

# Priority Sector Lending -- Redirecting the Course of the Economy

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“Our nation has seen great socio-economic growth but it is more important that we have growth with equity. We must raise, with all our effort, the less fortunate so that they may, at the earliest, begin to partake in the opportunities brought by modernisation and progress.”

His Majesty The King - National Day, 17 December 2012.

A key impact of the Royal advice to the nation has been the Royal Monetary Authority’s (RMA) initiative to introduce the priority sector lending programme to diversify economic activity in Bhutan. This article looks at the Priority Sector Lending (PSL) initiative as Bhutan gears up for the BEFIT summit in 2019.

## Introduction

Past governments have made investments in basic infrastructure such as road connectivity, water supply, electricity and telecommunications, basically creating an enabling environment to explore economic opportunities. Pairing this with improved access to finance, Bhutan is well placed to enhance income and improve livelihoods of the people through engagement in the Cottage and Small Industry (CSI) sector.

The CSI sector is a low-hanging fruit that has the potential to be a catalyst for Bhutan’s economic transformation beyond the hydropower sector. The government has identified this sector as one of the five economic jewels of Bhutan, and numerous support schemes and incentives are already in place to promote CSIs.

As of 15 June 2018, there were 20,195 licensed and operational CSIs in the country, up from 16,887 on 30 June 2017, as per the annual report of the Department of Cottage and Small Industry (DCSI). In June 2018, 15,936 establishments constitute the service sector dominated by hotels

and restaurants, 2,116 were in production and manufacturing, mostly comprising wood-based industries, and 2,143 small firms are in the contract sector.

The reason for the passivity in the past is explained in the Enterprise Survey, 2011, which surveyed more than 500 CSIs and identified major constraints: Access to finance, hiring of foreign workers, transport infrastructure, and low skill levels among workers. In terms of financing, it was reported that most CSIs source finance from internally generated funds or through informal borrowing from friends and family.

The Ministry of Economic Affairs classifies the scale of industry by the size of capital investment and the number of people it employs. A firm with an investment of less than Nu 1 million (M) and employing more than one but fewer than four employees is classified as a cottage industry. If the investment is between Nu 1M and 10M, employing five to 19 people, it becomes a small industry. In case of a conflict, the investment takes the precedence.

With more than 95 percent of the industries in Bhutan being small and cottage scale, the DCSI was established in July 2010. The CSI policy was established in 2012 to provide policy, legislation, and institutional framework to the sector. In a major step to increase service delivery efficiency of the PSL, the DCSI has developed an online system for Priority Sector Lending. The main objective of the PSL is to transform CSI sector into a more enterprising and commercial-oriented sector with better access to finance. Banks have Nu 1.5 billion (B) for PSL activities.

The PSL scheme attempts to bring together stakeholders like the *dzongkhag* (District) administration, financial institutions, different government agencies and the central bank on the same page.

## **Background and Scenario**

After Bhutan introduced planned modernisation in the early 1960s, the country has seen unprecedented socio-economic development based on the vision of Gross National Happiness. Initially, the emphasis of plans was on basic infrastructure, primarily roads, forestry, healthcare, education and communications. This opened up economic opportunities, and some sections of the population took advantage.

However, weaker sections of the society, particularly youth, women and rural poor, were left behind, despite the goal of equitable socio-economic development and social justice. The next phase of development focused on weaker sections of the society, and five-year plans aimed to develop the weaker sections of society through special programmes.

Agriculture and livestock were the priorities. Subsistence farming was seen as untenable in the face of rural-urban migration and growing population. The outcome is evident from the poverty rate being brought down to 8 percent from 24 percent in a decade or so. But, the “white gold” (hydropower) being inadequate, the country needs more producers of food, raw materials, goods and services. Cottage and Small Industries are identified as one of the jewels of the economy, the low-hanging fruit that could help diversify the country’s economy.

### **Birth of Priority Sector Lending**

With more than 30 percent of the population economically active, there should be no dearth of innovation and ideas, and access to finance has been touted as the biggest constraint for the private sector. The Royal Monetary Authority’s statistical bulletin for October 2018 revealed that the loan portfolio for the agriculture sector was Nu 5.7B of the total domestic credit of Nu 107B.

The concept of PSL was discovered in many developing nations to re-direct resources to the neglected and weaker sections of the population. PSL in India, for instance, was rolled out in 1967, aimed at bringing the credit allocation from the financial sector in line with the country’s development plan’s priorities. It was believed that the banking sector should emerge as an active agent for social and economic change.

In Bhutan, the RMA has defined Priority Sector Lending as an integrated platform to coordinate government policy interventions and support schemes, with improved access to finance for the promotion of Bhutan’s Cottage and Small Industries sector. The PSL is mainly intended to ensure assistance from the banking system to those sectors of the economy that have not received adequate support of institutional finance.

Apart from Bhutan Development Bank Limited (BDBL), the rest of the banks' loans to the agriculture sector, if computed, was below one percent of the total loan as of 2017. This was because the interest rates for the agriculture sector were as high as the consumer loans, or even transport loans. Subsequently, micro financial institutions like Loden Foundation and Rural Enterprise Development Corporation (REDCL) have been key sources of finance for entrepreneurs and farmers, simply because loans provided by commercial banks are unaffordable for a farmer or a young entrepreneur. Those who could afford the agriculture loan at an interest rate of more than 10 percent did not use the loan as intended. It was being misused to construct houses and to buy pick up trucks in the rural areas.

One year after His Majesty The King prompted the financial sector to create opportunities in the agriculture sector during the National Day address in 2016 held in Trongsa, the RMA launched the Priority Sector Lending scheme, mandating the banks to increase their agriculture-lending portfolio by one percent within a year.

The PSL initiative was intended to supplement the loans provided by financial institutions like BDBL and REDCL. The PSL aims to make the banks move away from traditional lending norms, where collateral and guarantor is a prerequisite. The RMA Act also gives the central bank the authority to come up with preferential lending rate lower than the market price.

## **Where is the Priority?**

A World Bank's assessment report on Bhutan's investment climate, 2017, recommended tourism, agribusiness, manufacturing and ICT sectors that have the potential to diversify the country's economy. A major reform the World Bank recommended was to improve access to finance.

Similarly, the Asian Development Bank (Bhutan critical development constraints, 2012) stated that Bhutan's continued reliance on one major sector and trading partner made the country vulnerable to sectoral and external shocks. It was also stated that Medium, Small, and Micro Enterprise sector was engaged in low value-added and low productivity activities. The ADB recommended that Bhutan broaden its industrial base and diversify economic activity in the field of ICT, and clean manufacturing, handicrafts, agro-based manufacturing and dairy products, among others.

In 2017, the fiscal incentive policy became an Act. It granted an income tax holiday of 10 years to CSIs and Co-operatives, mineral based industries, hotels, Renewable Natural Resources (RNR) and agriculture activities such as organic farming, agro-processing, biotechnology, poultry, fisheries, floriculture, health food, animal feed, apiculture, horticulture and dairy. Schools, institutions, IT, and infrastructure development are other priority sectors identified in the Act.

The fiscal policies are in place, but the potential in agriculture and CSI sector is yet to be realised. In 2014, the government rolled out Nu 5B worth of economic stimulus plan, of which Nu 2.1B was injected into the financial institutions to ease their liquidity. The rationale was to make the banks lend more. For the priority sector, the government instituted a revolving fund spearheaded by the erstwhile Business Information and Opportunity Centre (BOiC) to facilitate collateral-free and subsidised lending for manufacturing, CSI and Agriculture. After much controversy, the government closed BOiC and established Rural Enterprise Development Corporation Ltd. mainly to cater to the financing needs of the farmers.

In 2016, primary sector growth decelerated to 3.65 percent, down by 1.40 percentage points from 5.07 percent in 2015. The sector constitutes only 16 percent of the GDP in 2016. The lower rate of growth can be attributed to poor performance in the forestry sector. Agriculture (Crops) sector remains the main driver of the primary sector's growth in 2016. (National Accounts Statistics, 2017).

## **The PSL Scheme**

The PSL guidelines recognise the CSI sector, as the largest source of domestic production and employment, as being critical for addressing challenges facing the agriculture sector and stemming from rural-urban migration. It is estimated that PSL will inject a total of Nu 1.5B capital into the CSI sector (Nu 530M for primary agriculture and livestock production and Nu 950M for non-agriculture CSI). This will be achieved if every bank increases its lending in the agriculture and CSI by one percent.

Farmers and young entrepreneurs are the target groups, while clients can avail themselves of loans as individuals, groups or as a company incorporated in Bhutan. PSL financing is available for start-ups as well as CSI business expansion.

In return, the banks get an income tax waiver on interest earned from its lending made for PSL, provided that interest on loan towards agriculture to be used for primary production is kept below 8 percent and 8.5 percent for the cottage and small industries and projects involving value addition to primary production. The maximum loan ceiling is Nu 500,000 for farmers, Nu 10M for cooperatives and groups, and Nu 10M for companies.

While lending to primary production is based on mandatory insurance, which replaces the need for collateral or guarantor, other projects are based on cash flow with mandatory fire and theft insurance.

PSL has two exclusive emphases when it comes to CSI-agricultural CSI and non-agricultural CSI. Agricultural activities include primary production and value-added activities such as processing, packaging, marketing and sales. Non-agricultural CSI comprises manufacturing and services. The RMA has compiled a list of potential opportunities in the two sectors, with the help of cottage and small industries department and agriculture ministry. The aim is to revolutionise the farming system, from subsistence to enterprise farming.

## **The Procedure**

All priority sector projects are routed through a special Technical Window Services (TWS) of the government. TWS will also be responsible for providing technical clearances to potential clients by coordinating with other agencies like local governments, the National Land Commission and the National Environment Commission. Every Dzongkhag has a PSL committee, chaired by the *Dzongda* (Governor), and the members constitute sector heads from various departments and organisations like agriculture, livestock, land commission, and environment commission. This is to expedite and support the projects with feasibility and clearances, besides ensuring seamless delivery of service through a single window.

Similarly, access to loans from financial institutions will be coordinated through special credit channels in each of the financial institutions.

A PSL Council chaired by the governor will periodically review and coordinate the interventions and the role of the financial sector, to ensure the success and relevance of the policy objectives. The council also monitors and evaluates the implementation of the PSL Guidelines.

Applicants must get a clean chit from the Credit Information Bureau, along with security, land and community clearance. In the case of cooperatives and groups, registration certificates from relevant authorities are required. Should an applicant meet the pre-requisites, the PSL application would be followed by clearances and field visits.

This will be followed by PSL committee assessment, which will take into account technical feasibility reports and further clearance. This process must be completed within 10 working days. Once the committee approves a proposal, it will be forwarded to the respective financial institutions for appraisal.

The financial institutions are guided by another standard operating procedure framed by the RMA. The ceiling for interest rates has been fixed at 8 percent for primary production under Agriculture CSI and 8.5 percent for non-agriculture CSI and projects involving value addition to primary production. However, 100 percent debt financing is available only for primary production, which is capped at Nu 0.5M. For other PSL loans, debt to equity ratio is 70:30.

Under the PSL, agriculture CSI has been grouped into three categories: Primary production, processing and packaging and marketing and sales. This ensures a value chain.

Primary production mainly involves agriculture, livestock and forestry activities such as cultivation of crops, livestock farming, production of farm inputs like fertilisers, seed, pesticides, animal feeds and purchase of greenhouse, fencing, machinery and farm equipment.

Under the non-agriculture CSI, a list of 13 priority products are identified under production and manufacturing while there are 16 products under services, including research and development centres, performing arts, cleaning services and mule transportation.

For loans up to Nu 0.5M, the *gewog* (block) technical window service will be given the authority to issue technical clearance. For loans above Nu 0.5M and up to Nu 1M, the *dzongkhag* (district) technical window is the authority. If the loan amount is more than Nu 1M, the regional technical window will issue the clearance.

## Update

On 13 March 2018, Bhutan National Bank (BNB) disbursed its first PSL loan of Nu 500,000 to a farmer from Bjena *Gewog* in Wangdue Phodrang for potato farming. Three days later, the Bank of Bhutan (BoB) disbursed its first loan under the PSL, of Nu 846,000 to a woman from Begana in Thimphu to start a poultry farm and harvest shitake mushrooms.

Six months after the launch, a total of 681 applications had been received, of which 78 percent were agriculture CSI projects and the remaining 22 percent were for non-agriculture. Except for Trashiyangtse, all the dzongkhags received at least one PSL application. Thimphu received the highest numbers of PSL applications with 169, followed by 113 in Tsirang and 69 in Samtse.

Of the total 513 applications approved by the dzongkhags, 278 have reached the financial institutions, of which loan approvals were given for 127 projects amounting to Nu 138.55M. As of June, the financial institutions have disbursed Nu 41.69M in PSL loans.

## Entrepreneurs Face Problems

It took three months for Ambika Devi Lamichhane, the first PSL applicant of BoB to process the loan under the scheme. Pem Tenzin from Zomlingthang village of Gosarling, Tsirang, who applied for a Priority Sector Lending (PSL) loan, had to wait for more than three months to hear from the bank.

This is one of the major complaints from PSL applicants that the Dzongkhag PSL committee receives on daily basis. The guideline mandates that the Dzongkhag PSL committee must complete the review process within 10 days. It is meant to save time for the bank because the relevant officials have already studied the technical feasibility of the business. Once the committee approves a proposal, documents are submitted to the bank for further review. The ball is then in the banks' court and it must expedite the process, because the only task then is to study the financial feasibility. However, the bank branches in the dzongkhags do not have the authority to approve loans above a certain limit. It is forwarded to the headquarters and this takes time.

The Royal Audit Authority (RAA) observed that a delay in planned commencement of a project might result in higher financial cost due to escalation and inflation. Especially in poultry and piggery, a delay in disbursement results in huge implications for the chickens and pigs brought to the farm requiring feeds and other necessities. The RAA also noted that the Dzongkhags did not monitor the projects as agreed.

The RAA's field visits and interaction with gewog level officials and the public indicate that the awareness campaigns have not spiralled down to the gewog level or the public as intended. RAA is of the opinion that confusion among the public and at the gewog level is a result of weak collaboration and linkages among the stakeholders.

## Way Forward and Recommendations

The PSL should not orbit around data collection and numbers. It could indicate where the economy is heading and correspondingly let the banks and the government capitalise on potential sectors.

The IMF suggests frequent review of interest rate caps. “Global experience suggests that the effectiveness and any unintended side-effects will depend on the type and specification of the cap. Calibrating interest caps at the ‘right’ level to achieve operational efficiency is difficult, while binding caps set below market levels can affect not only profitability and risk in financial institutions, but also the overall credit supply.”

In the PSL, primary production related to agriculture activities are backed by insurance instead of collateral, which is a new business model for the insurance companies. The IMF has also spelt out that commercial banks may face barriers and risks, given the lack of relevant expertise, reach, and operational efficiency. The Dzongkhag PSL committee must fill this gap, as there is a need for vivid coordination between the financial institutions and the *dzongkhag*.

Technical capacity and coordination among all relevant parties should be strengthened. PSL loan proposals are routed through Special Technical Window Services that involve coordination with multiple agencies, including regional and local administration officials. Given the complexity of the undertaking and the moral hazard involved, capacity building and inter-agency coordination are critical.

Further analysis of the PSL report reveals that most projects are clustered around similar ideas, poultry, livestock and dairy being common activities. The country is yet to see CSI activities being spurred on in the field of processing, packaging and marketing.

Almost half of the projects rejected by the bank were based on bad credit records of the applicants. Some of the reasons for PSL loans getting disapproved are viability of the project, unclear reports, and incomplete documents, among others. There were also a few cases where the proponents dropped the idea because they had to get a separate trade license for CSI activities.

While the fiscal incentives grant income tax holiday for the agricultural activities, businesses engaged in trading of agriculture and RNR goods are not exempted from customs duty and sales tax. To avail themselves of this incentive, project proponents, who are basically farmers, have to directly import from third countries.

Loan default will be the biggest challenge. REDCL's Non-performing Loan (NPL) ratio has already crossed 25 percent. The RMA considers six to seven percent as a tolerable level of NPL. It is important to ensure that PSL applicants are responsible borrowers.

The financial sector in Bhutan was formally set up in 1968 with the establishment of the first bank. Banking is a fledgling industry that has grown slowly after the Royal Monetary Authority was set up in 1982. For a traditional society moving from barter system to formal banking channel, the challenges were plenty. Even after decades, there is a misconstrued concept of credit.

A traditional saying goes that “wealthy is a man who has no loans”. People considered loan as a burden on their livelihood because loans were used to satisfy their daily needs. This is no more relevant in today’s context, especially when the private sector is lobbying for better access to finance. The PSL, while freeing lending, must avoid a lending spree, because credit should translate into productive activities leading to revenue generation.

There is also a thin line between a loan and credit, which is often misconstrued by many. A loan is borrowed money that is repaid over a fixed term, while credit is a revolving account that lets borrowers draw, repay and redraw from available funds.

The PSL needs the right impetus, because inclusive growth could be achieved if the weaker and vulnerable sections of the society are given access to finance to explore economic opportunities. In doing so, financial institutions will be working for the collective good.

Agreements could also be drawn with the financial institutions to fix a time frame. Incentivising banks to become a part of a national effort may help only so much. The waiver of income tax on the interest from PSL may not be commensurate with the cost of financing, on the banks’ part. While tax benefits can be perceived as an offset to below-market pricing, according to the IMF article IV consultation report, 2018, this may not be enough to compensate for the full difference between preferential and commercial rates, as well as for the losses of targeting a potentially riskier market segment. Any deviations from market conditions should be fully compensated.