PD-ABH-863

AGENCY FOR INTERNATIONAL DEVELOPMENT

PROJECT DATA SHEET

1. TRANSACTION CODE: A = Add, C = Change, D = Delete
Amendment Number: 3
DOCUMENT CODE: 3
8649

COUNTRY/ENTITY: Honduras

3. PROJECT NUMBER: 522-0325

4. BUREAU/OFFICE: LAC 05

5. PROJECT TITLE (maximum 40 characters): POLICY ANALYSIS AND IMPLEMENTATION

6. PROJECT ASSISTANCE COMPLETION DATE (PACD): MM 08 DD 28 YY 97

7. ESTIMATED DATE OF OBLIGATION (Under "B." below, enter 1, 2, 3, or 4)
A. Initial FY 87 B. Quarter 4 C. Final FY 97

8. COSTS ($000 OR EQUIVALENT $1 =)

A. FUNDING SOURCE	FIRST FY 87 B. FX	C. L/C	D. Total	LIFE OF PROJECT E. FX	F. L/C	G. Total
AID Appropriated Total						
(Grant)	(3,000)	(500)	(3,500)	(28,350)	(4,000)	(32,350)
(Loan)	( )	( )	( )	( )	( )	( )
Other U.S. 1.						
Other U.S. 2.						
Host Country		200	200		19,090	19,090
Other Donor(s)		150	150		1,000	1,000
TOTALS	3,000	850	3,850	28,350	24,090	52,440

9. SCHEDULE OF AID FUNDING ($000)

A. APPROPRIATION	B. PRIMARY PURPOSE CODE	C. PRIMARY TECH. CODE 1. Grant	C. 2. Loan	D. OBLIGATIONS TO DATE 1. Grant	D. 2. Loan	E. AMOUNT APPROVED THIS ACTION 1. Grant	E. 2. Loan	F. LIFE OF PROJECT 1. Grant	F. 2. Loan
(1)				7,000				7,000	
(2)				8,350				15,350	
(3)				4,000				4,000	
(4)						6,000		6,000	
TOTALS				26,350		6,000		32,350	

10. SECONDARY TECHNICAL CODES (maximum 6 codes of 3 positions each)

11. SECONDARY PURPOSE CODE

12. SPECIAL CONCERNS CODES (maximum 7 codes of 4 positions each)
A. Code
B. Amount

13. PROJECT PURPOSE (maximum 480 characters)

To strengthen the Honduran capacity to formulate and implement economic policies and administrative reform.

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14. SCHEDULED EVALUATIONS
Interim MM YY | MM 09 YY 94 | Final MM 01 YY 97

15. SOURCE/ORIGIN OF GOODS AND SERVICES
[X] 000 [ ] 941 [X] Local [ ] Other (Specify)

16. AMENDMENTS/NATURE OF CHANGE PROPOSED (This is page 1 of a ______ page PP Amendment.)

This amendment adds funding for the implementation of policy change in the financial sector.

17. APPROVED BY
Signature: [signature]
Title: Marshall D. Brown, Mission Director
Date Signed: MM 9 DD 24 YY 92

18. DATE DOCUMENT RECEIVED IN AID/W, OR FOR AID/W DOCUMENTS, DATE OF DISTRIBUTION: MM DD YY

AID/LAC/P-744
CR-507+ 386

Policy Analysis and Implementation Project
Financial Sector Amendment No. 3
522-0325.3

I. Summary

The Financial Sector Amendment to the Policy Analysis and Implementation Project (PAIP) is designed to increase the capacity of the Honduran public and private sector to formulate and implement reforms that improve financial intermediation. This project component consists of four activities:

- Improved Regulation/Supervision of the Financial Sector
- Promotion of Financial Sector Reforms
- Commercial Bank Strengthening
- Development of New Medium and Long-Term Financial Instruments

The Financial Sector Component will be divided into two phases of two years each. Policy benchmarks have been developed for each project phase and a mid-term assessment of the achievement of these benchmarks will determine which activities will be continued in Phase II.

The estimated total cost of this amendment is \$8.64 million. USAID will contribute \$6.0 million in grant funds; the Government of Honduras (GOH) will contribute the local currency equivalent of \$1.14 million; and the private sector will contribute \$1.5 million for commercial bank training activities. The major GOH implementing agencies will be the Central Bank of Honduras (BCH) and its dependency, the Superintendency of Banks (SB). Other organizations that will receive support under the project amendment are the Honduran Council for Private Enterprise (COHEP) and the Honduran Association of Banking Institutions and Insurance Companies (AHIBA).

II. Background and Problem

The original Project Paper for the Policy Analysis and Implementation Project states that the specific problem to be addressed is how to stimulate the savings and investment required to move Honduras out of economic stagnation and improve standards of living in a sustainable fashion. It identified key constraints as 1) inadequate GOH capability to analyze and implement required macroeconomic reforms; and 2) lack of private sector capacity to understand economic issues, analyze GOH policy proposals, and educate the public on these issues. Technical assistance and training were provided to both the public and private sector to strengthen their capacity to formulate and implement macroeconomic reforms.

Significant progress has been made during the project's five years of implementation. The GOH has adopted a comprehensive set of measures to restructure and stabilize the economy. Reforms have reduced the GOH budget deficit, reduced inflation and slowed devaluation. Since 1990, Honduras has eliminated most sector subsidies, decontrolled prices, become a leader in Central America in liberalized trade policies and, most recently, approved two significant pieces of legislation -- one that improves land titling and ownership and another that will facilitate foreign investment. While Honduras needs to continue its economic stabilization program and implement agricultural sector reforms, a major reform program focussed specifically on the financial sector is now needed to improve the efficiency of Honduras' financial system in mobilizing and allocating resources through market mechanisms to a broader segment of the population and thus fuel economic recovery.

To identify the principal constraints to financial sector efficiency in Honduras, the Mission commissioned a comprehensive Financial Sector Assessment (see Annex D) and consulted with the GOH and several donors. The assessment identified the following key constraints to an efficiently functioning financial system:

- Inappropriate economic and financial sector policies that discourage domestic savings, the potential source of funds for long-term financing. Such policies include controls on interest rates, high reserve requirements that tax bank deposits, the availability of low interest rediscounts that reduce the incentive to financial institutions to mobilize deposits and the poor enforcement of loan contracts by the judicial system.

- An obsolete system for regulating and supervising the banking system consisting of public sector institutions (the Central Bank and the Superintendency of Banks) that lack the proper organizational structure and authority to effectively carry out their monetary management responsibilities.

- Commercial sector banks that are ill-prepared to deal with the funds management, treasury and foreign exchange trading requirements and opportunities that will result from changes in financial sector policies.

- Lack of stable financial instruments and mechanisms that attract domestic savings and provide an attractive source of medium and long-term financing for investment projects.

III. Relationship to USAID and Country Strategy

This project component will support the design and implementation of financial sector policy reforms required for the disbursement of ESF funds under the Mission's Structural Adjustment Program (SAP). It will also support the Mission's Strategic Objective of Increased Private Sector Investment, Production and Trade and is a key element in the Program Output of Improved Financial Intermediation.

The activities financed under this amendment are consistent with USAID's policy on financial market development which states that USAID, as one of its first priorities in the financial sector, should help host governments develop and implement policies to encourage, mobilize and monetize domestic savings. Other priority areas are the improvement of supervisory/regulatory frameworks governing the operation of financial institutions and the strengthening of private financial systems.

The amendment is also congruent with the Economic Assistance Strategy for Central America which identifies poorly functioning financial markets and inadequate levels of long-term financing for private investment as two constraints to economic growth in the region. As a strategy to address these constraints, it proposes to strengthen the ability of the financial sector to mobilize domestic resources and channel them efficiently to the most productive sectors of the economy.

The Mission has coordinated with both the Interamerican Development Bank (IDB) and the World Bank in the development of this financial sector component. The IDB is in the process of designing a loan program for private sector investment. Under this program loan funds would be disbursed to the Central Bank in tranches according to demand and the Central Bank would auction the funds to qualified financial institutions using open market procedures. Conditionality for this loan is similar to that of the financial sector reforms that are required under the Mission's SAP program: freeing of interest rates, rationalization of rediscount lines, open market operations and improved regulation of the banking system. In the design of this loan package the IDB is relying on USAID to provide assistance to: (1) the Superintendency of Banks to ensure soundness and competitiveness of the participating commercial banks; (2) the Central Bank's Department of Credit and Securities to initiate open market operations, (3) the Central Bank to establish a treasury function. The World Bank will support stabilization of the economy through its Structural Adjustment Loan II (SAL II) which provides balance of payments support. Conditionality for SAL II includes the same financial sector reforms required by both the IDB and the Mission's SAP program. The World Bank has also agreed to finance computer hardware and software and technical assistance to modernize the Central Bank's MIS and accounting systems. The purchase of this equipment will be closely coordinated with other activities to upgrade the Central Bank in this project amendment.

IV. Objectives

The overall purpose of the Policy Analysis and Implementation Project is to improve the capacity of Honduran public and private sector entities to formulate economic policies and administrative reforms.

The subpurpose of this financial sector amendment to the project is to increase the capacity of Honduran public and private sector entities to formulate and implement policies and related legislative and administrative reforms that improve financial intermediation. At the end of the project the following conditions related to this amendment should exist:

- Gross private investment, as a percentage of GDP, will increase from 8.1% in 1991 to 11% in 1996.

- Gross domestic savings, as a percentage of GDP, will increase from 10% in 1992 to 15% in 1996.

A logical framework for this amendment is provided in Annex A.

V. Detailed Project Description

A. Project Strategy

The Financial Sector Assessment identified a number of macroeconomic and macrofinancial policies that must be implemented to liberalize the financial sector and promote domestic savings and investment. This project amendment will focus on the **promotion** of improved financial sector policies and the **implementation** of these policies by the public and private banking sector.

To ensure GOH commitment to financial sector reform, the project amendment will contain a condition precedent to initial disbursement that requires the submission of a revised Banking Law to Congress before technical assistance is provided to the Superintendency of Banks. Before assistance other than technical assistance (i.e., commodities, training, etc.) is provided to the Superintendency, this law must be passed. The project amendment will also contain a condition precedent to assistance aimed at strengthening the Central Bank's capacity to regulate the financial system that will require the Central Bank to develop and approve a restructuring plan. More details on Conditions Precedent are provided in Annex M.

To assure continuing GOH and private sector commitment to financial liberalization, policy indicators or benchmarks have been developed for each year of the project. At the end of the second year of the project (late 1994), an assessment will be made of progress in achieving these policy benchmarks. Such an assessment is particularly important because of elections in late 1993 and a change in government in early 1994. Based on the results of this assessment, the project will either: continue as planned; be modified to eliminate areas where there is lack of commitment or strengthened in areas where there is substantial progress; or be terminated if progress in reforming the financial sector is judged unsatisfactory. Yearly policy benchmarks developed for the Financial Sector Amendment are provided in Table 1.

The project amendment's four activities are discussed below. The largest project component involves improving the regulation and supervision of the financial system. This activity is of utmost importance to ensure solvency and transparency of operations of banks and other financial entities and to restore public confidence in these institutions. Other project activities include the promotion of policy reform through a grant to the Honduran Council for Private Enterprise (COHEP), the strengthening of the commercial banking sector through a grant to the Honduran Association for Banking Institutions and Insurance Companies (AHIBA) and assistance to the Central Bank to develop new medium and long-term financial instruments.

B. Improved Regulation/Supervision of the Financial Sector

Output: **A Central Bank that has sufficient autonomy, appropriate organizational structure and adequate internal controls to manage and regulate Honduras' financial system.**

Problem: The Central Bank of Honduras (BCH) does not have the appropriate autonomy, organizational structure or adequate internal control systems to operate as a modern central bank.

6

TABLE 1
Financial Sector
Policy Benchmarks

ACTIVITY	PHASE I (FASE I)		PHASE II (FASE II)		
	October 1, 1992 - September 30, 1993	October 1, 1993 - September 30, 1994	October 1, 1994 - September 30, 1995	October 1, 1995 - September 30, 1996	October 1, 1996 - September 30, 1997
Component I (Componente I) <u>Supervisory and Regulatory Framework (Marco de Trabajo Supervisorio y Regulatorio)</u>	Restructuring plan for Superintendency approved. (Plan de reestructuración aprobado para la superintendencia.) Banking Law regulations approved by BCH. (Regulaciones de la Ley Bancaria aprobadas por el BCH.) Creation of a Legal Advisory Unit at Superintendency of Banks. (Creación de una Unidad de Asesoría Legal en la Superintendencia de Bancos.) Open market operations initiated by the BCH. (Comienzo de las operaciones del mercado abierto por el BCH.) A strategic plan to reorganize the BCH developed and implemented. (Un plan estratégico desarrollado y ejecutado para la reorganización del BCH.)	Capital markets regulatory unit established at Superintendency. (Una unidad regulatoria para los mercados de capital establecida en la Superintendencia.) Bank inspection methods modernized. Bank intervention plan finished and staff trained. (Métodos de inspección bancaria modernizados. Plan de intervención bancaria finalizado y el personal capacitado.) Insurance regulations revised. (Regulaciones de Seguros revisadas.) BCH's Foreign Exchange Management Unit established and operational. (La Unidad de Manejo de Moneda Extranjera del BCH establecida y operando.)	MIS system at Superintendency interconnected with the financial system. (Sistema MIS de la Superintendencia interconectado con el sistema financiero.) Pension fund supervision procedures established by Superintendency. (Procedimientos de supervisión de fondos de pensiónes establecidos por la Superintendencia.) Legal department trained in modern financial legislation. (Departamento legal capacitado en legislación financiera moderna.)	Procedures established to regulate IRA management companies. (Procedimientos establecidos para regular las compañías administradoras de cuentas de retiro.) BCH Data Center makes available to public and GOH timely financial information. (El Centro de Datos del BCH hace disponible al público y al GdeH información financiera de manera oportuna.) Restructuring of the BCH completed. (El reestructuramiento del BCH terminado.)	A securities commission created by Congress to regulate and supervise capital markets. (Una comisión de valores creada por el Congreso para regular y supervisar los mercados de capital.) Strategic planning review by BCH to determine future activities. (Revisión estratégica de planeamiento por el BCH para determinar futuras actividades.)

ACTIVITY	PHASE I (FASE I)		PHASE II (FASE II)		
	October 1, 1992 - September 30, 1993	October 1, 1993 - September 30, 1994	October 1, 1994 - September 30, 1995	October 1, 1995 - September 30, 1996	October 1, 1996 - September 30, 1997
Component II (Componente II) <u>Policy Reform (Reforma de Política)</u>	Reserve requirement lowered to 30%. (El encaje legal reducido a 30%.) BCH-COHEP-Financial Sector Technical Working Group established and agenda determined. (Grupo de trabajo técnico del BCH, COHEP y del Sector Financiero establecido con agenda determinada.) Five policy conferences held. (Cinco conferencias de política llevadas a cabo.)	Legal framework established to regulate the securities market (Marco legal establecido para regular el mercado de valores) Insurance Law revised by Congress. (Ley de Seguros revisada por el Congreso.) Five policy conferences held. (Cinco conferencias de políticas llevadas a cabo.)	Study and promote the adoption of improved court procedures to enforce creditors' rights. (Estudiar y gestionar mejoras en los procedimientos judiciales para hacer cumplir los derechos de los acreedores.) Five policy seminars held. (Cinco seminarios de política llevados a cabo.)	Banks provided timely tax treatment for loan losses. (Los bancos proporcionados con un tratamiento fiscal oportuno para las pérdidas en préstamos.) Central Bank Law revisions drafted. (Revisiones de la Ley del Banco Central preparadas.) Five policy seminars held. (Cinco seminarios de políticas llevados a cabo.)	Central Bank Law revised to increase its autonomy. (La Ley del Banco Central revisada para incrementar su autonomía.) Five policy seminars held. (Cinco seminarios de políticas llevados a cabo.)
Component IV (Componente IV) <u>New Financial Instruments (Nuevos Instrumentos Financieros)</u>	Secondary market for GOH bonds established. (Mercados secundarios para bonos del GOH establecidos.) Interbank money and foreign exchange market created. (Creación de un mercado interbancario de dinero y de moneda extranjera.)	Bank commercial paper actively traded in stock exchange. (Papeles comerciales bancarios activamente negociados en la bolsa.) Development of new trade financing mechanisms (Desarrollo de nuevos mecanismos de financiamiento al comercio exterior.) Central Bank use of open market operations to effect monetary policy. (Uso por parte del Banco Central de operaciones de mercado abierto para el manejo de la política monetaria).	Mortgage-backed securities created, other loans contracts converted to securities, and traded in capital markets. (Valores hipotecarios creados, otros contratos de préstamos convertidos en valores y negociados en mercados capitales.) Hedging services for foreign exchange exposure offered by banks to businesses. (Servicios de protección del riesgo de cambio en moneda extranjera ofrecida por los bancos para las empresas.)	Foreign exchange forward and futures market established. (Mercados de futuro en moneda extranjera establecidos.) Modern trade financing mechanisms made available to the private sector by commercial banks. (Mecanismos modernos de financiamiento al comercio exterior disponibles al sector privado, establecidos por bancos comerciales.)	Widespread use of capital markets by financial institutions and institutional investors. (Uso amplio de mercados de capital por parte de instituciones financieras e inversionistas institucionales.) Medium term savings and financing instruments widely used. (Instrumentos de ahorro y financiamiento a mediano plazo ampliamente usados.)

These inadequacies inhibit the BCH from carrying out its essential functions of regulating the supply of money and credit, maintaining the foreign exchange regime and supervising the financial system in a more liberalized financial environment. According to the recent Financial Sector Assessment the BCH's specific problems are:

1) It lacks sufficient independence from the GOH in the area of monetary and financial policies. Its Board of Directors is dominated by representatives of the GOH who can readily be changed. At the same time, private sector members represent narrow commercial banking interests leading to a potential for conflict of interest. A review and modification of various banking laws is needed to grant greater independence to the BCH and define it more clearly as the key GOH institution in regulating the financial system.

2) The BCH has been delegated a number of responsibilities that are inappropriate to a Central Bank and often interfere with its basic role. For example, it is responsible for collecting excise taxes, analyzing the quality of commercial banks and managing long-term credit programs and foreign exchange export licensing. The BCH has developed a reorganization plan that has been reviewed by USAID and the IDB. This plan needs to be implemented.

3) The BCH lacks adequate systems for information coordination and internal control. Lack of internal controls is especially problematic and could lead to substantial losses.

Proposed Project Activities: The project amendment will provide technical assistance and training to address the above problems. More specifically it will finance:

- The services of a long-term policy coordinator (24 person months), who will facilitate the formation of a policy working group to address, among other things, the need to reorganize and provide greater autonomy to the Central Bank;

- Short-term technical assistance (3.5 person months) and on-the-job training to assist the BCH to improve its capacity to perform legal analysis;

- Short-term technical assistance (3 person months) to strengthen the BCH's administration of international reserves;

- Short-term technical assistance (3 person months) to assist the BCH improve its professional development program;

- Local long-term technical assistance (90 person months) to assist the BCH to upgrade its management information and accounting systems and a limited amount of computer equipment;

- Library equipment (books, catalogs, microfilm and computer equipment) and the services of a U.S. librarian (30 person months) to organize a financial library and periodicals center and train staff.

- Training in macroeconomic adjustment and financial liberalization, bank administration, modern bank procedures and human resources management. A more extensive list of training is provided in Annex E. Most of the training will be short-term and wil. take place outside Honduras at centers that specialize in bank training such as the Latin American Center for Economic and Monetary Studies (CEMLA) in Mexico, the Latin American Association for Development Institutions (ALIDE) in Peru and the Federal Reserve Board in the U.S. All attempts will be made to ensure that equal training opportunities are provided to both men and women in both the Central Bank and Superintendency (see below) training programs.

Output: A Superintendency of Banks that effectively and prudently regulates financial institutions to avoid insolvency and promote transparency in operations.

Problem: The Superintendency of Banks (SB) is a dependency of the BCH which supervises banks, insurance companies, savings and loan associations and bonded warehouses. It currently does not have the adequate attributes, power and autonomy to regulate the financial institutions and take appropriate action on institutions that are failing. Consequently, the following problems exist in the Honduran financial system: a deficiency of bank capital adequacy, a high level of past due loans and insider lending, and inadequacy of bank provisions for doubtful loans. Another major problem is the lack of public information on the financial condition of banks.

The Banking law needs to be modified to:

- Confer more power to the Superintendency of Banks to ensure bank solvency and intervene with failing financial institutions.

- Place limits on bank secrecy and allow full disclosure to the public on the financial condition of banks.

- Restrict insider lending.

- Provide more administrative and budgetary independence to the Superintendency of Banks.

A revised Banking Law that addresses the above points has been drafted and is under review at the BCH. Once this Law is passed, the SB will need technical assistance and training to implement its increased responsibilities and to improve and expand its supervision of insurance companies, pension funds and capital markets.

Proposed Project Activities: The project amendment will finance technical assistance, commodities and training to the Superintendency to assist it to improve its regulation of the financial system. Specific project activities are listed below:

- Short-term technical assistance (5 person months) to assist the SB to implement a reorganization plan and to develop a new legal unit that will provide assistance in the development of new laws and regulations.

- Short-term technical assistance (10 person months) for the development of improved internal regulations, inspection methods and procedures for intervention, and procedures for audit and financial analysis.

- Short-term technical assistance (14 person months) to assist the SB in developing implementing regulations for the new Banking Law, and in modifying laws and regulations regarding the supervision of insurance companies, pension funds, and individual retirement accounts.

- Short-term technical assistance (3 person months) to assist the Superintendency to improve its capacity to process, analyze and disseminate financial information.

- Commodities, mostly computer hardware and software, to upgrade the SB's management information systems so that it will be able to gather and process financial information on a timely basis (See Annex F for more details).

- Training (both classroom and on-the-job) to upgrade the skills of SB personnel in topics that will improve supervision. Training is contemplated in the following areas: financial analysis, asset evaluation techniques, data processing, financial control and development of reporting systems, and traditional audit techniques. A more detailed description of training courses is provided in Annex E.

C. Promotion of Financial Sector Reform

Output: **The promotion of policy, legislative and administrative reforms that support financial sector liberalization and increase domestic savings and investment.**

Problem: The Financial Sector Assessment found that Honduras' macroeconomic and financial sector policies discourage domestic savings and investment. The Stakeholder Analysis performed for this project amendment found that there are multiple and often conflicting interests within various groups interested in and/or affected by financial sector reforms. A mechanism is needed to build consensus on the kinds of financial reforms needed, to manage the reform process, and to facilitate dialogue between the private sector and the government on reform issues.

Proposed Project Activities: USAID will provide financing to the Honduran Council Private Enterprise (COHEP), a group whose mandate is to advocate the interests of the private sector, to continue its policy reform activities that were initiated under the original project. COHEP's major responsibilities under this amendment will be to gain consensus on the kinds of financial sector reforms needed and, once mechanisms for reforms are developed, gain private and public sector approval for the changes. Some of the policy issues that COHEP will deal with over the life of the project include:

11

- the removal of all controls on interest rates
- reduction in the reserve requirement for bank deposits
- the elimination of directed credit
- increased autonomy for the BCH
- increased supervision of insurance companies, pension funds and capital markets.

Specific activities to be supported include:

- A BCH-COHEP financial sector Policy Steering Committee which will set the agenda for financial sector reform activities and build consensus on the necessary conditions for the development of financial markets.

- Seminars, Conferences and Publications: COHEP will organize national conferences, seminars and workshop to disseminate the findings and recommendations of the Financial Sector Assessment and other studies of financial sector issues and to develop a consensus on what needs to be done to address the issues. It is anticipated that COHEP will put together a total of three-day conferences and 15 half-day seminars or workshops over the life of the project. COHEP will also develop short articles and brochures to educate both the general public and private and public financial sector leaders on various financial sector issues and proposed reforms.

- Lobbying and Dialogue Efforts with the Public Sector: COHEP will organize structured meetings with government leaders three to four times a year to discuss issues pending in Congress or the Executive Branch that effect the financial sector. These meetings will be coordinated by COHEP's Government Affairs Liaison Director, a position that was created under the initial phase of this project.

COHEP's existing Cooperative Agreement will be extended by four years to 1996 and increased by $355,000 to accomplish the above activities. The additional funding will not finance any of COHEP's operating expenses. Rather, it will pay the actual cost of carrying out specific project activities detailed above.

D. Commercial Bank Strengthening

Output: A commercial banking community that accepts financial sector reform and possesses the skills to deal with the requirements and opportunities of financial liberalization.

Problem: The Honduran commercial banking community is aware that financial sector reform is needed, yet apprehensive of the impact that financial liberalization may have on their operations. Most banks are not prepared to deal with funds management, treasury, and foreign exchange trading requirements and opportunities that well result from financial liberalization. Financial liberalization will be brought about by enhancing the regulatory powers of the Superintendency of Banks, increasing disclosure of financial information to the public, increasing creativity in financial services, and permitting a larger number of financial institutions entry into this sector. Liberalization, if properly implemented, will raise the level of competition in the financial system, thereby strengthening efficient institutions and weakening those who fail to adopt to the new order. Banks will need training and technical assistance in bank restructuring, strategic planning, asset/liability management, portfolio management, cash flow lending, savings mobilization, treasury operations and controls, trade finance and human resources development.

The Mission financed the development of a comprehensive bank training program for the commercial banking sector under the auspices of AHIBA. This training program is designed to overcome the Honduran banking community's resistance to reforms with courses that help it to better understand the need for macroeconomic adjustment and financial liberalization and to increase its efficiency.

While the commercial banking sector may be capable of paying a large percentage of training costs, the Mission proposes to pay a certain percentage (33%) so that it will be able to leverage the types of courses offered and ensure that they promote banking sector acceptance of financial sector reform and greater efficiency and competition in banking operations. In this way, the Mission will be able to influence the mindset of bank managers and credit officers and convince them to liberalize their lending policies and provide improved services to the private sector.

Proposed Project Activities:

- One-third of the costs of a training program that was developed by Price Waterhouse for AHIBA. Those specific details on this training program are provided in Annex E. The total cost of this program is estimated at $ 2.3 million; thus USAID would contribute $750,000. All efforts will be made to ensure training is available on an equal basis to both men and women.

- The development of a data bank that will gather information on financial flows from the financial system and disseminate it on a timely basis to bank treasurers and managers to enable them to make informed pricing and funding decisions.

E. Development of New Medium and Long-Term Financial Instruments

Output: **New medium and long-term financial instruments that will attract domestic savings and satisfy the investment needs of the productive sector.**

Problem: Honduras lacks many of the financial instruments and mechanisms that exist in a modern financial system, including: medium term deposit and lending instruments which are created through the conversion of financial instruments such as mortgages and letters of credits into bundles of negotiable securities and bonds that can be traded by institutional investors such as pension funds, mutual funds, banks and insurance companies.

In the past, the Central Bank, with donor support, has provided medium-term funding to commercial banks at fixed, below market, rates of interest. This practice has encouraged capital flight and discouraged the development of instruments that attract domestic savings and can be traded in capital markets. Now that the Central Bank is rapidly phasing out its rediscount lines, the financial system needs to develop instruments and mechanisms to gather domestic savings and allocate them to the productive sector at market terms.

The credit market uses the money market to provide short-term financing. However, for medium term financing, the credit market needs a capital market to attract medium term savings. Two features that are lacking in the incipient capital market in Honduras is a secondary market for openly traded, securitized medium and long term instruments that would provide for liquidity in the capital market, and a freely determined, market index against which the pricing of longer term debt issues could be floated.

Another problem in Honduras is the lack of sophisticated financing mechanisms to finance trade, preventing Honduras' exporters to compete in world markets. The lack of export credit insurance prevents exporters from competing in world markets by offering terms of repayment and discounting their trade receivables in local and foreign banks to recover their working capital.

Project Activities:

The GOH and the Central Bank are making significant financial reforms to enable the development of market-based financing and trade instruments and mechanisms. A limited amount of project assistance is needed in the short term during the transition period to help develop such mechanisms. After that, the continuous development of money and capital market instruments and trade financing schemes will be assumed by the financial institutions. Specific activities include:

- Short-term technical assistance (5 person months) and on-the-job training for the BCH in the development of open market operations and a secondary market for BCH bonds.

Short-term technical assistance (10 person months) and training for the BCH in the development of capital markets and medium and long-term financing mechanisms.

- Short-term technical assistance (6 person months) and training in the development of export financing mechanisms such as an export credit insurance fund and "forfeiting" export-import financing.

Annex G provides more detail on this activity.

VI. Financial Plan

The cost of the Financial Sector Amendment to the PAIP is $8.64 million. USAID will provide $6 million form the Private Sector, Energy and Environment (PSEE) functional account and the GOH will provide the equivalent of $1.14 million from both ESF local currency ($.5 million) and from interest earnings from export credit lines provided under the Export Development Services Project ($.64 million). A detailed budget showing project input by project activity is provided in Table 2. Additional financial information is provided in Annex H. A 15% change in line items can be undertaken by USAID with notification to the Project Committee.

VII. Implementation Arrangements

A. Obligating Instruments

The funds provided under this amendment will be obligated through an amendment to the existing Handbook 3 Bilateral Agreement with the Government of Honduras. The Bilateral Agreement will provide for an amendment to the project's existing Cooperative Agreement with COHEP for private sector policy reform activities and for a Cooperative Agreement with AHIBA for commercial bank training activities.

B. Implementing Agencies and Arrangements

1. GOH Implementing Agencies

The GOH implementing unit for the supervisory/regulatory framework and new financial instruments activities of the project will be the Central Bank. The primary office responsible for supervising and coordinating project assistance for policy reform and institutional strengthening activities for both the Central Bank and the Superintendency will be the Office of the General Manager within the Central Bank. The General Manager will designate two coordinators, one to coordinate the administrative aspects of this project component and the other to act as Secretary of a Policy Steering Committee that will be comprised of both public and private entities involved in the financial sector. The General Manager will also be responsible for chairing the Policy Steering Committee. USAID will finance a policy coordinator for the project who will work with the Secretary of the Policy Committee in organizing this entity. The primary office within the Central Bank for coordinating project assistance on the development of new financial instruments will be the BCH's Department of Credit and Securities. The Honduran Council for Private Enterprise (COHEP) will manage policy dialogue/consensus building activities in coordination with the Policy Steering Committee. The Honduran Bankers Association (AHIBA) will be responsible for managing commercial bank training activities. Annex I provides more details on the responsibilities of each implementing agency.

TABLE 2

FINANCIAL SECTOR POLICY ANALYSIS AND IMPLEMENTATION PROJECT BUDGET

COMPONENTS	USAID			GOH			AHIBA	TOTAL
	FX	LC	TOTAL	BCH	GOH	TOTAL		
I. REGULATORY FRAMEWORK								
Technical Assistance	1261	0	1261		0	0	0	1261
Equipment & Commodities	966	0	966	340	0	340	0	1306
Training	973	0	973	300	500	800	0	1773
SUBTOTAL	3200	0	3200	640	500	1140	0	4340
II. POLICY REFORM								
Policy Conferences	220	0	220	0	0	0	0	220
Adoption of new laws	135	0	135	0	0	0	0	135
SUBTOTAL	355	0	355	0	0	0	0	355
III. COMMERCIAL BANK STRENGTHENING								
Technical Assistance	0	0	0	0	0	0	0	0
Equipment & Commodities	90	0	90	0	0	0	0	90
Training	750	0	750	0	0	0	1500	2250
SUBTOTAL	840	0	840	0	0	0	1500	2340
IV. NEW FINANCIAL INSTRUMENTS								
Technical assistance	420	0	420	0	0	0	0	420
Equipment & Commodities	0	0	0	0	0	0	0	0
Training	110	0	110	0	0	0	0	110
SUBTOTAL	530	0	530	0	0	0	0	530
V. MANAGEMENT								
Technical assistance	0	0	0	0	0	0	0	0
Equipment & Commodities	0	0	0	0	0	0	0	0
Training	0	0	0	0	0	0	0	0
Management	700	0	700	0	0	0	0	700
Financial Analyst	100	0	100	0	0	0	0	100
Evaluations	150	0	150	0	0	0	0	150
Audits	125	0	125	0	0	0	0	125
SUBTOTAL	1075	0	1075	0	0	0	0	1075
TOTAL	6000	0	6000	640	500	1140	1500	8640

2. USAID

The Mission's Office of Private Sector Programs (PSP) will manage this project component. A USDH project officer overall responsibility for monitoring this activity. A USPSC will oversee the day-to-day implementation of this amendment.

3. Overall Project Coordination

At the working level, quarterly project meetings attended by key project representatives together with USAID Project Managers will be held for the purpose of facilitating coordination between various project component activities and assessing the progress of the project implementation. The Ministry of Finance (MFPC) will represent the Public Sector component, the BCH General Manager's Office will represent the Financial Sector Component and the Director of the Agricultural Sector Policy Unit (UPSA) within the Ministry of Agriculture will represent the Agricultural Sector Component.

Overall project coordination will also take place in monthly meetings of the Policy Steering Committee which will be attended by representatives from the MFPC, the BCH, the Ministry of Natural Resources and other public and private organizations.

C. Procurement Plan

The authorized source, origin and nationality of goods and services procured under the Financial Sector Component to the PAIP is the United States. Project-financed goods and services will be procured in accordance with relevant USAID Handbooks, USAID Acquisition Regulations, and the Federal Acquisition Regulation, as applicable. In addition, the project will comply with the Agency's rules and procedures for Gray Amendment procurement.

A technical assistance plan for the project is provided in Table 3. Most of this technical assistance will be performed as a series of discrete, short-term tasks and will be procured directly by USAID under an 8a contract. The only exception to this will be a buy-in to the PRE Bureau's Financial Sector Development (FSDP) to continue specialized capital markets assistance that is already being provided under the current project to the Central Bank.

A long term policy advisor to the Central Bank will be directly contracted by the Mission under a non personal services contract. The amendment will also finance a personal services contractor for project management and part of the cost of a US financial analyst personal services contractor for the entire PAIP project.

The Mission will rely on the Central Bank to undertake local procurement procedures for contracting a local firm to provide long-term assistance in the development of its MIS system and for the services of a library advisor.

TABLE 3
TECHNICAL ASSISTANCE PLAN

ACTIVITIES	TECHNICAL ASSISTANCE ($000)	TECHNICAL ASSISTANCE (PERSON/ MONTHS)
REGULATORY FRAMEWORK		
A. Central Bank		
– Policy Coordination	250	24
– Improved Procedures		
• Foreign Exchange Management	60	3
• Modernization of Management Information System	90	90
• Improved Capacity for Legal Analysis	70	3.5
• Improved Human Resources Development	60	3
– Organization of Research Library	91	30
	621	153.5
B. Superintendency of Banks		
• Establishment of a New Legal Unit	100	5
• Development of Improved Inspection Methods for Banks	120	6
• Improvement of Capacity to Process, Analyze and Disseminate Financial Information	60	3
• Develop Implementing Regulations for New Banking Law and New Legislation for Supervision of Insurance Companies, Pension Funds and Capital Markets	280	14
• Development of Internal Regulations for Supervision of Insurance Companies, Pension Funds and Capital Markets	80	4
Sub total	640	32
NEW FINANCIAL INSTRUMENTS		
• Development of Open Market Operations	100	5
• Development of Medium and Long-Term Financial Instruments	200	10
• Creation of Trade Financing Mechanisms	120	6
Sub total	420	21
TOTAL	1,681	206.5

Most commodities (computer hardware and software for the Superintendency, library equipment and small amounts of computer equipment for the Central Bank and data bank equipment for AHIBA) will be purchased through USAID direct contracts.

The Central Bank and the Superintendency of Banks will directly arrange for training in accordance with Handbook 10 requirements. AHIBA will directly arrange for training and will request reimbursement from USAID in accordance with its Handbook 13 Cooperative Agreement.

Training for other entities and observational tours will be arranged directly by the Mission.

Additional information on project procurement is provided in Annex I.

D. Buy America

This project component has been designed in accordance with the Agency's Buy America Guidance. None of the currently planned local procurement, which totals $465,000, requires a waiver under this guidance. If, however, during project implementation, an activity is proposed that requires a waiver, such waiver will be obtained before proceeding with the transaction.

VIII. Information System and Evaluation

The financial sector policy coordinator within the BCH will manage the project monitoring system. The major users of the information will be the BCH, the Superintendency of Banks, COHEP, AHIBA and USAID. The system will measure achievement of the policy benchmarks set forth in Table 1 and of the project's outputs set forth in the logframe. It will also attempt to measure the impact of achieving these benchmarks and outputs. A mid-term assessment will be held in September 1994 to review achievement of benchmarks as well as overall project implementation. A final evaluation will be undertaken in March 1997. More information on the information and evaluation plan for the amendment is provided in Annex J.

IX. Analytical Considerations

A. Stakeholder Analysis

The Mission financed a stakeholder analysis (see Annex I) to determine: 1) the key individuals and/or groups (stakeholders) to be impacted by, or with an interest in, proposed financial sector reform, and 2) the potential roles of stakeholder interests in either facilitating or blocking the reforms. The analysis focussed on five reforms that have been proposed in the financial sector:

- Removal of controls on interest rates;

- Reduced reserve requirements on bank deposits;

- Legislation increasing the powers of the Superintendency of Banks;

- Enforcement of bank solvency and tax credits on loan losses;

- More financial and political independence of the Central Bank.

The analysis found that within the various stakeholder groups (consumers of credit; providers of credit; and regulators) interests in the reform process were highly fragmented; that there was no clear and committed client for financial reform and that there are no simple or obvious mechanisms for mobilizing support for financial sector reform. To overcome fragmentation and cross-pressures in various stakeholder groups, which lends a highly inertial effect to the reform process, the stakeholder analysis recommends the formation of a coalition of various stakeholder groups to manage the reform process and serve as a broker to the multiple, and often conflicting, interests in this area. COHEP was recommended for the leadership role in the creation of such a coalition because it is the only organization with links into each stakeholder group and because of its experience in brokering conflictive interests and facilitating dialogue on important macroeconomic issues. The recommendations of this analysis were taken into account in the design of the Policy Reform Component of this project amendment.

B. Economic Analysis

An Economic Analysis for the Financial Sector Amendment to the project estimates that benefits will equal 160% of project costs. This is based on an analysis of project input costs and on projections of changes in the rate of investment in the economy (a 1% increase in the rate of gross capital formation) resulting from the project. Annex L provides further detail.

C. Environmental Analysis

The initial environmental examination for the PAIP determined that the project would have no direct impact on the environment and recommend a negative determination (i.e. no further environmental evaluation required). Since this amendment will continue to support the same type of activities contemplated under the original project, the negative determination still applies.

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ANNEX A
POLICY ANALYSIS AND IMPLEMENTATION PROJECT LOGICAL FRAMEWORK
FINANCIAL SECTOR AMENDMENT

SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	MAJOR ASSUMPTION
SUBPURPOSE: Increase capacity to formulate and implement reforms that improve financial intermediation.	END OF PROJECT STATUS Gross domestic savings as a percentage of GDP increases from 10% in 1992 to 15% in 1996.	Central Bank records	Financial liberalization: cooperation by banks, other financial institutions: the Central Bank and COHEP: Central Bank compliance with IMF Agreements
	Gross private investment as a percentage of GDP increases from __% in 1992 to 11% in 1996.	National Accounts	
OUTPUTS Improved supervision and regulation of financial institutions.	- New Banking law that provides more power to Superintendency of Banks passed.	National Gazette	- Opposition by banks neutralized
	- Law regarding supervision of Insurance companies revised.	National Gazette	
	- Legislation increasing BCH autonomy passed.	National Gazette	- Consensus developed by COHEP on BCH independence
	- Improved internal accounting controls, foreign exchange management and MIS at BCH.	Project Evaluation reports	- Continued cooperation of the Central Bank
	- Restructuring plan for BCH approved and implemented.	Project Evaluation reports	
Promotion of monetary policies that support open market mechanisms.	- All controls on interest rates removed.	Central Bank Board resolutions	Central Bank compliance with IMF Agreements
	- Reserve requirement reduced from 35% to 20% in 1996.	Central Bank records	Central Bank compliance with IMF Agreements
	- Automatic BCH rediscounts at market rates.	Project evaluation of BCH procedures	BCH compliance with agreement with the IDB
	- Open market operations initiated by BCH.	Project evaluation of BCH procedures	BCH compliance with agreement with the IDB
More efficient and competitive commercial banking sector	- Tax legislation allowing deduction of loan losses from taxable income passed.	National Gazette	Resistance from the Ministry of Finance overcome with BCH assistance
	- Bank spreads reduced from 6% in 1992 to 3% in 1996.	Superintendency of Banks records	Competition promoted by the Central Bank and SB

21

SUMMARY	OBJECTIVELY VERIFIABLE INDICATORS	MEANS OF VERIFICATION	MAJOR ASSUMPTION
	- No insider lending.	Superintendency of Banks records	
	- One new bank authorized.	Banking license issued	
	- Bank collateral requirements reduced.	Project evaluation reports	- Improved land titling procedures; SB regulations relaxed.
	- Improved court procedures to enforce creditors' rights.	Project evaluation reports	- Cooperation by Supreme Court
	- Secondary market for BCH bonds established	Project evaluation reports	
New financial instruments	- Securities law passed.	National Gazette	Consensus reached by Stock Exchange, AHIBA and Superintendency.
	- Individual retirement accounts authorized.	National Gazette	
	- Export credit insurance fund established at BCH	Agreement with USAID	
	- Mortgage-backed securities created	Project evaluation reports	
	- Pension funds law passed.	National Gazette	Opposition from pension funds neutralized by COHEP, AHIBA and BCH

INPUT:	AID ($000)	GOH	MEANS OF VERIFICATION	CONDITIONS:
Technical Assistance	1,752		MACS reports FARS reports	- Development of a strategic restructuring plan by the BCH
Training	1,381		Project Implementation Reports	
Commodities	862		MIS	- Passage of a new Banking Law that increases the powers of the Superintendency of Banks
Evaluations/Audits	340		Evaluation reports	
Project Management	1,040			
Policy Reform	610			

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FUNDADO EN 1950

Banco Central de Honduras
Tegucigalpa, M.D.C., Honduras, C.A.

DIRECCION CABLEGRAFICA
BANTRAL

09-44

1 de septiembre de 1992

Señor
MARSHALL BROWN
Director
Agencia de los Estados Unidos
para el Desarrollo Internacional
Ciudad

Estimado Señor Brown:

El objeto de la presente es solicitar formalmente, en nombre del Gobierno de Honduras (GdH), financiamiento de la Agencia de los Estados Unidos para el Desarrollo Internacional (AID) para la inclusión de un nuevo componente -el Programa de Desarrollo del Sector Financiero de Honduras- en el Proyecto de Análisis y Ejecución de Políticas (522-0325) por medio de una enmienda al mismo.

Como es de su conocimiento, la llegada de la presente Administración del Presidente Rafael Leonardo Callejas al Gobierno de Honduras marcó el inicio de un programa de reformas económicas y estructurales cuyo propósito ha sido realizar los ajustes necesarios a nuestra economía, para superar la crisis en que se encontraba el país en ese momento y asegurar la estabilidad necesaria para continuar con su proceso de crecimiento. El éxito de la primera fase de estabilización del programa de reforma ha sido reconocido por la comunidad internacional, incluyendo la Misión a su digno cargo.

El Gobierno está comprometido a continuar y perfeccionar su programa de reforma macroeconómica y estructural. En tal contexto, la modernización del sector financiero es indispensable para lograr el crecimiento autosostenido del país.

El Programa de Desarrollo del Sector Financiero apoyará el compromiso del GdH con AID y otros donantes de realizar profundas reformas a corto plazo, particularmente el estudio de funciones del Banco Central y su correspondiente reestructuración y la modernización de la supervisión del sistema financiero, entre otros, mediante la aprobación de una nueva Ley de Establecimientos Bancarios y la reestructuración de la Superintendencia de Bancos. La reforma al sector financiero facilitará la intermediación financiera promoviendo mayor eficiencia, solvencia y competitividad de las instituciones financieras privadas y gubernamentales.

El Programa de Desarrollo del Sector Financiero complementará nuestra capacidad de modernizar el marco legal del sistema financiero, desarrollará un mayor entendimiento y consenso nacional sobre las políticas apropiadas para el desarrollo ordenado del sector, fortalecerá las tareas regulatorias y de supervisión del Banco Central de Honduras, incluyendo la Superintendencia de Bancos y Seguros, capacitará al personal de la banca comercial y desarrollará instrumentos y mecanismos de financiamiento a mediano y largo plazo.

En forma específica, deseamos que las siguientes áreas sean incluidas en una enmienda para la extensión del Proyecto 522-0325:

1) Asistencia al Banco Central de Honduras para llevar a cabo con éxito su programa de reestructuración, modernización de procedimientos y capacitación de su personal. El Banco Central iniciará un programa de planificación estratégica; desarrollará operaciones de mercado abierto y mejorará la administración de sus fondos de redescuento; reorganizará su programa de biblioteca y publicaciones; mejorará la administración de las reservas internacionales; fortalecerá su departamento legal; capacitará al personal asignado a nuevas funciones y mejorará el desarrollo de sus recursos humanos.

2) Asistencia a la Superintendencia de Bancos y Seguros para que supervise con prudencia la solvencia, transparencia y competencia del sistema financiero mediante la reorganización de su estructura operativa y la revisión del marco regulatorio del sistema financiero. La Superintendencia llevará a cabo su plan de reorganización interna; creará una unidad legal y revisará el marco legal de bancos, seguros, valores y otros relacionados; actualizará sus métodos y procedimientos de supervisión bancaria, incluyendo la evaluación de activos y provisiones, auditoría general, análisis financiero, interpretación estadística y métodos de intervención de instituciones financieras; diseñará e implementará un sistema integral de información; creará una central de riesgo de deudores; fortalecerá los procedimientos de supervisión de seguros, incluyendo el análisis financiero y actuarial, la supervisión del reaseguro y la interpretación estadística; llevará a cabo la capacitación integral de los niveles profesionales en las áreas bancarias, de seguros y mercados de capitales, y capacitación especializada de los mandos intermedios y superiores.

3) Asistencia al Banco Central para promover las condiciones para el desarrollo ordenado del sistema financiero y lograr el consenso nacional sobre la liberalización financiera, la modernización del marco legal, el fortalecimiento de las facultades de la Superintendencia y la autonomía del Banco Central. El Gerente del Banco Central dirigirá un comité interinstitucional representando al sector financiero. Con asistencia técnica del Programa, el comité determinará prioridades para promocionar las principales políticas financieras adoptadas por el GdH. COHEP, con recursos del Programa, promoverá por medio de seminarios, talleres y conferencias la creación del consenso nacional sobre las políticas financieras y temas seleccionados por el comité.

4) Asistencia complementaria a la Asociación Hondureña de Instituciones Bancarias (AHIBA) para actualizar los conocimientos técnicos del personal de la banca comercial. AHIBA llevará a cabo un programa de capacitación integral de los mandos superiores, supervisores y técnicos de la banca comercial con el fin de permitirle a la banca apoyar el proceso de liberalización financiera mediante la modernización de sus políticas, procedimientos y servicios.

Asimismo, AHIBA implementará un servicio de información de estadística financiera que permita la toma informada de decisiones por los bancos.

5) Asistencia al Banco Central de Honduras para apoyar el desarrollo de nuevos instrumentos y mecanismos de financiamiento, incluyendo el mercado de capitales. El Banco Central coordinará la asistencia técnica y capacitación del programa a las instituciones del sector financiero para apoyarlas en participar en el desarrollo de un mercado secundario de valores del GdH, crear instrumentos de captación a mediano plazo.

6) Financiamiento de la administración del programa, evaluaciones y auditorías. Estas actividades serán coordinadas por AID.

De estar usted de acuerdo con nuestra solicitud, el Señor Gerente del Banco Central, Licenciado Rigoberto Pineda, Coordinador del Programa por parte del GdH, discutiría con las personas que usted designe los detalles de la enmienda y la implementación del Programa. Asimismo, el Superintendente de Bancos, Licenciado Fernando Vega, participaría en la preparación de lo que sea requerido para concretar la enmienda e implementar el Programa.

Para la enmienda al Proyecto 522-0325 que financiaría el Programa de Desarrollo del Sector Financiero de Honduras solicitamos el financiamiento de AID por US$ 6 millones en los próximos 5 años. El GdH y el Banco Central contribuirán con aproximadamente Lps.2,750.000 y Lps.3,530.000 respectivamente, en los 5 años de implementación del programa. AHIBA ha indicado que aportará aproximadamente Lps.8,250.000 durante 5 años como contraparte de su programa de capacitación.

Sin otro particular al cual referirnos, y deseándole el mayor de los éxitos, le reiteramos las muestras de nuestra más alta consideración y estima.

BANCO CENTRAL DE HONDURAS
PRESIDENCIA

RICARDO MADURO JOEST
Presidente
Banco Central de Honduras

BENJAMIN VILLANUEVA T.
Ministro de Hacienda y
Crédito Público

25

PROJECT AUTHORIZATION

(Amendment No. 3)

Name of Country:	Honduras
Name of Project:	Policy Analysis and Implementation
Number of Project:	522-0325

1. Background. Pursuant to Sections 103, 106, 531, and 534 of the Foreign Assistance Act of 1961, as amended, the Policy Analysis and Implementation Project for the Republic of Honduras was authorized on August 28, 1987 with an initial Life of Project ("LOP") of $12,000,000. It was amended on March 5, 1990 to increase the LOP to $16,350,000 and to add an agricultural sector component. It was further amended on July 21, 1992 to increase the total LOP by $10,000,000, to expand the agricultural sector component to encompass natural resources, and to extend the LOP from seven to ten years. The purpose of this Amendment is to further expand the scope of the Project to encompass the financial sector and to increase the LOP by an additional $6,000,000.

2. Additional Financing. Pursuant to Sections 103, 106 and 531 of the Foreign Assistance Act of 1961, as amended, I hereby authorize an additional Six Million U.S. Dollars ($6,000,000) for the Policy Analysis and Implementation Project for Honduras. The total planned obligations, consisting of amounts earlier authorized and authorized by this Amendment, shall not exceed Thirty-Two Million Three Hundred Fifty Thousand Dollars in grant funds ("Grant"), subject to the availability of funds for this purpose in accordance with the AID OYB/allotment process, to help in financing foreign exchange and local currency costs for the Project. The planned LOP shall be until August 28, 1997.

3. Project Components. The Project shall include a public sector component, an agriculture and natural resources sector component, a private sector component, and a financial sector component. It consists of providing technical assistance, commodities and training: (1) to the Central Bank of Honduras, the Ministry of Finance and Public Credit, and other public sector institutions involved in the formation and implementation of economic policy; (2) the Ministry of Natural Resources, the Agricultural Development Council, SECPLAN and other public sector institutions involved in the formulation and implementation of agricultural and natural resources policies; (3) to the Honduran Council for Private Enterprise (COHEP), the Honduran Association for Banking Institutions and Insurance Companies (AHIBA) and other private sector institutions as A.I.D. may deem appropriate; and (4) to the Central Bank of Honduras for the implementation of policy reforms in the financial sector. This paragraph 3 replaces in its entirety paragraph 2 of the original Authorization, as amended to date.

4. Conditions Precedent and Major Covenants. The Project Agreement, which may be negotiated and executed by the officer to whom such authority is delegated in accordance with USAID Regulations and Delegations of Authority, except as USAID may otherwise

agree in writing, shall be subject to the following conditions precedent and major covenants, together with such other essential terms and conditions as such officer or his successor may deem appropriate. This paragraph 4 supersedes and replaces in its entirety paragraph 3 of Authorization Amendment No. 2.

4.1 Conditions Precedent

A. Agricultural Sector Component

Prior to the initiation of the second phase of the Agricultural Sector Component (January 1, 1995-August 28, 1997), USAID and the Grantee will complete a formal assessment, in form and substance satisfactory to USAID, of progress in achieving agricultural/natural resources policy benchmarks that will be mutually agreed to in the Project Agreement.

B. Financial Sector Component

1. Prior to any disbursement, or the issuance of any commitment documents under the Project Agreement, for technical assistance aimed at improving the regulation and supervision of financial institutions under the financial sector component of this project the Government of Honduras will submit to Congress for approval a revised Banking Law in form and substance satisfactory to USAID.

2. Prior to the disbursement of funds, or the issuance of any documentation for the disbursement of funds for assistance to Superintendency of Banks other than technical assistance (i.e., commodities, software, and training) the Government of Honduras will pass a revised Banking Law.

3. Prior to the disbursement of funds, or the issuance of any documentation for the disbursement of funds for activities designed to strengthen the capacity of the Central Bank to regulate the financial system, the Government of Honduras will develop and approve a restructuring plan for the Central Bank in form and substance satisfactory to USAID.

4. Prior to the initiation of the second phase of the Financial Sector Component (January 1, 1995-August 28, 1997), USAID and the Grantee will complete a formal assessment, in form and substance satisfactory to USAID, in achieving financial sector policy benchmarks that are mutually agreed to in the Project Agreement.

4.2 Covenants

A. Counterpart Funds The Cooperating Country shall make every effort to ensure that counterpart funds are available in a timely and satisfactory manner. Likewise, the Cooperating Country shall provide USAID with quarterly reports on the provision of counterpart contributions.

5. Source and Origin of Commodities, Nationality of Services

5.1 U.S. Source/Origin/Nationality. Except to the extent permitted by paragraphs 5.2 and 5.3 below, commodities financed by USAID under the Project shall have their source and origin, and suppliers of goods and services under the Project shall have their nationality, in the United States (USAID Geographic Code 000), except as USAID may otherwise agree in writing. Ocean shipping financed by USAID under the Grant shall, except as USAID may otherwise agree in writing, be financed only on flag vessels of the United States. Air transportation services shall be on U.S. flag carriers except to the extent such carriers are not "available" as defined by the U.S. "Fly America Act."

5.2 Local Procurement. Procurement of commodities with a source or origin in Central American Common Market Countries, and procurement of services from suppliers whose nationality is in the Central American Common Market, is authorized only to the extent permitted by the Agency's Buy America guidance and Ch. 18 of HB 1B, up to an aggregate amount of $965,000 United States Dollars , or other amount as USAID may agree in writing. Of this amount, an estimated $865,000 will be local procurement for services in project management, secretarial support, studies, and audit costs, and $100,000 will be for third country training and observational tours. None of the currently planned local or third country procurement requires a waiver under the Buy America guidance. Local procurement by HB 13 grantees is also permitted to the extent allowed by the standard grant provisions of such grants. Finally, non-U.S. procurement for training services is permitted to the extent allowed by A.I.D. HB 10.

5.3 Source/Origin/Nationality of Prior Funds. Paragraphs 5.1 and 5.2 above shall apply to procurement from funds obligated on or after July 21, 1992. Funds obligated prior to that date shall continue to be governed by the terms of the prior source/origin/nationality requirements.

Marshall D. Brown
Mission Director
USAID/Honduras

Date: 9/24/92

1.0 EXECUTIVE SUMMARY

1.1 Overview of the Financial Sector and Introduction to the Report.- The Honduran financial sector is composed primarily of private sector institutions but nonetheless has a significant public sector presence. Of greatest importance is the Central Bank of Honduras (BCH) which not only carries out typical central banking functions but is also involved in a number of other activities that may detract from its ability to undertake the new responsibilities that inevitably arise in the process of financial reform and liberalization. As one of its units, the BCH contains the Superintendency of Banks (SB) which is charged with oversight of the system. While at a technical level the SB compares quite well with similar institutions in other Latin American countries, it lacks certain essential powers to deal effectively with potentially insolvent banks. Among the other public sector financial institutions are: an insolvent development finance company that is being liquidated, a very small bank for municipalities, and an important agricultural development bank that is preparing to undergo a major and badly needed program of rehabilitation.

The predominant private sector financial institutions in Honduras are the commercial banks, of which a few are mixed capital with marginal public sector participation. The savings and loan associations are much smaller in size and fewer number, and several of them have common ownership with commercial banks. Finance companies in Honduras are not dedicated to development finance, as in most other Latin American countries, but are rather part of the informal, non-regulated financial sector. In fact, informal financial markets (IFMs) are highly important in Honduras and include a wide variety of agents, institutions and arrangements that extend far beyond finance companies and moneylenders and probably provide financial services to a larger proportion of the Honduran population than do formal financial institutions. The other financial institutions to be examined in this report are pension funds, insurance companies and the recently-created securities market. Although pension funds and insurance companies have received virtually no analytical attention in Honduras they are nonetheless potentially an important source of long-term funds.

Honduras has recently embarked on a series of major economic reforms that seek to rekindle growth based on a larger role for the private sector -- wherein entrepreneurs respond to signals provided by prices generated in relatively undistorted and competitive markets. However, a well-functioning financial system is essential for this approach to lead to a resurgence of economic growth. Only an efficient and growing financial system can mobilize adequate domestic savings to finance the new activities that will arise as entrepreneurs respond to more appropriate price signals, and only an efficient and properly motivated system can allocate these savings to activities with the best prospects. The focus of the analysis in this report is thus on the adequacy of existing financial markets and institutions in Honduras -- and the policy framework underlying them -- to provide the required basis for the resurgence of economic growth that is the desired outcome of the economic reforms already underway.

The following analysis reveals that there is much to be done to strengthen the financial sector in Honduras so that it can fulfill its necessary role. Moreover, even though greater reliance is to be placed on private sector initiative, major reforms will be required in public sector policies and institutions to provide essential infrastructure and appropriate incentives. For example, although low-interest BCH rediscounts may seem a plausible way to stimulate productive investments, they instead discourage deposit mobilization and promote dependent financial intermediaries that come to focus primarily on capturing subsidized credits for their owners and managers. In addition, if the public sector fiscal deficit cannot be significantly reduced and financed in a way that does not substantially tax the financial system, it will be far more difficult to provide the private sector with the financing that it requires to play a leading role in the resurgence of economic growth in Honduras.

The following executive summary covers briefly each of the key elements that must be taken into account in designing a strategy for the development of a financial sector supportive of renewed economic growth in Honduras. The macro-economic context and, in particular, the main features of the government's policy framework for the financial sector are examined. Monetary management, the instruments of monetary control and the ability of the BCH to carry out functions essential for financial reform are analyzed, with particular attention to the regulation and supervision of financial intermediaries by the SB. The performance of the main private sector financial institutions is evaluated, including especially commercial banks, savings and loan associations, pension funds and insurance companies, and the recently-created securities market. The importance of IFMs is also examined and, in particular, the possible lessons from IFMs for policy makers and managers of formal financial institutions. Based on this analysis, the key components of a strategy for the financial sector are outlined, including not only high priority adjustments in the policy environment but also actions to strengthen specific financial institutions in both the public and private sectors.

1.2 Macro-Economic Background.- Like many developing countries, especially in Latin America, Honduras experienced a series of external shocks during the 1980s that reduced prospects for future economic growth and continuing development. Many of these external shocks increased the need to undertake basic economic policy reforms but, at the same time, made these needed reforms more painful, and hence more politically difficult, to carry out. In many countries, for example, deteriorating terms of trade during the 1980s created balance of payments problems that led governments to place further restrictions on imports -- thereby exacerbating the bias toward policies of inefficient import substitution -- rather than pursuing more far-sighted policies of export-oriented trade liberalization.

Honduras itself had until recently followed policies of promoting industrialization through import substitution, but now has embarked on a major program of trade and tariff reform and liberalization. This program bodes well for future economic development and sustainable growth in Honduras -- especially if these measures can be complemented by a major reform of the financial sector that would allow more resources to be mobilized domestically and to be allocated to their most efficient uses.

The 1980s brought to the fore not only the importance of trade reform for Honduras but also the need to deal with a growing fiscal imbalance. The series of external shocks that began in the late 1970s had led Honduras to rely more heavily on its public sector, using increased public sector investment to attempt to lay the basis for future growth, along with increased public sector employment to stimulate the economy in the short run. Not only were these programs less successful than had been anticipated, but they also had to be financed.

As government revenues failed to keep pace with the growth in government expenditures, the growing fiscal deficit was financed primarily by increases in foreign debt. After foreign credit became virtually unobtainable from commercial sources, Honduras turned more and more to borrowing from foreign governments and international agencies and ultimately to the accumulation of external arrears. Faced with a long-standing problem that has now reached crisis proportions in the form of an unmanageably large foreign debt (approximately US$3.3 billion as of June 1990) and continuing insupportable public sector fiscal deficits, the new Honduran Government has recently initiated a major program of fiscal reform along with various proposals to deal with its foreign debt and external arrearages.

1.3 The Fiscal Situation.- The trade reforms already underway, especially if complemented by significant financial sector liberalization, can help to lay the basis for future growth and economic development in Honduras. However, successful fiscal reform is also essential for the Honduran economy in general and for the financial sector in particular. Now that the public sector fiscal deficit can no longer be financed in any significant way through continued foreign borrowing, it must be financed domestically.

Financing a significant fiscal deficit through the domestic financial system inevitably means fewer resources available for the private sector -- and thereby compromises the benefits that might otherwise be obtained from trade liberalization and other market oriented reforms. Moreover, financing the fiscal deficit through non-transparent means (e.g., monetary expansion leading to inflation or excessive and unremunerated reserve requirements against deposits that act as a tax on the financial system) will reduce further the resources available to the private sector as such policies reduce the ability of the financial system to mobilize domestic savings. In addition, savings mobilization through the domestic financial system will be further compromised by unresolved foreign debt problems and resulting threats of large and sudden devaluations.

The progress made to this point in solving the crucial problem of the public sector fiscal deficit may be less than appears. For example, government revenues lagged behind projections throughout 1990, and it may be difficult to maintain the reductions that have been made on the expenditure side in public sector investment and real wages. Moreover, certain public sector transactions continue to be recorded at the official exchange rate, thereby making the public sector deficit appear smaller, but in fact such procedures are basically just transferring losses to the books of the BCH where they are still part of the overall public sector fiscal problem. In part as a reflection of this, other net assets of the BCH expanded rapidly during 1990.

Until the public sector fiscal situation has been brought under control in a thoroughly credible way, it will be difficult to convince the Honduran public to have the kind of confidence in domestic financial assets that is essential for successful domestic savings mobilization. In short, an excessive and continuing public sector fiscal deficit punishes the private sector in basically two ways: (1) by reducing the volume of resources mobilized, and (2) by channeling more of those resources to the public sector.

1.4 Government Credit Policies.- The Honduran Government has recognized that the availability of credit to the private sector may not be adequate and has taken certain steps to attempt to insure that more credit flows to the private sector. However plausible these steps may seem, they have nonetheless been misguided in two fundamental ways. First, they do not deal directly with the essential problems -- the demands of an excessive public sector fiscal deficit on the resources flowing through the domestic financial system and the need for a direct attack on whatever imperfections might be inhibiting the flow of credit to the private sector in general and to priority groups and activities in particular. Second, they impose remedies that are not only likely to fail but also to curtail further the availability of credit to the private sector.

Government programs of directed credit at below-market interest rates targeted to priority groups and activities discourage deposit mobilization. In some cases, the lower rates charged to borrowers are subsidized by lower rates paid to depositors, and in other cases trust funds or BCH rediscounts provide financial intermediaries with sources of funds that are cheaper than deposits. With reduced deposit mobilization, the total amount of funds available for private sector credit shrinks. Traditional directed credit programs also overlook two fundamental principles: (1) increases in domestic credit not validated by an increase in the demand to hold domestic financial assets will leak out through the loss of foreign exchange reserves or through inflation; and (2) targeted credit is incompatible with a market-oriented economy in which private agents are free to select the activities most profitable to them.

The example of credit targeted to the Honduran agricultural sector not only provides a clear illustration of the results of directed credit programs but can also provide the basis for certain recommendations, some of which could be implemented in the short run. According to official figures, the amount of credit being allocated to Honduran agriculture is high compared to most other Latin American countries, both relative to agricultural output and as a proportion of total banking system credit. Nonetheless, Honduran agriculture is widely believed to be in a bad state.

This suggests, on one hand, that credit is not the basic problem; rather, it is inadequate prices and markets, inadequate land tenure arrangements, inadequate research and extension, inadequate rural infrastructure, etc. -- problems that must be dealt with directly and cannot be resolved through credit. On the other hand, much of the low-interest credit targeted to agriculture is clearly being sought for the subsidies involved and being diverted to other activities with higher rates of return (including capital flight). Moreover, banks that have depended heavily on BCH rediscount lines for agriculture tend to have poor deposit mobilization and loan recovery performance.

Directed credit lines also involve high transaction costs for both lenders and borrowers as the result of attempts to target credit to approved recipients and activities and to monitor its use. The existence of these high transaction costs suggests that, if interest rates were raised to market levels, directed credit lines might cease to have much relevance. In particular, if the interest rate charged to financial intermediaries for such funds was continually adjusted to the marginal cost of mobilizing deposits (including the cost implied by reserve requirements) financial intermediaries would have less interest in utilizing these funds, subsidy seekers would largely lose interest in accessing these funds, and the BCH would be able to cover the effective cost of providing these funds.

The reduction in the amounts outstanding under directed credit lines could be compensated by an offsetting reduction in required reserves. Such a compensated reduction would not only leave monetary aggregates unchanged but would also decrease the costs and increase the incentives for financial intermediaries to mobilize deposits. Reductions in directed credit lines and reserve requirements, along with a reduction in the public sector fiscal deficit, can be key elements in a policy reform program to enhance the performance of the financial sector.

1.5 Monetary Management.- With a reduction in the public sector fiscal deficit to manageable proportions and the financing of that deficit in ways consistent with the transparent and efficient operation of financial markets (that is, without excessive and unremunerated reserve requirements or inflationary monetary expansion) it becomes both possible and necessary to improve the instruments of monetary management. Moreover, Honduras has made significant progress in two other areas that also both permit and required improved monetary management. First, the overvaluation of the exchange rate has been greatly reduced and the foreign exchange market has been partially unified and made more flexible (although more remains to be done, as discussed in more detail in a subsequent chapter). Second, some progress has been made in interest rate liberalization so that interest rates can begin to be managed through modern instruments of monetary policy rather than through direct controls. With the exchange rate and interest rates free to reflect underlying market forces, and without the need to finance an excessive public sector fiscal deficit through nontransparent means, it becomes possible for the BCH to guide interest rates and the exchange rate in ways that can promote the long-run development of Honduran financial markets and the growth of Honduran economy in general. It also becomes necessary for the BCH to do so.

Three elements are essential for the BCH to be able to carry out its crucial role of monetary management effectively. First, it must have fewer responsibilities but more power and independence to fulfill appropriate responsibilities. The role of the BCH should be limited to managing the financial sector; it should not be involved directly with other aspects of the Honduran economy. In order to have the necessary power and independence to act for the overall long-run good of the Honduran economy, its Board of Directors must be constituted and appointed to be free from direct intrusions by other Government entities and from narrow private sector interests.

Second, the BCH must have an appropriate organizational structure and a staff with adequate skills to analyze the conditions of the financial sector and the Honduran economy in general, to design a monetary program and to implement that program. A variety of organizational changes could improve the functioning of the BCH (e.g., increased decentralization with better internal controls), but most important is that the new organizational structure serve the essential functions of the BCH and not reflect its various inappropriate activities. A program of technical assistance and training for staff, especially in the key Economic Studies Department, should also be given high priority.

1.6 Monetary Instruments.- The third element -- the development of adequate monetary instruments -- requires somewhat more detailed discussion. As already indicated, reserve requirements must become an instrument to control monetary aggregates and not a mechanism to finance the public-sector fiscal deficit cheaply (and thereby tax depositors and the banking system) -- but this can only happen after the deficit has been brought under control. Buying and selling international reserves can be (and in fact has been in the past) an instrument of monetary control, but in the short run the BCH lacks adequate international reserves and in the long run this instrument should be targeted toward smoothing inappropriate fluctuations in the foreign exchange rate.

Buying and selling government bonds -- that is, open market operations -- is potentially a more appropriate instrument of monetary control than buying and selling international reserves. The BCH recently tried to implement open market operations through an auction system for government bonds -- a good approach -- but unfortunately this was not successful as few bids were submitted. Failure resulted in part from the existence of tax-free government bonds that are redeemable on demand (which should be phased out) but primarily from the BCH's attempt to fix both price (the effective interest rate) and quantity simultaneously. The key feature of open market operations is that they allow the BCH to control either interest rates or monetary aggregates -- but not both simultaneously.

Another important instrument of monetary control is rediscount operations which, like buying and selling international reserves or open market operations in government bonds, control the monetary base and hence influence all monetary aggregates. Unfortunately, however, rediscount operations in Honduras have been governed primarily by various directed credit programs rather than by the need to manage overall liquidity. In addition to disrupting monetary control in general, the below-market interest rates associated with most directed credit programs have increased pressures for excessive expansion of the monetary base while reducing incentives for deposit mobilization, as already noted.

Short-term rediscounts should be used solely for monetary management and offered only at interest rates above the cost of mobilizing deposits. Long-term rediscounts might be used for development purposes -- but only if interest rates are raised to market levels and transaction costs are reduced. Financial intermediaries must take full responsibility for the risks on rediscounted loans, while the BCH must cease to be involved in client selection and the ex-ante evaluation of loans and only audit ex-post a sample of rediscounted loans. Moreover, as indicated below, the supply of long-term funds might be adequate without BCH rediscounts if policies toward pension funds and insurance companies were appropriate.

1.7 Interest Rate Control.- With adequate instruments of monetary control, attempts to control interest rates directly could be abandoned. Interest rate control as traditionally practiced in Honduras has focused on controlling rates on loans and has generally left rates on deposits free from control -- an approach that is totally inappropriate. Controls over interest rates on loans are at best ineffective as lenders can readily impose additional charges to raise rates to equilibrium levels no matter how diligent the regulatory authorities may be. At worst, controls over rates on loans can lead to the formation of economic groups to take advantage of low rates, can be a devise to enforce cartel arrangements and thereby promote monopoly profits, or can lead regulated financial institutions to divert their lending to informal markets -- something that has been widely observed in Honduras, as discussed below. On the other hand, arguments can be made for limited controls over interest rates on deposits in certain circumstances in order to prevent insolvent or risk-prone financial intermediaries from taking advantage of explicit or implicit deposit insurance that is not accompanied by adequate regulation and supervision of deposit-taking institutions.

1.8 Savings Mobilization.- In spite of the possible need to limit interest rates on deposits under certain circumstance, it is nonetheless crucial that interest rates on deposits not be set at levels that are negative in real terms or in ways that inhibit competition for deposits by financial institutions that are solvent and prudent. The performance of financial institutions in deposit mobilization has been poor in Honduras during the 1980s. Enhanced deposit mobilization is the only way that more funds can be made available on a sustainable basis to finance increased private sector investment. Many of the reasons for poor mobilization revolve around inadequate macro-financial policies that have already been discussed -- excessive fiscal deficits leading to a lack of confidence in domestic financial assets, high and unremunerated reserve requirements that tax deposits, availability of low-interest rediscounts that reduce incentives for financial institutions to mobilize deposits, etc. Even when these policies have been changed, financial institutions may nonetheless require training and technical assistance to promote a rapid response in deposit mobilization after years of neglect, especially of depositors in rural areas and of individuals of modest means.

1.9 Commercial Banks.- Commercial banks and other formal financial institutions in Honduras have often been harshly criticized for their failure to provide adequate financial services to the majority of the Honduran population and especially to individuals of modest means. In recent years, moreover, questions have also been raised about the solvency of certain banks. While some of these criticisms may be correct, they do not necessarily mean that Honduran bankers are by-and-large incompetent, lazy or dishonest. Rather, to the extent that the current condition of the Honduran banking system is problematic, this largely reflects inappropriate incentives facing bankers -- incentives that are mainly due to inappropriate government policies. For example, as long as interest rates on loans are below the rate of inflation, bank owners and managers will have clear incentives to lend only to those who have the best collateral and who are well known -- often friends and relatives or related economic groups -- rather than seeking out new clients who will be more costly to serve than current borrowers and who may also turn out to be more risky.

Among the fourteen commercial banks in Honduras, at least two or three have serious problems with respect to solvency. These problems are well known to the BCH and within the Honduran banking community, and in fact these banks are under a mild form of intervention ("supervision preventiva") by the SB. These solvency problems appear to have arisen mainly from non-performing loans and to have reached serious proportions because of the failure to act more aggressively to collect overdue loans or to make adequate provisions for loan losses (including the accrual of interest not collected). However, the legal collection process is slow and costly, while loan loss provisions are discouraged by tax policy. In addition, problem banks have tended to depend heavily on BCH rediscount lines (possibly for targeted and subsidized lending to riskier clients) and consequently to have neglected deposit mobilization.

Besides attacking these fundamental policy issues, a key question is what to do with problem banks to minimize subsequent losses. Unfortunately, there is no well-developed process in Honduras for recapitalizing, merging, selling or liquidating problem banks -- or having them rehabilitated by the SB. While such processes are being developed, it is crucial that precedents not be established of bailing out problem banks to the benefit of current owners and managers -- otherwise, the costs to the Honduran Government could extend far beyond the banks that may currently be insolvent, as strong incentives are created for excessive risk taking by other banks.

There may in fact already be other banks with potential solvency problems, but this is difficult to know in Honduras because of excessive concern for bank secrecy, together with tax incentives not to provision for non-performing loans and hence not to reveal their existence. Compared to most developing countries, relatively good information does exist about the financial condition of Honduran banks. Honduran banks all have external audits, and the firms that carry out these audits are highly competent; in fact, most bank audits are carried out by Honduran offices of major U.S. accounting firms. Most bank statements in Honduras have "qualified opinions" from their auditors for the reasons suggested above (e.g., accrual of interest on delinquent loans and inadequate loan loss reserves), but this information is generally available only to stockholders and to the SB. Moreover, as discussed in greater detail below, the SB has relatively good information about the financial condition of banks, but this information is also generally unavailable because of excessive concern for bank secrecy. Consequently, in spite of the existence of information, the lack of availability of information makes depositing in Honduran banks largely an act of blind faith -- because of the lack of explicit deposit insurance as well as the lack of information.

Banking in Honduras is becoming a riskier business. In part this is due to the recent upsurge in inflation that will require banks (and especially savings and loan associations, as discussed below) to adopt more flexible interest rate policies and to appreciate more fully the impact of interest rates on the profitability and cash flow positions of their borrowers.

More fundamentally, the process of financial liberalization that is being recommended to increase the efficiency of the Honduran financial system will not only give banks more freedom in decision making but will also expose them to greater competition. Financial liberalization not only entail programs to make interest rates more flexible but also involves policy changes that will increase competition among banks -- such as the reform of barriers that block the entry of new banks. Both theory and practice have shown that, if there is more than a small number of potential competitors (e.g., three or four), banking cartels or oligopolies that extract monopoly profits from their clients can only exist if they are aided by government regulations such high and arbitrary barriers to entry. For Honduras, this implies that applicants for bank charters should be required to supply adequate capital along with impeccable records of honesty and assurances of competence for potential owners and managers, but there should be no arbitrary or non-transparent requirements or untimely delays in approvals.

Three additional initiatives are implied by the foregoing discussion of the impact of financial liberalization on the Honduran banking system. First, accurate information about the current financial condition of banks must be more widely available on a timely basis so that potential depositors and others who may have dealings with Honduran banks can make well-informed decisions. Second, the Honduran Government must adopt an explicit policy toward deposit insurance. If there is to be official deposit insurance, then the Government must assure that there is adequate prudential regulation and supervision of insured institutions to

avoid excessive risk taking. If there is not to be official deposit insurance, then the Government must make absolutely clear by both its statements and its actions that it will not bail out depositors or owners and managers of failed banks on an ex-post basis.

Third, programs of technical assistance and training for banks and bank staff should be initiated. Training and technical assistance programs will not be very helpful as long as inappropriate incentives and the inappropriate policies creating them have not been changed. However, once reform is underway, enhanced training and technical assistance will be crucial (e.g., how to deal with inflation and resulting high and variable interest rates, the use of cash flow analysis, learning from the techniques of client selection and loan recovery used by informal financial agents, etc.). Moreover, to finance this training and technical assistance and to assure its relevance and quality, the recipients should pay a portion of the costs commensurate with the direct benefits received.

1.10 Savings and Loan Associations.- The problems facing the six Honduran savings and loan associations should not be over-emphasized because they represent less than 10 percent of the Honduran banking system. Nonetheless, their problems are quite similar to those experienced by U.S. savings and loan associations -- long-term loans, many with fixed interest rates, in the presence of rising inflation and interest rates, together with efforts to diversify out of housing finance and into riskier operations for which they have little experience -- and at least one Honduran savings and loan is already believed to be insolvent.

Honduran savings and loan associations also face potential funding problems as they have become heavily dependent on low-interest rediscount lines from the BCH (which should not continue for the reasons discussed above) and on low-interest deposits from various pension funds (which cannot continue indefinitely). As discussed below in more detail, these pension funds will be unable to honor commitments to their beneficiaries if they continue to make deposits at interest rates than are highly negative in real terms. Moreover, the maturing of Honduran pension funds will eliminate their substantial surpluses of revenues over expenditures. In addition, higher interest rates on housing loans to compensate for higher inflation may cause cash flow problems for borrowers if conventional level-payment mortgages are used, since level payments in nominal terms imply payments that are high in real terms in the initial years of a loan. In fact, for all types of long-term lending, consideration may need to be given to some form of indexation of principal or capitalization of interest to deal with such potential cash flow problems.

1.11 Public-Sector Banks.- There are three public sector banks in Honduras, but of these only BANADESA, the agricultural development bank, warrants any serious attention. BANMA, the bank for municipal financing, never played any significant role in the Honduran financial sector, while CONADI, the investment finance company, has been insolvent for some time and is currently in liquidation.

The history of BANADESA is not unlike that of other agricultural development banks in Latin America. Attempts to provide targeted loans at subsidized rates of interest to priority borrowers and activities in the agricultural sector (e.g., small farmers, producers of basic grains and agrarian reform beneficiaries) have resulted in high operating costs and a very high proportion of non-performing loans -- due in part to the difficulty of dealing with such clients but more importantly to political intrusions. Recently, BANADESA management appears to have made serious attempts to bring costs under control, to improve the collection of overdue loans and even to minimize political intrusions, but the ultimate success of these efforts remains to be seen. To have any chance to be viable, BANADESA needs to focus on providing a full range of financial services in rural areas (including loans to non-farmers and especially deposit mobilization), to eliminate activities unrelated to providing such services (which have been the source of BANADESA's most serious losses), to develop incentive systems that reward autonomous branch managers for good performance, and, above all, to protect BANADESA from political intrusions. Until substantial progress is made in these respects, it would be a serious mistake to channel funds to recapitalize BANADESA or to finance its lending and other activities.

1.12 Superintendency of Banks.- The SB is largely well regarded by Honduran bankers and by foreign experts for its technical skills, but it nonetheless faces certain significant problems that will require additional strengthening of its technical capabilities and especially of its powers to deal with banking problems. Two of the most important areas have been noted above. First, the SB needs to deal with the problem of lack of public information about the financial condition of banks which, in turn, will require a clear recognition that banking secrecy applies only to information about deposits. As part of this, the SB also needs to improve the way it collects and organizes the data provided to it by the banks that it supervises. Second, the SB needs enhanced powers to deal with problem banks. The results of its bank analyses must lead not simply to recommendations but to actions that will ultimately be enforced either by the SB itself or by some other governmental agency to which it reports its findings. In addition, if the SB is to have responsibility for dealing with problem banks, it will need to expand its operational skills substantially to include areas of bank management. This will allow the SB to operate efficiently in selling, merging, or liquidating insolvent banks, or rehabilitating and recapitalizing them if this is deemed appropriate.

There are also a number of specific actions that might be taken to strengthen the SB's capabilities. First, it needs to focus its analytical work on capital adequacy. This, in turn, requires much greater attention to the quality of bank loan portfolios -- including not only the timeliness of loan repayments, but also loan concentration, lending to related parties and adequate documentation of borrowers' financial condition -- as well as the adequacy of provisions for non-performing loans and the overall credit administration capabilities of banks. One action along these lines would be to establish portfolio review and loan classification standards that would be applied by the banks themselves and then reviewed by their external auditors and finally by the SB itself.

It would also be useful to develop a credit information bureau to collect, organize and provide information about the overall exposure of the banking system to different borrowers. This could be helpful in monitoring loans to related parties as well as portfolio concentration. The SB could also consider developing a strong legal department not only to provide interpretations of laws and regulations but also to provide recommendations for on-going reform for banking legislation. In addition, a strong data processing and systems department would be useful to reformulate the way information is collected from banks and to expedite the handling of such information. New computer hardware and software and substantial amounts of training and technical assistance would subsequently be required to implement the new framework.

1.13 Pension Funds.- There are currently seven pension funds operating in Honduras, but three of these are very small. All seven of them initiated operations in the 1970s or 1980s. Because they are so new, they tend to have relatively large numbers of contributors compared to beneficiaries, so they are growing rapidly in total assets. In fact, they have already reached almost L. 2,000 million in total assets and are thus more than one third the size of the Honduran banking system.

In spite of their growth and size, as well as the many recent studies of financial markets in Honduras, only one serious study of pension funds could be found. Pension funds have also been neglected in terms of regulation and supervision, as the law provides few limits on their investments beyond the recommendation that prudence be emphasized over return. Currently, almost 50 percent of total pension fund assets are in government bonds and bank deposits, both of which have yields that are highly negative in real terms, and another 35 percent are in loans to beneficiaries, also at interest rates that are negative in real terms. This apparent emphasis on prudence, together with pressure to make low-interest loans to beneficiaries, is leading the pension funds toward rapid decapitalization. If they are to honor commitments to their contributors, they must find outlets for funds that provide yields that are positive in real terms. Furthermore, their current size and growth potential could make them a key element in Honduran financial markets, especially as providers of longer-term funds of which there is said to be a great deficiency.

1.14 Capital Markets.- Development of capital markets is necessary for Honduras not only to help to provide sources of longer-term financing for investment projects but also to provide instruments with market-determined rates of return that can enable institutions such as pension funds and insurance companies to earn positive real rates of return and thereby to protect their asset bases. As indicated above, such instruments do not appear to be widely available. For example, the Honduran Government uses a variety of non-transparent devices to avoid paying market rates of interest on its debt. It is essential for the development of capital markets -- and, as explained above, for the development of appropriate instruments for monetary management -- that the Honduran Government and the BCH issue instruments that can be freely traded in the capital markets of Honduras at market-determined rates of interest.

BCH rediscount lines at below-market rates of interest for long-term loans have also discouraged the development of instruments that could be traded in Honduran capital markets, as potential borrowers in capital markets prefer to seek subsidized funds through these rediscount lines. Although many individuals believe that the development of capital markets in Honduras is hindered mainly by the lack of supply of long-term funds, the foregoing discussion of pension funds suggests that this is not the case and that the main barrier is instead current government policies toward rediscount lines and the financing of the public sector fiscal deficit.

The recent creation of a securities exchange in Honduras is a promising development. However, as is widely recognized and discussed in detail elsewhere in this report, substantial technical assistance and training efforts will be necessary before this exchange can reach the efficiency and size that will allow it to contribute significantly to the development of financial markets in Honduras. This training and technical assistance can be focused most effectively if the process begins with the development of a strategic plan for the securities exchange.

It is also essential to provide the appropriate regulatory environment for the securities exchange to function, and a number of specific recommendations are made elsewhere in this report. While it is important eventually to write a law specifically for the securities exchange and to insure that this law is consistent with other Honduran laws and regulations, dealing with the specific issues detailed below should not wait. An important aspect of the regulatory environment is assurance of timely disclosure of relevant and accurate information so that participants in the market can make well-informed decisions -- a point that has also been stressed for the banking system. Because of the time required for the development and dissemination of information that will have adequate credibility, it is likely that trading on the securities exchange will develop first in government and BCH instruments, later in instruments issued by the banking system and only later in prime commercial paper and other debt and equity instruments of the non-financial private sector.

1.15 Informal Finance.- Informal financial markets (IFMs) in Honduras are highly diverse, may be almost as large as formal financial markets in the total volume of operations, and are certainly much larger in the number of clients served. The extreme diversity of IFMs makes it difficult to define them precisely, but the most common and useful definition focuses on the fact that they are unregulated, that is, they are not subject to the regulations and supervision that monetary authorities impose on formal financial markets and institutions. Nonetheless, Honduras presents an interesting case distinct from most other developing countries in that informal lenders are supposed to register with the BCH, to pay taxes on the volume of lending reported, and to be subject to interest rate limitations. The interesting issue is why any informal lenders would in fact register -- and more than 1,000 currently do. There are two important reasons: (1) interest rate limitations can easily be avoided (e.g., by mis-stating the amount of the loan); and (2) registration is necessary to have access to the legal system to enforce loan contracts.

IFMs demonstrate considerable flexibility in their operations, including taking advantage of the legal system and various aspects of the commercial code whenever the benefits exceed the costs. Their diversity and flexibility has allowed IFMs to serve far more clients than are served by formal financial markets and institutions, in spite of the hostility often expressed by formal sector agents and by policy makers and government officials charged with financial sector regulation. Before deciding on the appropriateness of such hostility, and consequently on the position that should be taken toward IFMs, it is essential to know more about their operations in Honduras. These operations are not well documented in large part because of official hostility, which has also led to severe under-estimation of the importance of IFMs.

Among the most common types of IFMs in Honduras are individual moneylenders, pawnshops, informal groups that pool savings and make loans, and a wide variety of traders, marketing agents and merchants, as well as friends and relatives. IFMs also include various types of more formal institutions (that are nonetheless informal in that their lending activities are not regulated by the monetary authorities) such as finance companies, leasing and credit card companies, non-governmental organizations (NGOs), and credit unions and other types of cooperatives. Most IFMs charge interest rates of 2 to 5 percent per month on loans, but rates sometimes range much higher, especially in cases of small amounts for short periods of time. Borrowers are willing to pay such rates because of the other terms and conditions of informal loans, especially the speed and flexibility and the absence of formalities that raise borrower costs or ration out potential borrowers completely. In short, lower transaction costs on informal loans can more than compensate for higher interest rates.

Another significant aspect of IFMs is their savings mobilization activities, which are extensive but largely undocumented. It is well known that credit unions mobilize deposits, and it is also widely recommended that they could enhance their viability if they did so more aggressively through higher interest rates and better service for depositors. In addition, however, many pawnshops, finance companies, credit card and leasing companies, and even merchants, traders and individual moneylenders, as well as informal groups, also mobilize deposits. They are successful in deposit mobilization primarily because they offer higher interest rates than formal financial intermediaries that are limited by high reserve requirements and low interest rates on loans. The interest rates paid by IFMs must be higher to compensate depositors for the real and perceived risks of depositing with IFMs rather than with formal financial institutions.

Some of the lessons that can be learned from the operations of IFMs in Honduras should be quite clear both for government policy makers and for operators of formal financial markets and institutions. If interest rates that formal financial institutions pay on deposits are repressed by high reserve requirements and discouraged by low-interest BCH rediscounts, potential depositors will seek outlets in IFMs for their savings -- which, however, may turn out to be more risky as well as more rewarding. For policy makers, an appropriate response is clearly greater incentives for deposit mobilization by formal financial institutions, along with clear and convincing statements that depositors in unregulated IFMs will not be bailed out by the Honduran Government if these IFMs become bankrupt. For operators of formal financial markets and institutions, much can be learned from the deposit mobilization techniques of IFMs and especially from the success of IFMs in mobilizing deposits from segments of the population that formal financial markets and institutions have traditionally neglected.

With respect to lending by IFMs, operators of formal financial markets and institutions can learn much about techniques of client selection and loan recovery that would allow these institutions to deal with the types of potential borrowers that they have neglected in the past (e.g., small-scale enterprises, small commercial farmers and others who live in rural areas). Formal lenders will also need to set interest rates freely and flexibly to reflect the full costs of dealing with these new types of clients -- otherwise, they will have no incentive to expand their client base. Policy makers must therefore come to recognize more clearly the importance of market-determined interest rates for formal lenders, together with the fact that attempts to repress IFMs will not only largely fail but will also drive up the costs of financial services for all users. There are undoubtedly many examples of the abuse of borrowers by informal lenders, but such abuses should be dealt with through the enforcement of laws and regulations that protect everyone against fraud and extortion and not through special regulations that inhibit the flexibility of IFMs to provide a wider range of financial services at lower cost.

There is an emerging view of IFMs that sees them in a much more favorable light and often recommends that they be incorporated in government and donor projects or linked with formal financial institutions. However, because of past neglect of IFMs in Honduras and elsewhere, more detailed study is needed to know about the impact of recommended interventions on IFMs and the likelihood of benefits for the overall economy. There are some examples of positive interventions in Honduras, such as the current program to strengthen credit unions in their ability to provide a wider array of financial services on a more sustainable basis. However, there are also examples of negative interventions, such as the programs that involve NGOs in targeted lending at below-market interest rates to small-scale enterprises. These programs have not only tended to compromise the viability of participating NGOs but have also achieved only limited outreach.

Programs to formalize IFMs may also sometimes be counter-productive, as IFMs may lose their flexibility and no longer be able to serve even their traditional clients efficiently. Programs to link IFMs with formal financial markets and institutions may also involve significant risks for the parties involved. More basic approaches, such as reducing the biases against bank lending to marketing agents and merchants, may be more effective in allowing funds to flow to neglected sectors of the economy. If the best that IFMs can do is to provide some lessons for policy makers and for the managers of formal financial market and institutions, along with some financial services for those who would not otherwise receive them, this is nonetheless a significant accomplishment.

1.16 A Strategy for Financial Sector Development.-

Broadly speaking, the following overall guidelines should characterize efforts to reform the financial sector of Honduras.

- Implement fiscal policies which will permit the government to operate with a balanced budget. To the extent possible, the financial sector should not be utilized as a source of incremental financing for the central government. Taxes, and other forms of financing for the central government, should be levied in a transparent manner.

- Policies and interventions in financial markets and capital markets should be directed at removing **distortions** from the financial system to permit market forces to efficiently allocate resources in the financial system.

- Policies and interventions should be directed at fostering **competition** in financial markets wherever possible. The more competition that exists in financial markets, the more efficient the markets. In the long run, financial resources will be allocated to their highest and best use in the economy.

- Care should be taken to insure that financial market and capital market strategy be **integrated**. This will insure the balanced development of both markets.

1.17 Specific Recommendations for Financial Sector Interventions.-

Macrofinancial Policy Reforms.-

- Reduce the public sector fiscal deficit such that it can be financed through transparent, market-oriented means that do not crowd out the private sector and consequently undermine investment.

- Unify the foreign exchange market by eliminating exchange controls that require exporters to surrender their foreign exchange to the BCH and importers to access foreign exchange through the BCH.

- Attempt to assure greater independence for the BCH and allow it to use monetary instruments for monetary control rather than for financing the public sector fiscal deficit and channeling funds at below market interest rates to the private sector.

- Improve the technical capabilities of the BCH to use the main instruments of monetary control, that is, open market operations, reserve requirements and rediscounts.

- To the extent that interest rate controls are not completely phased out, tie them to a market rate of interest such as that determined in the auction market for government bonds where the BCH would carry out its open market operations.

- As a first step, undertake:
  - a parallel reduction in reserve requirement and rediscounts;
  - a movement of the rediscount rate to market levels;
  - the remuneration of remaining required reserves at market rates; and
  - the initiation of open market operations through an auction system.

BCH Operational Reforms.-

- The focus of the BCH should be narrowed so that it is clearly responsible for monetary and financial sector policies and their implementation and not for a boarder range of economic or governmental activities.
- The BCH should have adequate autonomy and independence which will require modification of pertinent laws, including those covering the selection of members for its Board of Directors.
- The plan to reorganize and decentralize the BCH should be implemented, with some modifications, but only after the essential functions of the BCH have been clearly defined -- except that immediate attention should be given to improving internal controls and to developing an integrated accounting system for management information and financial control.
- The BCH should reform its rediscount policies so that short term credits are granted to banks only for liquidity management purposes and so that procedures for granting long term credits for development purposes are reformed. In both case, interest rates on rediscounts should be high enough to cover the costs of funds (including any foreign exchange risk) and not to discourage deposit mobilization by banks.
- The BCH should be assisted in obtaining training and technical assistance in a variety of areas, but especially with respect to the following:
- for the Department of Economic Studies so that it can play its essential role in developing the BCH's monetary program and in providing crucial information and analysis to highest level BCH management;
- for the Department of Credit to develop new approaches to handling rediscounts and for the initiation of open market operations; and

- for improving internal controls and developing an integrated financial system for management information and control.

Financial Institution Recommendations.-

- Facilitate the development of formalized, on-going training programs (described in Chapter 4, para.,4.181,) to assist financial institutions with the modernization and liberalization process that will inevitably result from policy recommendations recommended in Chapter 2.

- Provide technical assistance to the banking system, through the Superintendency of Banks, or through the Bankers' Association, to facilitate the implementation of **credit process management and credit review** related recommendations suggested in Chapter 7.

- As suggested in the specific recommendations under Chapter 4, para., 4.32, serious consideration should be given to liquidation or privatization of BANADESA. It will be difficult for market mechanisms to effectively intermediate financial resources in the agricultural sector while BANADESA continues to operate under pricing standards that are not market determined (and with different credit standards) in competition with the private sector (both the formal financial institutions and the informal financial system).

- Conduct a review of all existing legislation, Central Bank regulations and other constraints upon the banking system that inhibit open competition among financial institutions. Develop a plan to dismantle barriers to competition. The results of this survey must be incorporated into any overall plan to modernize current banking legislation.

Pension Fund and Insurance Company Recommendations.-

- Facilitate the development of a seminar, adapted to the Honduran context, on macro-financial issues, capital budgeting, bond yields and short term investment for the participation of pension plan managers and staff.

- Facilitate the development of a statistical data bank to record statistics on insurance claims. This will permit insurance premiums and reserves to be mathematically calculated.

Capital Market Recommendations.-

- Develop and implement a training program for the management and staff of the securities exchange as set forth in Chapter 6, para., 6.5.

- **Facilitate the establishment of a commission to study and propose immediate partial reform to the existing legislative and regulatory framework as set forth in Chapter 6, para., 6.6.**

- Carry out the specific legal recommendations as set forth in Chapter 6, para., 6.7.

Recommendations for the Superintendency of Banks.-

- Establish and implement clear, written guidelines and definitions for the banks so that periodic information submitted to the superintendency is uniform and can be utilized for effective monitoring of the banks' asset quality and financial health.

- Modify current strict interpretation of bank secrecy law so that there is ample disclosure of information regarding the financial health of financial institutions, to include information that will permit analysts to assess the quality of loan portfolios, other assets and earnings. Periodic reports by independent external auditors should be required and should be available to the public upon request.

- The Superintendency of Banks should establish clear minimum guidelines for **Credit Process Management** requirements at financial institutions. Standards must be set for information required to be available in credit files and other credit administration procedures. Standards established must be audited periodically in conjunction with asset/loan quality review. Banks with sub-standard credit process management must be sanctioned and forced to adhere to minimum standards.

- Banks should be required to establish internal credit review programs as part of their **Credit Process Management.** Existing loan classification standards should serve as the basis for each bank's credit review program. The Superintendency should, in turn, conduct periodic credit reviews to audit the programs established by the banks. As part of the credit review, the Superintendency must assess the adequacy of each bank's reserves set aside for loan losses. Banks must immediately establish any provisions required by the Superintendency as part of the credit review.

- Specifically, the Superintendency should require that financial institutions write off their worthless investments in CONADI

- The Superintendency should develop a practical **implementation plan** for dealing with sick financial institutions. Certain legislation which inhibits the power of the Superintendency to act swiftly and forcefully to intervene must be re-written.

The implementation plan must address how runs on deposits will be handled and how to deal with the stockholders of the intervened institutions.

- Once the plan is in place the Superintendency should move forcefully to intervene, liquidate or merge the existing financial institutions in the system that are failing.

- Tax legislation must be overhauled to permit banks to deduct loan losses and provisions for losses from taxable income.

- Conduct a computer systems review to determine optimum hardware and software requirements of the Superintendency needed to manage the desired data base. The system should be designed to permit electronic reporting by financial institutions.

- Design and implement a training program for Superintendency personnel stressing, financial analysis, credit review and asset evaluation and how to monitor economic groups and lending to related parties. Additionally, training programs should be implemented in areas such as the mathematical review of insurance premiums and mathematical reserves to permit the Superintendency to monitor the insurance companies.

Informal Financial Market Recommendations.-

- It is clear that far too little is known about this major component of the Honduran financial system, so that any additional studies of financial markets in Honduran should give high priority to both surveys and case studies of IFMs.

- Any additional regulation of IFMs in Honduran should focus on protection of investor funds and should not inhibit competition and innovation in IFMs through attempts at enforcing interest rate controls or similar regulations.

- Interventions to strengthen specific agents in Honduran IFMs should focus on making these agents financially viable and should not involve them in programs to strengthen their clients that are patterned after traditional directed credit programs.

- Agents in IFMs can provide better service to their clients if they can obtain credit from the formal system on competitive terms, and this should include pawnbrokers, marketing agents and other informal lenders and not just credit unions and NGOs.

ANNEX E
BANK TRAINING PROGRAMS

1. Commercial Banking

A key objective of the project's commercial bank training activities is to influence the mindset of bank managers and credit officers, and the conditions in which they operate, to liberalize their lending policies and provide improved services to the private sector. The training activities will support the development of a more efficient and competitive banking system, and a reliable and timely flow of necessary information through the system, through the provision of a comprehensive and sustainable bank training program that allows bank staff to better manage their institutions and make more informed credit decisions.

The commercial bank activity addresses the need for training at four levels of commercial bank staff: senior management (Management Program); upper and middle level management (Specialized Program); mid-level officers (Technical Program); and entry-level personnel (Bank Technician.) Each level has different needs which require distinct training approaches and subject matter. For example, senior managers need interactive sessions in which they can discuss and learn about the effects of a competitive economy on their sector and how to best set their bank's policies to take advantage of freer markets. Managers and professionals, such as loan officers, may require technically-oriented training using case studies and other materials on subjects that grow out of the senior manager seminars, such as project lending and loan supervision. In addition, the project will train Honduran instructors as trainees in modern bank procedures so they can continue the training activity.

The training program is designed around seven areas that Price Waterhouse identified as areas needing improvement. These areas are: Macroeconomic Environment, Bank Operations, Capital Markets Development, Human Resource Development, Management Information Systems, Strategic Planning and Regulatory Environment. The program is designed for the attainment of specific goals in each area through courses directed at the four levels of bank staff previously noted. A description of training goals and courses that will be provided in each area is given in Table E-1.

In the first year of implementation of the Management Program, each of the general managers of the 14 commercial banks will receive three senior level seminars on macroeconomic adjustment and financial liberalization, strategic planning, bank administration, asset/liability management, and human resources management. During the following four years, the Management Program will expose bank presidents, managers and some regional managers to the latest issues and developments such as strategic planning, loan policies, financial controls and planning, systems for loan loss reserves, as well as international issues affecting banking. The ultimate goal of training at this level is to enable bank managers to refine their ability to do strategic planning and to implement these plans in different areas of bank operations.

The second priority of the training activity in the first year of project implementation will be to initiate managerial seminars under the Specialized Program. These seminars will cover personnel policies and management, treasury management, portfolio management, trade finance, financial control, electronic banking, capital market operations, etc. Participants at this level may include some general managers but will more likely incorporate assistant managers, area managers, heads of departments or divisions, and managers of large regional offices. The goal of the Specialized Program is to provide training to participants in more specialized technical and management skills that will feed into and facilitate the implementation of strategic plans prepared by upper management.

The Technical Program will provide training to bank professionals, such as credit and operations officers, in the latest techniques and procedures, products and services. The Bank Technician Program is designed to expose entry level and clerical personnel to banking and to serve as a basis for understanding and mastering the more advanced technical skills required at higher levels. This level of training will repeat a sequence of introductory and advanced courses on a variety of bank activities such as: letters of credit, credit administration, trust services, balance sheet analysis, payment systems, treasury, economics for bankers, bank marketing, etc. Clerical level training will be provided to at an estimated 1,000 employees with the potential to advance to more skilled technical and professional positions.

Training will take place at the Central Bank's La Granja training center in Tegucigalpa and at the facilities of local training institutions. In addition, AHIBA and the BCH are attempting to reactivate a one year university level banking program to be held in Tegucigalpa and San Pedro Sula. Initially only commercial bankers will participate in the training activities. Ultimately, all financial institutions will be incorporated, without additional AID financing. A total of 170 seminars will be provided to 1,784 bankers. After the PACD, AHIBA will continue the training activities on a full cost recovery basis.

Short-term technical assistance will assist AHIBA to establish a data bank of aggregated statistics on the financial system. Information for the data bank will flow form the Superintendency of Banks and the member banks. The financial data bank, which is of specific interest to the commercial banks, will be a small but important activity which will provide bank treasurers and managers with current information necessary for business decisions. AHIBA will operate the data bank with its own microcomputer equipment and staff and will charge for this service through its membership fees.

A proposed budget for the AHIBA bank strengthening program is provided in Table E-2.

2. Central Bank Training

The project will provide a total of $1,083,000 to the Central Bank and Superintendency of Banks for short term training and observational tours. The Central Banks training proposal is attached. Both the Central Bank and the Superintendency will be required to submit yearly training plans for USAID approval.

TABLE E-1

LIST OF COURSES BY GOAL

GOAL 1: MACROECONOMIC ADJUSTMENT AND MANAGEMENT DECISION-MAKING: Apply an increased understanding of macroeconomic adjustments to management decision-making. Draw on lessons from experiences of other countries.

- Financial Sector Reform and Structural Adjustment: Experiences from Other Countries and Their Relevance to Honduras.

GOAL 2: OPERATIONS: Improve skills in key areas such as treasury; portfolio management, credit policy and loan performance; international operations; asset and liability management; financial controls; and profits and losses. Measure improvement (in terms of profitability, increased market shares) annually.

- Impact of Structural Adjustment and Liberalization for the Management and Development of Banking Institutions in Honduras.

- Treasury Management under Inflation and Devaluation
- Credit Policy and Loan Portfolio Management
- Advanced Project Analysis
- Financial Planning and Asset and Liability Management
- Risk and Liquidity Management
- Planning Savings Mobilization
- Account and Product Profitability
- Advanced Auditing
- Financing International Trade
- Financial Accounting and Controls
- Developing and Marketing New Financial Services and Products

- Credit Evaluation and Analysis of Financial Statements
- Loan Recovery and Renegotiation
- Introductory Project Analysis
- Small Business Loans
- Agricultural Loans
- Construction Loans
- Housing Loans
- Trade Finance
- Intermediate Auditing
- Systems for International Payments
- Cost and Expense Accounting
- Customer Relations

- Auditing Principles
- Accounting Principles
- Credit Principles
- Foreign Exchange
- Letters of Credit
- Teller Operations
- Business Math
- Deposit Accounts and Services
- Selling Financial Services

GOAL 3: **CAPITAL MARKET DEVELOPMENT: Deepen capital market development and diversify banking operations. Identify and offer new financial instruments. Explore feasibility of, and develop if relevant: stock markets, futures markets, swaps and options. Apply appropriate lessons from other countries.**

- New Financial Instruments for Development

- Building Effective Financial Markets
- Securities Market Management in Emerging Economies

GOAL 4: **EFFICIENCY AND HUMAN RESOURCE DEVELOPMENT: Increase efficiency. Identify and implement innovative and self-sufficient human resource development programs to meet institutional development needs. Measure results annually.**

- Managing and Developing Human Resources in Banking

- Career Paths and Incentive Systems in Banking
- Developing an Organization through Training
- Systems for Monitoring and Evaluating Training Impact

- Career Development Workshop

- Career Development Workshop

GOAL 5: **MANAGEMENT INFORMATION SYSTEMS: Assess management information needs and apply appropriate systems and technologies. Examine how management information systems and new technologies for banking institutions can improve decision-making and performance in key areas of operations. Explore the trade-offs in adopting these systems and technologies in banks.**

- Management Information Systems for Decision-Making.

- New Technologies for Commercial Banks

- Introduction to Microcomputers
- Introduction to Spreadsheets and Accounting Software

GOAL 6: **STRATEGIC PLANNING: Improve management decision making; develop and implement strategic plans, identify ways to improve bank management during economic liberalization. Devise work plans to implement strategic plans, including methods to effectively communicate plans to staff members and motivate them to contribute to the realization of planned objectives. Measure improvement (in terms of profitability, increased market shares) annually.**

- Strategic Planning and Plan Implementation for Financial Institutions.

- Plannning Branch Management and Division Operations

- Planning Work Relative to Managerial Objectives

GOAL 7: **REGULATORY ENVIRONMENT: Create collaborative processes between AHIBA, the Central Bank and the Government of Honduras to strengthen the financial system. Identify major bottlenecks in communications; devise joint strategies to overcome these bottlenecks. Explore and apply appropriate experiences of other countries in terms of relations between commercial banks and government regulatory institutions, and the types of govenrment programs to support the banking sector.**

- Mutual Perception Workshop
- Government and Banking Industry Relations: International Comparisons.
- Development and Implementation of Monetary Programs and their Impact on Local Financial Institutions
- Central Bank Organization and Operations
- Advanced Bank Examination
- Bank Regulation and Supervision

TABLE E-2

AID/AHIBA/BCH BANK STRENGTHENING PROGRAM
TRAINING COMPONENT

YEAR 1

		NO. OF COURSES	AVERAGE AID	TOTAL AID	AVERAGE AHIBA	TOTAL AHIBA	AVERAGE COURSE	TOTAL PER YEAR	PARTICIPANTS	AVG. COST PER PART.
Management Program		3	35,000	105,000	0	0	35,000	105,000	42	2,500
Specialized Program		3	30,000	90,000	0	0	30,000	90,000	60	1,500
Technical Program		6	0	0	7,500	45,000	7,500	45,000	150	300
Bank Technician	Modules	5	0	0	5,500	27,500	5,500	27,500	125	220
	Seminars	5	0	0	5,500	27,500	5,500	27,500	125	220
TOTAL		22		195,000		100,000		295,000	502	

YEAR 2

		NO. OF COURSES	AVERAGE AID	TOTAL AID	AVERAGE AHIBA	TOTAL AHIBA	AVERAGE COURSE	TOTAL PER YEAR	PARTICIPANTS	AVG. COST PER PART.
Management Program		2	35,000	70,000	0	0	35,000	70,000	28	2,500
Specialized Program		3	30,000	90,000	0	0	30,000	90,000	60	1,500
Technical Program		7	0	0	7,500	52,500	7,500	52,500	175	300
Bank Technician	Modules	7	0	0	5,500	38,500	5,500	38,500	175	220
	Seminars	6	0	0	5,500	33,000	2000	33,000	150	220
TOTAL		25		160,000		124,000	78,000	284,000	588	

YEAR 3

		NO. OF COURSES	AVERAGE AID	TOTAL AID	AVERAGE AHIBA	TOTAL AHIBA	AVERAGE COURSE	TOTAL PER YEAR	PARTICIPANTS	AVG. COST PER PART.
Management Program		2	38,000	76,000	0	0	38,000	76,000	28	2,714
Specialized Program		2	33,000	66,000	0	0	33,000	66,000	40	1,650
Technical Program		8	0	0	8,250	66,000	8,250	66,000	200	330
Bank Technician	Modules	10	0	0	5,500	55,000	5,500	55,000	250	220
	Seminars	8	0	0	5,500	44,000	5,500	44,000	200	
TOTAL		30		142,000		165,000		307,000	718	

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YEAR 4

		NO. OF COURSES	AVERAGE AID	TOTAL AID	AVERAGE AHIBA	TOTAL AHIBA	AVERAGE COURSE	TOTAL PER YEAR	PARTI CIPANTS	AVG. COST PER PART.
Management Program		2	38,500	77,000	0	0	38,500	77,000	28	2,750
Specialized Program		2	33,000	66,000	0	0	33,000	66,000	40	1,650
Technical Program		10	0	0	8,250	82,500	8,250	82,500	250	330
Bank Technician	Modules	8	0	0	6,100	48,800	6,100	48,800	200	244
	Seminars	8	0	0	6,100	48,800	6,100	48,800	200	
	TOTAL	30		143,000		180,100		323,100	718	

YEAR 5

		NO. OF COURSES	AVERAGE AID	TOTAL AID	AVERAGE AHIBA	TOTAL AHIBA	AVERAGE COURSE	TOTAL PER YEAR	PARTI CIPANTS	AVG. COST PER PART.
Management Program		2	38,500	77,000	0	0	38,500	77,000	28	2,750
Specialized Program		1	33,000	33,000	0	0	33,000	33,000	20	1,650
Technical Program		7	0	0	8,250	57,750	8,250	57,750	175	330
Bank Technician	Modules	11	0	0	6,100	67,100	6,100	67,100	275	244
	Seminars	11	0	0	6,100	67,100	6,100	67,100	275	
	TOTAL	32		110,000		191,950		301,950	773	

SUMMARY

		COURSES	AID GRANT	AHIBA COUNTERP.	TOTAL PROGRAM
Management Program		11	405,000	0	405,000
Specialized Program		11	345,000	0	345,000
Technical Program		38	0	303,750	303,750
Bank Technician	Modules	41	0	236,900	236,900
	Seminars	38	0	220,400	220,400
	TOTAL	139	750,000	761,050	1,511,050

ANTEPROYECTO DE CAPACITACION DE RECURSOS HUMANOS DEL BANCO CENTRAL DE HONDURAS

INTRODUCCION

Los cambios suscitados en la estructura económica del País y específicamente los consecuentes a la reestructuración y la modernización del Banco Central de Honduras, han hecho necesaria la readecuación y la redefinición de algunas premisas, énfasis, orientaciones, contenidos, etc. que se habían manejado tradicionalmente en la función de capacitación de los Funcionarios y Empleados de la institución.

Históricamente encontramos que en el Banco ha habido como en ninguna otra institución nacional de servicio público, una atención constante hacia la formación profesional del personal; no obstante, la concentración de los esfuerzos se ha dado en los sectores operativos, mediante el impartimiento de materias que les permitan un desempeño eficiente de sus puestos de trabajo, mientras que a los sectores de la Alta y Media Gerencia y a los Técnicos, se les ha dado en forma poco sistemática y mas que todo orientada a aspectos de formación académica, que a los de capacitación en el desarrollo de destrezas gerenciales.

La actual coyuntura institucional nos obliga a redefinir el propósito, buscando con mayor énfasis mejorar la capacidad analítica, técnica y administrativa de la Alta y la Media Gerencia, tanto para permitirle un mejor desempeño de su quehacer, como para que pueda entender mejor y adaptarse con mayor éxito a los cambios que se suscitan tanto en el interior de la estructura organizacional del Banco, como en el contexto que le rodea nacional e internacionalmente; sin desmedro de la atención al personal operativo, que constituye el porcentaje mas alto de la estructura ocupacional y de donde se sustentan los cuadros de reemplazo.

Por tales razones se vuelve imperativo desarrollar acciones concretas y sistemáticas que lleven a mejorar las habilidades gerenciales del sector responsable de dirigir, planear, supervisar y evaluar el quehacer de la institución y volver concreto el pensamiento estratégico de la Administración Superior. No hacerlo implicaría el enorme riesgo de que los agentes responsables, no estén preparados para poder cumplir y hacer cumplir los lineamientos de la reestructuración y la modernización del Banco Central.

Asimismo deberán continuarse atendiendo los requerimientos específicos de capacitación del personal operativo, resultantes de la detección de necesidades que se levantó oportunamente y que ha permitido conocer qué es lo que necesita para desempeñar con mayor efectividad sus labores.

OBJETIVOS

Propiciar la formación profesional y de actitudes en el personal del Banco Central de Honduras, con una orientación hacia la obtención de resultados, con capacidad de enfrentarse con éxito a los retos, con una tendencia de acción proactiva y estratégica y una conciencia de servicio con altos indicadores de desempeño, comprometido con el desarrollo institucional y nacional.

Establecer un sistema basado en la metodología de la Educación Permanente, que a la par de permitir que la gente adquiera conocimientos, modifique su comportamiento, detecte los problemas y les busque soluciones.

DESCRIPCION DEL PROYECTO

COBERTURA

PERSONAL EJECUTIVO	116
PERSONAL TECNICO	273
PERSONAL ADMINISTRATIVO	360
PERSONAL DE SERVICIO	204
PERSONAL TOTAL	953

AMBITO GEOGRAFICO

OFICINA PRINCIPAL		765
SUCURSALES:	San Pedro Sula, Santa Rosa de Copàn, La Ceiba y Choluteca.	188

INDICE DE MATERIAS

FORMACION DE EJECUTIVOS

1. Alta Gerencia
2. Planeamiento Estratégico
3. Informática para Apoyo Gerencial
4. Desarrollo de Liderazgo
5. Toma de Decisiones
6. Indicadores Económicos para Ejecutivos no Economistas
7. Técnicas de Formulación de Presupuestos
8. Técnicas de Planificación
9. Desarrollo Organizacional
10. Técnicas de Comunicación Ejecutiva
11. Técnicas de Motivación
12. Calidad Total
13. Administración y Desarrollo de Recursos Humanos
14. Aspectos Econ. y Operativos de Banca Central

FORMACION TECNICA

1. Planeamiento Estratégico
2. Técnicas de Formulación de Presupuestos
3. Técnicas de Planificación
4. Análisis y Evaluación de Proyectos
5. Mercados de Capitales
6. Aspectos Económicos y Operativos de Banca Central
7. Programación Financiera
8. Redacción de Informes Técnicos
9. Indicadores Económicos
10. Ajuste y Reexpresión de Estados Financieros en Situaciones de Inflación y Devaluación
11. Supervisión Bancaria
12. Auditoría Administrativa
13. Auditoría de Informática
14. Estadística Analítica
15. Métodos y Técnicas de Capacitación
16. Administración por Objetivos
17. Administración General
18. Calidad Total
19. Ciencias Actuariales
20. Seguridad Social
21. Salud Mental
22. Estadística Social
23. Financiamiento Para el Desarrollo
24. Supervisión y Dirección de Personal
25. Organización y Métodos
26. Psicología Industrial

27. Técnicas de Entrevista
28. Psicometría
29. Técnicas de Investigación Social
30. Psicología Social
31. Formación de Instructores
32. Estructuración del Tiempo
33. Métodos y Técnicas de Evaluación.
34. Relaciones Públicas.

FORMACION OPERATIVA

La detección de necesidades de capacitación del personal operativo se basó en el formulario que denominamos "Perfiles del Puesto", cuyo propósito es identificar y cuantificar las diferencias que existen entre lo que lo que el empleado responsable de determinado puesto conoce sobre el mismo y lo que debe conocer, asi como las materias y técnicas que le son necesarias para un rendimiento óptimo.

La secuencia del proceso es la que sigue:

a) Determinación del perfil del puesto
b) Determinación del perfil del empleado
c) Determinación de Técnicas o conocimientos requeridos.
d) Establecimiento de diferencias entre el perfil del puesto y el perfil del empleado.
e) Tabulación de materias por nivel, número de personas y área del conocimiento, Departamento etc.
f) Programación
g) Evaluación.

INDICE DE MATERIAS DETECTADAS

1) Contabilidad General
2) Contabilidad Bancaria
3) Contabilidad Intermedia
4) Contabilidad Superior
5) Contabilidad de Costos
6) Contabilidad de Seguros
7) Contabilidad Fiscal
8) Contabilidad Financiera
9) Técnicas Aduaneras
10) Cartas de Crédito y Cobranzas al Exterior
11) Operaciones de Comercio Internacional
12) Prácticas Bancarias Internacionales
13) Principios de Auditoría
14) Muestreo Estadístico
15) Auditoría de Sistemas
16) Auditoría Administrativa
17) Auditoría Financiera
18) Matemáticas Financieras
19) Cálculo
20) Principios de Economía
21) Moneda y Banca
22) Análisis Macro y Microeconómico
23) Mercado de capitales
24) Estadística Descriptiva
25) Estadística Analítica
26) Estadística Aplicada
27) Estadística Económica
28) Análisis Estadístico

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29) Operaciones de Fideicomiso
30) Almacenes Generales de Depósito
31) Análisis Financiero
32) Programación Financiera
33) Administración Financiera
34) Evaluación de Instituciones Financieras
35) Regulación y Supervisión Bancaria
36) Operaciones de Banca Central
37) Administración de Cartera
38) Análisis de Crédito
39) Técnicas de Detección de Falsificación de Moneda
40) Organización y Métodos
41) Legislación Bancaria
42) Legislación de Fianzas
43) Legislación sobre Seguros
44) Redacción de Informes
45) Técnicas de seguridad e Inv. Especiales
46) Teoría sobre Seguros (Daños, Vida, Riesgos, Fianzas)
47) Análisis y Valuación de Proyectos
48) Manejo y Control de Inventarios
49) Investigación de Mercados
50) Bibliotecología
51) Técnicas Secretariales
52) Organización y manejo de Centros de Información
53) Calidad Total

ENTRENAMIENTO EN SERVICIO

Viajes de estudio, coordinados por Organismos Internacionales tales como AID, FMI, IDE, Trade World Center, CEMLA, ALIDE, FELABAN, otros Bancos Centrales, etc., mediante las cuales se pueda obtener Entrenamiento en Servicio para Funcionarios y Técnicos de la institución, en materias en las que se tenga poca experiencia, no se cuente con posibilidades de entrenamiento a nivel nacional y se requiera refuerzo de conocimientos.

BECAS

Formación académica en Banca Central, Administración General, Recursos Humanos, Alta Gerencia, Administración Bancaria, Informática, Economía, Supervisión Bancaria etc., en instituciones educativas nacionales o del extranjero, de reconocido prestigio.

ASESORIA EN EDUCACION PERMANENTE

Capacitación del personal técnico del Departamento de Recursos Humanos, para que sea capaz de presentar una propuesta de capacitación y desarrollo de los Recursos Humanos; ejecutarla, supervisarla y evaluarla, dentro de una metodología eficaz, viable y pertinente con nuestra realidad institucional y nacional y que haga posible que el proceso no descanse en un limitado número de responsables, sino que pueda contarse con cuadros de reemplazo oportunos, para permitir su continuidad.

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INGLES

Organizar un sistema de enseñanza del idioma inglés en forma sistemática, accesible tanto a funcionarios, como a técnicos y operativos; considerando este aspecto como fundamental para el éxito del Programa de Capacitación, ya que ha sido detectado como una necesidad urgente de capacitación y una debilidad crítica dentro del nivel de conocimientos del personal del Banco central de Honduras

COSTOS

En cuadros anexos.

OTROS ASPECTOS

Simultáneamente se están elaborando los documentos de respaldo a las actividades, especialmente de capacitación, tales como el Inventario de Recursos Humanos, que nos permitirá disponer de un sistema de información del personal, completo, oportuno, organizado y procesado electrónicamente, que facilite y agilice la administración de los Recursos Humanos.

Cada programa de estudios constará de un esquema que básicamente consistirá en:

- Objetivos de Aprendizaje
- Metas
- Contenido
- Metodología
- Instrumentos de Evaluación
- Instructores
- Presupuesto
- Calendarización

DALILA PINEL DE PINEDA

Tegucigalpa MDC 26 de Agosto 1992

BANCO CENTRAL DE HONDURAS
Departamento de Recursos Humanos

DISPONIBILIDAD PARA CAPACITACION
EN MONEDA LOCAL
(En miles de dólares)

CONCEPTO	AÑOS					TOTAL
	PRIMERO	SEGUNDO	TERCERO	CUARTO	QUINTO	
ESF/ GOH	80.0	80.0	75.0	70.0	70.0	375.0
BANCO CENTRAL DE HONDURAS						
Intereses Export. Produc. no Tradicionales	70.0	70.0	60.0	50.0	50.0	300.0
DISPONIBILIDAD	150.0	150.0	135.0	120.0	120.0	675.0
1/ CAPACITACION B.C.H.	70.0	80.0	115.0	110.0	110.0	485.0
1) Funcionarios	15.0	15.0	25.0	25.0	25.0	
2) Técnicos	15.0	15.0	25.0	20.0	20.0	
3) Operativos	40.0	50.0	65.0	65.0	65.0	
Construcción y Reparaciones	40.0	30.0	10.0	0.0	10.0	90.0
Capacitación Informática y Tecnología	25.0	25.0	0.0	0.0	0.0	50.0
1) Técnicos	10.0	10.0	0.0	0.0	0.0	
2) Usuarios	15.0	15.0	0.0	0.0	0.0	
2/ MOBILIARIO Y EQUIPO	10.0	10.0	10.0	10.0	0.0	40.0
Asesoría en Educación Permanente	5.0	5.0	0.0	0.0	0.0	10.0
TOTAL	150.0	150.0	135.0	120.0	120.0	675.0

NOTAS:

1/ Primero y segundo año, capacitación básica, principalmente en estructuras locales a partir del tercer año, capacitación de mayor complejidad, enfasis en instructores internacionales, becas y entrenamiento en servicio.

2/ Incluye habilitación, locales, materiales y equipos en las sucursales.

BANCO CENTRAL DE HONDURAS
Departamento de Recursos Humanos

DISPONIBILIDAD PARA CAPACITACION
EN MONEDA EXTRANJERA
(En miles de dólares)
FONDOS AID - US$ 530,000.00

CONCEPTO	AÑOS					TOTAL
	PRIMERO	SEGUNDO	TERCERO	CUARTO	QUINTO	
PLANEAMIENTO ESTRATEGICO	87.0	82.0	0.0	0.0	0.0	169.0
CAPACITACION B.C.H.	72.0	60.0	56.0	46.0	27.0	261.0
1) Funcionarios	42.0	32.0	30.0	30.0	20.0	
2) Técnicos	22.0	20.0	21.0	16.0	7.0	
3) Operativos	8.0	8.0	5.0	0.0	0.0	
CAPACITACION INFORMATICA Y TECNOLOGICA	30.0	20.0	0.0	0.0	0.0	50.0
1) Técnicos	30.0	15.0	0.0	0.0	0.0	
2) Usuarios	0.0	5.0	0.0	0.0	0.0	
EQUIPO DE COMPUTACION	30.0	0.0	0.0	0.0	0.0	30.0
MOBILIARIO Y EQUIPO	20.0	0.0	0.0	0.0	0.0	20.0
T O T A L	239.0	162.0	56.0	46.0	27.0	530.0

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ANNEX F
MIS TECHNICAL ASSISTANCE AND COMMODITIES FOR THE SUPERINTENDENCY

The Superintendency only has one systems programmer who acts as manager for its MIS system. Once the MIS system is fully developed and installed, the Superintendency will need to expand its present computer staff by one or two to maintain the system and attend to user needs (200 staff). A temporary team of programmers is needed during program development, hardware installation and user training. The team of three local systems analysts and programmers will be contracted from a local computer or accounting firm directly by the Superintendency with project financing. The team will be contracted through a local firm for three important reasons: to retain objective supervision, and the capability for replacement of a team member, by the contracted firm; to maintain the integrity of the MIS design process, including the determination of work priorities and the deployment of equipment, without concerns for future employment with the Superintendency; and to isolate the team from undue interference by Superintendency staff during the technical design of the MIS system.

The PAIP will finance a team of three local systems analysts/programmers for two and one half years to assist the Superintendency to organize its MIS. The total cost for the 90 person months of team technical assistance is $90,000. The computerized MIS system will allow the Superintendency to connect its computers with regulated financial institutions, and with its branch in San Pedro Sula (where 60% of financial transactions take place). This system will extract needed statistics every night, process them that same night, and disseminate them the following morning, as needed, to Superintendency and BCH staff, and, in aggregate form, to the financial system through the AHIBA data bank. Once the MIS review is completed, the project will provide approximately four person-months of short-term technical assistance to help the Superintendency to organize a systems department, to train staff in the new procedures, and to verify the specifications of the hardware and software needed. A preliminary analysis indicates that an IBM AS 400 or equivalent is required. Prior to initiating procurement of the system, its hardware or software components or ancillary equipment such as modems, etc., AID will seek and receive approval from AID's Office of Information and Resources Management (IRM). The Mission will procure both the computer hardware and software in the U.S.

Superintendency staff and local IBM staff have made preliminary designs for the following configuration for the MIS system: one AS/400 E35 system unit with 32MB of system memory and 1228MB of disk memory with six communication lines. The suggested system would have magnetic tape attachment, an 8" diskette unit and a magnetic tape unit. Only seven terminals will be requested since the system can use the terminals that were already procured under the Export Development Services (EDS) project and the portable micros to be used by bank inspectors. This equipment will cost approximately $250,000, CIF Tegucigalpa. In addition, it is projected that the following communication equipment will be needed to gather data from financial institutions and to communicate with the Superintendency branch in San Pedro Sula: one 7861 014 Modem with 4800 KBPS; two microchannel emulators; two modems (300–12,000 BPS), one 5324 remote control unit, four 3477 wide-view display stations: one 4334 printer; one SDIC and a permanent power source. This equipment is estimated to cost $50,000, CIF Tegucigalpa.

Software will most likely include the OTC V2 operating system and COBOL and RPG programs for A/S 400, application development tools, office management, PC support, Office Vision, Query for A/S 400, SQL and language dictionaries. It is estimated to cost $100,000.

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Annex F
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ANNEX G

FINANCIAL INSTRUMENTS AND MECHANISMS

INTRODUCTION

The financial sector reforms being put in place by the Central Bank, which include the phaseout of medium term rediscount facilities, will require that the financial system create instruments and mechanisms to gather and allocate domestic savings. The financial sector component of the project will initiate the process of development of capital markets. The assistance will focus on the provision of medium term financing to the productive private sector. Thus, the instruments and mechanisms to be created will be long term bank negotiable certificates of deposit with fixed and variable rates, bankers acceptance of export receivables, export financing through "forfeiting", commercial paper, treasury bills, money market mutual funds, individual retirement accounts and export related securities. These instruments are described below.

The project will also assist the Central Bank to create an export credit insurance facility which would allow banks to discount receivables from exporters.

Description of New Financial Instruments

1) Export Credit Insurance Facility

Most countries have established export credit insurance facilities to support their export programs. Since 1984 the Mission identified the need to support such a facility. However, the development of an export credit insurance facility was deferred until the appropriate policy environment was in place and until the BCH developed experience with dollar based credit and guarantee facilities.

The export credit insurance fund to be established at the BCH would guarantee payment by banks of foreign buyers of Honduran goods to a Honduran exporter's local bank. Local exporters will be able to quickly recover their working capital by discounting with local banks their receivables of goods shipped under a confirmed letter of credit. With the letter of credit from the overseas buyers' bank and proof of shipment, exporters would obtain a guarantee from the export credit facility that it will pay if the foreign buyers' bank fails to pay. Once export receivables are insured for payment banks can discount them, converting them into "Bankers Acceptances". Banks, in turn, generally sell the Acceptances to investors through the local and U.S. capital markets.

With this facility, the project would assist the BCH and the commercial banks to provide financial services not currently offered in Honduras to non-traditional exporters such as post-export financing and export credit insurance. Through these instruments and mechanisms, Honduran non-traditional exporters will be able to compete in world markets with the many other countries which offer payment terms for their exports and discount export receivables in local and international money markets. These mechanisms also create depth in financial markets by converting a promissory note under a commercial letter of credit into a government-backed security that investors can buy with confidence.

The project will finance $30,000 in technical assistance for a feasibility study for the establishment of an export credit insurance facility. If feasible, and subject to GOH establishment and capitalization of the facility, the grant will finance $15,000 in computer equipment and $5,000 in training for BCH staff.

If successful, the guarantee facility could eventually be expanded to allow the issuance of medium term guarantees covering both the financing of capital goods imported by Honduran exporters and the exports from Honduras sold under installment terms. This medium term guarantee would be made possible by a similar mechanism, supported by AID's PRE Bureau and known for its French name as " forfeit" or "forfeiting".

2) Securitization of Financial Instruments

As discussed earlier, export-oriented ventures, and their ancillary businesses, need medium and long term financing to establish their operations. At present, Honduras lacks such financing mechanisms. The project will provide technical assistance to Honduran private and public financial institutions, through the Central Bank, to develop such mechanisms. The technical assistance will educate financial professionals on the role and use of financial instruments as a tool to gather savings so as to provide the medium term financing needed to foster investments and exports. To provide financing, a financial system must create instruments and mechanisms to meet the needs of savers and borrowers through a process of financial intermediation. This process can be either indirect or direct.

Under direct financial intermediation, such as the trading of shares in a stock market, investors provide funds to enterprises. Investors are willing to share various degrees of risk of loss of principal and/or investment income in expectation of greater returns on their funds. Depending on their capital structure, credit market conditions, and other considerations, entrepreneurs are willing to provide to investors a guaranteed return or a contingent return, such as a share of the profits.

Working capital loans are generally financed with short-term or call bank deposits where banks match their loans with deposits of the same tenor. To make available long-term financing, financial institutions must find a way to cover the interest rate and liquidity risk. Since there is usually unmet demand for long and medium term loans, and a dearth of term deposits, banks restrict their mismatching of assets and liabilities because as the period of a loan lengthens, the risk to the lender of not finding funds (liquidity risk) or having to buy them at a loss (rate risk) increases geometrically.

Under the EDS project, the Mission pioneered the establishment of variable rates of interest and pressed for the removal of the cap on lending rates, thereby lessening the interest rate risk for the lender and allowing banks to start selling long term variable rate deposits. However, financial institutions and/or entrepreneurs still have to obtain funds to finance medium term loans without assuming excess rate and liquidity risks. These can be obtained by either: issuing medium and long term deposit instruments that guarantee savers a fixed or, most likely, variable (to ensure a positive return in real terms) rate of interest, or: the sale (discounting) of financial assets, such as loan promissory notes.

Financial institutions can assist entrepreneurs to obtain funding through the conversion of ordinary financial obligations, such as mortgages and promissory notes, into homogenous bundles of obligations known as securities. Securities are instruments which present written evidence of title to a claim on financial assets. Examples of securities are stock shares and government and corporate bonds, but their variety is limited only by the imagination of financial professionals.

The project will finance short term technical assistance to assist the GOH (BCH, Ministry of Finance, BCH Superintendency) and the private sector (Stock Exchange, pension funds, insurance companies, banks) to facilitate the creation of new deposit instruments, the securitization of debt instruments and their trade in the capital market. Technical assistance provided under the project will assist banks to create variable rate certificates of deposit and commercial paper, and will seek to develop the capital market since it is the best mechanism to provide medium and long term financing. Development of the capital market will be characterized by trading in securities backed by financial instruments such as bankers acceptances, government bonds and mortgages.

Since the GOH will continue to be the leading issuer of securities, the project will provide technical assistance to the stock exchange, the BCH and the Ministry of Finance to assist the GOH in the use of capital market mechanisms and market determined rates to finance its operations and to effect monetary policy. One priority will be to assist the BCH in complementing its long-term bonds with the issuance of treasury bills that can be bought by banks and used by them in lieu of required reserves. In this case, the present tax on financial intermediation caused by high and unremunerated reserve requirements can be substantially reduced, allowing banks to share the reduction in cost by paying more interest to savers and charging borrowers less.

Technical assistance provided will assist the Superintendency to establish the orderly development of the capital market (solvency, liquidity, fair play). The technical assistance will seek to identify how the stock market can promote widespread stock ownership and thus the support of the public for the free enterprise system including support for Employee Stock Option Plans. Through donor provided training and technical assistance to the capital market, investment for export and other productive ventures can be obtained through the development of secondary markets for mortgages and other financial instruments and the general development of equity financing mechanism and instruments such as venture capital and country funds.

The instruments and mechanisms to be created under the project include:

INTERBANK MARKET is the trading amongst banks of short and medium term funds raised from the public as well as the temporary laying off of excess funds. The terms of the placements (otherwise known as loans and deposits) range from overnight and "call" to a fixed period as long as five years.

CERTIFICATES OF DEPOSIT are negotiable bearer instruments issued by banks for deposits placed with them for a fixed period. The security is the same as a regular certificate of deposit but offers the advantage of obtaining liquidity before maturity by selling in the secondary market.

COMMERCIAL PAPER are unsecured promissory notes issued by commercial or financial institutions for a fixed maturity. It is usually only issued by banks or companies with a very high credit rating. Buyers of commercial paper can obtain liquidity before maturity by selling in the secondary market.

BANKER'S ACCEPTANCES AND BILLS OF EXCHANGE are time drafts, that is, orders to pay to the holder an amount by a due date. They are normally issued by an exporter (seller) and signed by the importer (buyers) who undertakes to make the payment. The drafts are usually are "accepted" by a bank for a fee. Under its acceptance the bank guarantees payment. Drafts accepted by top banks become fairly safe bankers acceptances that can be freely traded in secondary markets.

FORFEITING is the non-recourse purchase from an exporter of receivables arising from an international trade transaction. The debt by the importer from the export transaction usually takes the form of a series of semi-annual maturing promissory notes carrying interest at a fixed rate. Unless the importer is well known, the debt instruments usually are guaranteed by the importer's bank or another acceptable guarantor, including foreign banks and foreign governments and agencies. The term is between six months and seven years and denominated in a major international currency.

TREASURY OR GOVERNMENT BILLS are obligations of the central bank or national government. The bulk of these are negotiable and constitute the safest instruments and their yield is an important indicator for the pricing of other instruments. T Bills are have usually short term (3 to 6 months) maturities while those with medium term maturities (1 to 10 years) are called T Notes and those with long term maturities (10 to 30 years) are called T-bonds.

ANNEX H COST ESTIMATES AND FINANCIAL PLAN

A. FINANCIAL PLAN

The total estimated costs of activities financed under this Financial Sector Amendment is $8.64 million. USAID will contribute $6 million in grant funds; the GOH will contribute the local currency equivalent of $1.14 million from ESF local generations and interest earnings from export credit lines provided under the Export Development Services (EDS) Project. AHIBA will provide an additional $1.5 million for commercial bank training. It is anticipated that $2.5 million will be obligated in FY 1992; $3.2 million will be obligated in FY 94; and $.3 million will be obligated in FY 1995. Financial tables H-1 and H-2 show both dollar and local currency costs over the five-year life of the amendment. Table H-3 provides an obligation schedule.

B. METHODS OF FINANCING AND DISBURSEMENT

USAID will contract for technical assistance through several different mechanisms, direct contracts, IQCs, Buy-ins to centrally funded projects and host country contracts. All commodities and training for GOH employees will be procured directly by the Mission. The Mission will contract with Personal Services Contractors for project management. The Mission also plans to: (1) amend an existing Cooperative Agreement with COHEP to finance consensus-building/lobbying activities for financial sector reform; and (2) to provide a grant to AHIBA to partially fund the costs of its training program and the development of a data bank. Table H-4 displays Methods of Financing and Disbursement.

C. AUDITS

The project has budgeted $125,000 to contract for independent non-federal audits of financial sector amendment activities. This amendment will have non-federal audits in 1994 and 1996. The audit section of the Regional Inspector General's Office will supervise these audits, and may make its own periodic audits of the use of project funds. In addition to these audits, because the project will be executed under a Handbook 3 Bilateral Grant Agreement with the Government of Honduras, the Controller General of the Republic may also audit the project amendment's activities.

TABLE H-3
OBLIGATION/EXPENDITURE SCHEDULE

Fiscal Year	Obligation	Expenditure	Projected FYE Balance
1992	2,500	0	2,500
1993	0	1,946	554
1994	3,200	1,344	2,410
1995	300	1,228	1,482
1996	0	862	620
1997	0	620	0
TOTAL	6,000	6,000	6,000

TABLE H - 4

METHODS OF FINANCING AND DISBURSEMENT

Activity/Commodity	Type of Contract	Responsible Contracting Party	Method of Payment	Estimated Amount ($000)
Technical Assistance	8a contract	USAID/Honduras	Direct Payment	829
	Buy-in to centrally-funded project	AID/W	Direct Payment	420
	Local procurement	GOH	Direct Reimbursement	182
	Direct contract (Non-PSC)	USAID/Honduras	Direct Payment	250
Commodities	Direct Contract	USAID/Honduras	Direct Payment	1,056
Training/Observational Tours for BCH and SB	Arranged by HC	GOH	Direct Reimbursement	1,083
Evaluation	IQC	AID/W	Direct Payment	150
Audit	Direct Contract	USAID/Honduras	Direct Payment	125
Project Management	Personal Services Contracts	USAID/Honduras	Direct Payment	800

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TABLE II-1

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TABLE H-2

FINANCIAL SECTOR POLICY ANALYSIS AND IMPLEMENTATION PROJECT BUDGET

COMPONENTS	USAID			GOH			AHBA	TOTAL
	FX	LC	TOTAL	BCH	GOH	TOTAL		
I. REGULATORY FRAMEWORK								
Technical Assistance	1261	0	1261		0	0	0	1261
Equipment & Commodities	966	0	966	340	0	340	0	1306
Training	973	0	973	300	500	800	0	1773
SUBTOTAL	3200	0	3200	640	500	1140	0	4340
II. POLICY REFORM								
Policy Conferences	220	0	220	0	0	0	0	220
Adoption of new laws	135	0	135	0	0	0	0	135
SUBTOTAL	355	0	355	0	0	0	0	355
III.COMMERCIAL BANK STRENGTHENING								
Technical Assistance	0	0	0	0	0	0	0	0
Equipment & Commodities	90	0	90	0	0	0	0	90
Training	750	0	750	0	0	0	1500	2250
SUBTOTAL	840	0	840	0	0	0	1500	2340
IV. NEW FINANCIAL INSTRUMENTS								
Technical assistance	420	0	420	0	0	0	0	420
Equipment & Commodities	0	0	0	0	0	0	0	0
Training	110	0	110	0	0	0	0	110
SUBTOTAL	530	0	530	0	0	0	0	530
V. MANAGEMENT								
Technical assistance	0	0	0	0	0	0	0	0
Equipment & Commodities	0	0	0	0	0	0	0	0
Training	0	0	0	0	0	0	0	0
Management	700	0	700	0	0	0	0	700
Financial Analyst	100	0	100	0	0	0	0	100
Evaluations	150	0	150	0	0	0	0	150
Audits	125	0	125	0	0	0	0	125
SUBTOTAL	1075	0	1075	0	0	0	0	1075
TOTAL	6000	0	6000	640	500	1140	1500	8640

ANNEX I

IMPLEMENTATION AND PROCUREMENT PLAN

A. IMPLEMENTING AGENCIES

1. The Central Bank (BCH)

Under the Central Bank Law, the General Manager is the Chief Executive Officer of the Central Bank and has sole authority to supervise and direct its operations. The President of the Board of the BCH, along with the Board itself, sets policy guidelines. However, the General Manager runs the bank.

The Office of the General Manager will be responsible for overall supervision and coordination of three of the four components of the project. These components are:

a. Promotion of Policy Reform. The General Manager will chair a Policy Steering Committee representing the BCH, COHEP and other private sector financial sector associations. The General Manager will appoint a coordinator to act as Secretary of a Policy Steering Committee. This coordinator will be assisted by a project-financed policy adviser who will serve as liaison with COHEP staff for project-financed policy reform activities. The Policy Steering Committee will also consist of two other BCH representatives who will represent the regulatory and supervisory arms of the BCH. These representatives are expected to be the BCH Deputy Manager for Credit and the Superintendency of Banks.

Under the guidance of the General Manager of the BCH, the Policy Steering Committee will set an agenda of policy topics to be discussed by members and define the work plan of seminars and other educational and lobbying activities financed by the project through COHEP.

b. Improved Regulation/Supervision of the Financial Sector. The Office of the General Manager of the BCH will supervise and coordinate all BCH and Superintendency institutional strengthening activities financed by the project. He will be assisted by the Deputy Managers for Credit, Operations, Technical Offices and Administration.

Most technical assistance and commodities for the BCH will be directly contracted by USAID in coordination with the BCH. The BCH will make all training arrangements financed by the project under this component and will be reimbursed by USAID.

The Superintendent of Banks will assist the BCH General Manager in coordinating all project activities involving the Superintendency. The Superintendent has appointed two senior officers to act as project coordinators with USAID project management. While the Superintendency of Banks is a department of the BCH, one of the project objectives is to promote its financial and administrative independence. To that effect, AID project management will coordinate directly with Superintendency officials on the day-to-day details of timing and sequence of technical assistance and commodities. The Superintendency will directly manage its own training program and will be reimbursed by USAID.

c. Development of New Medium and Long-Term Financial Instruments. The Credit and Securities Department of the BCH will be responsible for managing the three project activities under this component: the development of open market operations, the development of new trade instruments and the creation of medium-term financing mechanisms. The bulk of the work for the first two activities involves mostly internal BCH operations, although coordination with the financial system (banks, brokers, pension funds and insurance companies) is also necessary. USAID will coordinate directly with the Deputy Manager for Credit or his representative on the contracting, by USAID, of technical assistance, the financing of training and the provision of commodities. The third activity, the creation of medium term financial instruments, will require more USAID management involvement to assist the BCH to coordinate activities with the Superintendency, banks, brokers, the stock exchange, insurance companies and pension funds. USAID will coordinate with the BCH the provision (and contracting by USAID) of technical assistance and training for the various institutions participating under this activity.

2. The Honduran Council for Private Enterprise (COHEP)

The Mission currently provides funding to COHEP for private sector policy reform activities through a Cooperative Agreement under the private sector portion of the PAIP Project. The Executive Director of COHEP directs the technical staff of the organization. As such, he or she will direct COHEP's staff to conduct financial sector policy reform education and lobbying activities supporting the agenda determined by the Policy Steering Committee. The Executive Director will be assisted in his work under the project by the COHEP Manager of economic studies. Under this project amendment, USAID will amend the Cooperative Agreement with COHEP, increasing the funding to reimburse COHEP for its direct costs of contracting financial sector seminars, conferences and other policy dialogue/lobbying activities.

3. The Honduran Bankers Association (AHIBA)

The Executive Secretary of AHIBA directs the work of the staff of the association and the work of ad hoc committees formed amongst the staff of AHIBA. The Executive Secretary acts on the instructions of the four member of AHIBA's Board, elected every year to represent the 14 member banks. USAID will sign a Cooperative Agreement with AHIBA, once conditions precedent are met. The Executive Secretary will supervise the implementation of two activities under this component: the provision of training to bank officers through contracts with various educational institutions and educators and the creation of a data bank on financial flows which will disseminate information to member banks. USAID will reimburse AHIBA for up to 33% of the training costs and for the costs of the data bank as specified in a Cooperative Agreement.

B. OBLIGATING INSTRUMENTS

Funds for the project will be obligated under a Handbook 3 Bilateral Agreement with the GOH. This Agreement will cover all activities with the BCH and the Superintendency of Banks and Cooperative Agreements with COHEP and AHIBA.

C. PROCUREMENT PLAN

The authorized source/origin for procurement under the project is the United States.

1. Technical Assistance

Technical assistance to: (1) the Superintendency of Banks for the development of improved supervision procedures, an improved information system and a legal framework for supervising pension funds and capital markets; and (2) to the Central Bank to assist with foreign exchange management, human resources development, the development of staff training plans and changes to the Central Bank Law will be procured through an 8(a) contract. A decision was made to procure most of the technical assistance through the 8(a) contractor to furhter Gray Amendment objectives. Using the 8(a) contracting mechanism will also save time. Technical assistance to the Central Bank and the financial system for the development of new financial instruments, open market operations and capital markets will be contracted through a buy-in to centrally-funded Financial Services Development Project (FSDP).

A non-personal services contractor will be directly contracted by USAID to serve as the long-term policy advisor to the Central Bank. This advisor will coordinate policy reform efforts between the public and private sector. A long-term library advisor for the Central Bank and a team of three local long-term computer technicians to assist with the development of the Superintendency's MIS system will be procured using local contracting procedures.

2. Commodities

The project will finance computer hardware and software for the Superintendency of Banks, microcomputers and library equipment for the Central Bank, and data bank equipment for AHIBA. USAID will procure most commodities directly through Project Implementation Orders for Commodities (PIO/Cs).

3. Training

The Central Bank and the Superintendency of Banks will directly arrange for training in accordance with Handbook 10 requirements. AHIBA will directly arrange for training and will request reimbursement from USAID in accordance with the terms of its Cooperative Agreement. Training for other entities and observational tours will be arranged directly by the Mission.

4. Project Management

USAID will contract the services of a PSC Project Manager. The project amendment will also provide partial financing for a financial analyst for the overall PAIP project.

5. Evaluation and Audit

USAID will contract directly with institutions or individuals for evaluations and audits.

6. Buy America

The project has been designed in accordance with USAID's Buy America Guidance. U.S. procurement is required whenever practicable. Local procurement is planned only for those goods or services for which Buy America guidance provides a specific exemption. None of the planned local procurement requires a waiver under the Buy America Guidance. If during project implementation a transactions is proposed that requires a waiver under the Buy America guidance, such a waiver will be obtained before proceeding with the transaction.

In those transactions for which Buy America regulations authorize local procurement, CACM will be utilized in accordance with Handbook 3, Appendix 5D, and the LAC Central American Strategy to encourage effective regional cooperation. It is, however, anticipated that most local procurement will take place in Honduras.

Table I-1 presents the procurement plan in chart form and indicates the Buy America implications of each category of procurement (technical services, commodities, etc.) financed by the project. All transactions will require U.S. source, origin, and nationality except for the following, which are permissible under Section a of the Buy America Guidance, which allows for the purchase of services not exceeding $250,000 in the host country (includes CACM for Honduras).

- The Policy coordinator, who will work with the Central Bank and COHEP on lobbying and consensus building activities related to policy reform, will be a non-personal services contractor of CACM nationality (unless a US contractor can be identified). The estimated LOP cost of this position is $250,000;

- The project will finance Host Country contracts with three CACM (most likely Honduran) MIS technicians over a 2 and 1/2 year period to develop new MIS systems for the Superintendency. The total cost of all three contracts is estimated at $90,000;

- The project authorizes $125,000 for audits to be obtained through an IQC or direct contract with a U.S. or CACM audit firm. At the time of contracting, every preference will be given to the use of a U.S. firm.

TABLE I-1[1/]

PROCUREMENT PLAN

Commodity/Service	Description	Estimated Cost ($000)	Source	Origin	Type of Procurement	First Delivery Date (Months)	Lead Time (Months)	Purchase Agent AID/W	Waiver Approval Required	Buy America Implications
Technical Assistance										
- Policy Coordinator (BCH)	N-PSC	250	US/CACM	US/CACM	Competitive	3.0	3.0	USAID/H	Note 2	Note 2
- Technical Assistance (SB)	8(a) Contract	829	000	000	8 (a)	3.0	3.0	USAID/H	None	None
- Technical Assistance (Financial Instruments)	Buy-in to FSDP Proj.	420	000	000	NA	Various	Various	AID/W	None	None
- Library Consultant	Local proc.	92	000	000	Competitive	1.0	1.0	GOH	None	None
- MIS Consultants (BCH)	Local proc.	90	CACM	CACM	Competitive	6.0	6.0	GOH	None	Note 2
Commodities for BCH and SB, AHIBA										
- Computer Hardware/ software	AID Direct Contract	758	000	000	Competitive	6.0	6.0	USAID/H	None	None
- Library Books/ Equipment	AID Direct Contract	208	000	000	Competitive	6.0	6.0	USAID/H	None	None
- Data bank equipment (AHIBA)	AID Direct Contract	90	000	000	Non Competitive	12.0	6.0	USAID/H	None	None
Project Manager	PSC	700	000	000	Competitive	1.0	1.0	USAID/H	None	None
Project Financial Analyst	PSC	100	000	000	Competitive	12.0	12.0	USAID/H	None	None
Evaluation	IQC	150	000	000	NA	Various	Various	AID/W	None	None
Audit	AID Direct Contract	125	CACM	CACM	Competitive	Various	Various	USAID/H	None	None
TOTAL		3,812								
TOTAL U.S.		3,347								
TOAL NON-U.S.		465								

Notes 1. Project will also directly reimburse the BCH and Superintendency for training costs ($1,083,000), finance training and a development of a data bank for commercial banks through a cooperative agreement with AHIBA ($750,000) and finance policy reform activities through a Cooperative Agreement with COHEP ($355,000).

Notes 2. Buy America Guidance does not apply to professional services contracts under $250,000.

D. IMPLEMENTATION SCHEDULE

The following implementation schedule indicates targeted dates for the project's first year actions:

ACTION	DATE	ACTION BODY
Project Documentation		
- Project Authorized	9/92	USAID/GOH
- Bi-lateral Grant Agreement Signed	9/92	USAID/GOH
- PIL No. 1 Issued	10/92	USAID
- Initial Conditions Met	11/92	GOH
Contracting Actions		
- PIO/Ts developed for TA	10/92	USAID/GOH
- Cooperative Agreements with COHEP and AHIBA developed	11/92	USAID
- PIO/Ts for TA signed	11/92	USAID
- Cooperative Agreements signed	1/93	USAID/GOH
- Contracts Executed for TA	2/93	AID/W
- Contractors in Place	4/93	
- PIO/Cs for commodity procurement developed	4/93	USAID/GOH
- IFB for commodity procurement issued	6/93	USAID
- Training courses for BCH and SB initiated	6/93	GOH

ANNEX J MONITORING AND EVALUATION PLAN

A. USERS OF INFORMATION

The major users of the information collected through this monitoring plan will be the Central Bank, COHEP, AHIBA and USAID.

B. INSTITUTIONAL LOCUS

The institutional locus for data collection and analysis will be the General Manager's Office within the BCH. The project coordinators appointed by the General Manager will have the responsibility for collecting all data and for managing the undertaking any special studies or analyses required to measure achievement of project goals objectives and policy benchmarks.

C. PROJECT GOAL, PURPOSE, AND OUTPUT QUESTIONS, INDICATORS AND METHODOLOGIES

The following questions will be examined during project implementation indicators and methods are identified below:

1. Project Goal: The goal of this project is to promote sustained economic growth and stability. Measurement of achievement of this goal will be undertaken as part of USAID's monitoring of its action plan objectives.

2. Project Purpose: The subpurpose of this amendment to the PAIP is to increase Honduran capacity to formulate and implement policies that improve financial intermediation.

Purpose-Level Questions: To what extent has financial intermediation increased? Have domestic savings and private investment increased?

Purpose-Level Indicators: Change in gross private investment as a percentage of GDP. Change in gross domestic savings as a percentage of GDP.

Data Collection Methodology: Information on purpose-level indicators can be easily collected from Central Bank and Ministry of Finance records on a yearly basis. It will be part of the job of the Policy Coordinator at the BCH to collect this information and transmit it to USAID.

3. Project Outputs: Project outputs are:

- Improved regulation of the monetary system and supervision of financial institutions;
- Promotion of monetary policies that support open market operations;
- A more efficient and competitive commercial banking sector;
- New financial instruments that attract savings and investment;

Output-Level Indicators: Output-level questions and indicators are provided on the next page by project output. It should be noted that many of the output-level indicators are the same as the yearly policy benchmarks that have been developed for this project. A final list of indicators that will be measured will be developed by USAID and the project coordinators with assistance from the AID-financed policy coordinator.

Data Collection Methodology: All the above data will be collected by the project coordinators from BCH and Ministry of Finance records, the National Gazette and from project implementation reports required from project-financed TA consultants.

D. FEEDBACK: The Policy coordinator will be required to report on the achievement of all purpose and output-level indicators and any additional information required to evaluate achievement of project benchmarks on a semi-annual basis.

E. BUDGET: Approximately $150,000 has been set aside for project evaluations. In addition, approximately 10% of the project-financed policy coordinator's time will be devoted to monitoring activities.

F. EVALUATION SCHEDULE: Project evaluations will be held in 9/94 (midterm) and 9/97 (final). The major purpose of the mid-term evaluation will be to measure achievement of project policy benchmarks and to recommend what activities should be continued because of substantial progress; what activities should be modified and how; and what activities should be terminated due to lack of GOH or private sector commitment.

This evaluation will also: identify major project implementation problems and propose solutions; reassess the relevance of proposed project purpose, outputs and policy benchmarks; identify means to improve the efficiency and lower the cost of amendment activities; and recommend mid-course modifications. Data collected will be gender disaggregated whenever feasible.

The final evaluation will:

- summarize project objectives and background.

- assess progress in meeting project objectives (goal, purpose, outputs).

- review whether midterm recommendations were implemented.

- determine overall impact in terms of improved policy environment in the financial sector.

- draw conclusions and lessons learned and make recommendations for follow-on activities

Information Plan for Output Indicators

Output	Questions	Indicators
Improved regulation and supervision	Has the supervisory/ regulatory framework for the financial sector been strengthened? Have the supervisory powers of the Superintendency of Banks increased? Has the BCH restructured itself to deal with financial liberalization? Has the BCH become more autonomous?	- Passage of Banking Law that strengthens supervision of banking system - Passage of legislation to improve supervision of other financial institutions, i.e. insurance companies and pension funds - Central Bank Law revised to increase autonomy. - Reorganization plans for the Superintendency of Banks and BCH approved and implemented. - New bank inspection methods and intervention plan developed and implemented. Evaluation of effectiveness of procedures.
- Promotion of policy reform	Have policies that support open market mechanisms been promoted and adopted?	- Reduction in reserve requirement. - All controls removed on interest rates. - Adoption of open market operations by the BCH. - Automatic BCH rediscounts at market rates.

		- No. of Policy seminars/conferences held by COHEP on financial issues. - No. of Policy dialogue/lobbying activities translated into reform.
More efficient and competitive banking sector	Is the commercial banking sector providing more competitive services to the public?	- % reduction in bank spreads. - No insider lending. - No. of new banks authorized. - Reduction in bank collateral requirements. - Improved court procedures for protection of creditors rights. - Securities law passed.
New financial instruments	Have new financial instruments been developed? Are they attracting domestic savings and investment?	- Individual retirement accounts authorized and implementation of IRA procedures. - Establishment of secondary market for BCH bonds and level of investment in these bonds. - Establishment of export credit insurance fund. - Creation of mortgage

backed securities and level of investment in such securities.

- Evaluation of effectiveness of financial instruments in promoting savings and investment.

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EXECUTIVE SUMMARY

Since 1990, the Government of Honduras has been engaged in a broad structural adjustment program, aimed at achieving a greater degree of economic stability as well as more dynamic economic growth and investment. While producing positive results in 1991 and alleviating some of the larger pressures on the Honduran economy, it has yet to resolve some of the basic problems affecting monetary and fiscal conditions, national savings, and investment. USAID-Honduras, through an amendment to the Policy Analysis and Implementation Program (PAIP), proposes to assist the Government of Honduras in strengthening the financial sector through a series of reforms (some of which are already underway) aimed at enhancing the GOH's increasingly market based monetary policy, deregulation and more effective supervision of the financial sector, increased Central Bank independence, and development of capital markets. This study examines stakeholder interests affected by these reforms and their potential impact. The study will serve as input toward the design of an effective strategy for implementation of the proposed project paper amendment.

USAID-Honduras contracted the services of Management Systems International to carry out the analysis to determine: 1) the key individuals and/or groups (stakeholders) to be impacted or with an interest in the proposed financial sector reforms and, 2) the potential roles of stakeholder interests in either facilitating or blocking the reforms. The purpose of this study is to assist the mission: 1) in analyzing the social and political feasibility of the project and, 2) in determining who must be involved in the design and implementation of these policy changes. Finally, the team will recommend a strategy that will assist in building consensus for support of the reforms and which will minimize both cost and conflict.

The reforms being proposed are both diverse and complex, ranging from fuller liberalization of interest rates to proposals involving the regulation of the now extensive informal financial sector to the restructuring of activities and organization of the Central Bank of Honduras. The initiative for most of the proposals stems from a perceived need to make Honduras' financial system more responsive to an increasingly liberalized economy and to implant effective mechanisms for long-term investment financing. Since some of the reforms being proposed are also part of the conditionality set by certain donors or IFIs for disbursement of assistance or other financing, a sense of urgency for initiation of the reform process exists.

The reforms to be undertaken are expected to have considerable medium to long-term economic impact; however, the decisions to implement those reforms are expected to have considerable short-run political impact. The current government of Honduras has eighteen months remaining in its elected term and within the next four to six months, it is expected that the political environment for undertaking serious and/or long-range projects will become less hospitable or manageable. The matter of whose interests are affected and in what measure will be key not only to the chances of success for implementation of the proposed reform measures but quite likely for the government party's future electoral success as well.

The stakeholder environment for financial sector reform in Honduras can be divided into three major types of interests: producer or provider (of financing) interests, consumer interests, and

regulatory interests. While the distinctions are analytically simple, in practice they are often less clear. For instance, there is often overlap between consumers (borrowers in the private sector) and providers (banks) due to the fact that many banks are key elements of major economic groups with diverse holdings.
It is often difficult to state precisely where the interests of the provider ends and the interests of the consumer part of such groups begins.

Since interests tend to be highly cross-cutting, among certain actors (such as medium-sized banks) one may find a range of views rather than a common position on the whole set of reforms being proposed for the financial sector -- some reforms will be supported while others will be opposed -- because one set of interests (the bank's holding company, for example) will temper the perception of the bank on any given issue, and may not reflect "bank interests or viewpoint" per se. This has serious implications for the development of a strategy for building consensus on financial sector reform.

In early interviews, subjects were asked which reforms had the most priority. Based on this information and earlier, preliminary conversations with AID/Honduras personnel, five priority reforms were selected from the principal areas of reforms being proposed and subsequent interviews focussed specifically, though not exclusively, on those areas. These reforms were:

1. Removal of controls on Interest rates.
2. Reduced reserve requirement on bank deposits.
3. Legislation increasing powers of the Superintendency of Banks.
4. Enforcement of bank solvency and tax credits for loan losses.
5. More financial and political independence of the Central Bank.

Several general conclusions emerged from the stakeholder analysis:
1) Interests in the reform process are highly fragmented. Because of such fragmentation, one rarely finds complete uniformity of interests within the major sectors. 2) Support and opposition on most reform issues examined in this study shows a rough balance. Quite often, where there is strong support on an issue it is counter-balanced by equally strong opposition. 3) On most of the issues there are no clear "champions" of reform -- ie., someone or ones willing to take risks to see the process of formulation of the reform and its implementation all the way through. 4) In many cases, particular stakeholder interests are divided, exacerbating the already fragmented nature of interests in the financial sector. 5) There is no obvious or present client within the financial sector for the reform implementation process as a whole. The reform process is a complicated one in which important interests will be both damaged and benefitted in nearly all sectors. 6) The problem of overlap of interests or cross-pressures lends a highly inertial effect to the possibilities for a fluid reform process.

A strategy for the effective implementation of financial sector reform in Honduras must take into consideration and deal with 1) highly fragmented interests in financial sector reform, 2) the current lack of an clear and committed client for financial reform, and 3) the lack of simple and obvious mechanisms or resources for mobilization of interests toward reform.

The strategy alternative recommended recognizes the fragmented nature of interests involved in financial sector reform but proposes the development of a coalition both to strategically manage the process and to develop mechanisms for integrating the different pieces into a more coherent whole. To achieve this, the following "next steps" are recommended:

1. Secure agreement among the chief groups/stakeholders on the need to develop a mechanism for facilitating financial sector reform. COHEP should serve as the vehicle for facilitating that process/agreement.

2. Organization of a "Strategic Working Group" (SWG) from among representatives from key stakeholder groups including Consumers, Producers and Regulators. The SWG should serve as advisor to reform interests and as the reform movement's principal decision-making body. COHEP would serve as the principal backstop and "secretariat" for the SWG.

3. Enhancement of the technical capacity of COHEP to carry out technical studies, legal analysis, development of lobbying and communication strategies, stakeholder and political analysis, and implementation analysis for management and monitoring of the reform effort.

4. Convocation of meetings with the SWG and other key stakeholders to initiate the process of prioritization and selection of issues, the development of an overall strategy, and design of an action plan for financial sector reform.

ANNEX L - ECONOMIC ANALYSIS

SUMMARY

On the basis of an analysis of the cost of project inputs and on projections of the resulting percentage change in the rate of investment in the economy, it is concluded that the project makes economic sense. This is established by a very high economic internal rate of return (1.6) given its strategic focus on a vital sector of the economy and the multiplier effect of changes in the efficiency of financial intermediation. In addition, the project will have beneficial impacts on employment, trade and access to credit.

BACKGROUND

The Financial Sector Amendment to the Project aims to build on the on-going adjustment of the economy, and develop the financial system to enable it to mobilize and allocate financial resources efficiently, helping to increase domestic savings and productive economic growth. The Financial Sector Amendment will support the development of an appropriate policy environment, a modern legal framework and effective supervision, improved technical skills and the creation of medium term financing mechanisms and instruments.

METHODOLOGY

One indicator used to ascertain the potential impact of improving the efficiency of financial intermediation is the rate of investment in the economy, defined as the rate of gross fixed capital formation. Gross capital formation is the level of real assets (buildings, equipment and machinery) in both the private and public sectors in the economy.

This analysis first analyzes the cost of project inputs, ascertains the present volume of gross fixed capital formation, determines the rate of growth of capital formation without the project and with the project, and calculates the internal rate of return of the marginal increase in the rate (volume) of gross capital formation over the project period. Where the value of benefits exceeds inputs the project meets the conventional criteria used in the economic evaluation of projects.

Project inputs are planned at $6,000,000 for training, technical assistance, commodities, policy analyses and audits and evaluations.

AID's Office of Economic Policy and Analyses has used a World Bank simulation model to forecast the Honduran economy. The most important variable in the model is the level of domestic savings, a factor which is directly affected by the project.

The Mission estimates that the project will improve financial intermediation as determined by the following indicators:

Program Output Indicators	Unit	value/yr.	Target/yr.
- Gross domestic savings	%GDP	7% '92	15% '96
- Bank reserve requirements	% deposits	35% '92	20% '96
- Bank spreads	int. rate	6.3% '92	3% '96

The Mission estimates that the project's effect on the rate of gross capital formation in the Honduran economy will begin after one year of implementation and will continue for four years.

The present (1991) volume of gross capital formation in the Honduran economy is 2,347 million Lempiras. The net effect of the project will be an incremental 1% in the rate of gross capital formation, as indicated below:

	(MILLIONS OF LEMPIRAS)				
	1993	1994	1995	1996	1997
- Increased Gross Capital Formation	0	23	23	24	24
- Project Expenditures	10	7	7	4	3
- Net Benefits	-10	16	16	20	21

The benefit/cost ratio of the project is 1.6, given a discount rate of 12% per year for the stream of benefits created by the project. Thus, during the life of the project benefits are generat which equal 160% of the cost of project inputs.

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ANNEX M

CONDITIONS AND COVENANTS

I. Conditions

A. Conditions Precedent to Disbursement of Funds for the First Phase of the Financial Sector Component of the Project

1. Prior to the disbursement of funds, or the issuance of any documentation for the disbursements of funds, for technical assistance aimed at improving the regulation and supervision of financial institutions by the Superintendency of Banks under the financial sector component of this Project, the Government of Honduras will submit to Congress for approval a revised Banking Law. This revised law will contain provisions for increasing the supervisory powers of the Superintendency Bank, restricting insider lending, increasing public disclosure of information on the financial condition of banks, and increasing competition in banking services.

2. Prior to the disbursement of funds, or the issuance of any documentation for the disbursement of funds for assistance to the Superintendency of Banks other than technical assistance (i.e., commodities, software and training), the Government of Honduras will pass a revised Banking Law. This law will meet the conditions described above.

3. Prior to the disbursement of funds, or the issuance of any documentation for the disbursement of funds for activities designed to strengthen the Central Bank's capacity to regulate the financial system, the Grantee will develop and approve a restructuring plan for the Central Bank. This plan will contain measures to improve the efficiency of the BCH and phase out all activities that are inconsistent with the BCH's primary role of managing Honduras' monetary system.

B. Conditions Precedent to Initiation of the Second Phase of the Financial Sector Component

The Financial Sector Component will be implemented in two phases. The first phase will cover the period form August 28, 1992 to December 31, 1994. Based upon the performance in achieving the policy benchmarks established for this first phase, subsequent increments in funds may be agreed upon for the second phase.

Prior to the initiation of the second phase of the Financial Sector Component (January 1, 1995 - August 28, 1997) USAID and the Grantee will complete a formal assessment, in form and substance satisfactory to USAID, of progress in achieving the policy benchmarks for this component. USAID will use this assessment to determine whether the Project has been successful in achieving the benchmarks and will continue as planned; be modified to eliminate components and/or activities where progress has not been satisfactory; or be terminated altogether if there is an overall lack of progress.