

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

HONDURAS

PROGRAMMATIC LOAN FOR HONDURAS

PROGRAM TO STRENGTHEN THE FINANCIAL SAFETY NET AND IMPROVE ACCESS TO FINANCING (SECOND PROGRAMMATIC OPERATION)

(HO-L1069)

LOAN PROPOSAL

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1.	Sector technical note: The Financial Sector in Honduras: Toward an Inclusive Financial Sector. November 2010– updated September 2011. http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36413240
2.	Country Strategy (under preparation). http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36413242
3.	Economic Analysis. http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36413244
4.	Program to Strengthen the Financial Safety Net and Improve Access to Financing HO-L1065. October 2010 http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36413245
5.	Technical Note: The Financial Sector in Honduras. Overview and topics on the financial safety net. IDB-TN-270. April 2011. http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36413248
6.	Honduras Country Program Evaluation 2007 – 2010. http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36413249
7.	First Review under the Stand-By Arrangement. IMF Country Report 11/101. May 2011 http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=36413252
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ABBREVIATIONS

ATM	Automated teller machine
BANHPROVI	Banco Hondureño para la Producción y Vivienda [Honduran Bank for Production and Housing]
BCH	Central Bank of Honduras
CCIT	Chamber of Commerce and Industry of Tegucigalpa
CGAP	Consultative Group to Assist the Poor (World Bank)
CID	Country Department Central America, Mexico, Panama and the Dominican Republic
CMF	Capital Markets and Financial Institutions Division
CNBS	Comisión Nacional de Bancos y Seguros [National Banking and Insurance Commission]
EWC	Early Warning Committee [Comité de Alerta Temprana]
FACACH	Federación de Cooperativas de Ahorro y Crédito de Honduras [Federation of Savings and Loan Cooperatives]
FI	Financial institution
FOSEDE	Fondo de Seguro de Depósitos [Deposit Insurance Fund]
FSN	Financial Safety Net [Red de Seguridad Financiera]
FSO	Fund for Special Operations
GDP	Gross domestic product
IIC	Inter-American Investment Corporation
IMF	International Monetary Fund
MIF	Multilateral Investment Fund
MSMEs	Micro, small, and medium-sized enterprises
OC	Ordinary Capital
OVE	Office of Evaluation and Oversight
PBL	Policy-based loan
PRI	Private Sector Department
S&L	Savings & loan cooperative (credit union)
TC	Technical cooperation

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Financial Terms and Conditions				
Borrower: Republic of Honduras Executing agency: Republic of Honduras, through the Ministry of Finance			Amortization period:	OC: 30 years FSO: 40 years
			Grace period:	OC: 5.5 years FSO: 40 years
			Disbursement period:	12 months
Source	Amount US\$	%	Interest rate:	OC: SCF fixed FSO: 0.25%
IDB (Ordinary Capital)	28 million	70	Credit fee:	OC: * FSO: 0%
IDB (Fund for Special Operations)	12 million	30	Inspection and supervision fee:	OC: * FSO: 0%
Total	40 million	100	Currency:	U.S. dollars from the Single Currency Facility
Project at a Glance				
Project objective/description: <p>This loan is the second operation in a policy-based programmatic series. Its objective is to continue to promote stability in the financial sector and to expand access to financing. The program has three components: (i) macroeconomic stability; (ii) strengthening of the financial safety net (FSN) through: (a) strengthening prudential regulation and supervision, (b) strengthening the other basic institutional elements of the FSN; (iii) improving access to financing, with the following subcomponents: (a) promoting transparency of information and protection for financial service customers; (b) improving the regulatory framework and the process for enforcing secured transactions; and (c) institutional strengthening of the savings & loan cooperatives.</p>				
Special contractual clauses: <p>Disbursement of the loan proceeds under this second operation is subject to fulfillment of the measures concerning policy reforms or institutional changes agreed and established in the Policy Matrix (Annex II).</p>				
Exceptions to Bank policies: None.				
Project consistent with country strategy: Yes [X] No []				
Project qualifies as: SEQ [] PTI [] Sector [] Geographic [] Headcount []				

* The credit fee and inspection and supervision fee will be established periodically by the Board of Executive Directors as part of its review of the Bank's lending charges, in accordance with the applicable provisions of the Bank's policy on lending rate methodology for Ordinary Capital loans. In no case will the credit fee exceed 0.75% or the inspection and supervision fee exceed, in a given six-month period, the amount that would result from applying 1% to the loan amount divided by the number of six-month periods included in the original disbursement period.

I. DESCRIPTION AND RESULTS MONITORING

A. Frame of reference

- 1.1 In 2008 and 2009 Honduras experienced a profound political crisis. Moreover, as the country's economy is small and relatively open, it was heavily impacted by the international financial crisis. Thanks to the reforms to the regulatory framework for the banking sector undertaken at the beginning of the last decade (and supported by a PBL from the Bank) and responsible management by the country's major banks, the financial system was able to cope with the impact of the dual crises without suffering a massive solvency crisis. However, during this time significant weaknesses were revealed in the regulatory framework for the banking system, as well as in financial supervision. In this context, a two-tranche programmatic operation was prepared last year to address these weaknesses and at the same time to lay the basis for future development of a more solid and inclusive financial system.

B. Macroeconomic framework

- 1.2 The Honduran economy is characterized by its heavy dependency on exports to the United States, a high level of oil imports, and significant inflows of remittances and foreign assistance. These factors have made the economy vulnerable to the effects of the financial crisis, which were aggravated by the political crisis of 2009. In that year economic growth fell from 4% to -1.9%, remittances shrank by 12.3% and the deficit of the consolidated public sector rose by 4.6%. The National Statistics Institute estimates that the number of poor households increased by 5% between May 2009 and May 2010: 62% of households are living in poverty and 45.3% in extreme poverty.
- 1.3 In its efforts to achieve political reconciliation and to reintegrate the country into the international community, the government negotiated a stand-by arrangement with the International Monetary Fund (IMF),¹ which helped to improve economic indicators in 2010.

¹ <http://www.imf.org/external/pubs/ft/scr/2011/cr11101.pdf>; IDB/CID, Independent Macroeconomic Assessment (IMA), September 2011 (paragraphs 1.1 to 1.4).

**Macroeconomic parameters and financing needs
of the Consolidated Public Sector (2011-2015)**

	2010	2011
Macroeconomic parameters		
GDP	2.8	3.5
Consumer price index	6.5	8 (+/-) 1
Current account deficit	(6.2)	(7.2)
International reserves	4.0	4.0
Calculated fiscal outcome (% GDP)		
Growth rate of GDP	2.8	3.5
Tax revenues	15.8	16.0
Primary expenditure	26.9	25.0
Primary outcome, combined public sector	(2.0)	(1.8)
Overall outcome, combined public sector	(2.9)	(3.1)
Calculated financing (US\$ millions)		
Gross financing needs	981	1,206
Overall deficit, combined public sector	448	525
Amortization	533	681

Source and preparation: CID/IDB, Independent Macroeconomic Assessment (IMA), September 2011.

- 1.4 The country's gross financing needs will stand at US\$1.206 billion for 2011 in net terms, which converts to US\$525 million. These needs will be met in part through credit from the international community. The Bank has a programmed share of US\$191 million,² representing 36% of the total. The financing from disbursement of this programmatic operation is essential to the sustainability of the country's public finances, as it is equivalent to 21.5% of the funds programmed for disbursement by the Bank.
- 1.5 The government's stand-by arrangement with the IMF, approved by that institution's Executive Board on 1 October 2010, has now been through its second quarterly review, based on outcomes and progress with structural reforms through the first quarter of 2011. IMF Country Report 11/101 describes compliance with all targets and, with reference to the financial sector, indicates continued progress in "improving the regulatory framework and supervisory practices in the financial system and strengthening the financial safety nets." The letter of intent negotiated between the Government of Honduras and the IMF, for implementation between June and December 2011, reaffirms the government's commitment to restore macroeconomic stability, protect the external position, stabilize the public finances and continue with structural reforms, considered key for improving competitiveness.

² Amount programmed in the stand-by arrangement with the IMF.

C. The financial sector

- 1.6 **Problem to be addressed.** In 2004, the law governing the financial system was issued together with reforms to the laws on the Central Bank of Honduras (BCH), the National Banking and Insurance Commission (CNBS) and the Deposit Insurance Fund (FOSEDE), to: (i) improve the country's compliance with the Core Principles of Effective Supervision, (ii) strengthen the regulatory framework and the capacities and independence of the supervisory authorities, and (iii) establish a legal framework for resolving crises and for institutions with solvency problems to exit the market. Technical and financial assistance for implementation of those reforms was provided by the IDB, the World Bank and the IMF.
- 1.7 Toward the end of the last decade, the reform process slowed down: there was some backsliding against progress achieved in terms of solvency regulations, capital adequacy, portfolio classification and provisioning, and indicators for the Honduran banking system deteriorated relative to the region. The regulatory framework was geared to setting normative limits, giving supervision an ex post nature, with risk coverage below what was necessary. The supervisory authority lost human resources, and the quality of supervision deteriorated.
- 1.8 Under these circumstances the Bank promoted the PBL programmatic operation HO-L1065,³ with a series of reforms designed to correct these weaknesses and to close the gaps vis-à-vis international best practices.
- 1.9 In addition to the macroeconomic framework, the operation was divided into two main components: (i) strengthening the financial safety net; and (ii) improving access to financing.

D. Strengthening the financial safety net

Regulatory framework

- 1.10 **First programmatic operation.** In 2010, prudential supervision went through a series of normative adjustments intended to close the gaps vis-à-vis international best practices and the recommendations of the Basel Committee.
- 1.11 Thus, the supervisory authority—the CNBS—issued amendments to the regulatory framework designed to: (i) eliminate from capital calculations the multiple leveraging among financial institutions; (ii) decrease the past-due portfolio; (iii) increase provisioning; and (iv) manage technical aspects of the liquidity risk from a qualitative and quantitative standpoint. Continued implementation of these reforms is an element of stability for the financial system. The outcomes of the reforms are summarized in the following table:

³ Loan contract 2447/BL-HO, “Program to Strengthen the Financial Security Network and Improve Access to Financing” (HO-L1065), US\$40 million, November 2010, first loan in a programmatic series of two operations, technically related but independently financed.

	2007	2008	2009	2010	2011
Capital adequacy ratio (CAR)	12.88	13.99	14.31	14.92	14.69
Past-due loan portfolio	3.05	4.33	4.71	3.65	3.42
Provisioning of the past-due portfolio	80.76	77.22	78.60	105.22	113.39
Return on equity	23.20	18.89	12.47	12.44	14.28

Source: CNBS, webpage, for 2011, data to June.

- 1.12 There has been a notable recovery in the quality of the portfolio, attributable in part to: (i) the issuance of new regulations and strengthening of supervision, and (ii) the improvement in economic activity, which has helped to restore borrowers' cash flow and allow them to meet their obligations.
- 1.13 **Second programmatic operation.** The rules adjustments made by the CNBS with support from the first programmatic operation, as they relate to capital adequacy, portfolio classification and liquidity match, have a timetable for moving to established standards that will require ongoing monitoring and evaluation in order to determine whether they strictly meet or have exceeded the requirements for their calibration.

Supervisory process and institutional capacities of the CNBS

- 1.14 **First programmatic operation.** PBL programmatic operation HO-L1065 initiated the shift in the supervisory process from a focus on compliance⁴ to a comprehensive, consolidated, cross-cutting approach to risk-based supervision. This shift entailed an evaluation of the institutional capacities of the CNBS, and technical assistance to resolve the shortcomings detected.
- 1.15 An evaluation of the organizational structure and human resources of the CNBS revealed shortcomings that made it difficult to recruit and retain qualified human resources. In addition, the sharp division between on-site and off-site work impeded the adoption of the new supervisory focus. The analysis also revealed the need to strengthen the Commission's independence and to make its operations more transparent.
- 1.16 Changes to regulatory provisions extended to the information reported by financial institutions (FIs): reports from the central registry contained errors and were produced late, making it difficult to use them as a supervisory tool.
- 1.17 **Second programmatic operation.** To institutionalize the shift in focus adopted by the CNBS toward supervision based on risk, and to improve these techniques, will require: (i) preparation of a manual documenting the process; (ii) training on the ground for CNBS supervisors, with a pilot project of assisted inspections; and (iii) introduction of computerized tools for implementing the new process. Opportunities for improving the regulatory framework are also being identified so that it can be applied properly.

⁴ Reviewing the degree of compliance with the rules, but not the quality of balance sheet data.

- 1.18 The recommendations from the evaluation of the organizational structure and human resources of the CNBS have led to the design of a career plan that will need to be implemented and supported by best practices in corporate governance.
- 1.19 Implementation of the normative reforms revealed weaknesses in the information systems in the CNBS, demonstrating the need to improve the credit rating agency in terms of data processing times, storage capacity and quality of statistical information, and reporting.

Other elements of the financial safety net

- 1.20 **First programmatic operation.** The evaluation of the financial safety net (FSN) revealed opportunities for improving other elements^{5,6}. The Early Warning Committee (EWC) had become non-operational because of the exclusion of the FOSEDE, and it was assigned a series of functions incompatible with its mission. Moreover, the reports that it used for making decisions were based on ex post indicators generated two months late. The Banking Capitalization Fund never became operational and the bank resolution mechanisms lacked the tools needed to be consistently and continuously operational.
- 1.21 The FOSEDE began operations with no capital of its own, as it had use of a line of credit granted by the BCH, which gave it access to funding to pay guaranteed deposits during the crisis that unfolded between 2001 and 2003. It was also found that some of the elements of its design were not consistent with the Core Principles for Effective Deposit Insurance Systems issued in June 2009 by the Basel Committee on Banking Supervision and the International Association of Deposit Insurers.
- 1.22 **Second programmatic operation.** If it is to be viable and credible, the FOSEDE needs to adopt and implement a real and achievable action plan for capitalization. The regulatory framework also needs to be adjusted to take expeditious steps for the resolution of problem FIs and to ensure that the components of the FSN are legally managed.

E. Access to financing and financial inclusion

- 1.23 **Problem to be addressed.** There was found to be little transparency in the public disclosure of information by financial institutions. This lack of transparency, particularly with respect to the cost of financial services, inhibits competition, undermines consumer confidence, and affects, in particular, the poorest users. Financial system institutions, it was found, lacked organized systems for dealing with customer complaints and the procedure for handling complaints in the CNBS took months to be resolved. A first attempt to create a consumer service office

⁵ In the case of Honduras, the other elements are: (i) Early Warning Committee; (ii) FOSEDE and the Capitalization Fund; and (iii) Bank Resolution (technical cooperation operation ATN/SF-11678-HO).

⁶ IDB, "The Banking Crises in Latin America," Ricardo Hausmann and Liliana Rojas, 1997, page 287: "a well-established legal and administrative framework makes it possible to assign clear responsibilities to the various institutions responsible for handling the crisis and also immunizes them against political pressure."

became merely an extension of the previous system, highlighting the need to issue new rules, to restructure the response systems, to improve financial education and to help consumers make informed decisions.

- 1.24 The subindicators of availability and affordability of financial services in the Global Competitiveness Report 2011-2012⁷ rank Honduras in fourth and fifth place, respectively, among seven countries of the region, and it ranks fourth in ease of access to loans. There is ample evidence that SMEs face more adverse credit conditions than larger firms.⁸ In Honduras, nearly 30% of SMEs identified as major obstacles⁹ the lack of access to credit, lack of transparency in the disclosure of information, and weak measures of protection for financial customers.
- 1.25 On the other hand, although Honduras has a vibrant cooperative sector, levels of banking penetration are still among the lowest in the region, and access to credit distribution channels is restricted, as is illustrated in the following comparative table. Honduras ranks next to last in Central America in terms of automated teller machines (ATMs) per 100,000 adults, far from the median for developing countries or for Latin America and the Caribbean, and it ranks last in the number of ATMs per 1,000 km². Lastly, among the most important sources of credit for low-income sectors are savings and loan cooperatives (S&Ls), which are not supervised by the CNBS, except for those that intermediate funds from the second-tier public bank, the Honduran Bank for Production and Housing (BANHPROVI). Most of these cooperatives are affiliated with the Federation of Savings and Loan Cooperatives of Honduras (FACACH), and they have received support through technical cooperation from the Bank.

⁷ World Economic Forum (WEF), "Global Competitiveness Report 2011-2012."

⁸ IDB, Economic and Social Progress in Latin America, 2005 Report, Unlocking Credit, page 191. "In general, there are four main causes of credit problems for small firms: fixed lending costs, imperfect enforcement of credit contracts, bankruptcy costs, and asymmetric information."

⁹ IDB/OVE, "Country Program Evaluation: Honduras 2007-2010," document RE-390, May 2011, footnote 68 (taken from World Bank, "Enterprise Survey 2006").

ATM availability¹⁰

Economy	ATMs	
	Per 100,000 adults	Per 1,000 km ²
Costa Rica	181.52	118.39
El Salvador	27.21	53.96
Guatemala	21.85	15.92
Honduras	23.38	9.38
Panama	40.56	13.03
Dominican Republic	27.11	37.58
High-income countries (median per 100,000 adults)	94.00	
Latin America and the Caribbean (median per 100,000 adults)	31.00	
Developing countries (median per 100,000 adults)	29.00	

Source: prepared by the author, based on Financial Access, 2010.

Note: data not available for Nicaragua.

- 1.26 **First programmatic operation.** The Secured Transactions Law was approved and came into force. Based on the OAS model, it meets the 12 principles for effectiveness of such systems: it allows guarantees to be established on intangible goods, future goods, individual guarantees on personal property, etc. The potential for promoting a credit market for micro, small and medium-sized enterprises (MSMEs) highlighted the need to make it operational through the functioning of a public registry.
- 1.27 In the first programmatic operation an agreement was signed between FACACH and the CNBS to carry out a pilot risk-based supervision project in 20 cooperatives, which could serve as the basis for designing a supervision process for the sector, designed to address the shortcomings identified in the first and second programmatic operations.¹¹
- 1.28 **Second programmatic operation.** The Public Registry of Secured Transactions will be put into operation, an essential step to make the Secured Transactions Law viable. Significant progress has also been made in the supervision of cooperatives, through the agreement on secured transactions, which highlighted the need to make it operational by implementing the public registry established between FACACH and the CNBS.
- 1.29 This operation focuses on a package of measures to strengthen the regulatory framework, to improve the capacity of the CNBS for effective supervision of the system, and to create an atmosphere conducive to expanded coverage of the

¹⁰ World Bank Consultative Group to Assist the Poor (CGAP), *Financial Access, 2010*.

¹¹ World Bank Consultative Group to Assist the Poor (CGAP), *Financial Access, 2009, Measuring access to financial services around the world*. "Policymakers need reliable information on access to financial services to design effective policies."

financial system. Consequently, the components of the operation as a whole, “Strengthening the Financial Safety Net” and “Improving Access to Financing,” will help to produce a solid, more secure financial system for small depositors and one that offers a better setting for promoting access to financing.

F. Government commitment

- 1.30 The initiatives that form part of the reform process are being coordinated between the IMF, the World Bank and the IDB. The issue is also part of the financial sector policy dialogue established in mid-2009 between the Government of Honduras and the Bank, which led to the first programmatic operation and various TC operations that have contributed to the launch of policy reforms in the sector, using a methodology based on OVE’s recommendations¹². These reforms will make it possible to pursue the strengthening of the FSN already under way. The TC operations have added some further elements: (i) they have supported the programmatic dialogue; (ii) they have demonstrated synergy between the different Bank windows (CMF, CID, MIF,¹³ PRI and IIC) for contributing to structural changes relating to opportunities for the majority (by improving access to financial products and services and protecting users from abusive practices); and (iii) their design and execution have helped to boost the prospects for success of this program.

G. The Bank’s country and sector strategy

- 1.31 **Bank strategy and lessons learned.** This operation, like the first programmatic operation, will contribute to the strategic objective of improving access to credit for MSMEs, as stated in the country strategy (document GN-2475), as well as the financial inclusion of the most vulnerable sectors.
- 1.32 As noted in the Report on the Ninth General Increase in the Resources of the Bank (document AB-2764), solid private sector institutions and an effective regulatory capacity are essential for the development of credit and financial markets. As well, a specific theme that will be of strategic value to the region and therefore to the Bank over the next decade is “expanding access to financial services.”¹⁴ The HO-L1069 program is in line with this, as an operation in a country with the characteristics indicated and one that seeks to strengthen financial sector institutions and to improve access to financing.
- 1.33 **Sector strategy.** During 2010, there was progress in consolidating reforms to strengthen and stabilize the financial system and boost access to financing for MSMEs, thanks to the efforts of the CNBS supported by the Bank through strategic dialogue and the execution of operations and technical assistance. The Financial

¹² IDB/OVE, “Country Program Evaluation: Honduras 2007-2010,” document RE-390, May 2011.

¹³ HO-T1148 “Saving and investment alternatives for SMEs: Credit Rating Agency and Career Plan”; RG-T1670 “Cooperatives Law.”

¹⁴ IDB Report on the Ninth General Increase in the Resources of the Inter-American Development Bank, document AB-2764, 21 May 2010, paragraph 3.19, pages 9-10.

Inclusion Policy will be pursued in future as a tool for promoting the country's growth, generating business development and reducing inequality in income distribution. This will require action to adapt the regulatory framework, to bring supply and demand into better balance, and to articulate government programs in order to target interventions.

H. Objectives and structure

- 1.34 This loan is the second operation in a policy-based programmatic series. Its objective is to continue to promote stability in the financial sector and to expand access to financing.
- 1.35 To achieve that objective, this operation has been designed in three components, which will consolidate and complement the regulatory and operational reforms initiated under the first programmatic operation. The reforms are designed to promote stability in the financial system and to establish a favorable environment in which financial products and services will be accessible to the lower-income population and to MSMEs, as a mechanism to help reduce poverty.
- 1.36 The programmatic loan modality, defined in HO-L1065 for the sector reform operation, remains applicable in accordance with the New Lending Framework and the management guidelines for preparation of programmatic loans, as this flexible instrument makes it possible to adjust the program to shifting technical needs emerging from: (i) active and systematic dialogue with the country authorities, and (ii) ongoing technical support provided by the Bank throughout implementation of the reform agenda.
- 1.37 The second loan operation is for a total amount of US\$40 million, a figure that is in line with the country's financial programming needs. It includes a number of agreed-upon measures and the corresponding means of verification (see Means of Verification and Annex II, Policy Matrix).

I. Components of the operation

- 1.38 The program has three components: (i) macroeconomic sustainability; (ii) strengthening of the financial safety net, essentially through: (a) strengthening prudential regulation and supervision, and (b) strengthening the institutional framework for the other components of the FSN; (iii) improving access to financing, with the following subcomponents: (a) promoting transparency of information and protection for financial services users; (b) improving the regulatory framework and the process for enforcing secured transactions; and (c) institutional strengthening of savings & loan cooperatives (S&Ls).
- 1.39 **Component I:** Macroeconomic sustainability. A general condition for disbursement applicable to any budget support loan is to maintain a stable macroeconomic policy, consistent with program objectives and the guidelines established in the country Sector Policy Letter and the Policy Matrix.
- 1.40 **Component II:** Strengthening the FSN. The objective is to reduce the risks of crisis and the associated fiscal costs. Steps to strengthen the FSN will continue, in

particular implementation of risk-based supervision, as the first line of defense against dangers in the financial system.

- 1.41 **Subcomponent II.a:** Strengthening prudential regulation and supervision.
- 1.42 **Modernizing the regulatory framework.** The CNBS will provide evidence of compliance with the rules required by the first operation with respect to: (i) capital adequacy, (ii) classification of the loan portfolio, and (iii) liquidity match. This verification will be used to generate a report demonstrating implementation and the respective resolutions for calibrating the rules.
- 1.43 The CNBS has issued a new resolution, now in force, regulating “integral risk management,” and establishing minimum criteria that FIs must observe in their internal risk management. In a parallel and complementary manner, the CNBS will institute risk-based supervision, for which it will use a manual based on international standards of supervision adapted to circumstances in Honduras. The calibration of that manual will be done through five assisted visits (three FIs and two S&Ls). Those inspections will serve to: (i) identify and make the necessary adjustments to supervision, and (ii) train CNBS inspectors in the new methodology. The CNBS will provide the Bank with a report on the five inspections and the risk-based supervision manual, with the corresponding adjustments.
- 1.44 The CNBS will present evidence to the Bank, through internal resolutions and progress reports, that it is implementing a professional career plan for its employees. That plan will contain as a minimum: an organizational structure, an analysis of the human talent administration system, a certification program for human resource management specialists by area of expertise, a strategic and operational plan, and technical standards.
- 1.45 **Restructuring the Early Warning Committee (EWC).** The operation will reformulate the EWC to incorporate the FOSEDE into its structure and to align its operating functions with crisis prevention and its technical attributes with the Core Principles for Effective Deposit Insurance Systems issued by the International Association of Deposit Insurers (IADI) and the Basel Committee on Banking Supervision in June 2009. The system of the early warning indicators used by the EWC will also be reformed, in order to add economic risk criteria for the assessment of FI risk. Implementation of these changes will be verified by means of an executive decree containing the reformed EWC regulations, including the new structure. In addition, approval of the reform to the system of indicators will be set forth in the minutes of an EWC session.
- 1.46 For the operational and technological strengthening of the credit rating agency, the CNBS will present to the Bank the resolution approving the diagnostic analysis and action plan for speeding the processing of information, expanding storage capacity, and boosting the quality of statistical information and reporting. This will result in timely and useful statistical information for determining the credit risk profile of FIs, portfolio and delinquency indicators by entity, type and system, etc., in the course of supervision.

- 1.47 **Subcomponent II.b.** Strengthening the other basic institutional elements of the FSN
- 1.48 The BCH Board of Directors will prepare and approve the Financial Assistance Regulations for FOSEDE, governing the acquisition of assets and liabilities by viable FIs. Those regulations will allow FOSEDE to finance FIs that take over the assets and liabilities of financial institutions in the process of liquidation and that must increase their equity in order to meet capital adequacy requirements. The regulations are contained in a resolution approved by the BCH Board of Directors. In addition, FOSEDE will provide evidence that it has received contributions from the government to increase its capitalization.
- 1.49 The CNBS has issued a set of rules governing the orderly market exit and liquidation of FIs in difficulty. Those rules include: (i) the regulation governing the transfer of assets and liabilities from FIs in the process of liquidation to acquiring FIs; and (ii) entry into force of the FI liquidation manuals for cases of: (a) systemic crisis, (b) forced liquidation, and (c) voluntary liquidation.
- 1.50 The CNBS will deliver evidence that a rule is in place to adapt its internal structure to best practices in corporate governance. That rule must include, at least: (i) the responsibilities of the officers who hold management positions; (ii) the requirement to apply best practices in banking supervision; (iii) the relationship with the government; (iv) the process of accountability; and (v) execution of administrative expenses. The corresponding resolution will be prepared and issued in line with the principles of good governance.
- 1.51 **Component III.** Improving access to financing. The objective of this component is to encourage the extension of services to population segments that are now excluded. To overcome obstacles to financial inclusion, the first operation identified, and helped address, the need to adapt the regulatory framework to foster access to financial services and to promote transparency of information (with the emphasis on MSMEs and vulnerable segments).
- 1.52 **Subcomponent III.a:** Promoting transparency of information and protecting financial system users. In this second phase, the mechanisms for disclosing information on financial products and services will be upgraded.
- 1.53 The CNBS will approve the regulatory framework governing transparency and disclosure of information and the mechanisms that FIs must introduce to protect financial customers. The object is to protect customers, particularly the most vulnerable, least informed and poorest ones and those with the least access and capacity to relate to FIs. The regulatory framework is spelled out in a resolution issued by the CNBS and the information on prices, fees and effective rates is published by the FIs and covered in a report by the Commission.
- 1.54 The CNBS will be reorganized to improve its capacity to handle claims and complaints, by creating a unit for the service and protection of financial services

- customers. It will act as a referral body for settling such disputes, and appropriate guidelines will be established to strengthen supervision of customer service in FIs.
- 1.55 The CNBS will develop a financial education campaign and will issue the corresponding budgetary certification committing funds for its execution. In addition, it will post an interactive mechanism on its webpage, which the public can use to make better decisions on the use of financial services.
- 1.56 **Subcomponent III.b:** Creation of the regulatory framework and the secured transactions enforcement process. In 2010, the Congress approved a legal framework in line with best practices for the administration, registration and enforcement of secured transactions, prepared in the framework of the strategic dialogue and in the context of work coordinated with other cooperation agencies (United Nations, World Bank, IMF). It specifies that the Registry will be managed by the Chamber of Commerce and Industry of Tegucigalpa (CCIT), which the CNBS has been helping to generate and obtain records. The CCIT will issue reports on progress of the operation.
- 1.57 **Subcomponent III.c:** The CNBS will support the institutional strengthening of the country's S&Ls, which administer a portion of the savings of lower-income people (600,000 depositors, equivalent to 7.2% of the population). The S&Ls are supervised by the CNBS when they intermediate funds from the second-tier public Bank, BANHPROVI. Guidelines will be established for a system of supervision that will enhance the security of their members, most of whom are low-income. Approval of the guidelines will be reflected in a CNBS resolution and a supervision manual.

J. Main outcomes and indicators

- 1.58 Disbursement of loan proceeds under the program will be subject to fulfillment of the agreements established in the Policy Matrix (Annex II). The anticipated program outcomes and the indicators for each component are summarized in the Results Matrix.

II. FINANCIAL STRUCTURE AND PRINCIPAL RISKS

A. Financial instrument

- 2.1 The program consists of two loans. The first operation, HO-L1065, was structured in the amount of US\$40 million. It was signed in November 2010 and disbursed on 8 December 2010. The second operation is structured in the amount of US\$40 million, consistent with the country program and approval of progress with the agreed reforms.

B. Coordination with other financing and donor agencies

- 2.2 The IMF and the Government of Honduras have signed and are implementing a stand-by arrangement, approved by the IMF Board of Executive Directors on 1 October 2010. The objectives of that arrangement in terms of macroeconomic

stability and financial sector reform are consistent with the objectives of the IDB program. IMF Country Report 11/101, presented to the Board of Directors in May 2011, describes compliance with all targets and, with reference to the financial sector, indicates continued progress in “improving the regulatory framework and supervisory practices in the financial system and strengthening the financial safety nets.” The Bank has coordinated with the IMF on preparation of the Article IV Consultation and, in the stand-by program, it is in permanent contact with the World Bank.

C. Social and environmental risks

- 2.3 No environmental or social risks are associated with the program, as it involves institutional strengthening activities. This operation has no negative impacts in accordance with the Environment and Safeguards Compliance Policy (OP-703). As it is a PBL, and in accordance with Directive B.13, and based on the Safeguard Policy Filter Report, this operation requires no classification.

D. Other key issues and risks

- 2.4 During the program design missions, a Gross Rating Point risk analysis of the operation was conducted with the participation of the government authorities. The key risks are: (i) a potential lack of sustainability in the reforms, which could stem from a change in strategies or policies on the part of the national authorities; (ii) the possibility of changeovers in the authorities for the sector, who might not be committed to adopting the reforms.
- 2.5 To mitigate these risks, the Bank has maintained a productive strategic dialogue with public and private stakeholders (Government, BCH, Ministry of Finance, CNBS, Honduran Banking Association (AHIBA) and FACACH) and has provided close technical assistance that proved helpful in the preparatory work for the institutional and regulatory framework reforms.

III. IMPLEMENTATION AND MANAGEMENT PLAN

A. Summary of implementation arrangements

- 3.1 The borrower will be the Republic of Honduras. The CNBS will be the executing agency, supported by policy actions undertaken by other institutions deemed necessary for the integrity of the proposed reform.
- 3.2 The CNBS, through the Ministry of Finance, will have the following responsibilities: (i) submit reports and evidence of compliance with the conditions for disbursement of loan proceeds, as well as any other reports the Bank may require; (ii) carry out actions to achieve the policy objectives specified in the program; and (iii) gather, file and present to the Bank all useful information, indicators, and parameters that will enable the government and the Bank to monitor and evaluate program outcomes.

- 3.3 To better support the country efforts and to adopt OVE's recommendations,¹⁵ the Bank will implement a strategy consisting of: (i) providing technical assistance in the areas already identified; and (ii) conducting special missions to coincide with critical steps in program implementation.

B. Summary of agreements to monitor results

- 3.4 The borrower and the Bank have agreed to supervise program execution by means of monitoring meetings, to be scheduled by mutual agreement. After disbursement of the loan proceeds, the project team will draft a simplified version of the project status report, which will provide a measurement of program indicators to determine the progress achieved and make any changes required to meet the program's targets. The Bank, in coordination with the borrower, will submit a Project Completion Report six months after fulfilling the conditions for disbursement. This report will evaluate the impact achieved and attainment of anticipated program outcomes. The borrower and the Bank have agreed in advance on the indicators and the baseline for that final evaluation. The borrower will be responsible for gathering and processing the data required for monitoring and evaluation of the operation, including financing costs. Consulting services to verify the indicators specified in the Results Matrix and the activities included in the Policy Matrix (Annex II) will be financed with Bank administrative resources (see Results Matrix). Strengthening of the credit rating agency could assist in measuring the operation's evaluability (OVE¹⁶).
- 3.5 The results of the cost-effectiveness analysis performed for this second programmatic operation show, first, a direct relationship between lengthening the periods between financial crises as a result of the reforms supported by the operation and the benefits produced for the country, including reducing the fiscal costs associated with resolving crises. Second, they reveal that an increase in access to credit, within the parameters used, will generate benefits in terms of economic growth and higher fiscal revenues, in excess of program costs.

IV. POLICY LETTER

- 4.1 The Bank and the Republic of Honduras agreed on the macroeconomic and sector policies contained in the Policy Letter remitted by the Ministry of Finance on 8 August 2011. The letter describes the chief components of the strategy being implemented by the government in the program areas of action detailed in this document, and reaffirms its commitment to implementing the reforms and activities agreed upon with the Bank.

¹⁵ IDB/OVE, "Country Program Evaluation: Honduras 2007-2010," document RE-390, May 2011.

¹⁶ Idem.

Development Effectiveness Matrix				
Summary				
I. Strategic Alignment				
1. IDB Strategic Development Objectives		Aligned		
Lending Program		(i) Lending to small and vulnerable countries, and (ii) Lending for poverty reduction and equity enhancement.		
Regional Development Goals		Percent of firms using Banks to finance investments.		
Bank Output Contribution (as defined in Results Framework of IDB-9)		Micro/small/medium productive enterprises financed.		
2. Country Strategy Development Objectives		Aligned		
Country Strategy Results Matrix		GN-2475	Improve the conditions of access to credit for MSMEs.	
Country Program Results Matrix		GN-2617	The project is included in the 2011 Country Program Document.	
Relevance of this project to country development challenges (If not aligned to country strategy or country program)				
II. Development Outcomes - Evaluability		Highly Evaluable	Weight	Maximum Score
		9.0		10
3. Evidence-based Assessment & Solution		9.5	25%	10
4. Ex ante Economic Analysis		10.0	25%	10
5. Monitoring and Evaluation		6.7	25%	10
6. Risks & Mitigation Monitoring Matrix		10.0	25%	10
Overall risks rate = magnitude of risks*likelihood		Low		
Environmental & social risk classification		B-13		
III. IDB's Role - Additionality				
The project relies on the use of country systems (VPC/PDP criteria)				
The project uses another country system different from the ones above for implementing the program				
The IDB's involvement promotes improvements of the intended beneficiaries and/or public sector entity in the following dimensions:				
Gender Equality				
Labor				
Environment				
Additional (to project preparation) technical assistance was provided to the public sector entity prior to approval to increase the likelihood of success of the project				
The ex-post impact evaluation of the project will produce evidence to close knowledge gaps in the sector that were identified in the project document and/or in the evaluation plan.				

The program is aligned with IDB institutional priorities defined by the Ninth GCI. The project contributes to the IDB's lending objective "Lending to small and vulnerable countries" and "Lending for poverty reduction and equity enhancement". It also contributes to regional goal "Percent of firms using Banks to finance investments" and "Micro/small/medium productive enterprises financed". The project is aligned with the current country strategy.

The project is well justified and based on a reasonable diagnostic. The project logic is also clear. The project's metric is reasonable, though some outcomes indicators should have been more precisely defined. The project includes a monitoring and evaluation plan. The evaluation will be conducted by repeating ex-post with the cost-benefit analysis. The risk matrix is very synthetic, but complete according to the DEM standards.

POLICY MATRIX

Policy objectives	Agreements First loan HO-L1065	Triggers Second loan	Agreements	Observations
			Second loan HO-L1069	
I. Macroeconomic sustainability				
Maintain a stable and sustainable macroeconomic environment conducive to achieving program objectives.	The macroeconomic policy framework is consistent with the guidelines specified in the sector policy letter.	The macroeconomic policy framework is consistent with the guidelines specified in the sector policy letter	The macroeconomic policy framework is consistent with the guidelines specified in the sector policy letter.	
II. Strengthening the Financial Safety Net				
a. Strengthening Prudential Regulation and Supervision				
(i) Adapt the regulatory framework, aligning it with best international practices, so that it contributes to maintaining financial system stability and sustainability.	Regulations aligned with best practices approved by the CNBS and in force: (a) Update of the capital adequacy ratio calculation to record and process multiple leveraging (b) Loan portfolio evaluation and classification (c) Liquidity risk.	Resolutions issued on regulations: (a) Capital adequacy ratio calculation to record and process multiple leveraging (b) Loan portfolio evaluation and classification (c) Liquidity risk.	Regulations approved by the CNBS and aligned with best practices are being implemented ¹ on: (a) Capital adequacy ratio calculation to record and process multiple leveraging. ² (b) Loan portfolio evaluation and classification. ³ (c) Liquidity risk. ⁴	During the first programmatic operation it was found that ongoing FI observance of the rules indicated in (a), (b) and (c) is essential for maintaining the solvency and liquidity of the financial system.

¹ Financial institutions subject to the rules approved by the CNBS, indicated in (a), (b) and (c), have strictly observed or have exceeded the requirements established in the schedules for migrating to the standards on capital adequacy, overdue loan provisioning and liquidity risk. The results of implementing the rules are as follows: the loan portfolio arrears rate fell from 4.71 in 2009 to 3.65 in 2010 and 4.42 in June 2011; provisioning coverage for the past-due portfolio rose from 76.6 in 2009 to 105.22 in 2010 and 113.39 in June 2011; the capital adequacy ratio rose from 14.31 in 2009 to 14.92 in 2010 and 14.69 in June 2011; all financial system institutions, except for BANADESA (first-tier public bank) are complying with the schedule for implementing the liquidity rule. The rules approved by the CNBS are based on the Basel accords and on best international practices.

² The new regulation aligns treatment of FI profits accrued via the equity method in conformity with the Basel recommendations, which allows for adequate calculation of the capital adequacy of FIs and the soundness of the financial system.

³ The new regulation eliminates exceptions that permitted under-provisioning of risky loans, it improves the treatment of refinancing and adjustments, it establishes five risk categories, the single debtor classification, and offers better treatment for microcredit, in this way helping preserve the quality of the loan portfolio of FIs, and thus the stability of the system.

⁴ Establishes qualitative and quantitative criteria based on best practices in liquidity risk management.

Policy objectives	Agreements First loan HO-L1065	Triggers Second loan	Agreements	Observations
			Second loan HO-L1069	
(ii) Strengthen the risk supervision process for IFIs, and for a pilot group of FACACH credit Unions (S&Ls)	(a) Risk-based supervision process in accordance with best practices, with related manual and software, contracted.	(a.1) New risk-based supervision process initiated (a.2) Pilot with five on-site inspections (three banking institutions and two credit unions based on the new supervision process, and outcomes with respective adjustment plans, finalized.	(a) Comprehensive Risk Regulation, approved by the CNBS. (a.1) New risk-based supervision process is being applied, the manual has been delivered, five on-site pilot inspections have been concluded and reports issued.	The CNBS went beyond the initial objective of the first programmatic operation. In the course of designing the new manual it saw the need to issue a Comprehensive Risk Management Regulation, which constitutes the framework for risk-based supervision and is being implemented by the CNBS in its supervision of FIs.
	(b) Ratification of the agreement between the CNBS and the FACACH.	(b) The agreement is in effect	(b) Through an addendum to the agreement between the CNBS and FACACH, the new risk-based supervision process is being implemented in two pilot S&Ls.	The addendum that was signed has been executed in full, and the risk-based supervision process in the two S&Ls has been completed.
(iii) Create the CNBS professional career service plan in accordance with best international practices	(a) Formulation of the CNBS professional career service plan developed in accordance with best practices, and the proposed implementation plan, approved.	The professional career service plan is being applied along the lines of the approved implementation proposal.	The professional career service plan of the CNBS is being implemented in accordance with best practices	The CNBS professional career plan has been implemented to a greater extent than required in the first programmatic operation.
(iv) Promote the operation of the Early Warning Committee (EWC)	(a) The action plan to reactivate and institutionalize the EWC is approved by its members.	The EWC is operational and its action plan is being implemented.	(a) An Executive Decree has been issued, restructuring the EWC and making it operational for crisis prevention. ⁵ (b) The reform of the early warning indicators for measuring economic risk has been	

⁵ The EWC is being restructured to incorporate FOSEDE and to align its functions with the Core Principles for Effective Deposit Insurance Systems issued by the International Association of Deposit Insurers (IADI) and the Basel Committee on Banking Supervision in June 2009.

Policy objectives	Agreements First loan HO-L1065	Triggers Second loan	Agreements	Observations
			Second loan HO-L1069	
			approved, according to the EWC action plan. ⁶	
(v) Technological and operational strengthening of the CNBS central risk registry.			The diagnostic analysis for strengthening the CNBS central risk registry has been approved.	Condition not previously considered. The CNBS went beyond the agreements for the first programmatic operation and identified the need to strengthen the central risk registry to improve storage speed and capacity and quality of statistical information and reporting.
b. Strengthening of the institutional framework for the other components of the FSN				
(i) Strengthen the Deposit Insurance Agency (FOSEDE) and evaluate the viability of the Capitalization Fund	Approval by the EWC of the Deposit Insurance Agency diagnostic assessment and action plan and the operational viability of the Capitalization Fund.	The action plan for capitalizing FOSEDE is in effect; report on viability of the Capitalization Fund.	The action plan for capitalizing FOSEDE and the report on viability of the Capitalization Fund are being applied, via: (a) Regulation of Financial Assistance from FOSEDE to FIs acquiring the assets and liabilities of a failed entity, approved by BCH. ⁷ (b) Agreement on capitalization of contributions received from the State to improve its capitalization, ⁸ approved and implemented by FOSEDE	

⁶ Includes the economic risk (caused by the shifting cyclical trend) and its effects on the FI portfolio in order to reinforce the preventive nature of systemic risk analysis.

⁷ The regulation allows FOSEDE to finance FIs that take over the assets and liabilities of failed financial institutions and that need to boost their equity to meet the capital adequacy ratio.

⁸ FOSEDE began operations without its own capital, repaying deposits with funds borrowed from the BCH, during banking liquidations from 2001 to 2003. With the contribution made by the Ministry of Finance in 2011, its capital is now positive and its crisis resolution capacity has improved considerably.

Policy objectives	Agreements First loan HO-L1065	Triggers Second loan	Agreements	Observations
			Second loan HO-L1069	
(ii) Strengthen implementation of the resolution mechanisms for financial institutions, in accordance with best practices	Diagnostic assessment of the operation of the financial institutions resolution process approved by the CNBS	The CNBS is strengthening the FI resolution process.	Tools approved and issued for the FI resolution process: ⁹ (i) regulation for FIs that take over assets and liabilities; and (ii) FI resolution manuals (systemic crisis, forced resolution, voluntary liquidation).	
(iii) Implement the best practices of corporate governance in the CNBS, as the lead entity for applying those practices in the financial sector.			Rule implemented for observing best practices of corporate governance in the CNBS defining as a minimum: (i) the responsibilities of the officers who hold management positions; (ii) the requirement to apply best practices in banking supervision; (iii) the relationship with the government; (iv) the process of accountability; and (v) execution of administrative expenses. ¹⁰	The CNBS implemented internal corporate governance measures covering a broader range of issues than requested, thereby surpassing what was called for in the first programmatic operation.

⁹ There are three mechanisms for the resolution of financial institutions in Honduras: forced liquidation, voluntary liquidation, and systemic crisis. For proper and consistent application, the procedures to be followed in each case need to be compiled into manuals that the CNBS can use as required for the timely and orderly resolution of insolvent financial institutions, so as to minimize the risk of contagion and damage to the country.

¹⁰ Good corporate governance practices in the supervisory body will help to strengthen its independence.

Policy objectives	Agreements First loan HO-L1065	Triggers Second loan	Agreements	Observations
			Second loan HO-L1069	
III. Improved access to financing				
a. Promoting transparency of information and protection for financial services users				
(i) Improve the regulatory framework governing transparency and protection of financial services users, in accordance with best international practices.	(a) Regulations approved by the CNBS are being implemented in accordance with best practices on: (a.1) Transparency and dissemination of information (a.2) Mechanisms to protect financial services users	(a) Resolutions issued with regulations on: (a.1) Transparency and dissemination of information (a.2) Mechanisms to protect financial services users.	CNBS regulations <i>approved and being implemented</i> on: (a.1) Transparency and dissemination of information (a.2) Mechanisms to protect financial services users. ¹¹	
(ii) Strengthen the user service processes by standardizing, systematizing, computerizing, and certifying last resort processing formalities performed by the control entity in the process for responding to financial services users, and promoting sustainable financial literacy campaigns.	(a) Management consulting services to enhance service and protection for financial services users have been contracted.	(a.1) The consultant’s recommendations to enhance service and protection for financial services users are being implemented	(a) Substantial progress by CNBS in restructuring the unit for service and protection of financial services users. ¹²	
	(b) The budget for the financial education campaign has become a line item in the CNBS budget.	(b.1) CNBS budget certification as to availability of resources for the financial education campaign (b.2) The CNBS web portal with information for financial consumers and the virtual classroom have been redesigned.	(b.1) Financial education campaign approved and budget certification that CNBS has the funds to implement it. (b.2) The redesigned CNBS web portal is operating with information and a virtual classroom for financial users.	

¹¹ To protect the most vulnerable, least informed and poorest users and those with the least access and capacity to relate to FIs.

¹² The restructuring makes the CNBS an appeals body for resolving disputes between FIs and their customers, significantly improving the availability of service and protection for users of the financial system.

Policy objectives	Agreements First loan HO-L1065	Triggers Second loan	Agreements	Observations
			Second loan HO-L1069	
b. Development of the regulatory framework and secured transactions enforcement				
Create a legal framework to improve the secured transactions administration and enforcement process.	Secured Transactions Law approved by the Congress of the Republic	The Secured Transactions Registry (<i>Registro de Garantías Mobiliarias</i>) is operational	New system for registering secured transactions, ¹³ implemented.	
c. Institutional strengthening of the S&L sector				
(i) Lay the basis for supervision of savings-and-loan cooperatives (S&Ls)			Guidelines are being applied for risk-based supervision of S&Ls regulated and supervised by CNBS. ¹⁴	During the first programmatic operation it was found necessary to issue guidelines for risk-based supervision of S&Ls, recognizing that they service more than 600,000 depositors, representing 7.2% of the country's population.

¹³ In Honduras, the system allows collateral to be constituted and registered on a form with a limited quantity of data. The registry is electronic and can be consulted from anywhere in the world. Guarantees can be constituted on intangible property, future goods, personal property items attached to real property, supply contracts or production contracts and equipment to be purchased, and productive chains and reverse factoring can be used. The registry also facilitates the creation of electronic markets for raw materials and foodstuffs.

¹⁴ S&Ls that intermediate BANHPROVI funds, pursuant to the law creating that second-tier public bank.