

Bhutan Policy Notes

Developing CSI Firms

Key issues and challenges

In recent years, the government of Bhutan has been placing increasing emphasis on cottage and small industry (CSI) development. It has been revising the 2012 CSI policy to provide strong support for the growing sector. The envisioned reforms focus on six key areas to develop entrepreneurship ecosystems: the policy and legislative framework, the entrepreneurship culture and human capital, business development support and infrastructure, access to finance and incentives, innovation and technology adoption, and access to markets. Under the oversight of the Royal Monetary Authority (RMA) and the Ministry of Economic Affairs (MOEA), efforts have been undertaken to streamline and improve institutional coordination and policy support in this nascent sector. In Bhutan, cottage industries are industries with an investment of less than Nu 1 million and engaging up to 4 people, while small industries have between 5 and 19 employees and an investment of Nu 1 million to Nu 10 million.

The CSI sector has several characteristics. First, the sector accounts for 90 percent of industry in Bhutan. Second, as of 2018, there were more than 30,000 registered CSIs in the country, although only a third of these are considered active and operational. Third, according to the 2011 World Bank Enterprise Survey, the average number of people employed by CSIs in Bhutan was 1.9 per cottage enterprise and 6.8 per small enterprise. Fourth, the CSI sector is dominated by men. Women are more active in service-oriented industries, where they represent more than 41 percent of firm owners. Fifth, partly because of a lack of collateral, the CSI sector has not received strong skills and financial support, especially in agribusiness. Except for the Bhutan Development Bank Limited, the exposure of financial institutions in the agricultural sector in 2017 was below 1 percent.

As part of the reform process, there have been multiple CSI interventions by several agencies in key sectors. In finance, the RMA has been working to advance financial inclusion through priority sector lending and the establishment of CSI banking to supply better access to finance. Loans of up to Nu 1 million for cottage industries and up to Nu 10 million for small industries will now become available. Interest will be capped at 8 percent for agricultural CSIs and 8.5 percent for nonagricultural CSIs. Certain lending targets have been established under these prescribed preferential lending rate ceilings. In 2018, the RMA issued rules and regulations for CSI banking that defined the size of bank investments, the requirements for initial public offerings among CSI banks, collateral rules, licensing rules, permissible activities, regulatory arrangements, and areas of corporate governance. To target mid-tier firms, a new CSI bank has been established based on the recapitalization of Rural Enterprise Development Corporation Limited, a microfinance lender. According to the rules, CSI banks can offer collateral-free loans of up to Nu 400,000 to cottage industries and up to Nu 2 million to small industries. CSI licensing and registration systems have been simplified, and several CSI support schemes are being run by the MOEA. The Ministry of Labor and Human Resources is increasing its emphasis on funding for youth-focused entrepreneurship development programs, and several incubation and start-up centers have been launched.

There are challenges in the implementation of the CSI policy. The policy implementation is still ongoing, but there are several preliminary considerations. First, the financial viability of CSI banks (especially REDCL) must be maintained, and the RMA should exercise strong oversight to ensure that nonperforming loan ratios are adequately monitored at banks. There is some concern about developing specialized institutions due to the limited market size and existing capacity constraints that could challenge the financial viability of a specialized stand-alone institution. Second, trends in priority sector lending among CSIs will need to be monitored because they are encouraging banks to shift away from traditional lending norms whereby collateral and loan guarantors are prerequisites. In this context, removing disincentives (e.g. financial infrastructure, reverse factoring platform) or providing incentives (e.g. partial credit risk

guarantees) rather than lending targets on financial intermediaries may serve the CSI segment best. The analysis suggests that the implementation of new priority sector lending policy for CSI banking reflects a degree of shift in RGoB approach to foster access to finance for CSI from one mainly focused on strengthening market functions through supporting the development of the financial infrastructure/ecosystem and institutional capacity to one of a higher degree of dirigiste intervention in the allocation process of loans by the banking system. This will have to be carefully monitored. Third, coordination between public agencies and the nascent private sector should be strengthened. It is critical that there is capacity building and strong coordination among all relevant parties (e.g. the PSL loan proposals are routed through Special Technical Window Services that involve coordination with multiple agencies, including Dzongkhag administration and local leaders and thus increasing complexity and raising moral hazard risk). Fourth, CSI skills training should be linked to labor market demands. Fifth, there will need to be a strong M and E framework with frequent evaluation as interest rate caps are blunt policy instruments.

The general principle

Policy recommendations

To address these issues, the government should undertake the following in the short term:

- Ensure continued policy support for the CSI sector, with a focus on financial inclusion, regulatory simplification, and skills enhancement
- Further develop rationale for CSI policy - regulatory simplification, reduction of crowding out of skills by the public sector (so that more skills are available for CSI and the private sector, more generally)
- Constant updating of the results with a robust monitoring and evaluation framework to avoid policies that have not worked well
- Promote continued interagency coordination by the RMA to avoid a multiplicity of programs and the fragmentation of tasks
- Closely monitor and evaluate priority sector lending to ensure that CSI firms benefit from financial support
- Guarantee RMA oversight and due diligence during the ongoing expansion in CSI banking
- Foster interagency coordination in the implementation of the CSI policy, especially with the MOEA and the Ministry of Labor and Human Resources
- Allow moveable assets to be used for collateral, develop valuation techniques, and encourage borrowing among networks of CSI firms
- Invest in financial literacy training among CSI entrepreneurs, with a focus on accounting and marketing
- Continue to develop viable incubation centers and increase the participation of start-ups
- Foster close coordination with the private sector to ensure that skills training reflects market realities
- Encourage matchmaking between foreign direct investment and local CSI firms, especially in agroprocessing
- Develop regulations, clear oversight roles, and a communication strategy for Brand Bhutan and explore avenues for greater CSI participation
- Prepare a consolidated inventory of all the various programs directed at CSI development
- Develop a stronger framework to monitor and evaluate the results of CSI policy reform

In the medium to long term, the government should do the following:

- Strengthen the capacity of the MOEA team working with the CSI sector
- Develop more effective forums for public and private collaboration
- Develop CSI industry associations able to provide marketing and training support
- Build credit scoring systems for larger CSI firms
- Ensure stronger CSI portfolio monitoring and financial reporting by the RMA by building a database of timely, consolidated information