



Short Procedure

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To: The Board of Executive Directors
From: The Secretary
Subject: Honduras. Reformulation proposal to expand the national coverage and strengthen the regulatory framework for municipal financing. Amendment to loan contracts 1024/SF-HO, 1104/SF-HO, and 1592/SF-HO

Basic information: Loan 1024/SF-HO for a municipal development program in San Pedro Sula and Tegucigalpa, approved pursuant Resolution DE-161/98, loan 1104/SF-HO for San Pedro Sula Municipal development program, Phase II, approved pursuant Resolution DE-51/02, and loan 1592/SF-HO for a municipal development program for the Central District, Phase II, approved pursuant Resolution DE-96/04.

Inquiries to: Mrs. Priscilla Phelps (extension 1156)

Remarks: In the attached document, Management recommends that the Board of Executive Directors approve the proposed modifications for the above-referenced loans. Also attached, is the corresponding proposed resolution.

The Executive Directors are requested to inform the Secretary, in writing, not later than **2 December 2005**, if they wish to interrupt this procedure. If no such communication is received by that date, the resolution will be considered adopted by the Board of Executive Directors, and a record to that effect will be made in the minutes of a forthcoming meeting

References: GN-1838-1(7/94), DR-398-5(5/03), PR-2350(11/98), PR-2350-1(11/98), PR-2673(5/02), PR-2891(11/04)

Other distribution: Representative in Honduras

HONDURAS

REFORMULATION PROPOSAL:

**MUNICIPAL DEVELOPMENT PROGRAM FOR THE CENTRAL
DISTRICT AND SAN PEDRO SULA (LOAN No. 1024/SF-HO)**

**SAN PEDRO SULA MUNICIPAL DEVELOPMENT PROGRAM
PHASE II (LOAN No. 1104/SF-HO)**

**CENTRAL DISTRICT MUNICIPAL DEVELOPMENT PROGRAM
PHASE II (LOAN No. 1592/ SF-HO)**

**TO EXPAND THE NATIONAL COVERAGE AND STRENGTHEN THE
REGULATORY FRAMEWORK FOR MUNICIPAL FINANCING**

(HO-0115)

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Annex I Logical framework

Appendix I Contractual changes (Loans 1024/SF-HO, 1104/SF-HO, and 1592/SF-HO)

Proposed resolution

Electronic Links and References	
Basic Socioeconomic Data	http://www.iadb.org/RES/index.cfm?fuseaction=externallinks.countrydata
Status of loans in execution	http://ops.iadb.org/approvals/pdfs/HOen.pdf
Information available in the RE2/EN2 technical files	http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=583451
Annex II Procurement plan	http://idbdocs.iadb.org/WSDocs/getDocument.aspx?DOCNUM=635903
Annex III Eligibility Matrix	http://idbdocs.iadb.org/WSDocs/getDocument.aspx?DOCNUM=635904

ABBREVIATIONS

APC	Private Loan Administrator
BCH	Banco Central de la República de Honduras [Central Bank of the Republic of Honduras]
CNBS	Comisión Nacional de Bancos y Seguros [National Banking and Insurance Commission]
DASM	Departamento de Auditoría del Sector Municipal [Municipal Sector Auditing Department]
DFM	Dirección de Fortalecimiento Municipal [Office of Municipal Strengthening]
EDF	Financial Performance Evaluation
FOMUNDE	Fondo Municipal de Desarrollo [Municipal Development Fund]
ICB	International competitive bidding
MDC	Municipality of the Central District
MDTF	Municipal Development Trust Fund
MEMP	Maintenance and Environmental Management Plan
MEU	Municipal Environmental Unit
MFCP	Municipal Financial Cleanup Plan
MSPS	Municipality of San Pedro Sula
NCB	National competitive bidding
PDM	Municipal Development Program
PFM	Municipal financial plan
PPMR	Project Performance Monitoring Report
PRODDEL	Programa Nacional de Descentralización y Desarrollo Local [National Decentralization and Local Development Program]
RGM	Regulations on General Matters
SEFIN	Ministry of Finance
SERNA	Ministry of Natural Resources and Environment
SGJ	Ministry of the Interior and Justice
SIAFM	Sistema Integrado de Administración Financiera Municipal [Integrated municipal financial administration system]
SINEIA	Sistema Nacional de Evaluación de Impacto Ambiental [National Environmental Impact Evaluation System]
TSC	Tribunal Superior de Cuentas [Auditor General's Office]

PROJECT SUMMARY

HONDURAS

PROPOSAL FOR REFORMULATION: LOANS 1024/SF-HO, 1104/ SF-HO, AND 1592/ SF-HO TO EXPAND THE NATIONAL COVERAGE AND STRENGTHEN THE REGULATORY FRAMEWORK FOR MUNICIPAL FINANCING (HO-0115)

Financial Terms and Conditions ¹					
Borrower: Republic of Honduras					
Executing agency: Ministry of Finance, with the support of the Ministry of the Interior and Justice and municipalities participating in the program.					
	Original Amounts (US\$ million)				
Source	Phase I 1024/SF-HO	MSPS Phase II 1104/SF-HO	MDC Phase II 1592/SF-HO	Project total	Reformulated Amount
IDB (FSO)	63.00	9.00	22.50	94.50	42.05
Local	7.00	2.25	2.50	11.75	3.89
Total	70.00	11.25	25.00	106.25	45.94
Project at a glance					
<p>Summary of the proposed reformulation:</p> <p>The objective of the reformulation is to permit the use of resources from the three loans in execution that comprise the Municipal Development Program for the Central District and San Pedro Sula, approved in 1998, 2002, and 2004, in order to finance: (i) activities similar to those financed to date (municipal technical assistance and municipal infrastructure investments), for a broader group of municipalities; (ii) strengthening of the municipal financing regulatory framework; and (iii) administrative expenses associated with the new execution structure. The change will also allow monitoring of the three operations to be harmonized.</p> <p>Project objective:</p> <p>The original objective of the Municipal Development Program was to support a comprehensive and sustainable program to modernize the municipalities of the Central District and San Pedro Sula, including: (i) comprehensive municipal finance reform; and (ii) reforms of services managed by the municipalities, in order to: (a) give the private sector a bigger role as a service provider; (b) strengthen municipal capacity to supervise service providers; and (c) facilitate access to services by the poor.</p> <p>The program's new general objective is to help deliver and finance sustainable municipal services. The specific objectives are the following: (i) to expand the municipal services provided by Honduran municipalities or associations that receive program subloans under financially and environmentally sustainable conditions; and (ii) to improve the municipal services financing system and the transparency of municipal financial management.</p> <p>To achieve the first specific objective, technical assistance will be financed for municipal strengthening and investments in municipal infrastructure. To achieve the second specific objective, a technical assistance component will be financed to reform policies, to expand the quality and quantity of municipal financial information available to the Government of Honduras and the banking sector, and to implement municipal financing control and monitoring systems.</p> <p>Special contractual conditions:</p> <p>See paragraphs 4.5, 4.12, 4.13, 4.17, 4.34.</p>					

I. BACKGROUND

- 1.1 On 18 November 1998, the Bank's Board of Executive Directors approved the Municipal Development Program for the Central District and San Pedro Sula in Honduras (Loan No. 1024/SF-HO). The program's objective was to support a comprehensive and sustainable program to modernize the municipalities of the Central District (Tegucigalpa) and San Pedro Sula, to achieve sustainable improvement in urban services in the municipalities. The program was designed to be implemented in two phases in each municipality.
- 1.2 The financing of the two phases for San Pedro Sula amounted to US\$27 million and US\$9 million, respectively. In 2002, the Bank's Board of Executive Directors approved phase II (Municipal Development Program for San Pedro Sula, 1104/SF-HO). In Tegucigalpa, the financing of the two phases amounted to US\$36 million and US\$22.5 million, respectively. Phase II was approved in 2004 (Municipal Development Program for the Central District, 1592/SF-HO). The total cost of the Municipal Development Program (PDM), including the two phases in each municipality, came to US\$105.75 million, of which Bank financing was to cover US\$94.5 million. The execution period for phase I was projected at five years, and for phase II four years (San Pedro Sula) and 3.5 years (Tegucigalpa). The executive summaries of the approved loan proposals are available in the operation's technical files.
- 1.3 According to the program's design, the strategy for improving municipal services includes: (i) restructuring the municipalities' financial administration; and (ii) modernizing the arrangements for providing services. The financial restructuring seeks greater transparency, more efficiency, and more rigorous discipline in financial administration. The program supported the implementation of strategies and investments to improve the potable water and sewerage systems, and construction and improvement of roads and road transportation; municipal environmental management, including solid waste management; and the improvement of low-income neighborhoods. The program seeks greater involvement by private companies in providing services, as well as efforts to strengthen the municipalities' capacity to supervise the delivery of private services.
- 1.4 To support these objectives, the program is financing: (i) technical assistance to improve financial administration and the capacity to manage or supervise services; (ii) the development and implementation of sectoral municipal services strategies; and (iii) municipal investments consistent with sector strategies. Financing is transferred to the municipalities as credit ("subloans").¹

¹ Because of the arrival of hurricane Mitch during program preparation, special financial conditions have been established for projects financed during year one of the program, relating to the repayment of services affected by the storm.

- 1.5 The PDM includes two innovations: (i) the creation of a fund using repayments of the subloans for financing new municipal investments managed by a private trust (the Municipal Development Trust Fund, or MDTF); and (ii) the use of an Eligibility Matrix to qualify municipalities and projects.
- 1.6 Although the loans are granted at market terms and conditions, they are still concessionary. The periods match the economic life of each investment, and the rates are variable. Although the MDTF is not a purely commercial mechanism, its use is intended to contribute to establishing good municipal financing practices in the national financial market, strengthen investment payment recovery practices, involve a commercial bank (the trustee) in the municipal financing, and contribute to developing risk management instruments in municipal projects.
- 1.7 Repayments are made by the MDTF to the government, which is responsible for repaying the Bank loan. To date, the government has recovered funds equal to what has been repaid to the Bank. To minimize the government's risk, and ensure capitalization of the revolving fund, the program includes a series of mechanisms to improve credit, and guarantees to facilitate the municipalities' payments to the MDTF.
- 1.8 **Status of decentralization and the municipal financial system.** The government and the Bank prepared the PDM in 1998, focusing solely on the Municipality of the Central District (MDC) and the Municipality of San Pedro Sula (MSPS), because of the two cities' importance as centers of development in the country. Since that time, the municipal sector's institutional consolidation has made several other municipalities powerful promoters of local economic and social development, capable of preparing projects of a regional or national scale, and with the potential (when properly prepared and carried out) of being economically and financially sustainable.
- 1.9 The current Honduran administration has placed priority on decentralization as an instrument to promote sustainable local development, preserving the country's macroeconomic equilibrium and democratic governance. In 2002 the National Decentralization and Local Development Program (PRODDEL) was developed, led by the Ministry of the Interior and Justice (SGJ), the institution that regulates municipal development and decentralization. PRODDEL establishes principles for guiding local development, including guaranteeing sound and healthy municipal finances, and strengthening the capacity of local participants. A Bank loan² supports PRODDEL activities aimed at strengthening municipal management and implementing sectoral decentralization policies. Within the SGJ, the Office of Municipal Strengthening (DFM) is responsible for regulating the quality of municipal training and technical assistance, and for organizing and rationalizing the

² Poverty alleviation and local development program, phase II (1478/SF-HO).

supply of and demand for municipal technical assistance, as well as for measuring its effectiveness.

- 1.10 Honduran municipalities are increasingly using credit as a source of financing, but often without strengthening their finances to make repayment sustainable and avoid negative impacts on national finances and macroeconomic targets. A study carried out recently for the SGJ identifies a troubling municipal debt situation.³ In 2003, 42% of Honduran municipalities received commercial bank loans. New loans that year totaled US\$14 million (excluding the MSPS and MDC).⁴ In a group of 25 municipalities, over 60% of operating income is committed to debt service (a common indicator of over-indebtedness).
- 1.11 Data in the banking information center do not facilitate analysis of municipal loans, due to such factors as inconsistencies in the classifications used and the practice of recording loans with dedicated sources of repayment as separate trusts. The National Banking and Insurance Commission (CNBS) is aware of the growth in lending to municipalities and is interested in strengthening its monitoring and communications with the banking sector to avoid future problems.
- 1.12 Financial auditing is a key control tool in mature municipal financing systems. The Auditor General's Office (TSC), which regulates and supervises funds, assets, and resources administered by the State, including municipalities, has a Municipal Sector Audit Department (DASM), with 22 auditors. The DASM can take seven years or more to audit the 298 municipalities. Recently, this situation has led it to begin engaging outside auditors to expand its auditing capacity. The DASM has received international assistance for training and for procuring basic computer equipment, but the success of the exercise depends upon other complementary activities, such as defining and disseminating municipal accounting standards and establishing a system to train and certify auditors (on contract and municipal employees), due to poor knowledge of municipal finance by the country's commercial auditors and experts.
- 1.13 The use of credit should be one of the basic pillars of a municipal financing system, but under controlled conditions. Proven measures for organizing the use of debt within the PDM (submitting external municipal audits, identifying financial repayment plans for each project, the guarantee system) have been partly effective, but were implemented in the absence of a framework of national policies for the use of credit in the municipal sector.
- 1.14 The current system's risk can only be mitigated by implementing a system of rules, reliable information, and arrangements to monitor and analyze outcomes. Priority

³ "Study of Municipal Debt Regulations in Honduras," Cesar Vargas, June 2005.

⁴ The MSPS and MDC contracted US\$27 million in 2003, approximately two thirds of which was program financing.

measures currently include: (i) defining and issuing municipal accounting standards; (ii) establishing and implementing a municipal financial administration system; (iii) putting in place an information and credit reporting center; and (iv) establishing a system to evaluate fiscal performance and municipal rankings. Implementing these initiatives also requires strengthening the institutions that would take on these responsibilities.

II. PROGRAM STATUS

- 2.1 Following is a summary of the execution status of the three loans as of 1 October 2005.

Table II-1 Status of municipal development program (US\$000)						
	Phase I			Phase II		Total project
	Total Phase I			MSPS II	MDC II	
	MDC	MSPS	1024/ SF-HO	1104/ SF-HO	1592/ SF-HO	
Original amount	36,000	27,000	63,000	9,000	22,500	94,500
Disbursed (as of 1 November)	26,126	22,782	48,908	0	0	48,908
In execution	1,939	1,618	3,538	0	0	3,538
Available	7,935	2,600	10,554	9,000	22,500	42,054

- 2.2 The deadline for disbursement of the loan for phase I of the PDM (1024/SF-HO) expires on 4 December 2005, and after that date, the sum of US\$10.55 million will not be committed. None of the phase II loans have begun to be disbursed. Consequently, the undisbursed total for the entire program is US\$42.05 million.
- 2.3 During phase I of the PDM, both municipalities achieved a significant number of institutional reforms and improvements in municipal services. In the Municipality of San Pedro Sula, phase I achievements included: (i) design of the Integrated Financial Administration System and implementation of administrative reforms; (ii) establishment of a financially sustainable environmental management system, including the measurement of environmental variables and achieving ISO 14001 certification; (iii) significant expansion in the coverage and quality of water and sewer services through a private concession; (iv) expansion of the road network and improved maintenance, through a planning system and the creation of a municipal road fund; (v) improved environmental management of solid waste and the municipal dump through physical investments and the private contracting of collection services; (vi) improved living conditions in low-income neighborhoods through a system of community works, and implementation of efficient property titling processes; and (vii) reintegration into society of families settled along rivers passing through the municipalities, as part of a relocation program. Practically all the physical targets of phase I were achieved. However, despite increases in municipal revenue during phase I, there were also corresponding increases in expenses, including the payment of credit obligations acquired outside the program, resulting in a failure to meet the financial targets set for phase I of the PDM.

Phase II for the MSPS includes additional investments in the phase I sectors, as well as activities to strengthen the urban planning system, and to restore the municipality's historic heritage.

- 2.4 In the Municipality of the Central District, phase I achievements included: (i) expanded coverage of solid waste service, and improved environmental management in the sector, including preparations for closing the municipal dump and opening a sanitary landfill; (ii) expanding the road network and improved maintenance, through a planning system and municipal roads fund; (iii) improved sanitation services and environmental and economic conditions in low-income neighborhoods, through a series of community projects, and a property titling program for occupants that will cover over 10,000 lots by the end of phase I; and (iv) improved environmental management by establishing a system that includes the monitoring of environmental variables. Despite an increase in municipal revenue during phase I, problems in implementing the financial administration system, budget controls, and investment repayment mechanisms have hindered the MDC's ability to meet the phase I financial targets. In turn, restricted access to the program's financial resources has prevented the phase I physical targets from being completely met. Phase II for the MDC includes continued modernization of municipal administration and service delivery. It also includes funds to prepare a metropolitan strategic plan.
- 2.5 Although designed in 1998, the program shares many features of the Bank's new results-based loans, since the program rewards good municipal performance with greater access to credit resources. The Eligibility Matrix was used to evaluate: (i) overall municipal performance, particularly with respect to financial administration and transparency; (ii) the performance of sectors eligible for financing; and (iii) the execution of specific projects. Prior to approval, each financing request requires an Eligibility Matrix review to verify that the relevant indicators are met, plus a project feasibility analysis.
- 2.6 The PDM began its municipality repayment phase in 2002. Up to 2004, the municipalities had maintained good repayment records, although concerns began to arise as to whether they would have the credit capacity to absorb the quantity of funds scheduled for phase II. In 2004, the municipalities began encountering difficulties meeting the Eligibility Matrix requirements, resulting in an interruption in new project approvals, and consequently, in the granting of new subloans. Eligibility Matrix requirements include (i) the establishment of works repayment mechanisms; and (ii) the submission and disclosure of audited municipal financial statements. This was due to a number of factors, some exogenous (lower-than-projected tax revenue), and others internal, involving decisions taken by the municipalities, unrelated to the PDM criteria.
- 2.7 The loan contracts also include subloan conditions that have not been entirely met, such as (i) the guarantee system ("Special Accounts"); (ii) the counterpart

contributions; and (iii) semiannual repayment of the subloans. The latter forced the MDTF to exercise the last-resort guarantee as provided in the loan contract, i.e., the pledging as collateral of national transfers allocated to the municipalities. The financial constraints were confirmed in the 2003 audited municipal financial statements and the risk studies prepared by the MDTF in 2004 and 2005. The Bank and SEFIN have agreed with the municipalities on corrective steps, but the results are not expected to correct these situations in the short or medium terms.

- 2.8 A phase I evaluation was performed in 2004. The evaluation notes the negative impact on the operation of flaws in the municipal regulatory framework in several areas, including taxation, the outsourcing of services, the division of responsibilities between the municipalities and the government, and above all, in the financial area (management, accounting, auditing, and financing). The evaluation's main recommendations were: (i) *improve the effectiveness of institutional reform activities*, avoiding the temptation to focus on works and ignore the reforms that should have been accomplished first; (ii) demand and implement reforms consistent with sectoral strategies, eliminating ad hoc initiatives in municipalities and promoting strategic and operational planning, process systematization, and results measurement; (iii) *establish collection capacity first and foremost*. Although implementation of a culture of paying for services is complex and requires political will and disciplined municipal management, the program should finance more directly recoverable investments and invest only as collection mechanisms are implemented; (iv) *overcome the complexity of the municipal services outsourcing process*. A number of factors complicates these efforts: pressure brought to bear by economic interests, fear of the economic impact on society, and poor understanding of the models, meaning these initiatives require significant and continuous political commitment and technical support; (v) *consider creating new institutions in the municipalities, rather than restructuring existing ineffective institutions*, since new institutions created as part of the program have proven to be more effective, efficient, and innovative than existing institutions subjected to reform attempts; and (vi) *recognize and compensate for the impact of disasters on the operations (the "Mitch factor")*. The Bank reviewed and changed the loan conditions to allow financing of urgent needs in the two municipalities after hurricane Mitch, but the financing structure or Eligibility Matrix milestones were not changed, contributing to the emergence of problems involving noncompliance. This reformulation proposal takes these recommendations into consideration.

III. REFORMULATION PROPOSAL

- 3.1 The results of the phase I execution in the MSPS and the MDC, along with changes in the country's local development strategy, have contributed to the government's conclusion that, without excluding the MSPS and MDC from additional financial support insofar as they meet the reformulated program's access conditions, the national coverage of the PDM needs to be expanded to allow participation by other municipalities. The government also believes it necessary to reallocate PDM resources to strengthen the regulatory framework for municipal financing, particularly the use of credit as a source of financing. The reforms being considered will establish better control over the credit activities of the country's municipalities, including those that will be participating in the program after its reformulation.
- 3.2 To achieve these objectives, the Bank and the Honduran government agreed to reformulate the program during the Portfolio Review Mission in Honduras from 1 to 3 June 2005. The agreement was recorded in the aide-mémoire signed by the government authorities upon completion of the mission.
- 3.3 The program's general objective after its reformulation will be to establish a sustainable system for providing and financing municipal services.
- 3.4 The specific objectives are: (i) to expand the municipal services provided by Honduran municipalities or associations that receive program subloans, in financially and environmentally sustainable conditions; and (ii) to improve the municipal services financing system and the transparency of municipal financial management.
- 3.5 To achieve the first specific objective, the program will support (i) strengthening municipal financial administration; and (ii) modernizing municipal public services. Municipal services currently covered by the program will be maintained. Investment projects focusing on improving local competitiveness will also be permitted, given the close relationship between these initiatives and the economic strengthening of municipalities.
- 3.6 To achieve the second specific objective, a component will be financed to support public policy reforms, expand the quality and quantity of financial information available to the government and the banking sector, and implement several systems for controlling and monitoring municipal financing.

A. Components

- 3.7 It is proposed that the program's structure be simplified, reducing its original components to just the following three components:

- 3.8 **Component 1: Municipal project financing** (US\$27,404,000). Using program funds, subloans will be financed in amounts equal to or greater than US\$50,000 per subloan, for municipal investment projects to improve services in the following sectors: (i) water and sanitation; (ii) low-income neighborhoods; (iii) local economic development;⁵ (iv) solid waste; (v) the environment; (vi) roads and transport; and (vii) financial administration and planning. The funds will be transferred as subloans to municipalities or associations⁶ participating in the program and administered and recovered by a Private Loan Administrator (APC), a banking institution, or a joint venture that will include a bank.
- 3.9 To ensure process transparency, projects will be selected according to criteria to be publicly announced in advance, and the results of the approval process will be published on the APC web page.⁷ The APC will apply a Credit Rule to standardize the technical and financial feasibility analysis of projects in each sector.
- 3.10 The Eligibility Matrix mechanism will be used to qualify municipalities and projects. The Matrix has been changed to best reflect the capacities and needs of the least institutionally advanced municipalities, but it retains: (i) municipal-level conditions (legal, financial, and transparency-related); (ii) project-level conditions (and the information requirements for project approval); and (iii) the monitoring indicators used after project completion. Among the minimum criteria for the projects will be: (i) the program requirements; and (ii) the national legislative framework, mainly (a) the project's environmental impact, (b) the technical, financial, and social feasibility, (c) the setting of rates or other cost recovery arrangements, (d) maintenance of the work, and (e) provision of the counterpart financing.
- 3.11 Municipalities will prepare projects using their own resources, provide a minimum of 5% of the project cost as financial counterpart funds,⁸ and submit to the APC a plan for repayment or recovery of the loan or from the beneficiaries, as part of the financing request. Municipalities may request new project financing approval if they are current with their repayments to the APC. To mitigate credit risk, the type of project permitted and the loan amount will vary according to the results of the municipal Financial Performance Evaluation (EDF) and the municipality's credit

⁵ Local economic development infrastructure must contribute to increasing local family income and might include such examples as the following: tourism facilities, buildings hosting crafts or small-scale nonindustrial activities, or investments that allow access to or use of local natural attractions. Markets financed by the program will tend to be "Type I."

⁶ The term "municipality" is used throughout this document to mean "a municipal entity or association" (i.e. institutions that may submit projects for program financing).

⁷ The final criteria will be defined in the program's Operating Regulations to complement the Mechanism for the Organization, Prioritization, and Financing of Project Requests within the ERP Framework.

⁸ Municipalities will also provide preinvestment studies and designs, which will be recorded as an addition to the local counterpart.

- capacity.⁹ In addition to being consistent with credit capacity, projects submitted by municipalities with low EDFs will have to include risk mitigation measures sufficient to guarantee repayment, in the APC's opinion, such as "closed-circuit recovery" (investment repayment funds allocated directly to repaying the subloan without the municipality's intervention).
- 3.12 The selection process is designed to encourage improved municipal financial performance and will be described in the program's Operating Regulations. It is believed that some 60 investment projects will be financed.
- 3.13 **Component 2: Municipal strengthening** (US\$4,654,000). This component will finance technical assistance to help municipalities implement approved projects, strengthen financial management, and improve management of the service to be financed by the subloan. This technical assistance may include models for private sector participation in service delivery, and the strengthening of municipal capacity to regulate these services.
- 3.14 Technical assistance resources will be allocated to municipalities by the SGJ, based on their institutional strengthening requirements identified in the EDF or by the APC during the investment project approval process. The guidelines for the allocation, amount, and use of the technical assistance will be set out in the program Operating Regulations.
- 3.15 **Component 3: Strengthening the municipal financial regulatory framework** (US\$5,600,000). The purpose of this component is to improve the quality and quantity of information on municipal financial management and establish municipal debt control rules and instruments, thereby strengthening the municipal financing system and transparency in the country's local governments.
- 3.16 These objectives will be promoted through a number of technical activities for the following subcomponents:
- 3.17 **Improving municipal financial management evaluation capacity:** (i) a Financial Performance Evaluation (EDF) system will be designed and introduced based on the existing municipal reporting system, and a ranking of municipalities, to be published in the media, posted on the SGJ web page, and disseminated at regional forums;¹⁰ and (ii) basic criteria for preparing Municipal Financial Plans (PFM) will

⁹ Until the EDF system is formally implemented (Component 3), credit capacity will be calculated according to a provisional methodology to be included in the program's Operating Regulations. A summary of the methodology is included in the program's technical files.

¹⁰ The Financial Performance Evaluation covers four elements: management of revenue, expenses, and debt, and the quality of the financial administration. A description of the EDF system may be found in the program's technical files. The EDF system will also provide an estimate of the municipalities' borrowing capacity.

be set out and published.¹¹ PFMs will complement the Municipal Strategic Plans prepared by all municipalities in 2003 and 2004 and be used to guide their financial planning and investment programming.

- 3.18 **Regulation of the use of credit by municipalities:** (i) a municipal credit operations information center will be established, complementing the national banking risk and information center; and (ii) the National Banking and Insurance Commission (CNBS) will be strengthened, to improve oversight of municipal finance activities within the banking sector, and to train lenders in analyzing municipal project risks.
- 3.19 **Improvements in municipal financial administration, the following will be financed:** (i) the issuance and implementation of municipal accounting standards based on national standards; (ii) the design and implementation of the Integrated Municipal Financial Administration System (SIAFM), whose transition plan was already defined by the Poverty Alleviation and Local Development Program, phase II (1478/SF-HO);¹² and (iii) the modernization of systems and expansion of activities by the Municipal Sector Auditing Office of the Auditor General's Office, to include (i) the training of internal and external auditors and public accountants in municipal audits; (ii) the updating and/or preparation of manuals for municipal financial administration and control; and (iii) a pilot social audit plan.

B. Financing costs

- 3.20 Available funds from the three program loans as of 1 November 2005 will be reallocated to support the "Reformulated PDM." The government, through the municipalities taking part in the PDM will contribute whatever is necessary to satisfy the local counterpart percentage included in the financing matrix for Honduras (10%) .

¹¹ A Municipal Financial Plan (PFM) includes: (i) the municipality's tax and financing policy, including debt policy; (ii) the human resources policy with regard to its financial impacts; (iii) the financial strategy for each municipal service; (iv) annual financial goals; and (v) medium-term financial and investment projections.

¹² This initiative will be coordinated with the Fiscal Management Strengthening Program (1546/SF-HO) and the Fiscal Reform Program (HO-0223) (in preparation), which finance implementation of the national SIAF and the reorganization of national public financial management.

Table IV-1
Sources and application of funds for the reformulation (US\$000)

Availability of Funds						
	1024/SF-HO	1104/SF-HO	1592/SF-HO	Total Loans	Local Contribution	Reformulated program
	10,554	9,000	22,500	42,054	3,887	45,941
Breakdown of Funds						
I. Municipal project financing	7,100	5,700	14,604	27,404	2,600	30,004
II. Municipal strengthening	1,135	1,100	2,419	4,654	-	4,654
III. Financial framework strengthening	750	1,100	3,750	5,600	220	5,820
Improved evaluation of financial management	250	150	125	525	-	525
Regulation of municipal credit	300	400	275	975	-	975
Municipal financial reporting system	200	550	2,000	2,750	220	2,970
Equipment	-	-	1,350	1,350	-	1,350
Administrative Costs	413	799	600	1,812	500	2,312
ATP Finance + Assistant (1st year)	126	110	-	236	200	436
DFM	100	150	50	300	-	300
Private loan administrator	187	539	375	1,101	300	1,401
Procurement training	-	-	175	175	-	175
Evaluations			350	350		350
Audits		125	135	260		260
Financing costs	1,156	176	642	1,974	567	2,541
Interest	1,156	85	417	1,658	-	1,658
Credit fee	-	-	-	-	567	567
Inspection and supervision	-	9	225	234	-	234
Previously capitalized financial expenses	-	82	-	82	-	82
Total	10,554	9,000	22,500	42,054	3,887	45,941

IV. PROGRAM EXECUTION

A. Borrower and executing agency

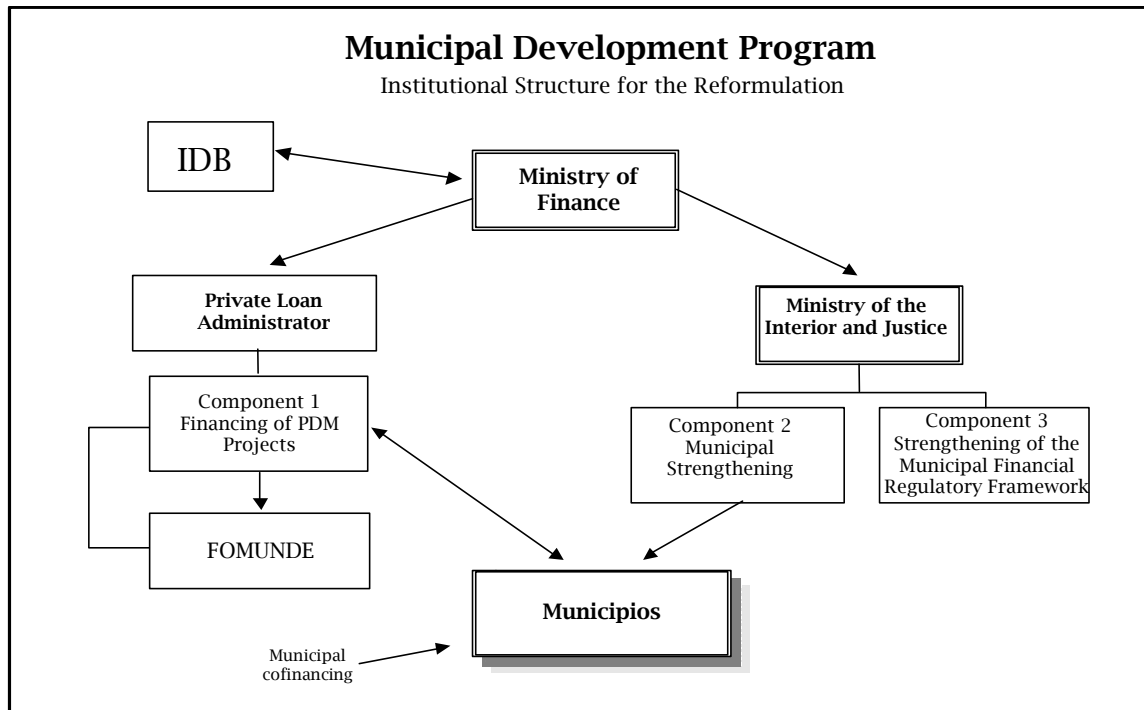
- 4.1 The borrower will be the Republic of Honduras. The executing agency for the program will be the Ministry of Finance (SEFIN) with the support of the SGJ and the municipalities eligible for subloans under the program.

B. Program administration – responsibilities

- 4.2 **Ministry of Finance.** SEFIN will be responsible for general program supervision, especially: (i) bidding on and contracting of the Private Loan Administrator (APC) and supervising its activities; and (ii) periodically calling together the institutions involved in executing the program to maintain good coordination between them. SEFIN will engage the services of a legal/administrative advisor to assist it in fulfilling its duties. During the first year of the program, the advisor will have the support of an administrative assistant.
- 4.3 **Ministry of the Interior and Justice (SGJ).** The SGJ will be responsible for supervising Components 2 and 3 and will have the following responsibilities: (i) to participate in selecting municipal financing projects; (ii) to determine municipal technical assistance requirements and setting the financing amounts in accordance with program Operating Regulation guidelines; (iii) to assist with the hiring and supervision of municipal technical assistance (Component 2); (iv) together with SEFIN, to coordinate the disbursement of funds through the APC for Components 2 and 3; (v) to define and request the procurement of technical assistance to strengthen and supervise the regulatory framework (Component 3); (vi) to participate in the coordination meetings called by SEFIN; and (vii) together with SEFIN, to coordinate with other cooperating institutions in supplementing the technical assistance financing and project financing.
- 4.4 The Office of Municipal Strengthening (DFM) will coordinate Component 2 and 3 activities within the SGJ. The DFM will be strengthened to effectively fulfill this role, and to help it coordinate and measure the effectiveness of other technical assistance offered to the municipalities, including such additional assistance as may be needed to prepare and/or cofinance the program's investment projects.
- 4.5 **As a special condition precedent to disbursement of the Bank financing, the borrower must demonstrate, to the Bank's satisfaction, that an Agreement setting out the responsibilities of the parties and the mechanisms for operational coordination of the program has been signed between the borrower, the SGJ, and the APC and is in effect in accordance with the terms and conditions previously agreed between the borrower and the Bank. As a condition for municipalities to be eligible to participate in the program, the**

participation agreement whereby the municipalities are bound to comply with the procedures and rules set out in the Operating Regulations previously approved by the Bank (the model agreement is part of the Operating Regulations) must have been signed by the executing agency, the SGJ, and the respective municipality and must be in force.

4.6 The following diagram shows the institutional structure of program execution.



4.7 **Municipalities.** All the country's municipalities and associations will be eligible to participate in the program. The municipalities will be eligible to participate when (i) they have fulfilled the conditions set forth in the Eligibility Matrix (Table I ("Minimum criteria for participation by municipalities and associations")); (ii) the APC has approved an investment project presented in accordance with the criteria contained in the Eligibility Matrix (Table II "Minimum criteria for investment projects") and Table III ("Information to be furnished with financing requests"); and (iii) they have committed to take part in performance monitoring process (Table IV "Indicators for monitoring municipal performance during the program").

4.8 The municipalities will have the following responsibilities: (i) in Component 1: (a) preparing and financing preinvestment studies and designs; (b) submitting financing requests for eligible projects to the APC and receiving approval; (c) signing the loan document with the APC, subject to authorization by the *Corporación Municipal*;¹³ (d) depositing the municipal contribution with the APC

¹³ The model contract will form part of the program's credit regulations.

- upon signing the contract; (e) bidding on the works and supervision; (f) implementing the financial repayment plan and repaying the subloan to the APC; and (g) submitting periodic project reports and collaborating in the semiannual performance evaluation, along with the SEFIN, SGJ and the Bank;¹⁴ and (ii) in Component 2: (a) signing the contract with the SGJ and SEFIN (see paragraph 4.5); (b) procuring and supervising municipal technical assistance; and (c) preparing a municipal financial plan.
- 4.9 **Private Loan Administrator (APC).** The APC, which is expected to be a private institution (a bank or a consortium that includes a bank), will be responsible for Component 1 and will make all program disbursements. The APC will have a Technical Unit for project review, and a Credit Committee. The APC will sign an agreement with SEFIN setting out the terms and conditions for its work. The APC will have the following responsibilities: (i) to participate in selecting municipal projects and review projects through the Technical Unit in accordance with the Credit Regulations; (ii) to coordinate project review by the Credit Committee; (iii) to respond to requests for information by the SGJ to support the identification of municipal technical assistance needs; (iv) to supervise and support municipalities in the bidding process; (v) to facilitate the submission of no objection documentation to the Bank; (vi) to maintain the revolving fund for the loan; (vii) to manage municipal contributions and handle them in a separate account; (viii) to ensure the establishment of municipal guarantees and monitor maintenance of the guarantees and repayment plans; (ix) to effect payment for program activities and, through SEFIN, to replenish and justify the disbursements; (x) to recover the subloans; (xi) to keep the accounts and issue financial statements and other program information; and (xii) to participate in the coordination meetings called by SEFIN.
- 4.10 With respect to program funds already lent and/or recovered under loan 1024/SF-HO, the APC will be responsible for: (i) managing the collection of the existing portfolio of approximately US\$50 million with the MDC and the MSPS; and (ii) investing the proceeds of payment recoveries that the program has accumulated, and continues to accumulate, in FOMUNDE.
- 4.11 The Credit Committee will assist the APC in resolving problems relating to portfolio repayment.
- 4.12 The APC's compensation for administering and managing program resources will consist of a fixed payment plus a fee based on the amount of the commission (less amounts recovered through guarantees). For managing the existing portfolio, compensation will consist of a fixed payment plus a staggered commission, depending upon the level of portfolio repayment (not including funds recovered through guarantees). For the FOMUNDE investment, the APC will receive a percentage of earnings above those needed to preserve the fund's value.

¹⁴ The performance monitoring structure may be found in Table IV of the matrix.

Compensation will be set through a competitive selection process. The APC's fixed payment will come out of the proceeds of the financing; the variable payment will be discounted from recoveries or earnings, as applicable. A portion of the APC's costs will be recovered through each subloan. **The borrower must submit evidence, to the Bank's satisfaction, that it has selected and engaged the APC in accordance with the terms previously agreed with the Bank, as a condition precedent to disbursement of the funds corresponding to the Bank financing.**

C. Execution of program components

- 4.13 **Operating Regulations.** The program will have Operating Regulations consisting of: the *Regulation on General Matters (RGM)*; *Credit Regulations*, which will govern the rules for awarding and repaying subloans; and *Municipal Regulations*, for the execution of activities for which the municipalities are responsible. The RGM include terms of reference, work plans, and performance indicators for the APC, the Technical Unit, and the administrative/legal advisor; the Eligibility Matrix; and procedures for program monitoring and evaluation. The Credit Regulations include project presentation guidelines; criteria for reviewing subloan feasibility; and procedures for subloan disbursement, funds control, and repayment. The Municipal Regulations include procedures for supervising program-financed technical assistance; guidelines for preparing works maintenance plans; guidelines for preparing and submitting periodic reports and publishing program-related information; and guidelines for preparing the PFM and corresponding targets. **The borrower must submit evidence, to the Bank's satisfaction, that the program Operating Regulations are in effect, in accordance with the terms and conditions previously agreed to between the borrower, the SGJ and the Bank, as a condition precedent to disbursement of the funds corresponding to the Bank's financing.**

1. Component 1: Municipal project financing

- 4.14 Investment projects will be coordinated by the APC, the SGJ, and SEFIN. APC activities will be selected and carried out in accordance with the Operating Regulations. The Eligibility Matrix, the EDF, and municipal financing requests will be used to evaluate the projects and identify technical assistance needs to be financed out of the resources for Component 2. The APC will maintain a web page reporting approvals, repayment status, and other information on this component.
- 4.15 The APC will provide technical and financial review of the projects, through a Technical Unit. The APC will have a Credit Committee to review subloans. After technical review, the Technical Unit will submit projects to the APC Credit Committee for final recommendation to the executing agency and subsequently to the Bank, for financing.

- 4.16 The APC will sign a credit agreement with each municipality and be responsible for compliance.¹⁵ A classification of projects used during the program will be maintained: Type I (projects with direct repayment), Type II (projects in sectors with a repayment structure that may be adapted to recover a new investment), and Type III (projects repaid through general municipality revenue). In the case of Type I projects in which “closed-circuit recovery” is used with an external institution responsible for managing collections (a trust, for example), this institution will have to be part of the subloan agreement.
- 4.17 **To commit the proceeds of the Bank financing totaling over 30% of the resources corresponding to Component 1 of the program, the borrower must submit evidence, to the Bank’s satisfaction, that the municipal accounting standards and the EDF system have been properly established and implemented (Component 3).**
- 4.18 **Financial conditions.** The subloan financial conditions are the following: (i) the **interest rate** will be 55% of the weighted average lending rate in the financial system officially sanctioned by the Central Bank of Honduras, unless otherwise agreed between the borrower and the Bank;¹⁶ (ii) **amortization periods** will be set to reflect the economic life of the project assets according to a structure based on international standards; subloan maturity must never exceed the period of the Bank loan; and (iii) the **grace period for payment of principal** will be the disbursement period plus a maximum of one year.¹⁷ Municipalities will make quarterly payments and may consult an online information system maintained by the APC.¹⁸
- 4.19 **Repayment sources.** Participating municipalities will set procedures acceptable to the APC for repaying subloans, depending upon the project type. As part of the financing request, the municipality will submit: (i) evidence of the sufficiency of the income of the sector or municipality to absorb the additional costs resulting from the project; or (ii) the structure for changing the arbitration plan during

¹⁵ The credit agreement specifications will be included in the program’s Operating Regulations.

¹⁶ The interest rate applied in any quarter to paying off the subloan may never be less than the official inflation rate published by the Central Bank of Honduras for the period in question, plus 200 basis points. Partial indexation of loan balances during the repayment period will be permitted, to level out the real values of the annual payments, reduce the interest rate, and protect FOMUNDE’s value. The procedure for setting the interest rate and applying indexation, which will form part of the Credit Regulations, will include a safeguard for cases of high inflation.

¹⁷ The credit terms for water and sanitation projects will be as stipulated in the water and sanitation investment program (1048/SF-HO).

¹⁸ The formula for setting the interest rate on subloans awarded before the reformulation will be maintained (unless otherwise agreed with the Bank), i.e., a variable rate adjusted automatically every six months, at 85% of the average weighted rate paid on deposits, excluding sight deposits, issued by the Central Bank of Honduras, which may never be less than the official inflation rate published by the Central Bank of Honduras for the same period.

subloan repayment, if necessary. For each project, the repayment arrangement will form part of the loan contract.

- 4.20 **Additional guarantees and conditions.** If a municipality is unable to meet its obligation to repay the subloan, the APC will pledge as security the financial transfers the municipalities receive from the central government. Participating municipalities will be subject to debt ceilings during the subloan repayment period, will accord to priority to the APC against all other financial obligations acquired after the subloan is granted, and will have to register all borrowing with the SGJ and the TSC, or with the information center (Component 3) as soon as it is operating .
- 4.21 **Maintenance of works.** Municipalities will submit a Maintenance and Environmental Management Plan (MEMP) as part of the project financing request. The SGJ will develop standards for preparing the Plan. The Plan will include a projection of maintenance cost and that cost will have to be taken into consideration in analyzing the project's financial feasibility and the work's financial repayment strategy. The agreement that each municipality will sign with the SGJ and SEFIN will include a commitment to implement the MEMP and collaborate in the monitoring process.

2. Component 2: Municipal strengthening

- 4.22 The SGJ will be responsible for coordinating this component. The SGJ will provide standard terms of reference to the municipalities and support them with procurement, and may assume responsibility for the awarding of contracts and/or calls for tenders on behalf of groups of municipalities. The SGJ will allocate resources in accordance with standards to be included in the Operating Regulations. The APC will be responsible for the disbursement of payments to consultants.
- 4.23 The SGJ, in coordination with SEFIN, will use its international cooperation coordinating mechanisms, whenever possible, to promote supplementary program financing for institutional strengthening, preparation of investment projects, and cofinancing.

3. Component 3: Strengthening of the municipal financial regulatory framework

- 4.24 The SGJ will be responsible for executing this component. The APC will handle all disbursements associated with the activities planned for this component.
- 4.25 The program will finance the engagement of a consultant and up to two assistants to coordinate strengthening the DFM and establish the program work processes. The DFM will engage and supervise this consultant plus the short-term consulting assignments involved in the EDF, the PFM, the municipal accounting standards, and the SIAFM. The DFM will also be responsible for coordinating the purchase of

computer equipment needed to implement the SIAFM and other component activities.

- 4.26 The DFM will negotiate the terms of reference and other aspects of the activities with the TSC and CNBS, and coordinate the signing of agreements between SEFIN, the SGJ, and each of the two institutions to document agreements that have been signed. The APC will coordinate disbursements for activities with the CNBS and the TSC.
- 4.27 To ensure coordination with SEFIN in activities relating to municipal accounting standards and the SIAFM, the DFM will maintain a coordination mechanism during the program. The DFM will also provide information to the donors committee working on municipal development projects.

D. Procurement of goods, works, and consulting services

- 4.28 **Management of funds.** Financing will be transferred to the APC and deposited to an account designated by the APC. Municipal counterpart funds must also be deposited in an account to facilitate project accounting control. Bearing in mind the demand for project financing and with a view to facilitating program execution, it is requested as an exception to Bank policy, that the Board of Executive Directors authorize the establishment of a revolving fund of up to 10% of the Bank financing. The APC will make disbursements directly to contractors or consultants for municipal investment projects and for all technical assistance activities. The conditions for funds management will be part of the agreement to be signed between SEFIN and the APC.
- 4.29 **Procurement of works, goods, and consulting services.** The procurement of works, goods and related services, and consulting services, will be conducted in accordance with Bank policies (documents GN-2349-4 and GN-2350-4), approved in January 2005. SEFIN, the SGJ, and participating municipalities will be responsible for the corresponding procurement processes, in coordination with the APC, under the supervision of the SGJ and SEFIN. In cases of complex procurements or small scale procurement that would be handled more efficiently in a package with other municipal procurement, municipalities will have the option of requesting SGJ management. Works procurements totaling over US\$1.5 million will be carried out by international competitive bidding (ICB). Goods procurements less than or equal to US\$1.5 million and over US\$150,000 will be carried out by national competitive bidding (NCB); and agreements in amounts less than or equal to US\$150,000 will be subject to price shopping. ICB will be used to procure goods and related services in amounts greater than or equal to the equivalent of US\$150,000; if the estimated cost is less than US\$150,000 but over US\$25,000, procurement will be conducted by NCB; if less than or equal to US\$25,000, the procurement will be done by price shopping. Consulting services whose estimated cost is greater than or equal to US\$200,000 will be advertised internationally; if the

value is below US\$200,000, the shortlist may consist entirely of national consultants.

- 4.30 **Financing framework.** As specified in the “Modernization of policies and practices that restrict the use of resources in investment loans” (document GN-2331-5) and in the financing parameters for Honduras published on 13 September 2005, provision has been made for the financing of (i) taxes and fees associated with the procurement of goods and services financed under the program; (ii) the purchase of land directly associated with the investment project (site for a sanitary landfill, for example); and (iii) the recurrent costs of SEFIN or the SGJ directly related to program execution or supervision. Such expenses may not exceed 5% of the program cost. and may be financed provided they are duly justified, are necessary for accomplishing the program objective, and have the Bank’s prior no objection in writing.
- 4.31 The total local counterpart funding of 10% approved for the program will be maintained, with the remainder accounting for approximately 8.5% of future disbursements.
- 4.32 **Retroactive financing.** With the Bank’s concurrence, the proceeds of the financing may be used to reimburse expenses incurred or to finance expenses in connection with the program provided that requirements substantially similar to those herein established have been satisfied. To this end, the reimbursement of expenses chargeable to the financing will be admissible only for those investment projects that are consistent with the terms and conditions of the present reformulation. The total amount of the Bank’s financing may not exceed US\$3 million.
- 4.33 The Bank will perform a prior review of the procurement process for at least the first year of the program, until it has been able to evaluate the institutional procurement capacity of the SGJ, the APC, and the municipalities, and the quality of SEFIN’s supervision. If the institutions’ performance is adequate, the procedure may change to a post review, delegating the verification of some specific steps to be agreed to between the borrower and the Bank. Procurement methods and prior review limits are included in the procurement plan (Annex II).
- 4.34 **Use of recoveries.** Recoveries from the program subloans as well as the financial return on such recoveries will be used to finance additional municipal development projects and for investment, in accordance with investment guidelines included in the program Operating Regulations, in low risk, high-liquidity instruments, with the objective of maintaining their value over time.¹⁹ **The borrower will undertake not to use funds from program subloan repayments until 95% of total PDM funds**

¹⁹ To be able to consolidate the FOMUNDE capitalization based on approval of the reformulation, recoveries will not be used to cover future payments of the Bank loan. The country will assume responsibility for such payments.

has been committed, and until the Bank has agreed on the institutional structure for management of FOMUNDE. After that time, and for at least 5 years, unless a lesser period is agreed to, FOMUNDE funds will be used to finance additional municipal development projects in accordance with regulations similar to the program Operating Regulations on which the borrower must reach agreement with the Bank.

E. Disbursement schedule

- 4.35 The program will be executed over four years, and have a disbursement period of 4.5 years.

Table V-1 Municipal Development Program (Reformulated) Tentative disbursement schedule (US\$000)						
Source	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Local	583	1,166	1,166	583	389	3,887
IDB/FSO	6,305	12,611	12,611	6,305	4,203	42,054
Total	6,888	13,777	13,777	6,888	4,592	45,941
%	15%	30%	30%	15%	10%	100%

F. Program monitoring and evaluation

1. External audit

- 4.36 During program execution, the borrower, with the support of the APC, will submit to the Bank annual APC and program financial statements within 120 days after the close of the corresponding fiscal year, duly audited by a firm of independent public accountants acceptable to the Bank, and engaged in accordance with the the terms of reference for external audits of Bank-financed projects (document AF-400). In selecting and hiring the firm, the procedures in the external audit bidding document (document AF-200) will be used. The audit costs will be part of the program cost and will be financed from the Bank loan.
- 4.37 Participating municipalities that have been audited externally or by the Auditor General's Office in the previous year will make a commitment, in an Agreement with the SGJ and SEFIN, to report their results publicly each year they participate in the program.

2. Supervision, control, and monitoring

- 4.38 In addition to the supervision contracted by the municipality for each work, for projects that exceed US\$1,000,000 (or such lesser amount as may be agreed to by

the parties in the APC agreement), the APC will perform “on-site” inspections every three months during construction to ensure the disbursement and construction schedules are applied as agreed. Participating municipalities will submit to the APC: (i) a preinspection report before each inspection; and (ii) a project completion report within two months before the last disbursement.

3. Evaluation plan

- 4.39 **Semiannual program evaluation.** The Bank’s Country Office will perform the semiannual phase II evaluation in the Bank’s Project Performance Monitoring Report (PPMR), using indicators from the Matrix and Component 3 indicators. Every six months for the first 18 months of the project, and once a year thereafter, the Project Team will organize an administrative mission jointly with the borrower, the APC, and the SGJ to evaluate the performance of a sample of municipalities, the APC, and general program execution based on the Eligibility Matrix, the performance indicators agreed to with the APC, and the logical framework.
- 4.40 **Program evaluation.** The borrower will contract independent firms using program funds to perform two evaluations of the program: a midterm evaluation at the end of the second year, or when 50% of the Bank financing has been disbursed, whichever occurs first, and the other at the end, once 95% of the financing has been disbursed. The evaluation reports will be submitted to the Bank for comments. Evaluations will use the Eligibility Matrix, the APC performance indicators, and the base line, with the objective of measuring program outcomes and impact. The midterm evaluation will have an additional focus, i.e., to analyze the effectiveness and efficiency of the program execution structure. To evaluate the program’s impact on citizens, both evaluations will include a survey of users and beneficiaries of the sectoral activities.
- 4.41 **Program base line.** The DFM will establish the program base line by using the program logical framework, and among other sources, data from the initial EDF, data resulting from applying the Eligibility Matrix in the participating municipalities, and information the municipalities provide in the preliminary and final packages. The base line will include information related to: (i) the financial performance of participating municipalities; (ii) experience in fulfilling the matrix indicators; (iii) data on municipal performance in executing the works and seeking repayment, and on the impact of works on local-level development indicators; and (iv) data to measure impact on the quality and quantity of municipal financial information. The base line will be finalized within nine months after the corresponding contract becomes effective. Component 3 includes funds for the DFM to set the base line and for data analysis, monitoring, and storage system.

V. ENVIRONMENTAL AND SOCIAL FEASIBILITY

- 5.1 Since its inception, the Municipal Development Program has emphasized strengthening municipal capacity for environmental management and addressing the unmet needs of economically disadvantaged populations. In preparing the program in 1998, the Bank required the creation of environmental units and the establishment of municipal environmental management systems and base lines. At the same time, the program provided for the environmental review of projects as one of the responsibilities of the MDTF (currently the APC). Honduras has been implementing legal reforms and systems to endow municipalities with strong leadership in the country's environmental management. Each municipality must establish a Municipal Environmental Unit (MEU). The Ministry of Natural Resources and Environment (SERNA), in addition to establishing the National Environmental Impact Evaluation System (SINEIA) to make environmental reviews more efficient, systematic, and transparent, has been one of the most proactive ministries in defining a decentralization strategy, which now includes a process for MEU certification that allows responsibility to be delegated to municipalities for the environmental review of projects that would otherwise be conducted by SERNA directly.
- 5.2 The operation will avail itself of national environmental review systems, while entrusting the APC with responsibility for ensuring that the projects proposed meet national standards for environmental review and mitigation. The environmental review procedures will form part of the Credit Regulations. Since this is a program with multiple projects that will be presented in accordance with requests from municipalities, there is only an illustrative list of projects by sector and size, and a sample of projects from one region of the country that have been submitted to the Bank as possible candidates in anticipation of a reformulation. Having an MEU established and operating is one criterion of the Program Eligibility Matrix. Municipalities will have to submit an environmental study prepared in accordance with the legal framework and an environmental permit issued by the SINEIA if applicable. The SINEIA review touches upon issues such as capital assets and involuntary resettlement. For the environmental management of works, municipalities will have to present maintenance plans covering the project's environmental management, as applicable. These plans will be subject to monitoring for two years after completion of the work.
- 5.3 The major social issues relating to the PDM are related to the participation of social groups historically excluded when identifying projects, and to equity in the distribution of investment benefits. With the publication of standards for local strategic planning and completion of the national plan preparation process in 2004, the country has plans the SGJ has certified as being in compliance with standards in all municipalities (except the MDC and the MSPS), and international cooperation

has been committed to promote different planning processes in their projects. The standards require that municipalities ensure the involvement of groups historically excluded from the planning processes. The PDM will use the results of these processes and demand that in their financing requests, municipalities certify and demonstrate that the project was prioritized in the strategic planning process. In the case of the MDC and the MSPS, investment plans and their economic and social justifications were extensively reviewed by the Bank when preparing the second phases. Any project submitted by these two municipalities is expected to be included in investment plans that already exist; otherwise it will be analyzed according to criteria already set for each sector. Regarding equity in the distribution of benefits, most projects expected to be financed by the PDM will have general benefits (improved solid waste collection or municipal environmental management, for example). However, for those projects whose impact benefits specific identifiable groups, such as neighborhood improvement projects, the APC will apply the rule of maximum cost per beneficiary, as already established in the program.

VI. JUSTIFICATION AND RISKS

A. Justification for the reformulation

- 6.1 The proposed reformulation will make it possible for Honduras to have a program that responds to the institutional evolution of the country's municipal sector, allowing public investment to address the local public investment requirements of a broader and more diverse group of municipalities, taking into account the lessons learned from the program to date.
- 6.2 The reformulated program contributes to realizing the potential for national economic development in the country, rather than concentrating investment only in the two largest cities. The operation's new focus rewards good management by sizing financing in accordance with borrowing capacity and financial performance. It also allows for several public policy reforms already implemented or under way to be simultaneously applied in the context of municipal finance, such as the updating of accounting standards, strengthening of the Auditor General's Office, and initiatives to strengthen risk management in the banking sector. Lastly, by acknowledging the existing municipal debt problem, the reformulation will allow the country to begin consolidating a policy framework for municipal financing that will reduce the current system's risks to the country's finances and macroeconomic situation.

B. Program risks

- 6.3 Risks related to the present reformulation are primarily associated with slow execution, high transaction costs, and the poor quality of financial information in the short term.
- 6.4 There might be delays in resuming the program due to the redistribution of responsibilities for administering the components and changes of focus in execution. Also, the program will be resumed during a change of administration, which could involve delays until the appointment of the new officials responsible for the operation at the two ministries involved in the program. In the municipalities, there will also be elections and possible changes of government.
- 6.5 It is hoped that these risks may be mitigated without difficulty since each element of the reformulated model of the operation has precedents in Honduras, as well as in the program itself, from the preparation of municipal infrastructure projects and municipal technical assistance, to the hiring of the loan administrator (a trustee). The PDM's experience to date has been carefully analyzed and the reformulation takes into consideration the recommendations received. Proven operating instruments, such as the Credit Regulations and Eligibility Matrix, will continue to apply with minimal changes. The new Component 3, which seeks to reform

policies related to municipal financing, is consistent with other reforms that have been under way for several years, in both public administration and the banking sector, that are expected to continue. In the municipalities, because of the possibility of reelection, there may not necessarily be changes in personnel, and the start of new municipal government administrations is viewed as a propitious time for the operation, since this tends to involve new government plans, and therefore, new investment projects, thereby creating a demand for financing.

- 6.6 Smaller local governments have little experience in using and repaying credit. Given the safeguards that exist in the operation (ultimately, the pledging of transfers as security), there is no default risk, but rather a risk of transaction costs involving both project preparation and financial repayment, particularly if a repayment plan fails. This risk is mitigated by the establishment of financial guarantees, the assignment of technical assistance resources to each municipality, the involvement of the Ministry of the Interior and Justice in the operation, the expected collaboration of other cooperating institutions that have support programs with municipalities, and experience already gained from the implementation of repayment mechanisms. Moreover, the opportunity for municipalities to request more than one loan under the program and the system for disclosure of municipal financial information that the program will establish, create strong incentives for municipalities to maintain good financial performance and a clean repayment record under the program.
- 6.7 The program will support a series of activities whose purpose is to improve the quantity and reliability of municipal financial information. Until these activities have an impact on the data produced by the municipalities, the quality of information is a risk for the program, and may affect the results of certain decisions taken, such as investment project approvals. Actually, this is a risk to any country development program that depends upon municipal information. Although it is a minor activity, the issuance and publication of municipal accounting standards will have a significant impact on reducing this risk. This task is expected to be completed by the end of the first year.

VII. RECOMMENDATION

- 7.1 Based on the information contained in the present document, and given that the proposed reformulation **will contribute to the development of municipalities in Honduras** that meet the eligibility criteria, and to expanding municipal public services, and to creating a better environment in the country for municipal financing, the Management of the Bank recommends that the Board of Executive Directors adopt the proposed resolution attached hereto, authorizing the modifications to the three programs forming part of the Municipal Development program (loans Nos. 1024/SF-HO, 1104/SF-HO, 1592/SF-HO), so that the funds of the PDM can be utilized for the activities described in this document, and that authorization be given to the President of the Bank, or such individuals as he may designate, to sign with the borrower the contracts and such other documents as are necessary to reflect the approved modifications.
- 7.2 In accordance with Bank procedures, the Board of Executive Directors must approve the modifications to resolutions and contracts that have not been delegated to the President of the Bank. Part III, section 2 (j) (vi), of the Regulations of the Board of Executive Directors specifies that the Board must process matters of this kind by short procedure.

**REFORMULATION OF THE MUNICIPAL DEVELOPMENT PROGRAM (LOANS 1024/SF-HO, 1104/ SF-HO, AND 1592/ SF-HO)
TO EXPAND THE NATIONAL COVERAGE AND STRENGTHEN THE REGULATORY FRAMEWORK
FOR MUNICIPAL FINANCING**

LOGICAL FRAMEWORK

Summary	Indicators	Means of Verification	Assumptions
OBJECTIVE: To contribute to the delivery of quality municipal public services in Honduras according to financially and environmentally sustainable principles.	Number of beneficiaries of new or improved municipal public services provided in accordance with best technical and financial practices.	Municipal data on (a) service coverage, and (b) recovery of service costs. Municipal data and service quality surveys	The operating capacity or financial situation of the municipalities does not deteriorate
PURPOSE: Improved and expanded municipal public services, delivered under financially and environmentally sustainable principles, in the participating municipalities.	<p><i>All dates based on the date of first disbursement of the new components.</i></p> <p>Number of new users (cumulative), classified in accordance with socioeconomic criteria, who receive or benefit from services financed by the program, per US\$1,000 of investment in the sector:</p> <ul style="list-style-type: none"> • Solid waste: [x beneficiaries]/US\$1,000 of investment. • Potable water and/or sanitation: [x/beneficiaries]/US\$1,000 of investment/ year 2, year 3, year 4, year 5. • Reduction in environmental pollution and management of natural resources: [x beneficiaries]/US\$1,000 of investment/ year 2, year 3, year 4, year 5. • Road projects: [x beneficiaries]/US\$1,000 of investment/ year 2, year 3, year 4, year 5. • DEL projects: [x beneficiaries]/US\$1,000 of investment/ year 2, year 3, year 4, year 5. 	The Municipal Financial Performance Evaluation system. Eligibility Matrix. Municipal indicators presented with the project package. National municipal reporting system. Municipal financial management systems. Semiannual program report – SGJ (SGJ performance indicators). Program web page.	<p>Municipal authorities of the participating municipalities adopt the program’s objectives and targets, and provide the necessary monitoring.</p> <p>Municipal authorities have the political support and influence to improve the payment culture among the public.</p>

Summary	Indicators	Means of Verification	Assumptions
	<p>Increase in effectiveness (average weighted) of collections in the service sectors financed by the program (cumulative):</p> <ul style="list-style-type: none"> • Solid waste: year 2: 50%; year 3: 65%; year 4: 80%. • Water and/or sanitation: year 2: 70%; year 3: 80%; year 4: 90%. • Property legalization: year 2: 70%; year 3: 80%; year 4: 90%. • Reduction in environmental pollution, and natural resource management: year 2: 45%; year 3: 50%; year 4: 60%. • Road projects: year 2: 30%; year 3: 40%; year 4: 50%. <p>Percentage of participating municipalities whose results from the post monitoring process are “good” or “excellent” in most areas evaluated: year 1: 60%; year 2: 65%; year 3: 70%; year 4: 75%; year 5: 80%.</p>		
COMPONENTS:			
<p>Component 1: Municipal Investments</p> <ul style="list-style-type: none"> • Investment projects approved and disbursed. • Timely recovery of the new portfolio. • Timely recovery of the old portfolio. • FOMUNDE value preserved. • The APC meets its performance indicators. 	<p>1.1 Approval of investment projects: year 1: 5 projects; year 2: 20 projects; year 3: 20 projects; year 4: 25 projects.</p> <p>1.2 Value of projects committed: year 1: US\$4 million; year 2: US\$7 million; year 3: US\$11 million; year 4: US\$5 million.</p> <p>1.3 Management of funds by the APC improves each year in accordance with the following goals:</p> <ul style="list-style-type: none"> • Timely recovery of the new portfolio (% of amount owed): year 2: 85%; year 3: 90%; year 4: 95%. • Recovery of the old portfolio (% of amount owed): year 1: 75%; year 2: 85%; year 3: 90%; year 4: 95%. • Percent of investment projects with guarantees used < 10% each year. • Increase in FOMUNDE value exceeds annual depreciation of the Honduran lempira. • APC performance indicators met: year 1: 80%; year 2: 85%; year 3: 90%; year 4: 95%. 	<p>PPMR.</p> <p>Semiannual program report – APC.</p> <p>Audited financial statements – APC.</p> <p>Program web page.</p> <p>Eligibility matrix.</p> <p>Matrix of APC performance indicators.</p>	<ul style="list-style-type: none"> • Program interest rates are competitive with other financing options. • The municipalities have projects prepared that meet program criteria or are making efforts to prepare them. • There are adequate options for the FOMUNDE investment that will protect its value over time. • The new administrations in San Pedro Sula and Tegucigalpa collaborate in portfolio recovery and have the necessary financial capacity. • Banks or other competent firms are interested in performing the APC role. • SEFIN, with the support of the Advisor, will have the capacity to supervise the APC and coordinate the program.

Summary	Indicators	Means of Verification	Assumptions
Component 2: Municipal strengthening <ul style="list-style-type: none"> Technical assistance for municipal institutional strengthening effectively delivered. Financial recovery plans for implemented investments. Municipal Financial Plans prepared and implemented. 	<p>2.1 Agreement to participate in the program signed within 45 days after project selection in each municipality.</p> <p>2.2 TA for municipal strengthening finalized within one year after project selection.</p> <p>2.3 Participating municipalities with Municipal Financial Plans under way (based on 60 participating municipalities): year 1: 10; year 2: 25; year 3: 40; year 4: 60.</p> <p>2.4 Percentage of participating municipalities that rate as “excellent” or “good” the technical assistance received: year 1: 50%; year 2: 65%; year 3: 70%; year 4: 75%.</p> <p>2.5 Percentage of participating municipalities that rate as “excellent” or “good” at the end of each year the support received from the SGJ the preceding year: >75%.</p>	<p>Semiannual program report – SGJ (SGJ performance indicators). Semiannual program report – APC. Program web page. Memorandum of review of PFMs prepared by the Office of Municipal Strengthening.</p>	<ul style="list-style-type: none"> Municipalities are capable of procuring and supervising technical assistance with minimal support. There is a sufficient supply of quality technical assistance to the municipalities in the program’s technical areas.
Component 3: Strengthening of the municipal financial regulatory framework <ul style="list-style-type: none"> Information and Risk Office established. Financial Performance Evaluation System implemented. MFCP and PFM methodologies designed and applied. Integrated municipal financial administration system designed and transition plan implemented. Institutions strengthened and trained. 	<p>3.1 Reduction in the number of municipalities classified as overindebted by the EDF. Number per year: year 1 (base line–2004): 30 (est.); year 2: 25; year 3: 20; year 4: 20.</p> <p>3.2 Improved EDF in participating municipalities each year compared to the previous year:</p> <p>(i) after the 2nd year of participation: 60% with improved EDF;</p> <p>(ii) after the 3rd year of participation: 70% with improved EDF;</p> <p>(iii) after the 4th year of participation: 75% with improved EDF.</p> <p>3.3 Percentage of municipalities nationwide whose accounting systems meet the national municipal accounting standards at the end of each year after their issuance: year 1: 3%; year 2: 10%; year 3: 25% year 4: 35%.</p> <p>3.4 Knowledge by banks of municipal finance and project quality improved.</p>	<p>EDF system. Semiannual program report – SGJ. Semiannual program report – SEFIN. External and TSC audits. Bank survey. CNBS report.</p>	<ul style="list-style-type: none"> SEFIN and SGJ reach agreement on the Municipal SIAF development strategy. The national SIAF plan advances and provides the inputs needed for designing the national system. Municipalities are willing to implement the new standards. Overindebted municipalities are willing to collaborate in developing and implementing a financial cleanup plan. The CNBS has authority to call on the banks to effectively provide training. Commercial experts and auditors are interested in becoming certified as municipal auditors.

Summary	Indicators		Means of Verification	Assumptions
ACTIVITIES:				
Component 1: Municipal financing	Cost: US\$27,404,000 Construction of 60 municipal works (est) <i>Cost range</i> > US\$6,000,000 US\$2,500,000 – 5,000,000 US\$1,000,000 – 2,500,000 US\$500,000 – 1,000,000 US\$250,000 – 500,000 US\$150,000 – 250,000 US\$100,000 – 150,000 US\$50,000 – 100,000	<i>Number of projects</i> 1 1 3 4 11 12 14 <u>14</u> 60	PPMR. Semiannual program report – APC. Program web page.	
	<i>Estimated breakdown by sector</i> Administration Water and sanitation Neighborhoods Economic development Solid waste Environment Roads	<i>Number of projects</i> 3 5 8 6 12 11 <u>15</u> 60		
Component 2: Municipal institutional strengthening	Cost: US\$4,650,000 Technical assistance contracts – for 60 projects.		Semiannual program report – SGJ. Semiannual program report – APC. Program web page.	
Component 3: Strengthening of the municipal financial regulatory framework	Cost: US\$5,600,000		Semiannual program report – SGJ. Semiannual program report – SEFIN. EDF system. External and TSC audits.	

Summary	Indicators	Means of Verification	Assumptions
	1. Improvement in municipal financial management evaluation Financial performance evaluation <ul style="list-style-type: none"> (a) Prepare and publish transitional methodology and EDF based on transitional methodology: 6 months. (b) Design definitive EDF methodology: year 1. (c) Audit to certify application of the methodology (2004, 2005, and 2006): year 1, year 2, year 3. (d) Publication of results and regional forums: year 2, year 3. 		
	Municipal financial plan <ul style="list-style-type: none"> (a) Design of a municipal financial plan methodology: year 1. (b) Test of the PFM in five municipalities: year 2. 		
	2. Regulation and control of use of credit by municipalities National Banking and Insurance Commission: <ul style="list-style-type: none"> (a) Bank training program on municipal finances: year 1, year 2, year 3. 		
	Structuring the Information and Credit Reporting Center <ul style="list-style-type: none"> (a) Design and assembly of system: Risk reporting center (b)) Hiring of technical staff for 3 years (i) programmer, (ii) specialist in municipal finances, and (iii) data entry operators (c) Purchase of equipment for intercommunication with CNBS risk center: year 1. 		
	Auditor General's Office <ul style="list-style-type: none"> (a) Training for auditors of the Auditor General's Office in municipal auditing, software use, and external experiences: year 1; year 2; year 3 (b) Training for auditors hired and expansion of procurement plan: year 1; year 2 (c) Updating of reporting manuals: year 1. (d) Update/preparation of manuals of internal control and financial administration: year 1, year 2 (e) Publication and distribution of manuals (hard copy and internet): year 2, year 3 		

Summary	Indicators	Means of Verification	Assumptions
	(f) Social audit pilot plan: year 2, year 3 (g) Modernization of software systems: year 1		
	Municipal Strengthening Office (SGJ) (a) Institutional study and reform plan (i) Preparation: year 1 (ii) Implementation of reforms: years 2 and 3 (b) Accreditation of consultants offering municipal training (i) Design of system and consulting work: year 1 (ii) Implementation of phase I: year 2, year 3		
	3. Municipal financial reporting systems Accounting training (a) Design, publication, and implementation of municipal accounting standards (i) Consulting assignment and consultation: year 1. (ii) Implementation and training: year 1, year 2, year 3.		
	Financial Administration Systems (a) Implementation of the municipal SIAF <ul style="list-style-type: none"> • Conceptual design: year 2. • Implementation of the transition plan: year 2 and year 3. • Development of the definitive system: year 2 and year 3. • Testing of the system on a sampling of municipalities: year 3. (b) Purchase of Municipal SIAF hardware and software for SGJ (year 1). (c) Purchase of Municipal SIAF hardware and software for municipalities (year 2 and year 3).		

Summary	Indicators	Means of Verification	Assumptions
Program administration: (a) Strengthened DFM (b) SEFIN advisor engaged and performing duties. (c) APC contracted on a timely basis. (d) Operating Regulations approved and implemented. (e) Interinstitutional coordination maintained.	Cost: US\$1,812,000 <i>Dates after the signing of the reformulation agreement:</i>	Semiannual reports from SEFIN.	
	SEFIN (a) Contracting of the Legal/Administrative Advisor by SEFIN < 2 months. (b) Contracting of the Assistant to the Advisor (during the 1st year) by SEFIN < 3 months. (c) Contracting of the ATP: < 9 months after program eligibility. (d) Commissioning the design of program baseline (e) Contracting of the midterm and final evaluations. (f) Regular meetings of coordinating group		
	Municipal Strengthening Office (SGJ) (a) Contracting of the ATP and Assistant in DFM/SGJ < 6 months.		
	Procurement SECI of SEFIN and Ministry of Interior (year 2)		
	Audits Commissioning audits of the program (every year)		

CONTRACTUAL AMENDMENTS
(LOANS 1024/SF-HO, 1104/SF-HO, AND 1592/SF-HO)

A. Loan 1024/SF-HO:

Considering that the proceeds of this loan have already been disbursed to finance activities still being implemented by the borrower, it is necessary to ratify the following contractual clauses, to reflect the changes proposed in this document:

- (i) The “Municipal Development Trust Fund” or “MDTF” will be reAPCced by the “Private Loan Administrator,” or “APC.”
- (ii) In the case of subloans already awarded, the special accounts the municipalities will establish to guarantee repayment of the subloans, and which the APC will be entitled to take as security in the case of failure to pay, will be used to capture the primary source of repayment of the subloan or to guarantee the expected repayment by another municipal source. In the case of type I subloans, in which the account accumulates revenue from specific projects, the account might be established at the sectoral level (or using a similar method related to specific project type) rather than the project level, which is permitted in the case of type II subloans where revenue originates from the sector corresponding to the subloan. For type III loans (repaid from the municipio’s general obligation revenue), the account will be used for ordinary transactions by the municipality, in which there is sufficient semiannual cash flow as for the account to be used to guarantee subloans without their own or sectoral source of repayment.
- (iii) The new eligibility matrix will be applied to the MSPS and MDC and be used to evaluate their performance during the program.
- (iv) Debt Service Reserve Account (DSRA). This account will be a permanent reserve in the APC equivalent to 30% of the semiannual payment owed by the MSPS and MDC to the APC. The program’s guarantees might be applied to capitalize this account in case of insufficient funds. As soon as the municipalities make the last debt service payment to the APC, the reserve will be returned to the municipalities. The reserve balance will be invested in low-risk, high-liquidity market instruments, with a view to maintaining their value over time.

B. Loans 1104/SF-HO and 1592/SF-HO:

On the basis of the modifications noted in the present proposed reformulation, the pertinent contractual conditions of each loan contract will be modified to reflect the changes proposed in the present document, except for the financial conditions for each operation, whose terms and conditions will remain the same as approved by the Board of Executive Directors of the Bank.

Lastly, with a view to standardizing the names of the three programs originally approved by the Board of Executive Directors of the Bank, the name of each operation will be reAPCced with the following title “Municipal Development Program”.

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-___/05

Honduras. Loans 1024/SF-HO, 1104/SF-HO, and 1592/SF-HO. Authorization to reformulate the following programs: San Pedro Sula and Tegucigalpa Municipal Development Program; San Pedro Sula Municipal Development Program -Phase II-; and Municipal Development Program for the Central District -Phase II-

The Board of Executive Directors

RESOLVES:

To authorize the amendments contained in document PR-_____ with regard to a reformulation proposal for the following programs: “San Pedro Sula and Tegucigalpa Municipal Development Program”; “San Pedro Sula Municipal Development Program -Phase II-”; and “Municipal Development Program for the Central District -Phase II-”, approved by Resolutions DE-161/98, DE-51/02, and DE96/04, respectively.

LEGIII/HO-627510-05
1025/SF-HO; 1104/SF-HO; 1592/SF-HO