DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

HONDURAS

FINANCIAL SECTOR PROGRAM

(HO-0219)

LOAN PROPOSAL

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BASIC SOCIOECONOMIC DATA

For basic socioeconomic data, including public debt information, please refer to the following address:

http://www.iadb.org/RES/index.cfm?fuseaction=externallinks.countrydata

INFORMATION AVAILABLE IN THE RE2/FI2 TECHNICAL FILES

Preparation:

Reports on assisted inspections of Honduran banks

Honduran government's strategy for the financial sector

Project Appraisal of the Financial Sector Technical Assistance Credit (World Bank)

Financial Sector Assessment Program for Honduras (International Monetary Fund and World Bank)

Honduras, Article IV (XX, 2003). International Monetary Fund

Consultants report: Financial crisis prevention early warning system

ABBREVIATIONS

BANADESA	Banco Nacional de Desarrollo Agrícola
BCH	Banco Central de Honduras [Central Bank of Honduras]
CNBS	Comisión Nacional de Bancos y Seguros [National Bank and Insurance Commission]
FOSEDE	Fondo de Seguro de Depósito [Deposit Insurance Fund]
FSAP	Financial Sector Assessment Program
GDP	Gross domestic product
IMF	International Monetary Fund
LISF	Ley de Instituciones del Sistema Financiero [Financial Institutions Act]
PRS	Poverty Reduction Strategy
PRGF	Poverty reduction and growth facility
SEFIN	Secretaría de Finanzas [Ministry of Finance]
UIF	Unidad de Información Financiera [Financial Reporting Unit]
WB	World Bank

HONDURAS

IDB LOANS

APPROVED AS OF SEPTEMBER 30, 2003

	US$Thousand	Percent
TOTAL APPROVED	2,398,015	
DISBURSED	1,944,357	81.08 %
UNDISBURSED BALANCE	453,658	18.91 %
CANCELATIONS	164,305	6.85 %
PRINCIPAL COLLECTED	688,847	28.72 %
APPROVED BY FUND		
ORDINARY CAPITAL	551,414	22.99 %
FUND FOR SPECIAL OPERATIONS	1,776,400	74.07 %
OTHER FUNDS	70,200	2.92 %
OUSTANDING DEBT BALANCE	1,255,509	
ORDINARY CAPITAL	174,620	13.90 %
FUND FOR SPECIAL OPERATIONS	1,080,617	86.07 %
OTHER FUNDS	272	0.02 %
APPROVED BY SECTOR		
AGRICULTURE AND FISHERY	296,827	12.37 %
INDUSTRY, TOURISM, SCIENCE AND TECHNOLOGY	73,899	3.08 %
ENERGY	420,074	17.51 %
TRANSPORTATION AND COMMUNICATIONS	405,401	16.90 %
EDUCATION	71,293	2.97 %
HEALTH AND SANITATION	260,585	10.86 %
ENVIRONMENT	80,247	3.34 %
URBAN DEVELOPMENT	154,749	6.45 %
SOCIAL INVESTMENT AND MICROENTERPRISE	366,177	15.26 %
REFORM AND PUBLIC SECTOR MODERNIZATION	235,492	9.82 %
EXPORT FINANCING	6,908	0.28 %
PREINVESTMENT AND OTHER	26,362	1.09 %

* Net of cancellations with monetary adjustments and export financing loan collections.

HONDURAS

STATUS OF LOANS IN EXECUTION

AS OF SEPTEMBER 30, 2003

(Amount in US$ thousands)

APPROVAL PERIOD	NUMBER OF PROYECTS	AMOUNT APPROVED*	AMOUNT DISBURSED	% DISBURSED
REGULAR PROGRAM				
Before 1997	4	53,900	44,227	82.05 %
1997 - 1998	6	172,106	96,357	55.99 %
1999 - 2000	12	206,049	77,099	37.42 %
2001 - 2002	15	180,243	18,936	10.51 %
2003	3	65,000	0	0.00 %
PRIVATE SECTOR				
2001 - 2002	1	13,700	0	0.00 %
TOTAL	41	$690,998	$236,619	34.24 %

* Net of cancellations. Excludes export financing loans.

Inter-American Development Bank
Regional Operations Support Office
Operational Information Unit

Honduras

Tentative Lending Program

2003

Project Number	Project Name	IDB US$ Millions	Status
HO0205	Sula Valley Citizenship Security	20.0	APPROVED
HO0221	Program to Foster Business Competitiveness	10.0	APPROVED
HO0220	Poverty Alleviation and Local Dev. phase II	35.0	APPROVED
HO0218	Pro-Bosque Program	17.5	
HO0212	Poverty Reduction Sector Program	30.0	
HO0219	Financial Sector Program	25.0	
	Total - A : 6 Projects	**137.5**	
	TOTAL 2003 : 6 Projects	**137.5**	

2004

Project Number	Project Name	IDB US$ Millions	Status
HO0208	Strengthening of Fiscal Management	15.0	
HO0202	Vocational and Technical Education Program	30.6	
HO0207	PPP Roads Integration	50.0	
HO0195	Sustainable Tourism	25.0	
HO1001	Municipal Development Program Tegucigalpa II	22.5	
HO1002	Health Sector Strengthening	25.0	
*HO0201	Privatization Four International Airport	22.0	
HO0224	PPP Energy Sector Support	50.0	
	Total - A : 8 Projects	**240.1**	
HO0197	Poverty Reduction Program focusing on Indigenous peoples and Afro descendants	10.0	
HO0222	Social Protection Program	30.0	
HO0223	Public Finance strengthening support	30.0	
HO0174	Sanitation and Water Investment Complem.	14.0	
HO0192	Credit Global Program	30.0	
	Total - B : 5 Projects	**114.0**	
	TOTAL - 2004 : 13 Projects	**354.1**	
	Total Private Sector 2003 - 2004	**22.0**	
	Total Regular Program 2003 - 2004	**469.6**	

*** Private Sector Project**

FINANCIAL SECTOR PROGRAM

(HO-0219)

EXECUTIVE SUMMARY

Borrower:	Republic de Honduras		
Executing agency:	Ministry of Finance (SEFIN) and National Banking and Insurance Commission (CNBS), through the Superintendency of Banks.		
Amount and source:	IDB (FSO):	First tranche	US$15 million
		Second tranche	US$10 million
		Total	US$25 million
Financial terms and conditions:	Amortization period:		40 years
	Grace period:		10 years
	Disbursement period:		3 years
	Interest rate:		1% for first 10 years and 2% thereafter
	Inspection and supervision:		1%
	Credit fee:		0.5%
	Currency:		U.S. dollar

Objectives: The general objective of the program is to contribute to financial sector development in Honduras, by assisting the government in its efforts to lay the groundwork for keeping the banking system stable and solvent.

Description: In its approach the program focuses on four aspects of the government's policy to resolve problems in the banking system. These aspects are: (i) a macroeconomic policy framework consistent with the program objectives; (ii) a set of prudential standards that conform to Basel Principles; (iii) strengthening of bank supervision; and (iv) efficient financial information systems.

The borrower's macroeconomic policy framework will need to be consistent with the program objectives as set out in the policy letter agreed on between the government and the Bank.

To bring prudential regulations into line with Basel Principles, the CNBS will need to carry out a number of different actions, the most significant of which concern: (i) capital adequacy; (ii) classification of loans, guarantees, and reserves; (iii) matching of maturities, currencies, and interest rates; (iv) external audits; (v) contingent assets; (vi) accrual of interest in income accounts; and (vii) electronic exchange of financial information. In the area of consolidated supervision, action will be taken on the following fronts: (i) establishment of financial groups and procedures for registration; (ii) the methodology for presentation of consolidated financial statements; (iii) financial group capital adequacy; and (iv) treatment of off-shore operations.

The Bank's country and sector strategy: The Bank's strategy with Honduras fits in with the poverty reduction strategy (PRS) insofar as it contributes to maintaining fiscal and macroeconomic stability, conditions that are essential for accelerating the rate of growth, attracting investment and enhancing return on investment, and making the financial sector less vulnerable. In its support for the Honduran financial and private sectors, the Bank has accorded priority to: (i) strengthening the regulatory and prudential framework; and (ii) developing a financial sector that works more closely with business. The program as proposed is consistent with this strategy since it will support the reform of the regulatory framework and prudential standards for banks, thus making for a stronger and more efficient financial system.

Coordination with other multilateral development institutions: The government has brought international agencies into the process of formulating and implementing its comprehensive strategy for financial sector consolidation. In pursuing this strategy, the government has reached agreement with the Bank, the World Bank, and the IMF on different areas of action that they would target in backing the bank consolidation program. The technical teams from the Bank, the World Bank, and the IMF have been working closely together to ensure that the program design is consistent with, and supplements, other operations being carried forward with international organizations. This collaboration has taken the form of joint missions, sharing of results of assisted inspections and assessments, and they will continue to work together for the duration of their respective operations.

The Honduran authorities are setting about the task of reform with the help of the Bank, with a focus on tightening bank supervision, improving and applying prudential standards, and financial reporting systems. At the same time, the IMF will assist the authorities with the reform of FOSEDE. Subsequently, using the outcomes of the Bank program as a starting point the World Bank will help the government perfect and introduce mechanisms for bank resolution with an eye to establishing an orderly exit mechanism for problem banks. In addition, the World Bank will assist with reform of the payments system and corporate monitoring (see paragraphs 1.27 through 1.32).

Environmental and social review: This operation has no direct environmental effects since the activities contemplated are confined to institutional and legal reform of the financial sector. The Committee on Environment and Social Impact approved this operation on 17 January 2003, without comment.

Benefits: The program will create a setting where financial service users benefit from the reforms the program seeks to introduce. With sound and solvent banks, depositors will be guaranteed greater safety and more prudent use of their funds. Borrowers also stand to benefit since they will be assured of a stable source of financing for productive activities.

The CNBS will benefit too since it will have the tools for effective banking supervision through standards to correct the major weaknesses in existing standards. Reliable up-to-date information will ensure that its decisions are more effective, more timely, and better informed, and within the purview of its legal powers, thus helping to sustain a solvent banking system.

By complying with standards that conform to Basel Principles, the banks will be able to expand the range of their financial activities thus raising confidence and trust amongst depositors and investors. At the same time, changing the focus from a balance-sheet audit to a risk-based approach means that bank solvency can be maintained through supervision and the financial services that banks deliver. Lastly, the country, too, will benefit from the likelihood of potentially avoiding further fiscal deficits precipitated by the collapse of banking institutions.

Risks: Given that it will take time to consolidate the reforms introduced under the program and that the present administration in Honduras comes to an end in two years' time, the main risk associated with the program is considered to be the political will of the next administration to press ahead with the reforms that are essential for correcting the weaknesses in the financial system. This is based on the assumption that some resistance is expected from some banks to the supervision regime proposed under the present operation. This risk will be minimized because the reforms are based on a political consensus reflecting a willingness of the Congress to approve, as it has done in recent months, major legislative reforms for the financial sector as well as the views of the banks themselves. In the context of its strategy, the government has been promoting a campaign to inform the public and to consult with all other branches of the State and the banking sector. The views that have emerged seem to favor the proposed reforms in order to minimize the hazards of a systemic crisis.

It is also felt that with the backing of three multilateral institutions, the government has been able to design a package of coherent reforms that is likely to be accepted with minimal resistance. As the reforms to the regulatory framework will be debated in the Congress, it will be more difficult for a future government to deviate from the course charted by the present administration.

Another risk associated with this operation is the ability of the CNBS to retain a team of professionals since the institution has been suffering from high turnover of its most qualified staff because its salary scale is lower than in the private sector. Mindful of this problem, the program matrix includes conditions for perpetuating training and development for CNBS professional staff. Also, on the strength of the agreements signed with the World Bank on bank regulatory reform, the government will be introducing an amendment to the CNBS Act for debate in the Congress that would accord the Commission a more independent structure of governance and greater flexibility in budget formulation and control.

Special contractual clauses: The program will be structured as a fast-disbursing sector operation consisting of two tranches of US$15 million and US$10 million, respectively. Release of the each tranche will be predicated on fulfillment by SEFIN and CNBS of the tranche conditions contained in the policy matrix agreed on with the government and in the policy letter in annex to this document.

Social-equity and poverty classification: The present program does not qualify as a social-equity enhancing project as described in the indicative targets mandated by the Bank's Eighth Replenishment (document AB-1704). Nevertheless, one of the benefits of the program will be to minimize the risks of a banking crisis, with its concomitant impact on the fiscal deficit and the funding available for the poverty reduction program (paragraph 2.9).

Exceptions to Bank policy: None.

Procurement: Not applicable.

I. FRAME OF REFERENCE

A. Macroeconomic framework

1.1 Commencing in 1998, in the aftermath of Hurricane Mitch, Honduras has been afflicted by a combination of internal and external factors that have adversely affected economic performance and aggravated poverty in the country. Economic growth has declined from 5.2% in 2000 to 2% in 2002. Lower prices for traditional exports and slumping business activity in the United States go a long way to explaining the country's weaker economic performance. However, Honduras has been losing its competitive edge in world markets, with a steady decline in exports as a share of GDP. One of the main reasons underlying the country's loss of competitiveness has been the appreciation of the lempira, an outcome of the public sector deficit and increased remittances. Also, the country's comparative advantages have been eroded by the strong drive of other countries to compete with Honduran exports in the United States market. At the same time, on the strength of proactive monetary policy and currency appreciation, inflation was down from 10.1% in 2000 to 8.1% at year-end 2002.

1.2 At the same time, fiscal policy discipline has been undermined by a public sector deficit that burgeoned from 1.8% of GDP in 2000 to 4.1% in 2002, and is expected to touch 4.5% for 2003, in spite of measures to boost revenue and to pare investment and current spending. Pressures for higher salaries and wages in the public sector, the deteriorating finances of public sector enterprises, the cost of closing and capitalizing problem banks, and the forgiveness of debt owed by agricultural producers as a result of the losses caused by the Hurricane Mitch continue to undermine efforts to restore fiscal discipline.

1.3 The government is negotiating an agreement with the IMF under a Poverty Reduction and Growth Facility in an effort to maintain macroeconomic stability. As a precondition for this agreement, it has already instituted reforms to increase revenue and cut spending, thereby reducing the public sector deficit. Before the agreement can be negotiated, it will need to establish a new economic track record. The main obstacle to completing the negotiations have been the problems the government has encountered in raising taxes, bringing down salaries in the public sector, and offsetting the impact of the forgiveness of agricultural debt, which together absorb resources that should be used for poverty reduction and public investment programs and projects. The government is expected to reach agreement with the IMF some time this year on a fiscal sustainability program for 2003-2006. Honduras will also need this agreement if it is to reach the HIPC completion point and qualify for relief on its external debt service.

B. The Honduran financial sector

1. Structure of the Honduran financial sector

1.4 As of 31 December 2001, the country's financial system consisted of 21 private commercial banks, four State-owned banks (two second-tier), four savings and loan associations, 364 cooperatives, nine finance companies, 11 insurance companies, five pension funds, and two stock exchanges (see Table 1.1). At the same time, total assets in the sector amounted to 94,848 million lempiras (nearly US$6,250 million), or approximately 95% of GDP at current prices.

1.5 Institutions in the financial sector are predominantly banks, including specialized and second-tier banks. At year-end 2001, the banking system accounted for 70% of all financial sector assets, or US$4.2 billion (67% of GDP). The largest nonbank institutions are savings and loan associations and credit unions that together represent 10% of sector assets.[1] The insurance market is small, representing only 4% of aggregate financial sector assets. Nonetheless, revenue from insurance premiums is substantial compared to other countries with a similar GDP. Pension funds account for 16% of total assets and 15% of GDP.

1.6 In Honduras, there is a high level of concentration amongst commercial banks, with the six largest banks controlling 70% of total assets and 76% of deposits. In addition, most banks in Honduras belong to economic groupings that generally include other financial intermediaries, insurance companies, and other nonfinancial institutions. Foreign private banks represent only about 4% of total assets in the banking system although there are no legal restrictions on their entry into the Honduran market.

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[1] Cooperatives are not supervised by the CNBS. A bill to extend supervision to cooperatives is presently before the Congress.

Table 1.1
Financial sector structure (December 2001)[2]

	Number	Assets (Mill. de Lps.)	Percentage Total assets	Percentage of GDP
Commercial banks	21	60,215	64	61
Specialized government banks[3]	2	1,176	1	1
Savings and loan associations	4	5,089	5	5
Credit unions[4]	364	2,959	4	3
Second-tier banks	2	5,037	5	5
Nonbank institutions[5]	27	19,582	21	20
Financial institutions total	420	94,848	100	95

Source: Financial Sector Assessment Program Report (World Bank (WB) and International Monetary Fund (IMF), 2003)

1.7 As to the legal and institutional framework for the sector, the CNBS, the Central Bank of Honduras (BCH), and the Deposit Insurance Fund (FOSEDE) are responsible for financial regulation. Responsibility for regulation and supervision falls to the CNBS, which monitors the solvency of sector institutions. The Central Bank is in charge of managing liquidity in the sector, granting and revoking banking licenses, authorizing capital increases, and loans to related companies. FOSEDE administers deposit insurance and has until now been playing a major role as a vehicle for capitalization and liquidation of problem institutions.

2. Recent developments in the banking system

1.8 The Honduran financial sector has become increasingly vulnerable in the wake of the estimated US$4 billion (80% of GDP) in losses caused by the devastation of Hurricane Mitch in 1998.[6] The damage occasioned by the hurricane was concentrated in the nonfinancial sectors, with the result that the quality of bank portfolios has been seriously eroded and the return on these loans declined. These effects were exacerbated by a deterioration in the terms of trade of the country's major exports, which were down by more than 25% between 1998 and 2002.

1.9 In response to the situation created by Hurricane Mitch and the worsening terms of trade, the Honduran authorities issued a series of policies enacted through legislation to make farm credits available. In late February 2003, such credits

2 FSAP information.

3 Banco Nacional de Desarrollo Agrícola (BANADESA) and Banco Municipal Autónomo (closed in 2002)

4 Assets are reported for only 61 credit unions that are members of the Federación de Cooperativas de Ahorro y Crédito.

5 Includes pension funds, which account for 16% of total assets in the system

6 Economic Commission for Latin America and the Caribbean. Impact assessment of Hurricane Mitch, 1999. The country was also seriously affected by a drought in 2000 and 2001.

amounted to 17% of total bank portfolios.[7] These policies provided for interest rate subsidies on agricultural loans, reductions in capital for farm credits, automatic government guarantees for 70% of the principal of rescheduled agricultural credits, and 50% for the rescheduled balance, and authorization for special waivers in respect of portfolio classification of agricultural loans, thus exempting them from the loan provisioning standards. To consolidate all of the policy initiatives that had been decreed, to reduce their fiscal impact, to share the losses already incurred by the banks and to stimulate investment in agriculture, the government passed Legislative Decree 68-2003 (Agriculture Sector Reactivation Act) in 2003. Under this legislation a trust was established and authorized to issue bonds in a maximum amount of 4 billion lempiras for the purchase of the remaining rescheduled portfolio by financial intermediaries including interest receivable, to pay the net present value of the interest rate subsidies previously granted for reactivation/rehabilitation loans and to create a fund for cancellation of small credits of less than 50,000 lempiras per borrower.

1.10 In addition to problem agricultural loans, a number of banks, for reasons that will be explained in due course, experienced a solvency or liquidity crisis that burdened the State with considerable fiscal expenditure in its efforts to capitalize or liquidate the institutions. Since 1999, four banks, five finance companies, and one insurance company have been liquidated by the authorities.[8] The State was forced to pay out in excess of the equivalent of US$200 million in compensation to depositors with banks liquidated in the 1999-2002 period. Of this amount, approximately 87% was paid by the revenue department and the remainder by the Deposit Insurance Fund (FOSEDE). The equivalent of US$30 million was also paid out to capitalize banks under Central Bank lines of credit. FOSEDE has enabled the State to keep deposits fully insured, a situation that causes distortions in the financial sector and poses the potential risk of further fiscal deficits.

3. Situation of the banking system

1.11 The shaky condition of the Honduran banking system prevents the financial sector from playing a role in the process of economic development and undermines the country’s fiscal stability.[9] The weaknesses of the banking system and of institutions in the financial sector may lead to systemic risk if steps are not taken soon to resolve the problems. The exposure of other financial institutions, which taken

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[7] The total commercial bank portfolio as of 28 February 2003 was 36,020 million lempiras, of which agricultural credits totaled 6,216.6 million lempiras. Nearly one half of the agricultural portfolio consists of restructured loans, accounting for a substantial portion of commercial bank nonperforming loans.

[8] In addition, a number of other institutions have formed mergers, been taken over, and gone into voluntary liquidation.

[9] In 2001, the Bank performed an assessment of the financial sector that was updated in March 2002. In April 2003 the Honduran government, with the help of the World Bank and the International Monetary Fund, completed a financial sector assessment program (FSAP).

alone do not threaten the stability of the sector, underscores still further the need to address the challenges facing the banking system.[10]

1.12 Table I.2 below shows the steady weakening in the main banking system indicators.

Table 1.2
Banking System Financial Indicators

Indicator	Dec 98	Dec 99	Dec 00	Dec 01	Dec 02	3-Jun
Regulatory capital/risk-weighted assets [1/]	7.5	11.4	12.3	12.7	13.1	12.9
Primary capital/risk-weighted assets	7.6	9.7	9.8	11.1	10.9	10.4
Nonperforming loans/total portfolio [2/]	11.2	11.2	12.5	13	12.4	12.3
Nonperforming loans less reserves/regulatory capital	55.8	56.1	56.9	55.8	44.3	58.9
Nonperforming loans/total assets	6.4	6.3	7.0	7.3	6.4	7.5
Contingent assets/total assets	0.7	1.5	2.1	2.6	2.5	2.4
Low quality assets less reserves/regulatory capital [3/]	59.5	63.9	83.9	117.3	118.9	126.9
Reserves/nonperforming loans	19.3	23.1	26.7	29.5	37.5	29.1
Reserves/total loans	11.2	11.2	12.5	13.0	12.4	12.3
Average return on assets (ROA)	1.7	1.2	0.8	0.8	0.7	0.5
Return on equity (ROE)	20.2	14	9	8.9	8.2	5
Liquid assets/total assets	25	26.4	26.3	26.6	31.7	32.5
Liquid assets/short-term liabilities	43.7	44.2	42.4	43	48	47.6

Source*: IMF Back-to-Office Report* (September 2003)

1/ Regulatory capital includes primary capital (paid-in capital less investment in other financial institutions) plus supplementary capital (reserves, retained earnings, subordinated debt).

2/ Nonperforming loans include loans > 90 days past due + loans in nonaccrual + loans subject to collection. Total loans include all loans outstanding and off-balance sheet loans for which the banks assume the risk.

3/ Equal to all nonperforming loans, official rescheduling, and contingent loans.

1.13 According to the recent FSAP the factors that are contributing to the deteriorating condition of the banking system are an inadequate legal framework and inadequate prudential standards, limited financial sector oversight capacity, ineffective use of prudential standards and the shaky condition of financial institutions, particularly as a result of problem loans, low profit margins, insufficient reserves and poor capital adequacy ratios. These factors were aggravated by regulatory waivers, increased debt balances through capitalization of unpaid interest, and forgiveness of agricultural loans in the aftermath of Hurricane Mitch.

[10] These assessments show that although nonbank financial institutions have a number of major weaknesses they are not likely to cause systemic risk in the financial sector. The management of nonbank institutions that take deposits (credit unions and savings and loan associations) can be improved particularly in the areas of risk management and administrative cost. Insurance companies are much less able to evaluate risk, and have high administrative costs, coupled with low retention capacity. Although pension funds do not pose a systemic risk either since they are solvent (large reserves and effective dependency relationships), they are vulnerable to political risk and have weak governance frameworks.

1.14 The FSAP also found that despite the progress made the regulatory framework for the banking system was still substantially flawed. The main weaknesses in the legal framework are:

a. An absence of consolidated supervision and regulation of conglomerates;

b. Legal and institutional instruments available to deal with problem banks are inefficient and costly;

c. Early warning mechanisms and corrective measures are not clearly established by law and are therefore vulnerable to legal risk;

d. The mechanisms of lender of last resort hinder efforts to resolve liquidity problems effectively and promptly;

e. The deposit insurance system is negatively capitalized and is entrusted with activities beyond its purview (bank resolution);

f. The special State guarantee does not provide proper incentives for savers and banks.

1.15 Although the authorities agree with the findings of the FSAP, the financial situation of these institutions cannot be resolved because of shortcomings in the reporting systems of both the CNBS and the banks themselves. It was decided therefore that a series of assisted inspections of all banking institutions would be carried out with the Bank's support to verify on the ground the problems that existed and to set in motion a bank rescue program. At this writing, the inspections are 90% complete. The conclusions are outlined in the following sections:

a. Weak CNBS institutional capacity

1.16 The issue of an independent oversight authority was addressed in the FSAP and it was found that CNBS autonomy is compromised by its status as a deconcentrated institution, and changing its status would call for a constitutional amendment, which is not politically feasible at the present time. The assisted inspections also detected structural institutional weaknesses that included no department to review and update prudential standards, the risk management center was attached to the Studies Management Office and the Information Management Systems Audits, not the Superintendency of Banks. Also, the focus of supervision is accounting not risk. Moreover, although CNBS is funded directly by the banking system, it is still not financially independent because its budget is approved by the Congress, subject to the same criteria as any other government ministry. Lastly, the staff of the CNBS, particularly the technical teams in the inspection and monitoring division and the information technology division are in need of more training and development.

1.17 It is important to note that as problems were identified by the consultants involved in the assisted inspections, the CNBS worked to take corrective steps to the extent possible, and the banks and the IMF have the perception that supervision of financial institutions has improved substantially in 2003. Also while the present operation was under negotiation, the national authorities informed the Bank that amendments to the CNBS Act would be introduced to the Congress in the first quarter of 2004 as agreed with the World Bank. The reforms entail changing the terms of commissioners so as not to coincide with the presidential cycle, to raise the requirements for commissioner, to transfer to the CNBS bank resolution responsibilities now being handled by the Central Bank, and to allow the institution greater autonomy in budget formulation and control.

b. Absence of effective prudential legislation

1.18 Prudential legislation now in effect is inadequate and needs major reform. Also, additional standards need to be put in place to permit comprehensive supervision of banking institutions. The major shortcomings are described below:

(i) ***Capital adequacy:*** a review is needed of those areas having to do with establishment and use of reserves, the capitalization of earnings, and the determination of weighted assets (guarantees, bank guarantees by foreign financial institutions, etc.).

(ii) ***Classification of assets and reserves***: a review is needed of those areas concerned with prioritization of a debtor's capacity to pay and the availability of guarantees, the classification of nonperforming loans by category and quality of information for large debtors, the treatment of rescheduled loans or successive rollovers, rescheduling of loans more than 90 days past due, and reclassification of rescheduled loans, the establishment and classification of loans for small debtors, the establishment of reserves, the information that debtors must report, and nonperforming classification. A restatement of risk assets found that bank reserves are under-funded by approximately 2,600 million lempiras (US$150 million).

(iii) ***Standards for matching lending and deposits*** do not exist and need to be implemented to permit matching of maturities and foreign exchange borrowings, as well as information on interest rates and penalties. Prudential standards in Honduras already set ceilings on lending in foreign currencies to lenders that do not generate foreign exchange (10% of foreign currency deposits) and whose foreign currency deposits are subject to a 12% reserve requirement as well as an additional requirement that 38% of the total be placed in liquid investments in first-tier foreign banks.

(iv) ***Consolidated supervision.*** There is no consolidated supervision at present and the Financial Institutions Act needs to be amended to give the CNBS this authority. Also, regulations will need to be drafted and enacted to define financial groups and procedures for registration, the methodology for supervision of financial groups, the standards for ensuring the capital adequacy of financial groups and the treatment of *offshore* operations, which should be included in any definition of the group.

(v) ***Standards of accounting principles.*** Existing standards need to be adjusted to conform to practices accepted under the Basel Principles with respect to the periodicity of financial statements, valuation of assets and financial instruments, the accounting treatment of derivative operations, the transfer of assets, related-party loans, and the likelihood of loan portfolio recovery.

(vi) ***Contingent assets.*** The regulations covering contingent assets are highly complex, and need to be simplified, particularly in the area of procedures for their liquidation.

(vii) ***Amortization of losses from the disposal of assets.*** As existing legislation fails to cover this area, standards are needed because of the high volume of contingent assets.

(viii) ***Accrual of interest in income accounts***. Certain shortcomings exist with respect to the definition of how such interest is calculated and no provision is made for prepayment of interest.

(ix) ***Classification of guarantees.*** No proper distinction is made between different types of guarantees.

(x) ***Bank information systems.*** These systems do not properly regulate the quality, timing, and reliability of financial reporting and the penalties for noncompliance.

c. Inadequate financial reporting systems

1.19 Amongst the problems affecting the banking system is the reliability and consistency of bank reporting mainly because there is no electronically connected system for computerized storage of data. Financial and accounting information from supervised institutions are often inconsistent especially with respect to loan portfolios and the information posted to the risk assessment center database. The information in the risk assessment center database has not yet been consolidated into a single database that provides accurate and timely information on all credit operations in the financial sector and serves as a useful tool for banking institutions and the CNBS itself. As a result, bank examiners continue to consider information verified on the ground as more reliable than any information furnished by the CNBS, a shortcoming that hinders the task of off-site supervision. In short, the reporting systems problem makes it difficult to assess accurately a financial institution's condition.

C. The Bank's strategy with the country and the rationale for the program

1.20 The Bank's strategy with Honduras fits in with the poverty reduction strategy (PRS) insofar as it contributes to maintaining fiscal and macroeconomic stability, conditions that are essential for speeding up the rate of growth, attracting productive investment, and making the financial sector less vulnerable. In its support for the Honduran financial private sectors, the Bank has accorded priority to: (i) strengthening the regulatory and prudential framework; and (ii) developing a financial sector that works more closely with business. The program as proposed is consistent with this strategy since it will set the stage for a more efficient banking system, which will in turn mean that the financial sector can offer a greater variety of user services.

1.21 In the past, there was a persistent lack of political will to introduce reform. This situation has now changed and the government now recognizes the need for reforms to resolve the problems affecting the banking system and to put the sector on a sound footing. An indication of this new approach is the government's success in securing Congressional approval of major amendments to financial sector legislation. Specifically, a decree has been enacted that (i) grants immunity to officials of agencies responsible for supervision in the performance of their duties, as stipulated in the Basel Principles (January 2002); (ii) amends Articles 43 and 57 of the Financial Institutions Act (LISF) whereby the ceiling on related party loans was lowered from 120% to 30% of current capital within a period of three years and bank investments in other companies to 20% of their capital and reserves (August 2002); and (iii) amends the CNBS Act to allow information to be shared between internal and external regulators. The government's strategy (*Financial Sector Consolidation Program*) was developed by the authorities with the help of international organizations. This strategy seeks to accelerate the pace of sustainable economic growth, to make public finances more stable, and to enhance and update the institutional framework for operations in the private sector.

1.22 The government's strategy encompasses more than actions to absorb the losses reported in bank financial statements. It also seeks to prevent the situation from repeating itself, to eliminate the factors contributing to systemic weakness, and to consolidate banking institutions with the capacity to compete in the market, by providing incentives for shareholders to continue with their effort at capitalization, thus supplementing government actions, in order to enable these institutions to perform their economic functions and operate profitably.

1.23 This strategy will consist of the following components: (i) strengthening of bank, insurance, securities, and pensions supervision, including the independence of the supervisory authority; (ii) amending existing financial and commercial legislation; (iii) coming up with alternatives for resolving the agricultural credit problem; (iv) approving and implementing more effective procedures for bank resolution; (v) effecting the gradual transition from a universal deposit insurance system to one based on appropriate incentives for shareholders and financial institution management and for depositors; (vi) establishing mechanisms for recapitalization of banks based on shareholder incentives; (vii) enhancing the legal, institutional, and operational framework in order to prevent asset laundering; (viii) introducing reforms to modernize the payment system; (ix) establishing a corporate financial monitoring system since companies are the largest debtors in the financial system; and (x) adding financial intermediaries, which are not now supervised, to the supervised system.

1.24 The authorities are of the view that the strategy for financial sector reform should go hand in hand with an information campaign to present the government's position and reinforce public confidence and trust. The authorities have therefore formulated an information strategy that presents an analysis of relevant social and political factors, clearly delineates responsibilities, allocates human and financial resources, and governs relations between government agencies concerned with regulation and the media.

1.25 The program meshes with this strategy and addresses the request from the Honduran authorities for a targeted operation that satisfies the objectives of this strategy in the short and medium term. The program has been conceptualized to strengthen those areas of the regulatory and prudential framework and of banking supervision where the need is most pressing.

1.26 The strategy is based on the premise that the problems affecting the banking system have now been clearly identified by means of the assessments and assisted inspections noted earlier. Given the government's immediate need to deal with these problems facing the country's banks and the potential systemic risk entailed, it is striving to take steps to strengthen the stability of banking institutions and bring bank supervision standards up to internationally accepted standards.

D. Coordination with other international organizations

1.27 The government has brought international agencies into the process of formulating and implementing its comprehensive strategy for financial sector consolidation. In pursuing this strategy, the government has reached agreement with the Bank, the World Bank, and the IMF on different areas of action that they would target in backing the bank consolidation program. This program is based on reforms that would be carried out under the sector program and the outcomes of Bank-financed technical-cooperation programs, with additional support from a World Bank technical-cooperation loan (US$9.9 million) approved in June for a project to be implemented between 2003 and 2007, and under an agreement with the IMF that included reform of FOSEDE.

1.28 The technical teams from the Bank, the World Bank, and the IMF have been working closely together to ensure that the program design is consistent with, and supplements, other operations being carried forward with international organizations. This collaboration has taken the form of joint missions, sharing the results of the assisted inspections and the assessments, and they will continue to work together for the duration of their respective operations.

1.29 Given the problems besetting the country's banks, which account for 70% of financial sector assets,[11] the government and the international organizations have concentrated their efforts on six of the 10 components in the *financial sector consolidation program*, which are directly related to the problems facing the banks. The Honduran authorities are setting about the task of reform with the help of the Bank, with a focus on tightening bank supervision, improving and using prudential standards, and financial reporting systems.

1.30 At the same time, the IMF will assist the authorities with the reform of FOSEDE in order to convert it into an institution concerned exclusively with administration of deposit insurance, and relieving it of its functions of bank resolution and liquidation. Subsequently, using the outcomes of the Bank program as a starting point, the World Bank will assist with the resolution of problem institutions. To this end, the legal, institutional, and operational framework will be amended to establish an orderly exit mechanism for problem banks that would be designed to assist with mergers, asset purchase and disposal, and other mechanisms. Also, the World Bank will advance payment system and corporate reform in Honduras, with support for a monitoring system through the BCH unit for registration and control of corporate groups. The table below outlines those areas in the banking system that the actions of the Bank, the World Bank, and the IMF would target.

1.31 The World Bank and the IMF are handling the four remaining components of the *financial sector consolidation program*. The components are: (i) alternatives for resolving the agricultural loan problem; (ii) mechanisms for bank recapitalization based on shareholder incentives; (iii) reform of the legal, institutional, and operational frameworks to prevent asset laundering; and iv) inclusion of financial intermediaries in the supervised financial system.

1.32 It should be mentioned here that although the programs of international organizations complement one another and are uniformly consistent with the government's comprehensive strategy, the Bank-supported reform program will be

[11] This figure includes specialized and second-tier institutions.

carried out separately from the World Bank and IMF programs on a different schedule since its components are self-contained.

Table 1.3			
COMPONENTS	**IDB**	**WB**	**IMF**
Strengthening of bank supervision			
(i) Supervise financial groups on consolidated basis and facilitate access to financial information from nonfinancial members of a financial group to determine whether any significant risk exist as a result of their operations that could jeopardize solvency of financial companies in the same group			
(ii) Improve on-site and off-site inspections for a level of supervision that is able to measure risk more effectively and perform ongoing assessments of an institution's future viability.			
(iii) To raise present capital requirements, bringing them gradually into line with international standards and to protect the solvency of financial institutions not only from credit risk but also from liquidity, interest rate, exchange, operational, and market risks.			
(iv) Tighten regulations governing classification of reserve risks and requirements, to reflect more effectively the risks inherent in credit operations and investment, to provide adequate coverage, and to prevent credit risk from being passed on to depositors.			
(v) Upgrade the risk management center in order to use information as a component in planning inspections and monitoring and to strengthen credit risk assessment by institutions in the financial system.			
(vi) Improve financial reporting systems in order to obtain timely and accurate information.			
(vii) Promote the adoption of best practices by supervised institutions thus spurring better evaluations and handling of risk management as well as corporate governance.			
(viii)Strengthening preventive actions in the case of Financial institutions with existing or potential problems so that management may take the necessary corrective steps and thus avoid the negative impact on institutional solvency.			
(ix) Impose stricter penalties to ensure compliance with the regulatory framework as well as discipline and transparency by supervised entities.			
(x) Strengthen supervision of financial institutions perceived to be the weakest.			
(xi) CNBS professional staff training and development for more effective performance.			
(xii) Communications strategy.			
II. Improve the regulatory framework and prudential standards including FOSEDE			
(i) Amend the Financial Systems Act (LISF) expressly to accord the CNBS authority and powers to perform consolidated supervision.			
(ii) Issue regulations on consolidated supervision.			
(iii) Issue regulations on the corresponding prudential standards.			
(iv) Amend the Financial Institutions Act (LISF) and the regulations governing the CNBS and BCH to permit: a) resolution of weak but viable institutions; b) mergers and acquisitions of institutions by other banks; and c) orderly exit mechanism for nonviable banks.			
(v) Amend the FOSEDE Act to grant BCH and CNBS powers previously held by FOSEDE with respect to bank capitalization and liquidation, leaving FOSEDE sole responsibility for deposit insurance established for protection of small savers to a maximum of US$10,000.			
III. Bank crisis resolution mechanism			
(i) Establishment of an efficient Financial crisis and management system consisting of: (a) a set of early warning indicators; and (b) the Early Warning Committee.			
(ii) Improved procedures for closure of problem banks.			
IV. Amendment to the legal, institutional, and operational framework for prevention of asset laundering			
V. Payment system reform			
(i) Improve and modernize existing systems, including the establishment of a large valued payments system that processes large and low value payments separately.			
(ii) Establish a securities center to spur capital market development and facilitate liquidity distribution within the financial system.			
(iii) Amend the respective legal, regulatory, and supervisory frameworks.			
VI. Corporate sector			
(i) Initiate a Financial monitoring system for the Honduran corporate sector.			
(ii) Regulate bankruptcy regime to facilitate corporate restructuring and to protect the rights of creditors.			
(iii) Promote modern system for registration of property rights for real assets such as buildings as well as a review of legislation of securities, personal property, and intangible assets.			

II. THE PROGRAM

A. Objective and description

2.1 The general objective of the program is to contribute to financial sector development in Honduras, by assisting the government in its efforts to lay the groundwork for keeping the banking system stable and solvent.

2.2 In its approach the program focuses on four aspects of the government's policy to resolve problems in the banking system. The aspects are: (i) a macroeconomic policy framework consistent with the program objectives; (ii) a set of prudential standards that conform to Basel Principles; (iii) strengthening of bank supervision; and (iv) efficient financial reporting systems.

B. Structure of the program

2.3 The program will be structured as a two-tranche fast-disbursing sector operation. Release of the each tranche will be predicated on fulfillment of the tranche conditions contained in the matrix agreed on with the government (Annex I to this document). The Ministry of Finance and the CNBS will be required to demonstrate to the Bank's satisfaction that the conditions precedent have been fulfilled. The Bank will provide financing in the amount of US$25 million, for disbursement in two tranches of US$15 million and US$10 million, respectively. The second tranche will be disbursed within 18 months.

2.4 The borrower's macroeconomic policies will need to be consistent with the program objectives as set out in the government's policy letter attached hereto (see Annex II). This requirement will be a condition precedent to disbursement of each tranche. The only condition requiring Congressional approval will be the amendment of the LISF according the CNBS the legal authority to perform consolidated supervision.

C. Conditions precedent to release of the first tranche

2.5 As conditions precedent to release of the first tranche, the CNBS will be required to demonstrate to the Bank's satisfaction that it has:

1. Prudential standards

a. Enacted prudential regulations for the banking system that conform to Basel Principles in respect of: (i) capital adequacy; (ii) classification of loans, guarantees, and reserves; (iii) matching of maturities, currencies, and interest rates; (iv) external audits; (v) contingent assets; (vi) accrual of interest in income accounts; and (vii) electronic exchange of financial information.

b. Approved, enacted, and introduced legislation according the CNBS the authority to perform consolidated supervision, and has enacted legislation, together with the corresponding regulations, on: (i) definition of financial groups and procedures for registration; (ii) the methodology for presentation of consolidated financial statements; (iii) financial group capital adequacy; and (iv) treatment of off-shore operations.

c. Set up an office with the necessary staff to administer standards, equivalent in rank to the Legal Advisory Service, with responsibility for issuing new standards and reviewing and updating existing ones.

2. Strengthening of bank supervision

2.6 This condition consists of the following requirements:

a. An institutional mechanism for crisis prevention that includes procedures for monitoring the banking system as agreed with the Bank must be in place and regular reports prepared.

b. The CNBS is receiving electronic financial reporting: (i) from all banking institutions, (ii) on all bank credit operations; and (iii) all noncredit operations involving risk.

c. A training and development program has been introduced for CNBS personnel to improve regulatory management and supervision capacity, with a focus on risk analysis and evaluation.

d. System audits have begun on procedures used by at least three banking institutions.

e. Methodologies have been introduced for validation of data from at least three banking institutions.

3. Financial reporting systems

2.7 The borrower is implementing procedures to improve financial reporting systems for internal and external users.

D. Conditions precedent to the second tranche

2.8 As conditions precedent to release of the second tranche, the CNBS will be required to demonstrate to the Bank's satisfaction that:

1. Prudential standards

a. It has enacted, the CNBS is applying, and banks are observing or have observed, by the prescribed deadlines, all prudential regulations in accordance with Basel

Principles to ensure the solvency of the banking system, with respect to: (i) capital adequacy; (ii) classification of loans, guarantees, and reserves; (iii) matching of maturities, currencies, and interest rates; (iv) external audits; (v) contingent assets; (vi) accrual of interest in income accounts; and (vii) electronic exchange of financial information.

b. It has introduced, the CNBS is applying, and banks are observing or have observed, by the prescribed deadlines, regulations on consolidated supervision with respect to: (i) the definition of financial groups and procedures for registration; (ii) the methodology for presentation of consolidated financial statements; (iii) financial group capital adequacy; and (iv) treatment of off-shore operations.

c. The CNBS Prudential Standards Office has been set up with the necessary staff and is discharging its functions with respect to the issuance of new standards and the review and updating of existing ones.

2. Strengthening of bank supervision

a. The effectiveness of the financial crisis prevention system has been assessed.

b. The risk assessment center is functioning normally, is providing accurate, timely, and reliable information, and includes financial reporting for consolidated supervision.

c. The CNBS has completed a staff training and development program to improve regulatory management and supervision capacity, with a focus on risk analysis and evaluation.

d. Systems audits have been performed on all banking institutions.

3. Financial reporting systems

2.9 The CNBS has completed the process of improving financial reporting systems for internal and external users.

E. Social equity enhancement and poverty reduction

2.10 The present program does not qualify as a social-equity enhancing project as described in the indicative targets mandated by the Bank's Eighth Replenishment (document AB-1704). The program will have the advantage of minimizing the risks of a banking crisis, with its potential impact on the fiscal deficit and the funding available for the poverty reduction program.

F. Environmental effects

2.11 This operation has no direct environmental effects since the activities contemplated are confined to institutional and legal reform of the financial sector. The Committee on Environment and Social Impact approved this operation on 17 January 2003, without comment.

G. Money laundering

2.12 In March 2002, Honduras enacted a new Asset Laundering Act (Decree 45-2002), which marks an important step forward in the fight against criminal activity of this kind. The new legislation expands and reinforces substantially the legal and institutional framework in effect by criminalizing certain activities not classified as such under the previous act and granting new powers for investigation and prosecution of asset laundering-related offenses. Under the new act, the Oficina Administradora de Bienes Incautados [Office of Asset Seizures Administration] (OABI) was established specifically to administer assets that have been seized, frozen, or confiscated, as well as a Financial Reporting Unit [Unidad de Información Financiera] (UIF) that is attached to the Superintendency of Banks, Insurance, and Financial Institutions. The UIF's functions will be to receive, analyze, and consolidate the information in forms submitted by institutions under the Commission's supervision and to administer the information in an electronic database. The UIF will also be the conduit through which the Attorney General's Office (Ministerio Público) obtains information for investigations into criminal activities. An official from the UIF will be attached to the Attorney General's Office on a permanent basis. The World Bank is strengthening this unit under its technical assistance program.

III. EXECUTION OF THE PROGRAM

A. Borrower, guarantor, and executing agency

3.1 The borrower will be the Republic of Honduras. The executing agency will be the Ministry of Finance, which will be responsible for demonstrating that the conditions on maintaining macroeconomic stability have been fulfilled and that the Bank financing has been used appropriately. The Ministry will in turn delegate responsibility for coordinating efforts and providing evidence that the contractual conditions on banking reform within the CNBS through the Superintendency of Banks have been fulfilled. To this end, the Ministry of Finance will enter into an agreement with the CNBS, whereby the latter will among other things assume responsibility for verifying that the contractual conditions have been fulfilled and providing documentary evidence to this effect.

3.2 The CNBS has the legal powers for fulfilling the contractual conditions set out in the program matrix. The CNBS Act provides that the Commission is the body that will exercise on behalf of the Executive Branch supervision, monitoring, and oversight of financial institutions and insurance companies, including pension funds and securities exchanges. The Commission will have three regular members and two alternates, all of whom will be appointed by the President of the Republic for four-year terms on a full-time basis. The CNBS has the authority to issue regulations, exercise oversight, perform inspections, apply sanctions and penalties, refuse permission for operations, and administer and liquidate problem institutions, and in general to exercise such powers as a regulatory body would exercise with the exception of interpretation of applicable law. The CNBS has a staff of approximately 180 officials, 80 of whom are employed in activities concerned with financial institution inspections. The institution is being reinforced with specialized consultants, with the support of a technical-cooperation project financed jointly by the Bank and the World Bank.

3.3 The Superintendency of Banks, the technical branch of the CNBS, is responsible for the banking system. It is headed by a Superintendent who is appointed by the Commission for a five-year term. He may attend meetings of the Commission with the right to express his views but without the right to vote. The Superintendency of Banks has two divisions: Banks and Insurance and Other Financial Institutions, which include pension funds. Also, the CNBS must process all matters in accordance with Administrative Procedures Act.

3.4 The Superintendency of Banks will receive technical support from a Bank Inspections Division (for on-site examinations), a Bank Monitoring Division (for off-site examinations), an Insurance and Pension Funds Division, a division for Inspection of Other Financial Institutions (to handle AAP, finance companies, foreign currency offices, and securities firms), and other departments such as an

Administrative Division (for human resources, general services, accounting, and internal audits), an Information Technology Division (housing the risk management center), a Division of Studies and Standards, and a Legal Services and Statistics Department to monitor reserve ratios and review the financial information of banks reporting to the CNBS.

B. Project execution and administration

3.5 **Disbursement of resources.** The borrower will be required to deposit the proceeds of disbursements in special separate accounts, specifying that the funds may not be used for purchase of items appearing on the negative list or for procurement of goods from non-IDB member countries.

3.6 **Accounting records**. The borrower will be responsible for: (i) maintaining through the executing agency all financial and accounting records in connection with the use of the resources and to demonstrate that such resources were used for the purposes of the loan (reforms, policy changes, etc.); (ii) keeping supporting documentation justifying the disbursements as well as documentation showing that the contractual conditions for release of each tranche have been fulfilled, as specified in the loan documentation (such information will be need to be made available for possible inspections by the Bank and/or external auditors); (iii) preparing disbursement requests for submission to the Bank; and (iv) preparing statement of account showing the how the resources have been used, is so required.

3.7 **External audits.** The Bank will have the right to request an audit of any disbursement or to request audited statements of account showing how the resources have been used. Such audits would be performed by independent auditors acceptable to the Bank in accordance with terms of reference approved by the Bank.

C. Inspection and supervision

3.8 The start up and management missions will be handled by the Bank's project team in coordination with the Country Office in Honduras. Under the contract, the borrower and the executing agencies will be required to provide such support as may be needed to further the tasks of inspection and supervision.

D. Monitoring and program evaluation

3.9 A system of bank supervision indicators has already been designed for one of the MIF technical-cooperation projects in progress.[12] This system consists of a series of indicators including liquidity and solvency ratios and early warning indicators for

[12] Systems for financial institutions supervision for the Central Bank of Honduras. Consulting services report. September 2002.

monitoring of banking institutions. The project team has selected certain indicators reflecting the objectives of the program.

3.10 It is proposed that the program objectives be monitored by means of a number of different solvency and liquidity ratios, to be agreed on with the Bank, that would include the following indicators:

Evaluation indicators

Indicator
Regulatory capital /risk-weighted assets
Nonperforming assets / equity
Nonperforming assets / total assets
General expenses / average assets
Financial margin / average assets

3.11 Information derived from the on-site assisted inspections carried out in 2002 and 2003, and from an assessment of the financial sector has been used to prepare the base-line data. Other input will include the results of the early warning indicators, a series of quantitative measures of basic financial health that gauge liquidity, profitability, asset quality, and solvency, which are calculated by the Central Bank and the CNBS for different timeframes. The crisis prevention mechanisms used by the Central Bank and the CNBS are supported by a permanent financial database that can be accessed at any time for evaluations of the health of the banking system. The borrower has decided not to have an ex post evaluation of the program. The government has made a commitment to furnish the Bank with any information that might be needed for verification of compliance with program objectives.

IV. VIABILITY AND RISKS

A. Viability of the program

4.1 The CNBS's success in preparing the program components with the help of the Bank is the most effective means of ensuring that it will not encounter major problems in carrying out the activities for each component. The assisted inspections, which were employed to correct the CNBS database, gauge the effectiveness of present standards, and train staff in the institution's Inspections Division, are now more than 80% complete. The reports, the consultants' recommendations, and the assisted inspections will provide baseline data for implementation, monitoring, and evaluation of the present program.

4.2 The earlier MIF operation and the IDB technical-cooperation projects approved in 2002 and 2003 will help the CNBS fulfill the contractual conditions established in the program matrix. At the outset, the CNBS will control the entire process since the introduction of standards and the new reporting systems will depend solely on its technical teams.

B. Benefits

4.3 The program will create a setting where financial service users benefit from the reforms the program seeks to introduce. With sound and solvent banks, depositors will be guaranteed greater safety and more prudent use of their funds. Borrowers also stand to benefit since they will be assured of a stable source of financing for productive activities.

4.4 The CNBS will benefit too since it will have the tools for effective banking supervision through standards to correct the major weaknesses in the banking system. Reliable up-to-date information will ensure that its decisions are more effective and more timely, based on more reliable data and within the purview of its legal powers, thus helping to sustain a solvent banking system.

4.5 By complying with standards that conform to Basel Principles, the banks will expand the range of their financial activities thus raising confidence and trust amongst depositors and investors. At the same time, changing the focus from a balance-sheet audit to a risk-based approach means that bank solvency can be maintained through supervision and the financial services that banks provide. Lastly, the country will benefit from being able to avoid further fiscal deficits precipitated by the collapse of banking institutions.

C. Risks

4.6 Given that it will take time to consolidate the reforms introduced under the program and that the present administration in Honduras comes to an end in two years' time, the main risk associated with the program is considered to be the political will of the next administration to press ahead with the reforms that are essential for correcting the weaknesses in the financial system. This is based on the assumption that some resistance is expected from some banks to the supervision regime proposed under the present operation. This risk may be overstated, however, since the reforms are based on a political consensus reflecting a willingness of the Congress to approve the legislative reforms described in this document as well as on the views of the banks themselves. In the context of its strategy, the government has been promoting a campaign to inform the public and to consult with all other branches of the State and the banking sector. The views that have emerged seem to favor the proposed reforms in order to minimize the hazards of a systemic crisis.

4.7 It is also felt that with the backing of three multilateral institutions, the government has been able to design a package of coherent reforms that is likely to be accepted with minimal resistance. As the reforms to the regulatory framework will be debated in the Congress, it will be more difficult for any future government to deviate from the course charted by the present administration.

4.8 Another risk associated with this operation is the ability of the CNBS to retain a team of professionals since the institution has been suffering from high turnover of its most qualified staff because its salary scale is lower than in the private sector. Mindful of this problem, the program matrix includes conditions for perpetuating training and development for CNBS professional staff. Alternatives for achieving greater employment stability and staff motivation have also been negotiated with the CNBS.

FINANCIAL SECTOR PROGRAM
POLICY MATRIX

Problem	Relevant Actions Taken (2001-2002)	Program Objectives	Conditions–Tranche I	Conditions–Tranche II
I. Macroeconomic Policy Framework				
Macroeconomic framework		Maintain an appropriate macroeconomic framework.	(a) The borrower's macroeconomic policy framework is consistent with program objectives.	(a) The borrower has maintained a macroeconomic policy framework consistent with program objectives.
II. Prudential Standards				
Existing prudential standards are not applied effectively and limit the CNBS's supervisory functions.	1. Decree No. 294-2002. Amendment of Financial Institutions Act (LISF) to limit a bank's related party operations to 25% of the equity capital of the company in which the investment is made and to 20% of the equity and reserves of a bank; and limits all loans that a financial institution may grant to related individuals and corporations directly or indirectly to 30% of its capital and reserves.	Prudential standards in the banking system brought into line with Basel Principles to ensure development of sound institutions in a solvent banking sector.	(a) The CNBS has enacted prudential regulations that are in effect for the banking system in compliance with Basel Principle with respect to (i) capital adequacy; (ii) classification of loans, guarantees, and reserves; (iii) matching of maturities, currencies, and interest rates; (iv) external audits; (v) contingent assets; (vi) accrual of interest in income accounts; and (vii) electronic exchange of financial information.	(a) Legislation has been enacted, and the CNBS is applying, and banks are observing, by the prescribed deadlines, all prudential regulations in accordance with Basel principles, to ensure the solvency of the banking system, with respect to: (i) capital adequacy; (ii) classification of loans, guarantees, and reserves; (iii) matching of maturities, currencies, and interest rates; (iv) external audits; (v) contingent assets; (vi) accrual of interest in income accounts; and (vii) electronic exchange of financial information.
	2. Decree No. 248-2002. Amendment of the National Bank and Insurance Commission (CNBS) Act and the Central Bank of Honduras (BCH) Act, granting CNBS officials immunity from prosecution for actions and decisions taken pursuant to the Act.		(b) Legislation has been enacted and is in effect granting the CNBS the authority to perform consolidated supervision, and the corresponding regulations have been enacted and are in effect, in the following areas: (i) definition of financial groups and procedures for registration; (ii) the	(b) Legislation is in effect, the CNBS is applying, and banks are observing, by the prescribed deadlines, the regulations on consolidated supervision with respect to: (i) the definition of financial groups and procedures for registration; (ii) the methodology for presentation of consolidated financial statements; (iii) financial group

Problem	Relevant Actions Taken (2001-2002)	Program Objectives	Conditions–Tranche I	Conditions–Tranche II
			methodology for presentation of consolidated financial statements; (iii) financial group capital adequacy; and (iv) treatment of off-shore operations.	capital adequacy; and (iv) treatment of off-shore operations.
	3. Decree No. 174-2002. Amendment of National Bank and Insurance Commission Charter to allow the exchange of information between internal and external regulators and to develop its supervisory capacity. 4. Passage of the Asset Laundering Bill in accordance with international standards.		(c) The CNBS has established an Office with the necessary staff, equivalent in the rank to the Legal Services Department, with responsibility for issuing new regulations, and reviewing and updating existing ones.	(c) The CNBS Prudential Standards Office has the necessary staff and is fully operational, performing the functions of issuing new standards and reviewing and updating existing ones.
III. Strengthening of Bank Supervision				
			a. Crisis prevention systems	
A financial crisis prevention mechanism does not exist.	1. The BCH in coordination with CNBS and FOSEDE designed the institutional structure for the crisis prevention system.	Establish an inter-agency crisis prevention system.	An institutional crisis prevention mechanism is in place, including procedures for monitoring the banking system agreed on with the Bank, and periodic reports are being prepared.	CNBS has prepared an evaluation of the effectiveness of the financial crisis prevention system.
			b. Operation and administration of the risk management center	
The CNBS risk management center does not have sufficient coverage for all financial institutions or their portfolios.	2. The CNBS issued standards to broaden coverage of loans by the risk management center that includes nonbank institutions	Have a risk management center that covers the entire banking system and is fully operational.	CNBS is receiving electronic financial reporting (i) from all banks, (ii) on all bank lending operations, and (iii) on all bank noncredit operations that involve risk.	The risk management center is fully operational, provides accurate, timely, and reliable information and includes financial reporting for use in consolidated supervision.

Problem	Relevant Actions Taken (2001-2002)	Program Objectives	Conditions–Tranche I	Conditions–Tranche II
			c. Institutional strengthening	
CNBS technical staff lack the financial analysis capacity and do not use a risk-based approach to analysis.	3. CNBS hired consultants to perform all assisted inspections and training of inspection and monitoring units.	Endow the CNBS with the capacity to perform on-site evaluations of all banks, verify the quality of information in terms of timeliness and reliability, and verify compliance with the existing regulatory framework.	CNBS has initiated a staff training and development program to improve regulatory and supervision capacity, with a focus on risk analysis and evaluation.	CNBS staff have completed a training and development program to improve regulatory and supervision capacity, with a focus on risk analysis and evaluation.
			d. Systems audits	
CNBS is unable to exercise effective quality control of bank reporting systems.	4. CNBS hired consultants to redesign this aspect of supervision	Endow the CNBS with the methodology for ensuring that bank-reporting systems produce accurate and timely financial information.	Systems audits have been initiated with a focus on procedures for at least three banks. Data validation methods have been implemented by at least three banks.	Systems audits have been performed for all banks. Data validation methods have been implemented by all banks.
IV. Financial reporting systems				
Lack of reliable and timely financial information.	5. Design of early warning system with corresponding indicators prepared by BCH and CNBS. 6. BCH undertook an internal restructuring to facilitate financial information gathering and analysis..	Correct CNBS reporting systems to ensure timely, accurate, and reliable information.	CNBS is implementing a process to improve financial reporting systems for internal and external users.	CNBS has completed the process to improve financial reporting systems for internal and external users.

MEANS OF VERIFICATION

Conditions–Tranche I	Conditions–Tranche II	Means of Verification–Tranche I	Means of Verification–Tranche II
I. Macroeconomic Policy Framework			
(a) The borrower’s macroeconomic policy framework is consistent with program objectives.	(a) The borrower’s macroeconomic policy framework is consistent with program objectives.	(a) The main macroeconomic aggregates are kept within the ranges agreed on with the Bank.	(a) The main macroeconomic aggregates are kept within the ranges on with the Bank.
II. Prudential standards			
(a) The CNBS has enacted prudential regulations that are in effect for the banking system in compliance with Basel Principle with respect to (i) capital adequacy; (ii) classification of loans, guarantees, and reserves; (iii) matching of maturities, currencies, and interest rates; (iv) external audits; (v) contingent assets; (vi) accrual of interest in income accounts; and (vii) electronic exchange of financial information. (b) Legislation has been enacted and is in effect granting the CNBS the authority to perform consolidated supervision, and the corresponding regulations have been enacted and are in effect, in the following areas: (i) definition of financial groups and procedures for registration; (ii) the methodology for presentation of consolidated financial statements; (iii) financial group capital adequacy; and (iv) treatment of off-shore operations.	(a) Legislation has been enacted, and the CNBS is applying, and banks are observing, by the prescribed deadlines, all prudential regulations in accordance with Basel principles, to ensure the solvency of the banking system, with respect to: (i) capital adequacy; (ii) classification of loans, guarantees, and reserves; (iii) matching of maturities, currencies, and interest rates; (iv) external audits; (v) contingent assets; (vi) accrual of interest in income accounts; and (vii) electronic exchange of financial information. (b) Legislation is in effect, the CNBS is applying, and banks are observing, by the prescribed deadlines, regulations on consolidated supervision with respect to: (i) definition of financial groups and procedures for registration; (ii) the methodology for presentation of consolidated financial statements; (iii) financial group capital adequacy; and (iv) treatment of off-shore operations.	(a) The resolutions containing the agreed prudential standards have been published and are in force. (b) Copy of the Official Gazette containing the legislation granting powers to perform consolidated supervision that needs to be in effect. (c) Copy of the resolutions containing the standards for definition of financial groups and procedures for registration; methodology for consolidated supervision of financial groups; standards for financial group capital adequacy; and treatment of off-shore operations. (d) Copy of CNBS Resolution to amend its organizational structure and create the Prudential Standards Office.	(a) A report from the CNBS demonstrating compliance by banks with the standards in effect and a menu of actions that an institution that fails to comply must take to be in proper compliance. (b) An annual report from the CNBS demonstrating that all Honduran banks are being supervised on a consolidated basis. (c) Report from the Prudential Standards Office including its work plan.

Conditions–Tranche I	Conditions–Tranche II	Means of Verification–Tranche I	Means of Verification–Tranche II
(c) The CNBS has established an Office with the necessary staff, equivalent in the rank to the Legal Services Department, with responsibility for issuing new regulations, and reviewing and updating existing ones.	(c) The CNBS Prudential Standards Office has the necessary staff and is fully operational, performing the functions of issuing new standards and reviewing and updating existing ones.		
III. Strengthening Bank Supervision			
An institutional crisis prevention mechanism is in place, including procedures for monitoring the banking system agreed on with the Bank, and periodic reports are being prepared.	BCH has prepared an evaluation of the effectiveness of the financial crisis prevention system.	(i) Copy of CNBS Resolution to create the crisis prevention system and its internal regulations; and (ii) a copy of the monthly reports.	(i) Evaluation report on the performance of the institutional early warning mechanism and its effectiveness; and (ii) copies of the monthly reports prepared since the last disbursement.
CNBS is receiving electronic financial reporting (i) from all banks, (ii) on all bank-lending operations, and (iii) on all bank noncredit operations that involve risk.	The risk management center is fully operational, provides accurate, timely, and reliable information, and includes financial reporting for use in consolidated supervision.	(i) Report on data processing and validation.	CNBS quarterly report on information users, visits, and errors; (ii) validation and evaluation performed by international consultants on the quality of financial information available to the CNBS.
CNBS has initiated a staff training and development program to improve regulatory and supervision capacity, with a focus on risk analysis and evaluation.	CNBS staff have completed a staff training and development program to improve regulatory and supervision capacity, with a focus on risk analysis and evaluation.	Semiannual report on the CNBS staff training activities.	(i) Semiannual report on the CNBS staff training activities; (ii) an evaluation of teaching materials; (iii) CNBS report on the results of the methodology of the new risk-based approach used by CNBS staff trained in the new inspections regime based on a sample. International consultants may be used to assist with this process.
Systems audits have been initiated with a focus on procedures for at least three banks.	Systems audits have been carried out at all banks.	Systems audit manuals and systems audits reports from three banks.	Systems audit reports from all banks with the results and respective adjustment plans and penalties.
Data validation methods have been implemented by at least three banks.	Data validation methods have been implemented by all banks.	(i) Report on data processing and validation from at least three banks.	(i) Report on data processing and validation from all banks.
IV. Financial reporting systems			
CNBS is implementing a process to improve financial reporting systems for internal and external users.	CNBS has completed the process of improving financial reporting systems for different internal and external users.	(i) Resolutions containing standards on delivery of financial information; (ii) evidence of interconnections; (iii) reports on financial information visits and errors; (iv) report on the effectiveness of data validation methods.	(i) CNBS report on electronic data retrieval from all commercial banks, containing corrections made through validation of data on financial groups; (ii) evaluation of reliability and timeliness of financial information provided by CNBS.

MINISTRY OF FINANCE
REPUBLIC OF HONDURAS

Tegucigalpa M.D.C. 12 November 2003

Mr. Enrique Iglesias
President
Inter-American
Development Bank (IDB)
Washington, D.C.

Dear Mr. President,

Our country's Poverty Reduction Strategy has been in effect for one year and a recent report assessed its performance. As in the case of other countries that have benefited from the HICP initiative, this first year has been a learning experience, in which we implemented innovative standards and procedures and were able to learn from the experiences of other nations that have carried out similar strategies before us. The document was scrutinized by the sector groups (government, civil society, and cooperants), taking part in the dialogue and consensus defined in the strategy as a consultative mechanism. To this end, nine workshops were organized for the most representative groups of Honduras society—women, nongovernmental organizations, local government, campesino groups, workers, the private sector, and ethnic minorities.

The report found that there is still a long way to go in the struggle to reduce poverty. The combined effects of export sector performance, the fiscal situation, an overly ambitious timetable at the outset, and the delay in reaping the benefits of debt relief converged to prevent the strategy from meeting its initial targets. Here it should be noted significant progress was indeed achieved in important aspects such as the implementation of the PRS, project prioritization, and administration of additional resources. Progress in the areas of rural poverty reduction, social protection, and sustainability was acceptable in the programs and subprograms implemented. More still needs to be done, however, to boost economic growth, reduce urban poverty, and develop human capital.

Given these results, it is felt that certain aspects of the strategy need to be updated. First tangible results in the 2003-2005 period must be obtained and elucidated by bringing the activities of the government and donors into line with one another in the key program areas as a criterion of for targeting programs to the country's most vulnerable sectors. Also, it is important to broaden the strategy's budgetary approach since the original design underestimated national expenditure, which account for over 65% of total outlays on poverty. In this same vein, additional external resources must be arranged to help cover part of the existing financing gap.

Such an update is not for a moment intended to modify the underlying elements of the PRS. The government holds firm on the strategy's long-term vision to 2015, the strategic guidelines, and the poverty reduction targets. Reducing the proportion of the population living under the poverty line from 66% in 2000 to 42% in 2015 continues to be the fundamental objective.

I.- Macroeconomic Framework

Since taking office in 2002, President Ricardo Maduro's administration has continued to be faced with macroeconomic problems brought about by the worldwide recession, deteriorating terms of trade cause by higher fuel prices, and declining commodity prices, particularly that of coffee. During the year, GDP expanded by just 2.7%, in line with population growth thus making for a situation of stagnating per capita GDP.

Macroeconomic management was seriously undermined by a fiscal policy geared to the 2001 elections. Payroll expenses exceeded the economy's absorption capacity leading to a slump in current savings in the public sector and a sharp divergence from the fiscal targets of the IMF program. The salary increases, which have now passed into law, affect over 70% of the central government payroll (covering the remuneration of teachers, doctors, nurses, and other officials in the social sectors).

In 2002 and 2003, the government took action to shore up public finances. The measures included improvements in tax administration, a new agreement with the teachers, setting salaries below the statutory levels, a freeze on all other public sector salaries, and a widening of the tax base by eliminating exemptions and deductions. Yet, despite these steps, the public sector deficit will amount to 4.5% of GDP for 2003.

As a result of the government's actions, negotiations with the IMF were able to continue throughout the period and are expected to conclude in December 2003 with agreement on a new poverty reduction and growth facility (PRGF) for 2004-2006.

Delays in reaching the HIPC initiative completion point have had an impact on the PRS since Honduras has been compelled to use its own resources to service its multilateral debt on its own. At the same time, it has fallen behind on loans and the additional financing contemplated in the strategy has not materialized. This situation has meant that the budget for financing the PRS is more than 2% of GDP lower than originally projected in strategy.

President Ricardo Maduro's administration is finalizing negotiations on a program with the International Monetary Fund as part of the PRGF, which incorporates one of the most important elements of the Poverty Reduction Strategy that was reviewed and validated by the Consultative Council, a consultative civil society body. The program is expected to be approved by the IMF's Executive Board in 2004.

In the context of the Great National Dialogue, the government in conjunction with civil society, the private sector, and different professional associations within the country, is discussing a Fiscal Accountability for Sustainable Development Act, as a regulatory mechanism for administration of public finances, for the purpose of meeting the targets set in the Development Program this involves balancing State revenues and expenditures, improving the quality and productivity of public spending in order to enhance transparency in the administration of public revenues, rational use of resources, investment borrowing, and transparency in government, with a view to attaining the targets of the macroeconomic program and generating more resources for the PRS. This new legislation will apply generally to all three branches of the State and to local government and monitoring compliance with this legislation and the recommendations made and powers accorded under the Fiscal Accountability Pact will fall to the Special Monitoring Commission (COESE).

II.- Program for strengthening the banking system

The vulnerability of the Honduran financial system surfaced in 1999, when four insolvent banks were either liquidated or recapitalized, at a cost to the government in excess of 3.5% of GDP. To minimize the systemic risks and to make the system less vulnerable, the government has formulated an action plan to improve the financial position of the banks and supervision of the sector with the backing of programs coordinated with the World Bank, the IMF, and the IDB.

To this end, the government has accorded top priority to reforms to correct the problems plaguing the banking system. In the past, the government through public institutions concerned with maintaining financial stability, bank supervision, and the payments system, has pursued actions evidencing its commitment to putting the financial sector on a sound footing—an about face from the persistent lack of political will in the past to tackle these problems—and it has introduced some major reforms. An indication of this commitment is the government's success in securing Congressional approval for various bills for financial sector reform. The government's strategy, as embodied in the Financial Sector Consolidation Program, has been developed by the authorities of the institutions concerned with the support of international organizations and has been approved at the highest levels of the Executive Branch. The program seeks to accelerate the pace of sustainable economic growth, contribute to the stability of public finances, and to improve and update the institutional framework for operations in the private sector.

The government's strategy encompasses more than actions to absorb the losses in the banking system at the least possible cost to the State. It also seeks to lay the groundwork for preventing a recurrence of such a situation and to eliminate the factors contributing to weakness, and to consolidate the banks that are able to compete in the market, by providing incentives for shareholders to continue their efforts at capitalization, thus supplementing government actions, in order to enable these institutions to perform their economic functions and operate profitably.

With this aim in view, the government has embarked on a strategy with the following components: (i) strengthening of bank, insurance, securities, and pension supervision, including the independence of the supervisory authority; (ii) amending existing financial and commercial legislation; (iii) coming up with alternatives for resolving the agricultural credit problem; (iv) approving and implementing more effective procedures for bank resolution; (v) effecting the gradual transition from a universal deposit insurance system to one based on appropriate incentives for shareholders and financial institution management and for depositors; (vi) establishing mechanisms for recapitalization of banks based on shareholder incentives; (vii) enhancing the legal, institutional, and operational framework in order to prevent asset laundering; (viii) introducing reforms to modernize the payment system; (ix) establishing a corporate financial monitoring system since companies are the largest debtors in the financial system; and (x) adding financial intermediaries, which are not now supervised, to the supervised system.

The authorities are of the view that the strategy for financial sector reform should go hand in hand with an information campaign to present the government's position and reinforce public confidence and trust. The authorities have therefore formulated an information strategy that presents an analysis of relevant social and political factors, clearly delineates responsibilities, allocates human and financial resources, and governs relations between government agencies concerned with regulation and the media and the private sector, particularly financial institutions.

The government is also considering the following regulatory reforms:

1. Deposit Insurance Fund (FOSEDE)

The FOSEDE Act will be amended to provide this entity with sole responsibility for deposit insurance administration. Its present bank resolution functions (bank capitalization and liquidation) will be transferred to the CNBS, which will in turn necessitate amendments to the charters of both institutions and to the Financial Institutions Act.

2. Resolution mechanisms

The aforesaid acts will also need to be amended in order to reform bank resolution mechanisms having to do with the regularization of financially weak banks that are still viable, consolidation of the system, through mergers and acquisitions, and liquidation of nonviable institutions.

3. Consolidated supervision

One of the major reforms will be granting the CNBS the legal authority to perform consolidated supervision. In addition, the Commission will be required to draft and issue regulations for enforcement of consolidated supervision in the following areas: establishment of financial groups and procedures for registration; the methodology for presentation of consolidated financial statements; financial group capital adequacy standards; and the treatment of off-shore operations, all of which should be included in the definition of the group.

The government will also modify standards of supervision and introduce new standards for brining them into line with international best practices and the recommendations of the Basel Committee, as described below:

1. Prudential standards

Aligning all prudential regulations with the Basel Principles will call for the following actions by the CNBS. The most significant are: to prepare, amend if necessary, and enact prudential regulations for the present banking system that comply with Basel Principle with respect to capital adequacy; classification of loans, guarantees, and reserves; matching of maturities on loans and deposits, standards for treatment of contingent assets; and standards for accrual of interest in income accounts.

Also, a Prudential Standards Office will be set up with the necessary staff and equivalent in the rank to an Internal Audit Department and Legal Services Department that reports directly to the Commission. This new Office will be responsible for proposing new regulations, and reviewing and updating existing ones so that the regulatory framework is kept permanently updated and consistent with international best practices.

2. Strengthening of bank supervision

The government seeks to strengthen bank supervision with the introduction of (i) an early warning financial crisis prevention system involving the creation and implementation of institutional mechanisms for crisis prevention; (ii) a risk management center that will need to have access to all banking institutions and all bank portfolio information. In addition, the CNBS will continue with its staff training and development program in a move to improve regulatory management and supervision, with a focus on analysis and supervision, based on the different risks affecting the financial sector; and (iv) systems audits with a focus on procedures and operational risk, in all banks.

3. Financial reporting systems

To complete this process, the CNBS will carry out the following activities: (i) issue standards for the data input system with commercial banks, including raising penalties for noncompliance; (ii) screen data from three commercial banks; (iii) implement data validation methods for at least three banks; (iv) initiate electronic data retrieval with commercial banks; and (v) effect electronic interconnections with all commercial banks.

4. Progress made with standards to prevent money laundering

In addition, Honduras has also been making great strides to control money laundering in the country. In recent years, the authorities have been moving ahead with various measures to eliminate money laundering. To this end, legislation has been passed and a number of different international agreements and treaties have been signed.

In March 2002, Honduras enacted a new Asset Laundering Act (Decree 45-2002), which marks an important step forward in the fight against criminal activity of this kind. The new legislation expands and reinforces substantially the legal and institutional framework in effect by criminalizing certain activities not classified as such under the previous act and granting new powers for investigation and prosecution of asset laundering related offenses. Under the new act, the Oficina Administradora de Bienes Incautados [Office of Asset Seizures Administration] (OABI) was established specifically to administer assets that have been seized, frozen, or confiscated, as well as a Financial Reporting Unit [Unidad de Información Financiera] (UIF), whose specific functions will be to consolidate the information provided by supervised institutions in connection with asset laundering and reports to the CNBS. In addition, Honduras has signed technical assistance agreements with various countries in the region, is receiving technical assistance from the United States Department of the Treasury, and has been invited to attend the Egmont Group as an observer as a prelude to consideration of its application for permanent membership in this body.

III.- *Support of the Inter-American Development Bank*

In the context of the financial sector strategy, the government has reached agreement with the IDB on a program of reform that targets three areas of government policy to resolve the banking crisis. These are (i) prudential standards in line with Basel Principles; (iii) the strengthening of banking supervision; and (iv) the creation of efficient financial reporting systems.

The program meshes with this comprehensive strategy for financial sector reform and addresses the government's desire for a targeted operation that satisfies the objectives of this strategy in the short and medium term. The program has been conceptualized to strengthen those areas of the regulatory and prudential framework and of banking supervision where the need is most pressing. The strategy is based on the premise that the problems affecting the banking system have now been clearly identified by means of the assessments and assisted inspections noted earlier. Given the government's immediate need to deal with these problems facing the country's banks and the potential systemic risk that is posed, it is striving to take steps to strengthen the stability of banking institutions and bring bank supervision standards up to accepted international standards.

The Government of the Republic of Honduras is committed to implementing the financial sector reform program, in the conviction that the sector will operate more efficiently and be better able to compete. Significant progress has now been made in this direction and the procedures that the government seeks to implement to achieve this objective will benefit the Honduran financial system through more effective allocation of resources, higher levels of savings flows, and lower financial intermediation costs. In moving forward in this area, the government is committed to maintaining as it has done in the past, an environment of macroeconomic stability that is conducive to growth and economic development.

The main accomplishments made to date include an assessment of the financial system in the context of the Financial Sector Assessment Program with the participation of the International Monetary Fund, the World Bank, and the assisted inspections financed by the Inter-American Development Bank. Considering these efforts, drafting and introducing to Congress the legislation mentioned and negotiation of a macroeconomic program with the International Monetary Fund as well as the remaining tasks involved in the process of strengthening the financial sector, particularly those efforts having to do with implementing the legal framework described in this Policy Letter, and keeping the system on a sound footing, the government hereby requests that you give your favorable consideration to a loan in support of these purposes.

Yours sincerely,

William Chong Wong
Assistant Secretary for Finance and Budget,
Ministry of Finance