the members had a BDFC loan in the past because they lacked sufficient collateral. When sufficient women had shown an interest in the group-lending scheme BDFC staff conducted a GGLS introductory training in group formation and functioning, GGLS procedures, loan use and other related issues. The group leaders were chosen on the basis of their literacy, capacity to speak in public and leadership qualities. After the groups were formed and the first loans were disbursed, many women decided to assist each other in operating their businesses in order to reduce risk.

Some groups helped each other with the potato seed planting others pooled part of their loans together in order to travel to the Indian border and do common purchase of fresh meat. The first loan cycle has been most successful for the traders: the women made a good profit and were able to repay their loan with the earnings.

[34] Business plan 2000 - 2002 of the Agricultural Lending Department of BDF
[35] BDFC. Annual Report 2001.

The manufacturers (weaver and tailor) had much more difficulties to make good use of the loan: as the market for their products is very small so the products produced with the loan have not yet been sold. The future concern of the group members is the size of the market: if more people receive larger loans, more trade volume can be generated until the market is saturated. Due to the low population density it is quite likely that this saturation point will be reached pretty soon.

The group of four men in Trashiyangtsi know each other since they were young. They have been doing some trading business on the basis of suppliers' credit, which costs 60% interest per year. The village leader and BDFC credit officer invited them to come to a meeting to get explanation on the group-lending scheme. The men decided to form a group in order to improve their living conditions and to access a cheaper source of credit. Three months after the group was formed they received the loan of Nu. 5,000 each.. Two group members started to trade in handicraft products in Thimpu.. Because of the relatively low interest rate, they expect to make a good profit from this business. One other group member paid labourers (Nu. 60/day) for his rice field; this enabled him to work on other people's fields, which earned him Nu. 200 per day. Last year the rice field labour was exchanged on an in-kind basis, this year the client expects to have some cash savings. The group leader bought a draught ox, which enables him to cultivate more land. The advantages of the group scheme are the low interest, the possibility of co-guaranteeing each other's loan and the collaboration in the group. The monthly meetings are sometimes considered as unnecessary, especially if there are no transactions.

The women groups in Kalikhar (Mongar district) were also formed after the public meetings of the village leaders and BDFC staff. Some of the members formerly borrowed from the moneylender at 5% interest per month. These loans were used to pay public utilities and taxes. The BDFC loans have been used for meat and vegetable trading. Like in Khaling the women have pooled their loans together in order to purchase meat and vegetables in bulk, which can be retailed in Mongar market. In the past 4 months, the group has made 8 trips to the Indian border. By sharing the workload among the group members, the activity does not affect the other work of the women. The main concern of the women is the failure of the business (loss or perishing of products) and risks related to borrowing. But being in a group also means helping each other when things go wrong, so that reassures the women.

Chapter 6: Regulatory Framework

A. Overview

The regulatory framework of the microfinance sector has to be understood in the context of the ultimate goal of Bhutan's development policy which is achieving Gross National Happiness (GNH).[36] Bhutan has cautiously followed the "middle path" balancing economic development with environmental conservation. Bhutan continues to pursue a holistic development approach placing people at the centre of development to ensure all plans; programs and economic reforms create an enabling environment for the people to achieve economic prosperity and happiness. With Bhutan's economy closely integrated to the Indian economy, and with the Bhutanese Ngultrum (Nu), pegged at par with the Indian Rupee, the scope for an independent monetary policy has been limited. However, there has been significant development in the monetary framework ranging from introduction of monetary instruments to strengthening of prudent regulations and improving efficiency and greater competition in the banking and financial system.

The Financial Institutions Act and the Company Act govern financial institutions. The Royal Monetary Authority of Bhutan (RMA) supervises the financial system and fulfils the role of a Central Bank. The Royal Monetary Authority (RMA) is responsible for monetary policy, issuing currency notes, the management of the country's reserves and supervision of the banks and financial institutions. The RMA's monetary policies involve maintaining price stability through the established exchange rate link with the Indian Rupee and, the management of money supply. Sterilization of excess liquidity in the financial markets will be major monetary issues that will be managed through the various available instruments such as the RMA discount bills and treasury bonds. The RMA played a key role in directing credit and interest rates in accordance with sound management and long-term development goals of the economy. Deregulation of interest rates was among the principle objectives of the monetary policy in the 8th Five Year Plan. The RMA set a first step in 1997 by allowing financial institutions to set their interests rates with the restriction of a 6 percent interest spread. In 1998, RMA initiated the process of strengthening prudential norms for financial institutions. Since 1998, the regulations of RMA are gradually moving to the prudential guidelines for financial institutions as laid down by the Bank for International Settlement (BIS) while interest rates have been deregulated. At present the RMA is receiving technical assistance from the ADB to strengthen its regulatory and supervisory capacity.[37]

B. Specific Regulatory Issues Regarding BDFC

The BDFC board and management were to pursue efforts with the RGOB and RMA with the objective to encourage establishment of an appropriate legislation and regulatory framework for the rural banking sector. Initially BDFC was subject to the same regulations as commercial banks even though it was a non-bank institution. It was therefore felt that the RMA should adopt a more lenient approach towards BDFC, with regard to its prudential requirements, also taken into account its specific social mandate. In addition, it was

[36] Sonam Tobgay. Small Farmers and the Food System in Bhutan. Agricultural Marketing Services. Ministry of Agriculture. FAO Symposium on Agricultural Commercialization and the Small Farmer, Rome, May 2005.
[37] Peter Kooi and Hedwig Siewertsen Mid-Term Evaluation BHU BHU/98/CO1. Strengthening Capacities for Sustainable Microfinance Draft Evaluation Report. FACET BV For Netherlands Development Organization. Bhutan. United Nations Capital Development Fund. May 2002.

viewed that BDFC should have autonomy in setting the interest rates at levels that would enable it to become self-financing. In 1997, the RMA further liberalized the interest rates for lending, except for agricultural loans, under the condition that the interest margin does not exceed 6 percent. Given that BDFC is not a deposit taking financial institution the RMA takes a relaxed approach with respect to supervision of the ALD department of BDFC. The regulations on collateral are for instance not stringently applied. Also other regulations with respect to provisioning are broadly adopted. The RMA perceives that the ALD department of BDFC is fully reliant on donors and government subsidies. At present, the RMA considers ALD more as a subsidized activity than as an integral part of the financial system. With support from technical assistance of the Asian Development Bank, RMA is actively working to further develop the regulatory framework and other measures required to increase the integrity and development of the financial sector. Non-bank financial institutions are still subject to the same regulations as commercial banks.

The RMA has periodically voiced two concerns with respect to BDFC. The first concern is due to the fact that BDFC provides commercial lending through ILD and subsidized lending through ALD. RMA considers that such a dual focus could undermine the confidence of the public in the financial system because there is no clear distinction between subsidized lending and commercial lending within BDFC. Secondly, the RMA is concerned that the ILD cross subsidizes ALD.

C. Future Plans

The future priorities for the RMA include strengthening of the financial sector through the following priority programs and activities:

Strengthening of Legal Framework

The strengthening of the legal framework for the banking sector is essential for facilitating the enforcement of financial contracts, loan recovery and realization of collateral. Various acts such as the Moveable and Immovable Property Act and the Bankruptcy Act have already been promulgated and the RMA has to work closely with the judicial system to implement the laws for the enforcement of economic rights and obligations. In addition the RMA will draft an Insurance Act, and in due course revise existing legislation such as the Financial Institutions Act and the RMA Act where necessary.

Strengthening of Payments and Clearing System

There is only a single clearinghouse in the country for local cheques. Given the need to develop banking culture and increase confidence in the utilization of cheques, of the establishment of additional clearing houses to other parts of the country is a priority programme.

Setting up a Credit Information Bureau

Presently, the loan approval process involves obtaining information from each of the financial institutions for a detailed credit history of the loan applicant. The establishment of a Credit Information Bureau as a priority programme would help streamline and expedite the loan approval process. The Credit Information Bureau would thus make a loan application process more efficient and effective. The Kingdom of Bhutan has received a Technical Assistance grant from the Asian Development Bank (ADB) towards the (i) procurement and installation of the credit information software and appropriate technological and physical infrastructure (including software, hardware and technology solution) to set up the data center, and (ii) capacity building of CIB staff for the proper operation and management of the CIB system. Bids were invited for the supply and installation of Technology and Physical Infrastructure for Credit Information Bureau of Bhutan at the end of December 2008.

Strengthening of Royal Securities Exchange of Bhutan

The RSEB established in 1993 has provided a small capital market and has been useful in the divestment of government holdings to private investors. However, the exchange is still very much in its infancy and needs to be further developed. At the same time, the RSEB must educate the public about its role and use of the exchange in the economy.

Rural Credit Programme Information Technology in the Financial Sector

The present IT capacity base and resources within the financial sector are inadequate and the sector is overly reliant on manual systems and procedures, there is an urgent need to strengthen and enhance the financial system operations through a modern, harmonized and properly networked, user-friendly IT system. The RMA envisages the future introduction of a common platform for the IT bases of all financial institutions to standardize accounting systems, interest calculations, and data reporting which would contribute to reliable, prudent and efficient supervision of the sector and the compilation of monetary statistics.[38] The World Bank is assisting the RMA to introduce IT systems in the country.

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[38] Third United Nations Conference on the Least Developed Countries. Country Presentation. Bhutan. 2001. Brussels, 14-20 May 200. Presentation of the Royal Government of Bhutan. Action Programme for the Development of Bhutan, 2001-2010.

Chapter 7: Challenges Facing the Microfinance Sector

A. Overview

The microfinance sector in Bhutan faces several challenges some of which are due to the unique characteristics of the country, some are due to the peculiar pattern of economic growth and development and others are related to the manner in which microfinance programmes have been designed and managed. Bhutan is unique in the manner in which the microfinance sector has evolved and continues to grow and is unusual in the SAARC region. The difficult terrain in the country, lack of physical and communication infrastructure, the low population density and the small population size present special challenges for the microfinance sector. The nascent nature of private sector, combined with the small size of the economy, has contributed to the under development of the financial sector in Bhutan. Despite these difficult challenges, the distinctively Bhutanese concept of maximising Gross National Happiness, propounded by King Jigme Singye Wangchuck in the late 1980s outlines some promising guiding principles. It forms the basis for identifying directions that are preferred above all others and has directed efforts to improve living standards, including spiritual well-being and preservation of cultural values and the physical environment.

B. Economic Growth and Development

One of the challenges Bhutan faces is with structural impediments, characteristic of small and landlocked economies which make transportation costs high and global integration difficult. In addition, there are numerous risks and difficulties for Bhutan associated with economic globalization and the constantly evolving and often volatile international and regional trading environments. Bhutan requires concerted efforts for private sector development, promotion of foreign direct investment and increase in regional trade. . While past development efforts have created a favourable and enabling environment with regard to the establishment of a basic infrastructure and the creation of a relatively modern economic production base, the focus now will need to shift towards developing a more diversified, sophisticated, monetized and globally integrated economy that grows sustainably, while ensuring and upgrading the quality and equitable spread of public social services. The RGoB has further set itself the task of fulfilling these important development objectives without undermining its natural environment and cultural heritage.

C. Financial Sector Issues

A strong financial sector is critical for the growth of the private sector in Bhutan. Many of the financial institutions in Bhutan face excess liquidity problems which can be attributed to the lack of investment opportunities in Bhutan and problems with limited financial intermediation. [39] A prominent issue in the 1990s was the significant build up of excess liquidity with the various financial institutions in the country largely due to credit policies. In this regard two key challenges were identified for the commercial banking sector. The first was to create credit and the other was to encourage saving and thrift among those with a productive surplus and to allocate savings in the most socially productive manner. The ability to create credit is important

[39] Private Sector development Project. World Bank. 2001.

not only because it can compensate for the failure of the economic system to equalise planned savings and investment but it also provides the means by which economic growth is financed. Thus, credit allows the Bhutanese economic system to expand in response to the opportunities for growth provided by technical progress, which a barter or semi-barter economy does not allow.

Towards improving the financial system and intermediation, several key reforms were introduced in the 1990s, such as the introduction of various securities and instruments to mop up excess liquidity, liberalization of interest rates, the creation of a second fully commercial bank, revision of cash reserve ratios, the introduction of RMA discount bills and government bonds, and a reserve repurchase scheme. Notable monetary developments in the 1990s have been the deregulation of foreign exchange, the establishment of a stock exchange, the introduction of the Bankruptcy Act and the Moveable and Immovable Property Act. The RMA has also formulated a comprehensive strategy for the financial sector.

Information Technology is underdeveloped and most accounts are still managed manually which has led to the financial sector being in a rudimentary stage. Unbalanced IT development exists between the Bhutan National Bank (BNB) and the Bank of Bhutan (BOB), which has been hampering the development of nationwide financial IT infrastructure including inter-bank electronic fund transfer system. Almost the entire financial operations and transactions in BOB are currently being carried out manually, which is both time-consuming and contributes additional costs to BOB. This underdeveloped IT system in BOB leads to operational inefficiency in the overall banking sector which, in turn, impedes the growth of private sector in Bhutan.[40] The nationwide financial IT infrastructure cannot be efficiently built up without enhancing the level of IT system in BOB. There are only 0.3 ATMs per 100,000 people in the country[41]. Given the rapid changes and growth in the financial and IT industry, IT development in the financial sector in Bhutan needs to be carried out in a more holistic way. Among other things, it involves development of a concrete strategy, regulatory, and legal framework and institutional arrangements, coupled with a detailed technical implementation plan for financial IT infrastructure. A World Bank Project was helping to upgrade the IT system in the BOB to enable the institution to accommodate the newly designed inter-bank Electronic Fund Transfer Clearing System.

D. Agriculture Sector

An analysis of the use of microfinance indicates that 80 to 90 percent of the rural credit is being used for agriculture and livestock activities. This further reinforces the importance of agriculture for rural livelihoods especially for rural households. Production is related to increasing farm productivity either through expansion in yields or cultivation acreage. Since commercialization is restricted due to terrain and farm size, concentration thrust would be towards growing high value cash crops. Given the wide agro-ecological zones, it is possible to grow a diversity of crops taking advantage of the difference in altitude ranging from 150 meters to 4500 meters. Response of farmers to price changes depends crucially on their ability to acknowledge price signals, which depends, in turn, on information, transport, infrastructure and access to agricultural inputs.

[40] World Bank: Project Appraisal Document. Private Sector Development Project. Kingdom of Bhutan. May 17, 2007.
[41]Project Appraisal Report. Private Sector Development. World Bank. May 2007.

Land fragmentation which is taking place due to demographic pressure and inheritance laws poses another challenge. In addition, valuable agricultural land has given way to government construction like housing colonies, national highways and other infrastructures. These factors pose a serious challenge to the food security concerns of the country, but more importantly it brings forth a grave threat to the livelihood of the small and marginal farmers. The forces of globalization could overwhelm small economies like Bhutan and therefore a conscious effort needs to be taken to protect small farmers. In the absence of any formal institution representing the farming community, it is the responsibility of the government to ensure that such important sectors of the society constituting a majority of the population are not left behind. Given this fact, it is crucial to maintain strong political will and sound public policy to successfully create an enabling environment for this group. National policies must accordingly be tuned keeping in mind the marginal subsistence farming and thus further strengthening investment efforts in research and extension, basic technology, mechanization and training.[42] Secondly, there is a need to promote a group of middlemen or co-operatives, who can act as merchants that promote economic linkages within the country as well as outside Bhutan. In many other countries co-operatives have facilitated the establishment of important backward and forward linkages associated with the production process, and with a Co-operatives Act ready for endorsement, this area needs further attention.[43]

E. Labour Issues

The microfinance sector does not address the needs of the urban poor in Bhutan. While the BDFC has been providing microfinance services designed for the agriculture sector there are no specific products which have been designed for the poor households in urban areas. This is in sharp contrast to other countries in the region where microfinance is mostly being used to finance trade in urban areas. The rural urban migration pattern in the country indicates that rural to urban migration is on the rise in Bhutan leaving village homes to the ageing population or to hired caretakers. Extreme cases have resulted in even abandoning of villages in search for more opportunities in urban areas. National concern has been raised on rural migration into urban centres, with many migrants looking for better-paying jobs. The rate of urbanisation is high, with migration not only to the main receiving centres of Thimphu and Phuentsholing, but also to general urban centres in rural Bhutan. The amenities of and public services of the urban area are attractive in themselves to labour from the rural sector. But in the case of Thimphu and Phuentsholing, there is no doubt that the strongest inducement has been the widening income difference between urban wages and rural income, at the same time as rural employment opportunities have not expanded. Some of those formerly in “disguised unemployment” in the rural sector have, in effect, transferred into visible unemployment in the modern sector.

Although data are lacking, it can be argued that the employment problem in the urban areas has been the result of a premature increase in the wage level combined with a premature reduction in agricultural employment. The high level of unemployment among school leavers supports this. Not only are there school leavers within Thimphu and Phuentsholing, but also those who attend schools in the villages reject the traditional occupations on the land and migrate to urban areas in search of wage-paid jobs. To a lesser extent, but still of importance, it seems that labour is being released from the very labour-intensive indigenous handicrafts industries that cannot compete with the growth in the new manufacturing activities. A large dilemma facing Bhutan is that, on the one hand, there is a significant shortage of human resources to cater to increasing development activities – explaining the sizable presence of up to 60,000 expatriate workers – while, on the

[42] Sonam Tobgay. Small Farmer and the Food System in Bhutan. Ministry of Agriculture. Royal Government of Bhutan.
[43] Ibid.

other, the increasing national workforce is for the most part untrained and with few skills to meet the demand of the market. Despite the current unemployment rate of 1.4%, the primary issue is not lack of employment opportunities but the mismatch between demand and supply of human resources.

If the present trend of rural-urban migration continues and the agricultural workforce declines at the rate of 1.3% per annum, around 34,000 persons will migrate from the rural areas to seek employment in the modern sector over the next 10 years. It is estimated that the present urban population of 90,000 will increase to 400,000 by the year 2020; thus, more than 100,000 new jobs will need to be created in the urban sector alone by the year 2009.[44]

The issue of a better matching of demand and supply, by improving the quality of the labour force through upgrading of skills, vocational training and increasing the access to further education, is closely linked to the educational infrastructure. At present there are 19 training institutes in the country, with an intake capacity of about 900 per annum. Hence, there is a large imbalance between the number of school leavers and the capacity of training institutes, especially if the intake capacities of the vocational and educational institutes remain stagnant. This calls for an in-depth analysis of the current workforce to chart a course of action. There will be large numbers of literate but unskilled workers entering the labour market. The situation is likely to worsen because the growth in employment opportunities in the civil service – the major employer of the educated in the past – is likely to be limited. Development of a special loan product to help these young men and women establish their own business enterprise is a special challenge for the microfinance sector in Bhutan.

F. Challenges Facing the BDFC

There is only one public sector institution which is trying to meet the diverse needs of the microfinance market in Bhutan. The products and delivery strategy only address part of the needs of the agriculture sector and there is no specially designed product for the urban poor. BDFC is attempting to be financially sustainable through its industrial lending product while subsidizing the agriculture portfolio. This puts a special strain on the organization and does not provide the incentives to expand its rural outreach. Its growth in the last few years has been modest, its portfolio quality is poor and its lending methodology and collateral requirements are such that demand for its services is low. Some of the key issues BDFC faces are outlined below:

Vision and Mandate

- The current focus of BDFC represents a hybrid approach between the old bureaucratic, beneficiary-orientated approach and a businesslike and client-orientated approach. This hybrid state of affairs across the board created cognitive dissonance among staff of the ALD. Combing these two

[44] UNDAF. Bhutan: Moving Toward a Common Understanding of the Key Development Challenges in the Country. Common Country Assessment. 2000

approaches presents a difficult challenge which it may not be possible to reconcile. A key question is whether ALD prefers to fall back towards the initial approach as a distributional channel for Government directed credit, albeit in a somewhat more efficient and effective manner, or whether ALD is determined and allowed to pursue gradual transformation into a self-financing and sustainable financial institution. It is of critical importance that all relevant stakeholders arrive at a common vision on the future development of ALD, its main corporate objective and its mandate. Without such a shared vision it will be hard for ALD to increase the quality and effectiveness of its operations.[45]

- Although the present business plan is a major step in the right direction, considerable work needs to be done to develop a full-fledged business plan. The business plan needs to provide a clear insight into envisaged governance and ownership structure, the institution's objective and strategies, staffing, its markets, products and product methodologies, expansion, detailed financial projections, capital budgeting, cash flows etc.

- The decentralization process initiated some years ago requires additional capacity building of project staff and a further refinement of the profit centre approach. The branches are not yet fully informed of implicit and explicit subsidies. Some branches are not yet fully aware of their responsibilities and wait to take initiatives until head office provides instructions. Some branches perceive the management information provided at branch level as report to be submitted to head office rather than as a tool to improve their performance. If the objective is to transform the present branches into semi-autonomous branch offices that are responsible and to optimize sustainability and outreach considerable work needs to be done.

Credit Accessibility and Outreach

- There has been slow growth in credit outreach and most of the growth has come in terms of loan amount rather than number of loans indicating that loan size is increasing and that the needs of poor rural households are not being addressed.

- The microfinance sector has not developed a product for the urban poor.

- In view of the smallness of the loan, difficult terrain and scattered settlements, the cost of both providing and obtaining credits are high.

[45] Peter Kooi and Hedwig Siewertsen Mid-Term Evaluation BHU BHU/98/CO1. Strengthening Capacities for Sustainable Microfinance Draft Evaluation Report. FACET BV For Netherlands Development Organization. Bhutan. United Nations Capital Development Fund. May 2002.

- The transaction costs for the borrower are often high due to the distance of the district office and long and cumbersome loan approval procedures. This results in high opportunity costs in obtaining a loan and low demand for BDFC's products.

- The savings product which has been identified as part of the GGLS appeared to be a disincentive

Sustainability

- The RGOB requires that as part of its social mandate, BDFC operates in all districts and serves the entire rural population.

- The density of population is quite low which is about 13 persons per square kilometers on an average in Bhutan and makes it difficult for an institution like BDFC to operate Microfinance.

- The low rate of recovery has been one of the major problems encountered ever since the inception of BDFC. Although the recovery rate has been increasing gradually over the years, BDFC needs to further work towards achieving a higher rate.

- In the rural areas, the lack of motorable roads and regular transport facilities have also acted adversely for farmers taking active part in the Microfinance programs.

- Lack of market for the local produce not only reduces the demand for credit, but also contributes to their failure in meeting loan repayments.

- Most microfinance loan repayments are made on longer term basis as they do not have the ability and capacity to pay back faster. This arrangement impedes quick recycling of available funds and higher earning opportunity for the MFI.

- Current level of the interest earnings of the portfolio does not cover actual overhead costs of administering and managing the microfinance programme.

Loan Appraisal Methodology

- There is no strategy developed to test new financial products such as the Group Guarantee Lending Scheme.

- The present cumulative and on time recovery rates were well below levels permitting operational self-sufficiency.

- The average loan maturity was estimated at around 5 years. Such un-favourable maturity composition of the portfolio plus the current practice of annual repayments for the smaller sized loans result in a low level of fund recycling and delays loan repayments.

- Loan appraisal methods were not based on an objective assessment of the client, the client's project and repayment capacity.

- Portfolio quality has been affected by (i) weak loan appraisal and monitoring systems, (ii) weak credit risk management, and (iii) inadequate internal control and audit. The portfolio quality will not improve significantly unless a significant change is introduced in these areas.

Financial Management and Management Information Systems

- The MIS needs to be expanded to provide reliable and timely information in several areas, including: cash flow statements, branch profitability statements, balance sheet, portfolio at risk, portfolio outstanding by maturity and gender; disbursement statements by loan purpose, by loan term, by gender.

- Information obtained is not always translated into information vital to optimally manage the microfinance operations. Although numerous reports are produced on defaults, it is not yet possible to obtain essential information to make a professional assessment of the quality of the portfolio.

- The existing reports do not provide complete information on the operational and financial self-sufficiency of the institution as a whole or its branches. The lack of detailed information on cash flows prevents adequate financial planning.

- The absence of detailed financial projections and sensitivity analyses impede sound strategic management.

- While plans to transform district offices into profit centres were made there was no system developed for planning, reporting and monitoring the branch operational and financial performance

Staff Productivity and Efficiency

- Several projects have contributed to the enhancement of technical skills of the staff but the incentives for innovation are limited. The corporate culture is more inclined towards risk aversion because innovation and related risk is not awarded but failures are penalised.

- Annual work plans and projections bear little relation to actual achievements. Branch staff is not held accountable for performance against plans.

- Branch staff had inadequate capability in loan appraisal and portfolio monitoring.

- The intended decentralization of credit operations both from branch to geog level and from head office to regional office have not resulted in plans for adjustments in the head office organization chart, staffing levels or job descriptions.

Resource Mobilization.

- As a nonbank financial institution, BDFC was not allowed to mobilize savings from the public. However, since 2005, it has been entitled to mobilize rural savings on a pilot basis to encourage rural savings. However, its savings program looks less like a financial product and more like a condition for receiving loans and therefore it provided little incentive for people to save with it. BDFC needs to develop a saving product which is attractive for its clients and also provides a source of financing for the institution and helps in the integration of the rural economy into the formal financial system.

- The main sources of funds are external concessional loans and grants from international agencies such as ADB, International Fund for Agricultural Development and Kuwait Fund for Arab and Economic Development. BDFC have been fortunate until now for not facing any fund crunch as the RGoB and donors have been able to provide financial resources that it required. But the situation is changing with the donor agencies coming up with stringent rules, and the demand for new credits increasing over the years.

- BDFC received a loan of Nu500 million with a 10-year tenure from BOB. Despite this, BDFC's loan portfolio growth projections for the next 5 years already exceed the organization's current funding resources. BDFC needs to develop a strategy and business plan in which it will be able to attract funds and be accountable for its performance as a development bank.

Human Resources

- BDFC has high staff turnover because of its limited benefit structure and inadequate human resources (HR) planning and management. An appropriate benefit and incentive structure should be provided to retain qualified personnel and ensure good staff performance.[46]

- A human resources development (HRD) division was established in 2003 to obtain and secure sufficient staff through adequate HR management. However, the division has limited authority and primarily provides administrative support while the management committee takes all HR and training decisions.

[46] ADB. 2005. Country Assistance Program Evaluation for Bhutan. 6. Manila; ADB. 2001. *Technical Assistance to the Kingdom of Bhutan for Financial Sector Review*. Manila (TA 3687-BHU); and ADB. 2004. *Technical Assistance to the Kingdom of Bhutan for Small and Medium Enterprises Development*. Manila (TA 4412-BHU).

Appendix : Consolidated Table on Bhutan

December 2008 (Ngultrum)

Name of MFI	Number of branches	Staff	Number of Borrowers	Loan outstanding (Ngultrum)	No of savers	Public deposits (Ngultrum)
The Bhutan Development Finance Corporation	23	185	13,887	322,000,000	9,728	137,968,384

December 2008 (US$)

Name of MFI	Number of branches	Staff	Number of Borrowers	Loan outstanding (US$	No of savers	Public deposits (US$)
The Bhutan Development Finance Corporation	23	185	13,887	6,708,333	9,728	2,874,341