ROYAL MONETARY AUTHORITY OF BHUTAN

FINANCIAL REGULATION AND SUPERVISION DEPARTMENT

PRUDENTIAL REGULATIONS 2017

In exercise of the powers conferred by the Royal Monetary Authority of Bhutan Act, 2010 and the Financial Services Act of Bhutan 2011, the Royal Monetary Authority of Bhutan (RMA) hereby issues these regulations to the financial institutions in Bhutan. These regulations shall come into force from 1st January 2018 and supersede the existing Prudential Regulations 2016. These regulations shall be amended in part or as a whole when the RMA feels the need to affect such changes.

Foreword

In exercise of the powers conferred by the Royal Monetary Authority of Bhutan Act, 2010 and Financial Services Act of Bhutan 2011, the Royal Monetary Authority hereby issues these regulations to the financial institutions in Bhutan. These regulations shall come into force from 1st January 2018 and supersede the existing Prudential Regulations 2016.

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

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

The RMA expects that the Prudential Regulations 2017 will facilitate the implementation of prudent practices and effective risk management techniques amongst financial institutions. These regulations shall also promote a level playing field for all market players, including transparency, accountability, corporate governance and fair competition. It is the RMA's expectation that all the financial institutions shall comply with and implement these regulations in an effective manner.

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

Thanking you,

(Dasho Penjore)
Governor

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SECTION 1

REGULATIONS ON CAPITAL ADEQUACY REQUIREMENTS

1.1 INTRODUCTION

1.1.1 Capital

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

To adopt the international best practices and to make the capital more risk-absorbent and build the financial sector more shock resistant and stable, this regulation determines the minimum level, the structure, and the ratios of the capital base of a financial institution, to its balance-sheet assets and off balance-sheet items. This regulation mainly seek to raise the quality and level of capital to ensure financial institutions are better able to absorb losses on both a going concern and a gone concern basis, increase the risk coverage of the capital framework, introduce leverage ratio to serve as a backstop to the risk-based capital measure and capital conservation buffer.

1.2 MINIMUM PAID-UP CAPITAL REQUIREMENT

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

1.3 MEASUREMENT OF REGULATORY CAPITAL

The capital of a financial institution, for the purposes of these regulations, shall be composed of Tier 1 capital and Tier 2 capital as defined below:

1.3.1 Tier 1 Capital

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

(a) Paid-up capital.

(b) [1]General Reserves (Statutory Reserves).

(c) Share Premium Account.

(d) Retained Earnings (Free Reserve).

(ii) In order to obtain the eligible regulatory capital for the purpose of calculating Capital Adequacy Ratio (CAR), financial institutions are required to make the following deductions from the Tier-1 capital. The claims that have been deducted from Tier 1 capital shall be exempt from risk weights.

(a) Loss for the current year.

(b) Buyback of the financial institution's own shares.

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

(c) Reciprocal crossholdings of capital artificially designed to inflate the capital position of a financial institution.

(d) Holdings of Tier 1 instrument issued by other financial institutions.

The investment of a financial institution in the capital instrument of other financial institutions contributes to the inter-connectedness amongst the financial institutions. In addition, these investments also amount to double counting of capital in the financial system. Therefore, such investments shall be subject to the following deductions:

Compute aggregate investments of a financial institution in the capital instruments of all other financial institutions and compare with 20 percent of its own capital fund.

(i) Aggregate investments less than or equal to 20 percent of its capital fund shall be given a risk weight of 100 percent.

(ii) Aggregate investments more than 20 percent of its capital fund shall be deducted from tier 1 capital.

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

1.3.2 Tier 2 Capital

Tier 2 capital, or supplementary or secondary capital which falls short of some of the characteristics of the core capital but contribute to the overall strength of a financial institution is formed as the sum of:

(a) Capital Reserve.

(b) Fixed Assets Revaluation Reserve.

(c) Exchange Fluctuation Reserve.

(d) Investment Fluctuation Reserve.

(e) Research and Development Fund.

(f) General Provisions to the extent that they do not exceed 1.25 percent of the sum of total risk weighted assets in respect of credit risk.

(g) Subordinated term debts with a minimum original maturity of at least 5 years. (The debt must be fully paid; the repayment of the debt must not be guaranteed in any form by the financial institution; the debt may not be repaid ahead of term without the permission of the RMA in writing. In case of liquidation of the financial institution, the repayment of the debt is admissible after all other creditors' claims have been met. During the last 5 years to maturity, the amount of subordinated term debt shall be included and reported in Tier 2 Capital reduced by 20 percent for each year. After the debt has matured, it shall be entirely excluded from the capital base calculation).

(h) Profit for the current year.

1.4 MINIMUM CAPITAL ADEQUACY RATIOS

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

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

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

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

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

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

For purposes of computing capital adequacy ratios:

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

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

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

(iv) Non performing loans (NPL) of related parties of a financial institution shall be deducted from its capital fund.

1.6 CAPITAL CONSERVATION BUFFER (CCB)

1.6.1 The Capital Conservation Buffer is designed to ensure that financial institutions build up capital buffers during normal times (i.e. outside periods of stress) which can be drawn down as losses are incurred during a stressed period. The requirement is based on simple capital conservation rules designed to avoid breaches of minimum capital requirements.

1.6.2 Every financial institution shall maintain a Capital Conservation Buffer of 2.5 percent of total risk-weighted assets (RWA) over and above the minimum ratios set out in Section 1.4.

1.6.3 The Capital Conservation Buffer must be met by Tier 1 capital.

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

	Regulatory Capital	**As a % to RWA**
(i)	Core Capital Ratio (Tier 1)	5%
(ii)	Capital Conservation Buffer	2.5%
(iii)	Core Capital Ratio plus Capital	7.5%

	Conservation Buffer [(i)+(ii)]	
(iv)	Tier 2 Capital	5%
(v)	Capital Adequacy Ratio (Tier 1 plus Tier 2 Capital) [(i)+(iv)]	10%
(vi)	Capital Adequacy Ratio Plus Capital Conservation Buffer [(v)+(ii)]	12.5%

1.6.5 Where a financial institution fails to meet in part or fully its Capital Conservation Buffer requirement, it shall be prohibited from declaring or paying dividends and bonuses.

1.7 ADJUSTMENT OF CAPITAL

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

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

1.8 RISK WEIGHTED ASSETS

1.8.1 For the purpose of these regulations, risk-weighted assets will be calculated by applying to the value of assets and off-balance sheet items (as calculated under Section 1.9) risk weights as follows.

(i) Zero Risk-Weighted Assets

(a) Cash in hand;

(b) Precious metals;

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

(d) Bills issued by the RMA;

(e) Both fund based and non-fund based claims on the Royal Government of Bhutan;

(f) Royal Government of Bhutan's guaranteed claims;

(g) Reserves Repurchased by the RMA;

(h) Money market instrument with remaining maturity of 90 days and less; and

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

(ii) 20 Percent Risk-Weighted Assets

(a) Claims on financial institutions in Bhutan;

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

(c) Bonds issued or guaranteed by the Government holding company;

(d) Money market instrument with remaining maturity of 91 days and more;

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

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

(iii) 50 Percent Risk-Weighted Assets

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

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

(iv) 100 Percent Risk- Weighted Assets

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

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

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

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

(e) Fixed Assets; and

(f) Other Assets.

(v) 150 Percent Risk- Weighted Assets

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

1.9 OFF-BALANCE SHEET ITEMS

1.9.1 General

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

(a) The amount of the off-balance sheet item is converted into a credit equivalent amount, by multiplying the amount by the specified Credit Conversion Factor; and

(b) The resulting credit equivalent amount is multiplied by the risk weight applicable to the off-balance sheet item.

(ii) Credit Conversion Factor refers to the percentage by which a financial institution's off-balance sheet exposures are to be multiplied, as specified, in order to express them as credit-equivalent exposures.

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

1.9.3 (i) The Credit Conversion Factor (CCF) for the off-balance sheet items net of margin money shall be as follows:

Nature of transaction	**CCF**
Direct Credit Substitutes (e.g. guarantees, letters of credit used as guarantees and bank acceptances)	100%
Transaction-Related Contingent items (e.g. performance bonds, bid bond/security)	50%
Undrawn commitments with an original maturity of over one year	50%
Undrawn commitments with an original maturity of under one year	20%
Commitments under facilities where the financial institution is able to cancel the commitment at any time without prior notice	0%

(ii) Direct Credit Substitutes means when a financial institution irrevocably undertakes to guarantee the repayment of a contractual financial obligation. It carries the same credit risk as a direct extension of credit that is the risk of loss is directly linked to the creditworthiness of the counterparty against whom a potential claim is acquired.

(iii) Transaction-Related Contingent item involves an irrevocable undertaking by financial institutions to pay a third party in the event the counterparty fails to fulfill or perform a contractual non-financial obligation. In such transactions, the risk of loss depends on the event which need not necessarily be related to the creditworthiness of the counterparty involved.

1.10 ZONES

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

(i) "Zone A" Countries

The term 'Zone A' covers full members of the Organization for Economic Co-operation and Development (OECD), as published by the OCED, and those countries which have concluded special lending arrangements with the IMF associated with the IMF's General Agreement to Borrow (GAB), as published by the IMF, provided they have not rescheduled their external sovereign debt, to official or private sector creditors, in the previous five years.

(ii) "Zone B" Countries

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

1.11 CREDIT RISK MITIGATION (CRM)

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

1.11.2 While the use of credit risk mitigation techniques reduces or transfers credit risk, it simultaneously may increase other risks (residual risks). Residual risks include legal, operational and liquidity risks. Therefore, it is imperative that financial institutions employ robust procedures and processes to control the risks arising from the use of credit risk mitigation techniques.

1.11.3 Legal Certainty

In order for financial institutions to obtain capital relief for any use of CRM techniques, the following minimum standards for legal documentation must be met.

(i) All documentation used in collateralized transactions must be binding on all parties and legally enforceable in all relevant jurisdictions.

(ii) Financial institutions must have conducted sufficient legal review, which shall be well documented. Such verification shall have a well-founded legal basis for reaching the conclusion about the binding nature and enforceability of the documents.

(iii) Financial institutions shall also undertake such further review as necessary to ensure continuing enforceability.

1.11.4 Credit Risk Mitigation Techniques - Collateralized Transactions

(i) A collateralized transaction is one in which:

(a) financial institutions have a credit exposure and that credit exposure is hedged in whole or in part by collateral posted by a counterparty or by a third party on behalf of the counterparty; and

(b) financial institutions have a specific lien on the collateral and the requirements of legal certainty are met.

(ii) The following collateral shall be taken into consideration for the purpose of credit risk mitigation:

a. Credit exposure covered by the cash held by the financial institution on its own balance sheet;

b. Credit exposure covered by cash held by another financial institution;

c. Credit exposure covered by financial collateral. Financial collateral shall take the form of gold or securities issued by the government.

1.11.5 Where the financial institution meets the conditions for recognition of credit risk mitigation arrangements, the risk weighting to be assigned shall be as follows:

(i) Credit exposure covered by cash held by financial institution on its own balance sheet shall carry a risk weight of 0 percent, except when a currency mismatch exists, where no reduction in risk weighting is permitted.

(ii) Credit exposure covered by (i) cash held by another financial institution and (ii) financial collateral which meet the conditions set out above shall be assigned a reduced risk weight of 20 percent.

(iii) The reduced risk weight shall be assigned only to those portions of claims collateralized.

1.12 OPERATIONAL RISK

1.12.1 Definition

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events and includes legal risk, but excludes strategic and reputational risks.

1.12.2 The Measurement Methodologies

Financial institutions must calculate an amount of risk-weighted assets for operational risk as set out in this regulation. The Basel Capital Adequacy Framework outlines three methods for calculating operational risk capital charges in a continuum of increasing sophistication and risk sensitivity: (i) the Basic Indicator Approach (BIA); (ii) the Standardized Approach (SA) and (iii) the Advanced Measurement Approach (AMA). To begin with, financial institutions in Bhutan shall compute the capital requirements for operational risk under the Basic Indicator Approach.

1.12.3 Basic Indicator Approach

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

$$K_{BIA} = [\Sigma\ (GI_{1\ldots n} \times \alpha)]/n$$

Where:

K_{BIA}= the capital charge under the Basic Indicator Approach.

GI = annual gross income, where positive, over the previous three years.

n = number of the previous three years for which gross income is positive.
α = 15 percent as determined by Basel Committee.

(ii) Gross income is defined as net interest income plus net non-interest income.

Gross Income
+1. Net interest income
+1.1 Total interest incomes from both (a) Positions in trading book (b) Positions in banking book
-1.2 Interest expenses
+2. Net non-interest income
+2.1 Total fee and service income, e.g. Letter of Credit fee, ATM and credit card usage fees etc. (including income from providing outsourcing services)
+2.2 Profit (loss) arising from sales of securities in trading book, including profit (loss) arising from foreign exchange transactions both in trading book and banking book.
-2.3 Related fees pertaining to procurement of fund for income generated under 1.1 (such as expenses pertaining to deposits, issuance of bonds or borrowing via money market etc.) and 2.2

(iii) However, the aforementioned gross income

(a) Shall not deduct provisions;

(b) Shall not deduct all types of operating expenses, such as employee-related expenses, equipment expenses, professional fees, remuneration of committees' members, consultation expenses, outsourcing fees, advertising expenses etc;

(c) Shall exclude realized profits/losses from the sale of securities in the banking book;

(d) Shall exclude extraordinary or irregular items;

(e) Shall exclude income derived from insurance activities (i.e. income derived by writing insurance policies).

(iv) Financial institutions are required to compute capital charge for operational risk under BIA as follows;

(a) Average of (gross income * alpha) for each of the last three financial years, excluding years of negative or zero gross income.

(b) Gross income = Profit before tax (+) provisions (+) operating expenses (-) items (c) to (e) of section 1.12.3 (iii).

(c) Alpha= 15 percent.

(v) The capital requirement derived from the calculation in Section 1.12.3 shall be converted into risk-weighted assets by multiplying the total capital requirement by 10 (i.e. the reciprocal of the minimum capital ratio of 10 percent). The risk-weighted assets thereby derived shall be added to credit risk-weighted assets as required under section 1.4 above.

1.13 INTERNAL CAPITAL ADEQUACY ASSESSMENT PROCESS

1.13.1 Financial institutions are exposed to various risks during their business operation. According to the Basel II framework, the major categories of risks are credit, market and operational risks. Besides, the financial institutions are also faced with other risks such as liquidity, interest rate, foreign exchange rate, credit concentration, reputational etc. Since the capital adequacy ratio prescribed by the RMA is only the regulatory minimum level, which addresses only credit and operational risks, financial institutions are required to determine their capital adequacy in relation to all material inherent business risks. Thus, financial institutions shall have a robust risk management system in place in order to ensure that they possess adequate capital in commensuration with all material risks posed to it by its operating activities.

1.13.2 The RMA generally expects financial institutions to hold capital above their minimum regulatory capital levels, commensurate with their individual risk profiles, in order to account for all material risk. The RMA shall assess the overall capital adequacy of a financial institution.

1.14 MINIMUM LEVERAGE RATIO

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

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

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

1.14.2 The Leverage Ratio shall be calculated as the bank's core capital/Tier 1 capital divided by the bank's total exposure. The Leverage Ratio shall be calculated using the following approach:

(i) The capital measure for the Leverage Ratio is the Tier 1 capital as specified under Section 1.3.1 of these regulations.

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

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

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

(v) Treatment of off-balance sheet exposures: financial institutions shall calculate the off balance sheet items (net of margin money) for the purposes of the leverage ratio by applying a uniform 100 percent Credit Conversion Factor (CCF).

1.14.3 Financial institutions in Bhutan shall maintain a minimum Leverage Ratio of 5 percent.

1.14.4 The RMA shall vary the minimum Leverage Ratio requirement specified above, if it is necessitated by macro-economic developments or by any other information.

1.15 REPORTING OF CAPITAL ADEQUACY

1.15.1 Report on the Risk Component and Capital Adequacy

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

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

1.16 ADDITIONAL INFORMATION

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

1.17 CONTROL OVER THE VERACITY OF DATA

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

SECTION 2

REGULATIONS ON RELATED PARTY TRANSACTIONS

2.1 INTRODUCTION

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

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

2.2 DEFINITION OF RELATED PARTY

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

(a) significant owner[2];

(b) a member of the Board of Directors;

(c) employees of the financial institution;

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

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

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

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

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

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

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

(j) parent/holding company of a financial institution;

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

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

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

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

2.3 RESTRICTIONS ON TRANSACTIONS WITH RELATED PARTIES

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

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

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

2.3.2 Aggregate Exposure Limit:

(a) aggregate exposure limit to all related persons of the financial institution, excluding those specified in (c), (e), (g) and (i) of Section 2.2.1, shall not exceed 30 percent of its total capital fund; and

(b) aggregate exposure limit to all those persons specified in (c), (e) (g) and (i) of Section 2.2.1 above, shall not exceed 10 percent of total capital fund.

2.3.3 For the purpose of the limits on exposure set out in this Section, total capital fund shall be as defined under Section 1 of these regulations.

2.3.4 For the purpose of the application of the limits in Section 2.3.2 above, the following exposures shall be aggregated:-

(i) loans and advances granted to the related parties;

(j) any exposures arising from off-balance sheet transactions;

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

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

2.3.5 Loans and advances shall include outstanding amount in case of term loan and outstanding amount or sanctioned amount whichever is higher in case of overdraft/working capital facilities. For off-balance sheet items, it shall be off-balance amount less margin money.

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

2.3.7 A report of all outstanding exposures to related parties must be submitted to the Board as and when required.

2.4 GRANTING OF FAVOURABLE TERMS PROHIBITED

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

2.4.2 Notwithstanding the requirement in Section 2.4.1 that loans and other transactions be made on the same terms and conditions as are offered to unrelated parties, financial institutions may make loans to their own staff under remuneration or incentive schemes on terms which are not offered to unrelated parties, provided such schemes are documented and approved by senior management and the board of directors and the same terms are offered to all staff or categories of staff.

2. 5 RESTRICTIONS ON THE PURCHASE OF GOODS AND PROPERTY OBTAINED BY THE INSTITUTION IN SATISFACTION OF DEBTS

2.5.1 The sale of goods or other property seized by a financial institution in satisfaction of a debt previously contracted must be carried out as per the provision of the Movable and Immovable Properties Act.

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

2.6 REPORTING OF RELATED PARTY TRANSACTIONS

In the context of this regulation, related party transactions shall be reported to the RMA as per the format prescribed by RMA. The report shall contain details of all loans, including overdraft facilities and other extensions of credit.

SECTION 3

REGULATIONS ON CREDIT CONCENTRATION

3.1 CREDIT CONCENTRATION AND ITS RATIONALE

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

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

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

3.2 RISK EXPOSURE

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

3.2.2 Loans and advances shall include outstanding amount in case of term loan and outstanding amount or sanctioned amount whichever is higher in case of overdraft/working capital facilities. For off-balance sheet items, it shall be off-balance amount less margin money.

3.3 SINGLE BORROWER LIMIT

3.3.1 The RMA hereby issues the following regulation to the financial institutions on maximum amount of credit exposure including off-balance sheet exposures as may be made by financial institutions:

(i) to an individual or to any single company, firm; or

(ii) In aggregate to:

(a) an individual, his/her spouse and economically dependent children and a company or a firm in which individual, his/her spouse, economically dependent children has a shareholding of more than 50 percent; or

(b) a company and one or more of the following:

(aa) its subsidiaries;

(bb) its holding company;

(cc) its associate company;

(dd) a subsidiary of its holding company; or

(ee) a company in which such company or its subsidiary, or its holding company, or a subsidiary of its holding company, has a direct or indirect equity interest equal to or exceeding 10 percent of the paid-up equity capital.

3.4 CREDIT EXPOSURE LIMITS

3.4.1 The maximum amount of credit exposure that may be granted by a financial institution shall not exceed the following percentage of the capital fund of the financial institution:

(i) 25 percent in respect of customers referred to in Section 3.3.1 (i)

(ii) 30 percent in respect of customers referred in Section 3.3.1 (ii)

3.4.2 Total capital shall consist of the amount based on the final and audited balance sheet. For this purpose, financial institutions must use the definition of total capital as defined in Section 1 of these regulations. The limit on credit exposure to a single borrower specified above shall not apply in the following cases:-

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

(b) exposures fully covered by cash collateral;

(c) exposures covered by government guarantees;

(d) exposures to governments and the central banks

3.5 LIMIT ON CREDIT TO TEN LARGEST OBLIGOR

The aggregate of the ten largest credit exposures of a financial institution, shall not at any time, exceed 30 percent of its total loans including off-balance sheet exposure.

The determination of exposure for this purpose shall be the same as for the limits specified in Section 3.4.1 and the definition of exposure in Section 3.2 above.

3.6 CONSORTIUM FINANCING

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

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

(b) the amount of loans sanctioned shall not, in any way, exceed 25 percent of the total capital fund of a financial institution, except that where the consortium financing arrangement was entered into before the commencement date of these regulations;

(c) the aggregate exposure of loan to a person under the consortium financing and loans to any of its connected parties as defined in Section 3.3.1 (ii) shall not exceed 30 percent of the capital fund of a financial institution.

(d) In case of financing to any related party of a financial institution under consortium financing, a financial institution shall not be the lead financer and the limit to such related party shall be as defined under Section 2 of these regulations.

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

3.7 REPORTING OF LARGE EXPOSURES

3.7.1 Every financial institution shall submit to the RMA:-

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

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

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

SECTION 4

REGULATIONS ON ASSET CLASSIFICATION AND PROVISIONING

4.1 INTRODUCTION

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

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

4.2 CREDIT POLICIES AND PROCEDURES, AND CREDIT COMMITTEES

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

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

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

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

4.3 GENERAL REQUIREMENTS

4.3.1 Financial institutions shall assess, classify and report their credit exposures in accordance with the principles and criteria provided for in this regulation.

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

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

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

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

4.4 EVALUATION AND CLASSIFICATION OF CREDIT EXPOSURES

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

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

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

4.4.2 The criteria for classification of credit exposures are based on some elements of objectivity that can be applied automatically, but for the most part, are based on the subjective judgments of evaluators. Credit exposures must be evaluated and classified according to the level of potential risk, the period of delinquency of amounts due and the main sources for repayment of the debtor's obligations, which altogether constitute the classification factors of the credit exposure.

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

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

4.4.5 Standard Exposure

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

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

4.4.6 Watch Exposures

Watch exposures shall be those credit exposures having potential weaknesses that deserve close attention, and which, if left uncorrected, may at some future date result in deterioration of the repayment prospects. A risk exposure shall be classified as Watch if:

Principal or interest payments have been overdue 31 to 90 days.

4.4.7 Sub-standard exposures

Substandard exposures shall be those credit exposures where well-defined weaknesses exist with respect to debt servicing, indicating a condition insufficient for the full repayment of his debts to the financial institution and to other creditors. A risk exposure shall be classified as Substandard if:

Principal or interest payments have been overdue 91to 180 days.

4.4.8 Doubtful Exposures

Doubtful exposures shall be those credit exposures where serious weaknesses exist with respect to their servicing. A risk exposure shall be classified as Doubtful if:

Principal or interest payments have been overdue 181 to 365 days.

4.4.9 Loss Exposures

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

Principal or interest payments have been overdue for more than 365 days.

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

4.5 NON-PERFORMING LOANS (NPL)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

4.6 RESTRUCTURED, RESCHEDULED, RENEWED AND ENHANCED CREDIT EXPOSURES

4.6.1 Restructured Credit Facility: – A restructured credit exposure is one whose original terms and conditions have been modified principally. This may include a change in the type or structure of facility, or changes to the existing terms and conditions to assist the borrower overcome its genuine shorter-term financial difficulties -particularly where the longer term prospect of the business or project is still deemed to be viable. When the borrower enters into schemes of arrangement of this nature, the new facility will constitute a restructured facility. However, such a facility may be granted only in the case of credit exposures that have been regular and have genuine unforeseen financial constraints.

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

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

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

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

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

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

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

4.7 ALLOCATION OF LOAN LOSS PROVISIONS

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

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

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

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

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

4.8 PROVISIONING REQUIREMENTS

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

	Category		Provisioning Requirement
i.	Standard	-	1 percent;
ii.	Watch	-	1.5 percent;
iii.	Substandard	-	20 percent; 30 percent for Sector with highest exposure
iv.	Doubtful	-	50 percent; 60 percent for Sector with highest exposure

v. Loss/litigation/suspended - 100 percent.

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

i. Credit facilities which are classified under Standard and Watch shall require a provision of 1 percent and 1.5 percent respectively.

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

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

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

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

4.8.4 RMA shall on case by case basis, determine financial institutions to allocate provisions in addition to the minimum provisioning requirement during the provisioning verification and finalization of the financial institutions.

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

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

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

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

4.10 INTEREST REGIME

4.10.1 Interest Rates

Financial institutions shall determine the rate of interest on deposits and loans and advances. The rates may be revised from time to time with the approval of the respective Board of Directors and subsequent notification to the RMA. The approved rates and any revisions thereof must be publicly announced and shall be available on the website.

4.10.2 Minimum Lending Rate (MLR) approach for Loans and advances

The rate of interest on loans and advances shall be based on Minimum Lending Rate (MLR) Framework issued by the RMA from time to time The MLR is a single benchmark or minimum reference rate for lending across all financial institutions. The financial institutions shall also report on the MLR and final lending rate in the form prescribed the RMA.

4.10.3 Method of Interest Calculation

All financial institutions shall follow the Simple Daily Product Method for computation of interest on loans and advances except otherwise provided in this regulation.

i. **<u>Simple Daily Product Method</u>**

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

ii. **<u>Compound Interest</u>**

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

iii. **<u>Term Loan</u>**

All financial institutions shall follow the following:

a. Simple Daily Product Method for computation of interest on loans and advances.

b. Compounding of interest and late fee shall not be allowed.

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

iv. **<u>Overdraft (OD)/working capital (WC)</u>**

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

a. **<u>Non-bank Financial Institutions</u>**

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

(ii) No compounding/capitalization of interest and late fee;

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

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

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

(i) ODs to be treated as a CASA product;

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

4.10.4 Interest during Project Gestation Period

(a) Financial institutions shall give project gestation period in line with their credit policies approved by the Board, subject to a maximum of the following limit;

(i) Housing: Maximum 3 years.

(ii) Hotel Construction: Maximum 5 years.

(iii) Manufacturing and Service: Maximum 5 years.

(iv) For any other loans which requires gestation period: Maximum 2 years.

(b) The RMA may on a case by case basis, approve the extension of aforementioned gestation period.

(c) Interest during gestation period shall be given the following treatment:

(i) Financial institutions shall follow the Simple Daily Product Method for computation of interest during the gestation period.

(ii) No compounding of interest shall be allowed during the gestation period.

(iii) Where gestation period is available, payment of interest usually becomes due only after the completion of the gestation period. Therefore, interest may be serviced:

(a) during the gestation period or at the end of gestation period; **OR**

(b) interest may be capitalized at the end of the gestation period only after full disclosure to and understanding and willingness by the client.

4.10.5 Suspension of Interest

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

4.10.6 Reversal of Interest Income

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

4.10.7 Interest on account of Rescheduled Loans

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

4.10.8 Commitment fee on overdraft limit

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

4.10.12 Accounts regularized near about the Balance Sheet date

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

SECTION 5

REGULATIONS ON LIQUIDITY MANAGEMENT

5.1 LIQUIDITY AND ITS RATIONALE

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

(a) obligation to pay deposits or borrowings;

(b) obligation to provide committed funds; and

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

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

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

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

(c) by borrowing.

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

5.1.4 Liquidity Measurement

Liquidity can be measured through stock or flow approaches:

(a) **Stock Approach –** Under the stock approach, liquidity is measured in terms of key ratios which portray the liquidity stored in the balance sheet.

(b) **Flow approach –** Under the flow approach, financial institutions prepare a statement of Maturities of assets and liabilities placing all cash inflows and outflows in the time bands according to the residual time to maturity. The difference between cash inflows and outflows in each time band, the excess or deficit of funds becomes a starting point for a measure of a financial institution's future liquidity surplus or deficit, at a series of points in time.

5.2 REGULATIONS FOR LIQUIDITY MANAGEMENT

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

(a) an adequate information system; and

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

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

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

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

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

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

5.3 METHODS OF ACHIEVING LIQUIDITY

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

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

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

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

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

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

(f) holding a sufficient volume of quick assets with respect to the repayment of short term deposits. For these purposes, quick assets are*:*

(i) cash;

(ii) gold and precious metals;

(iii) balances with the RMA (excluding statutory reserves);

(iv) demand deposits with banks in Bhutan, India and countries other than India;

(v) government and government-guaranteed securities;

(vi) RMA securities; and

(vii) time deposits with a remaining period to maturity not exceeding 180 days held with commercial banks in Bhutan.

(viii) any money market instrument with remaining maturity of 90 days

(g) RMA has the authority to change the components of the quick assets and shall notify the financial institutions if there are any changes in the methodology on computation of Statutory Liquidity Requirement;

5.3.2 Contingency Plan

(a) Financial institutions shall prepare liquidity contingency plans to measure their ability to withstand institution specific or market crisis scenarios;

(b) Financial institutions shall appoint an Asset Liability Management Committee which shall be responsible for formulating recommendations and implementing the financial institution's liquidity policy in accordance with the liquidity strategy, risk appetite, policies and limits agreed by the Board.

5.4 MINIMUM REQUIREMENTS AND REPORTING

5.4.1 Cash Reserve Ratio

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

5.4.2 Statutory Liquidity Requirement Ratio

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

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

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

5.4.3 Reporting requirements

Every financial institution shall submit to the Financial Regulation and Supervision Department, RMA, the information on liquidity in a Form prescribed by the RMA.

5.5 THE MATURITY MISMATCH APPROACH

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

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

5.5.3 Financial institution’s liquidity position shall be assessed by the RMA. While the mismatches up to one year would be relevant as these provide early warning signals of impending liquidity problems, the main focus shall be on mismatches up to three months.

5.5.4 Financial institutions, however, are expected to fix mismatch limits appropriate to the size, complexity and financial conditions across all time bands. Financial institution which is reliant on short-term funding shall, however, concentrate primarily on managing their liquidity in the very short-term horizons and preferably on a day-to-day basis.

5.5.5 A financial institution shall evaluate liquidity profile under different stress situations, viz. normal situation, institution specific crisis, and market crisis scenarios.

SECTION 6

REGULATIONS ON SUBMISSION OF ANNUAL AUDITED ACCOUNTS

6.1 INTRODUCTION

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

6.1.2 A licensed financial institution is required, within <u>three months</u> after the close of each financial year to prepare a balance sheet and profit and loss account as of the last working day of that year.

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

6.1.4 In terms of Section 96 of the Financial Services Act, a licensed financial institution must publish its annual audited accounts in a national newspaper. Financial institutions shall make available copies of their audited annual accounts and half-yearly unaudited financial statements on their websites.

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

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

SECTION 7

REGULATIONS ON BORROWER INFORMATION

7.1 INTRODUCTION

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

7.2 BORROWER INFORMATION

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

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

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

7.5 Such information shall:

(a) contain borrower's current and permanent address;

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

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

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

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

7.6 Credit files shall also include:

(a) loan application and all authorized approvals;

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

(c) loan agreements;

(d) certificates of insurance;

(e) collateral-inspection documents;

(f) credit reports & annual credit analyses;

(g) restructuring, rescheduling and renewal documentation;

(h) past loan applications;

(i) all updated financial statements;

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

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

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

(m) valid license/registration certificates;

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

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

7.7 INFORMATION TO CLIENTS

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

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

SECTION 8

REGULATIONS ON REVALUATION AND APPROPRIATION OF RESERVES

8.1 INTRODUCTION

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

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

8.2 TRANSFER TO GENERAL RESERVE/RESERVE FUND

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

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

(ii) a sum equal to not less than 25 percent of the net profits of that year once the reserve fund exceeds 50 percent of its paid up capital[3].

8.3 PROVISION FOR FOREIGN EXCHANGE FLUCTUATION RESERVE

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

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[3] Section 83 of Financial Services Act (FSA) 2011 provides RMA to specify different portion of the net profits (other than the one specified in Section 82 of FSA) to be transferred to the reserve fund.

SECTION 9

REGULATIONS ON DIVIDENDS AND RESERVES

9.1 INTRODUCTION

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

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

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

9.4 ELIGIBILITY CRITERIA FOR DECLARATION OF DIVIDEND

9.4.1 A financial institution that complies with the following criteria shall be eligible to declare dividends:

(1) A financial institutions shall have:

(a) Capital Adequacy Ratio (CAR) of at least 12.5 percent (including Capital Conservation Buffer) for preceding two completed years and the accounting year for which it proposes to declare dividend;

(b) Core Capital ratio of 7.5 percent (including Capital Conservation Buffer) for preceding two completed years and the accounting year for which it proposes to declare dividend;

(c) Net NPL ratio of less than 5 percent for the accounting year for which it proposes to declare dividend.

(2) In case a financial institution is unable to meet the CAR and Core capital norms in the previous two completed years, it may declare up to 15 percent dividend as proportion of profit after tax in the accounting year for which dividend is being considered provided that:

(a) CAR is at least 12.5 percent (including capital conservation buffer);

(b) Core Capital ratio of 7.5 percent (including capital conservation buffer); and

(c) Net NPL ratio is less than 5 percent.

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

9.5 QUANTUM OF DIVIDEND PAYABLE

9.5.1 A financial institution which fulfills the eligibility criteria set out in Section 9.4 is eligible to declare and pay dividends, subject to the following:

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

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

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

(ii) The remaining portion of profit after tax shall be transferred to general reserve/reserve fund as required under these regulations as well as to other reserves.

SECTION 10

REGULATIONS ON COLLATERAL AND OTHERS

10.1 INTRODUCTION

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

10.2 COLLATERAL

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

10.3 REGISTRATION OF MORTGAGES AND COLLATERAL

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

10.4 INSURANCE OF COLLATERAL

A financial institution shall ensure that fixed assets pledged as collateral or mortgaged against loans are properly insured. The loan agreement must include a condition stipulating that in the event of the borrower's failure to insure or to renew the insurance policy, a financial institution will insure or renew the insurance policy, as the case may be, and debit the cost of the insurance to the borrower's loan account or recover accordingly.

10.5 SUBSTITUTION OF COLLATERAL

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

10.6 THIRD PARTY GUARANTEES

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

10.7 FINANCING LIMIT

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

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

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

or

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

10.9 LOANS AGAINST SHARES OR LOANS FOR THE PURCHASE OF SHARES

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

SECTION 11

REGULATIONS ON RESTRICTIONS ON OWNERSHIP OF FINANCIAL INSTITUTION AND INVESTMENTS BY FINANCIAL INSTITUTIONS

11.1 No person shall hold more than the following percentage of interest in shares of a financial institution:

(a) In case of an individual, 20 percent;

(b) In the case of a company not being a financial institution, 30 percent.

11.2 Section 52 of the Financial Services Act 2011 provides exemption in the ownership restrictions covered under Sections 11.1. It does not apply where shares of financial institutions are held directly or indirectly by the Royal Government of Bhutan (Ministry of Finance), which shall be permitted to own 100 percent of the financial institution. These financial institutions shall not be required to list on the stock exchange.

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

11.4 For the purpose of Section 11.1:

a) Individual is a natural person and includes spouse, dependent children or other dependents of a person being of the same household; and

b) Company means a parent company, its subsidiaries and affiliates, and it shall also include their significant owners.

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

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

11.7 Section 57 of the Financial Services Act, 2011 provides an exemption for financial institutions to have share ownership of a financial institution in Bhutan in excess of the limit specified above under the following circumstances:

(a) To rectify the financial institution's financial condition;

(b) Merger and acquisition; or

(c) To maintain the overall Bhutanese financial system stability.

11.8 The acquisition or merger of a financial institution shall require the prior authorization of the RMA.

SECTION 12

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

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

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

12.1.2 In accordance with Chapter 7 of the Financial Services Act 2011, no financial institution shall, without the prior permission of the RMA, establish branches, agencies, and other such offices.

12.2 LAUNCHING OF NEW PRODUCTS

A financial institution shall seek written approval from the RMA prior to the introduction of new products to the public. Further, a financial institution is required to fulfill the prerequisite conditions listed below for the launching of the new products and furnish the details to RMA accordingly:

i. Board's approval on launching of new products;

ii. Adherence to principles on fair treatment of consumers which would include:
   a. Disclosure to customers on terms and conditions associated with the product.
   b. An adequate and effective system for resolving and monitoring customer complaints.
   c. Suitably trained staff to educate the customer on the product.

iii. Required to put in place adequate policies and procedures designed to ensure that the customer has practical understanding of products so as to meet the client's objectives.

SECTION 13

REGULATIONS ON ON-SITE EXAMINATIONS OF FINANCIAL INSTITUTIONS

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

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

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

13.4 Management of a financial institution is required to respond to the findings in the report within 14 working days of the meeting of the Board of Directors referenced in 13.3 above.

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

SECTION 14

REGULATIONS FOR COMPLIANCE OFFICERS

14.1 INTRODUCTION

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

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

(i) implementing and complying with all matters relating to prudential regulation and directives issued by the RMA from time to time;

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

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

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

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

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

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

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

SECTION 15

REGULATIONS ON INTERNAL AUDIT REQUIREMENTS

15.1 INTERNAL AUDIT

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

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

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

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

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

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

SECTION 16

REPORTING REQUIREMENTS

16.1 REPORTING FORMAT AND PERIODICITY

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

	Function/Purpose	Frequency
i.	Statement of Condition, Assets	Monthly
ii.	Statement of Condition, Liabilities	Monthly
iii.	Statement of Condition, Fixed Assets	Monthly
iv.	Statement of Condition, Other Assets	Monthly
v.	Statement of Condition, Other Liabilities	Monthly
vi.	Income & Expenditure Statement	Monthly
vii.	Foreign Currency Balances	Monthly
viii.	Liquidity Return	Monthly
ix.	Statement of Sectoral Investment	Monthly
x	Monthly Prudential Ratios	Monthly
xi.	Monthly Data History	Monthly
xii.	Classification of Loans & Advances by Sector & Repayment Status	Monthly
xiii.	Statement of Ten Largest Exposures & Exposures Exceeding 10% of Capital Funds	Monthly
xiv.	Statement of Large Loans & Advances by Sector	Monthly
xv.	Statement of New Loans Sanctioned During the Month	Monthly

	Function/Purpose	Frequency
xvi.	Term Loans/Overdrafts/Working Capital Advances Enhanced/Renewed During the Month	Monthly
xvii.	Statement of Off-Balance Sheet Items	Monthly
xviii.	Capital Adequacy	Monthly
xix.	Related/Connected Lending	Monthly
xx.	Statement of 30 Largest Non-Performing Loan	Monthly
xxi.	Statement of 30 Largest Depositors (for banks only)	Monthly
xxii.	Audited Annual Accounts	Annually

16.2 REPORTING DATE AND DATE OF SUBMISSION

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

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

SECTION 17

REGULATIONS ON PENALTY FOR NON-COMPLIANCE

17.1 PENALTY CLAUSE

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

(a) Issue warnings;

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

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

(d) Impose fines as determined by the RMA for each day of infraction;

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

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

(g) Revoke the license to operate.