SECOND MUNICIPAL DEVELOPMENT PROGRAM

(CO-0138)

EXECUTIVE SUMMARY

BORROWER:	Financiera de Desarrollo Territorial (FINDETER)	
GUARANTOR:	Republic of Colombia	
EXECUTING AGENCY:	Financiera de Desarrollo Territorial (FINDETER)	
AMOUNT AND SOURCE:	IDB:	US$ 60 million (OC)
	IBRD:	US$ 60 million
	Local counterpart funding:	US$ 80 million
	Total:	US$200 million
FINANCIAL TERMS AND CONDITIONS:	Amortization period:	20 years
	Disbursement period:	5 years
	Commitment period:	4½ years
	Interest rate:	variable
	Inspection and supervision:	1% of the loan amount
	Credit fee:	0.75% per year on undisbursed amounts
	Currency:	United States dollar from the Single Currency Facility

OBJECTIVES: The primary goal of the proposed project is to contribute to the consolidation and expansion of the municipal credit market by enhancing FINDETER's capacity to finance municipal infrastructure. More specifically, the Second Municipal Development Program (SMDP) will: (a) help FINDETER become an efficient second-tier financial institution; (b) promote the financing of high quality and sustainable infrastructure investments; and (c) create and develop a demand-driven technical assistance facility within FINDETER, separate from its banking functions.

DESCRIPTION: The project consists of three components:

a. Infrastructure investments (US$163 million): This component includes investments in eligible municipal subprojects. Through the rediscounting of financial intermediary loans to local governments and public service providers, whether public or private, FINDETER will support investments to rehabilitate, improve or expand urban

infrastructure and local services in sectors under local government responsibility including water and sewerage, urban and nonurban roads and traffic management, environmental protection (including drainage and flood control), solid waste management, slum improvement, bus terminals and river wharves, market places, parks and recreational facilities, slaughterhouses, local telephone networks, and educational and health facilities.

b. Municipal institutional strengthening (US$20 million): This component includes the financing of municipal capacity building activities in the areas of municipal management and provision of municipal services. Through this component, the project will support technical assistance for improving the overall management of municipal governments, especially in: (i) financial management; (ii) planning, programming, budgeting, and execution of investment programs, including their environmental aspects, and (iii) improving the management capacity of entities responsible for household service provision, especially in the water and sanitation sector, where they have to comply with Law 142. This law requires the entities to become financially autonomous and self-financing, and to operate on a business-like basis. This component would also support the purchase of equipment in connection with institutional programs for improving the management capacity of local governments or entities responsible for service provision.

c. FINDETER's institutional strengthening (US$5 million): This component will support several activities to hone the capacity of FINDETER to perform its role as a second-tier financial institution and promote municipal development in support of its strategic plan. It will finance consulting services to facilitate: (i) the diversification of financial products and funding; (ii) improvement of risk management capacity; (iii) development and implementation of a cost accounting system; (iv) improvement of quality and sustainability of subprojects, and (v) enhancement of its capacity to promote municipal development.

THE BANK'S COUNTRY AND SECTOR STRATEGY: The proposed program fits well within the Bank's strategy for Colombia, which has at its center the consolidation of the decentralization process through

the strengthening of subnational entities. The operation complements other Bank-supported initiatives that seek to strengthen regional, departmental and municipal capacity in the health, education and transport sectors. It complements, in particular, the Program for Strengthening Subnational Entities (CO-0155), which has as its main objective to strengthen subnational tax systems and support selected entities to restructure their finances.

ENVIRONMENTAL AND SOCIAL IMPACT:

The Environmental Management Committee, at its meeting of August 6, 1996, classified this as a Category III operation. The Environmental and Social Impact Report (ESIR) was prepared and was considered by the Technical Review Group of the Committee on Environmental and Social Impact (CESI) at a meeting on August 15, 1997. The project team has incorporated into the loan's operating regulations and contractual obligations the recommendations of the ESIR. The executing agency prepared and, on June 24, 1997, disclosed to the public an environmental report containing the proposed environmental management plan for the program.

BENEFITS:

The program will improve infrastructure and municipal services in a number of cities and towns. It will also enhance the productivity of urban centers which generate the great bulk of national GDP — through improving the efficiency of their physical plant, resulting in increased land values in beneficiary areas. The implementation of solid waste system, marketplace, and slaughterhouse investments, including sanitary precautions and sound waste disposal schemes, would help reduce the negative health and environmental impacts which result from the haphazard food processing and waste management arrangements now prevalent in many cities. Traffic management subprojects would yield savings of vehicle operating costs and help reduce congestion-related air contamination from vehicle exhausts. In addition to its impact on vehicle operating costs or land value, the paving and repair of urban streets would help reduce the production of dust particulates by vehicular traffic on unpaved or broken road surfaces, with beneficial effects on air quality and health.

Subproject eligibility criteria would include a minimum economic rate of return of 12 percent where applicable and cost efficiency criteria in other cases. Indirect benefits would accrue from the revision of FINDETER's subproject review and evaluation criteria, resulting in: (a) the execution of more cost-effective projects; (b) greater community

participation in municipal decision-making and design of projects; (c) the improvements of maintenance capacity; (d) the application of more transparent service pricing, and (e) improved institutional arrangements and human resource development.

Another category of benefits will result from the more focused and efficient leadership of FINDETER in the municipal market envisaged by the program, which will be achieved by the diversification of its financial products and funding base, longer term maturities for certain municipal investment projects, and the development of a municipal information bank and demand-driven advisory services. These changes will result in a deepening of the municipal credit market and will also yield a range of spin-off benefits to municipalities through better access to information and technical assistance that will ultimately translate into better quality of infrastructure projects and services. Another key long-term benefit will be the further development of a municipal bond market which will benefit from the planned operational reforms of FINDETER as well as from a healthier municipal credit market. Both these achievements will promote sustainable financial and investment operations by local government.

FINDETER's conversion into a financial innovator will result in better loan products for local governments, as the organization connects them with national and international sources of funding. The development of a municipal information bank and demand-driven advisory services will help improve the quality of infrastructure projects of local government, and increase the participation of the private sector in their provision. The development of FINDETER's second tier functions – such as the creation of lending manuals and dissemination of these manuals to participating intermediary financial institutions (IFIs) – will help IFIs to become better lenders for urban services and to local governments. Finally, the program's technical assistance to FINDETER will prepare the organization to manage the risks of banking and lay the foundation for greater independence of the organization from government, leading perhaps to privatization in the medium term.

RISKS: A change of leadership within FINDETER could threaten the implementation of the changes agreed upon with the current management. However, the continued commitment and oversight of the central government regarding support of reforms within FINDETER in the event of a change in leadership would serve to

mitigate this risk. At the subproject level, there is the possibility that the subnational entities fail to operate and maintain properly the new or rehabilitated public works. This risk will be addressed by the program's financing of technical assistance for the subnational entities, by the implementation of Law 142's mandate to create service companies that operate on a business basis; and by the expected increased role for the private sector in water supply, waste management and other sectors, which will improve efficiency in the medium and long term.

A different risk to the operation is posed by the Banco de la Republica's Resolution 5, in effect since June 1997, which requires a 30 percent deposit on disbursements of loans contracted in foreign exchange and therefore applicable to the multilateral banks' resources. The deposit, to be held for 18 months, would have increased the cost of the Bank's funding for the FINDETER subborrower. To reduce the effect of the resolution on demand for subloans, however, FINDETER has decided to absorb itself the cost of the retention. To reduce the effect of the resolution on demand for subloans, however, FINDETER has decided to absorb itself the cost of the retention. Recent analysis of the impact of this decision on FINDETER indicates that the net effect of the reserve requirement on its lending capability for the five years of the program, should it be maintained throughout the period, would be of 13.6 percent. Although the requirement will imply added financial costs for FINDETER, projected profits for the next five years would allow the institution to adjust easily to this rise in costs.

Concerning FINDETER's proposed role in intermediation, adverse moves by rating agencies or downgrading of Colombia's investment grade rating could reduce the attractiveness of FINDETER international issues. However, the rating agencies generally appear to be moving in the opposite direction – greater acceptance of subsovereign debt – while Colombia's standing appears solid. Similarly, new internal regulation could contract the market for local government credit and access to funding sources for this market. However, most experts and the authorities believe that the new local government indebtedness law has removed the need for harsher regulation. A decrease in central transfers to local governments or a substantial fall in household real incomes could also adversely affect the feasibility of market-rate municipal credit. However, GOC

remains strongly committed to decentralization, and is taking measures to stabilize the national economy.

SPECIAL CONTRACTUAL CONDITIONS:

Conditions precedent to first disbursement:

a. Establishment of a special foreign-exchange account (see paragraph 3.1).

b. Presentation of a model of the rediscounting agreement (see paragraph 3.6).

c. Approval of final text of the project's credit regulations (see paragraph 3.7).

d. Presentation of model legal documents to be used for onlending (see paragraph 3.10).

Conditions during the execution of the program:

a. Amendment of the credit regulations (see paragraph 3.7).

b. Subproject size limits (see paragraph 3.8).

c. Recognition of expenditures (see paragraph 3.22).

d. Celebration of annual and midterm reviews of the program (see paragraphs 3.24 and 3.25).

e. Tariffs (see paragraph 3.27).

f. Maintenance (see paragraph 3.30).

POVERTY TARGETING AND SOCIAL SECTOR CLASSIFICATION:

This is not a poverty-targeted operation.

EXCEPTIONS TO BANK POLICY:

None.

PROCUREMENT:

The contract will require that international public bidding be mandatory for acquisitions of goods and related services that exceed US$350,000 and US$5 million for civil works.

I. FRAME OF REFERENCE

A. Decentralization and the role of municipalities

1.1 Due to rapid urbanization, there is a growing demand for public services in Colombian cities. The coverage of municipal services varies considerably with city and region, but smaller cities and towns, as well as low-income areas in larger cities, still lack the most basic infrastructure. Over 40 percent of urban streets nationwide are unpaved. Street maintenance is neglected and traffic management remains nonexistent even in the larger cities. And at least 30 percent of solid waste in most cities remains uncollected.

1.2 As part of an ambitious decentralization effort carried out during the last decade, Colombia has redefined the responsibilities of the central, state and municipal governments and it is now the municipalities which have been charged with the delivery of a broad range of basic public services. To enable local government to carry out its new responsibilities, the central government has expanded its revenue-sharing mechanisms through a number of measures and legal changes, 1/ and especially through the Constitution of 1991. These changes have had dramatic impact on municipal revenue and expenditures, as is shown in the table below:

Table I-1
MUNICIPAL REVENUES AND EXPENDITURES
(percent of GDP)

	1988	1994	AVERAGE ANNUAL CHANGE
Own-source revenue	1.13	2.05	13.6
Current expenditures	1.25	2.18	12.4
Own-source deficit	(0.12)	(0.13)	1.6
Investment	0.70	1.80	26.1
Total deficit	(0.82)	(1.93)	26.1
Financing	0.88	2.03	21.9
- Transfers	0.76	1.49	16.0
- Debt	0.12	0.54	59.5

Source: IBRD, 1996, page 36 of Annex I.

1.3 Transfers have led a striking increase in municipal revenues. They roughly doubled from 1988 to 1994, from 0.76 percent to 1.49 percent of GDP. The rapid increase in transfers has had little or no negative impact on local fiscal effort; rather, municipalities have maintained or increased their fiscal revenues.

1/ See discussion of these changes in Descentralización en Colombia: Nuevos Desafíos, IDB, May 1997; and Colombia: Making Decentralization Work, IBRD, 1995.

Own-source municipal revenues have increased almost as fast as transfers – from 1.13 percent to 2.05 percent of GDP.

1.4 There are approximately 1,060 municipalities in Colombia, of varied size and capabilities. The larger and fiscally strong municipalities have moved quickly to take up new responsibilities and utilize their new resources efficiently, while smaller municipalities are responding more slowly, hampered by weak managerial, technical and financial capacity. The Government of Colombia (GOC) has sought to make financing and technical assistance available to local government, to enhance its ability to take on its expanded roles. The first such effort was made in the seventies, primarily through the Trust Fund for Urban Development (FFDU), part of the national mortgage bank. With the acceleration of the decentralization process, however, the GOC dissolved the FFDU and, in 1990, created an autonomous financial institution charged with financing investments in infrastructure and strengthening the institutional capacity of subnational entities: the Financiera de Desarrollo Territorial (FINDETER).

B. The Financiera de Desarrollo Territorial (FINDETER)

1.5 FINDETER is a financial institution supervised by the Banking Superintendency (Superbancaria) that performs three broad functions: lending to urban service providers; offering technical assistance to these entities in acquiring FINDETER finance; and – as an activity separate from its lending functions – managing three of Colombia's four cofinancing programs.

1.6 FINDETER does not lend to service providers directly, but rather operates as a second-tier bank by channeling its loans through intermediary financial institutions (IFIs), mainly commercial banks. The transfers from central government to local governments, or revenue from service tariffs or fees, serve as the main collateral for these loans. After appraising a project proposal, FINDETER approves it and then authorizes an IFI to lend to the requesting local entity. FINDETER then rediscounts 85 percent of the total loan amount from the IFI, while the IFI retains 15 percent of the loan in its own portfolio. FINDETER lends to IFIs at 2.5 percent over an index of bank deposit rates (DTF), and sets a maximum rate (DTF + 5 percent) at which IFIs can onlend to local governments. IFIs keep 100 percent of the credit risk on the entire loan. FINDETER also provides technical assistance to municipalities, primarily for project preparation support. Since its creation, FINDETER has made roughly US$1 billion in loans to over 700 municipalities and has pioneered urban service lending in Colombia.

1.7 **Banks' support of FINDETER**. In 1990 and 1992, respectively, the IBRD and the IDB approved loans to finance a municipal development program being carried out by FINDETER. The IBRD's loan was for US$60 million, while the IDB's was for US$45 million. Both loans

are fully committed and are expected to be totally disbursed by year's end. During the first stage of the Municipal Development Program (MDP), FINDETER executed a total of 118 subprojects, for the equivalent of over US$175 million, primarily in transportation, local telecommunications, markets and recreational facilities. A table detailing the use of the investment resources from the IDB and the IBRD programs is presented in Annex I-1 of this document. In addition to cofinancing resources for investments, the IDB financed a US$5 million loan (887/SF-CO) for institutional strengthening of FINDETER and technical assistance for municipalities. Resources from this loan, which are fully committed and almost completely disbursed, were used to strengthen FINDETER's regional offices and improve its subproject cycle, as well as to assist municipal governments in the identification and design of subprojects to be financed through the MDP.

1.8 Although the MDP has represented only a small subset of FINDETER's operations since it was created in 1990, 2/ the GOC considers that the Bank and the IBRD's involvement has been instrumental in helping the institution improve infrastructure project quality, incorporate lessons learned into its credit policies and regulations, and assist the smaller municipalities in developing infrastructure investments. As a result, in 1995, the GOC, reiterating and emphasizing FINDETER's central role in financing urban service infrastructure, authorized the institution to seek new financing from the multilateral Banks. Lessons from independent evaluations of both projects, which can be found in the technical files, have guided the proposed program's objectives and design (see discussion of lessons learned in chapter III).

1.9 In the 1991-94 period, FINDETER played a central role in the municipal credit market, offering a financial product with substantially longer term and somewhat lower interest rates than regular IFI loans 3/ to local government. More recently, however, it has lost market share relative to commercial banks. 4/ One reason is that IFIs can underwrite loans rapidly based on a review of the local government's borrowing capacity, while FINDETER's loan analysis process takes 6 to 12 months. Another reason is the ceiling on the IFI's lending rate. A third can be found in the changes that have taken place in the financial sector and in the regulatory context that affect municipal credit, with which FINDETER has not kept pace.

2/ FINDETER has financed over 1,100 subloans totalling over US$1 billion in about 60 percent of Colombia's municipalities.

3/ That is, loans not rediscounted via FINDETER.

4/ In 1991, FINDETER loans constituted 34 percent of the municipal credit market, while in 1995 its loans constituted 18 percent of that market.

C. Macroeconomic and financial sector overview

1.10 In recent years, the Colombian economy has been confronting increasingly difficult challenges. The sharp deterioration of Central Government finances in the context of a persistent real appreciation of the Colombian peso, continued inflationary pressures, and sluggish economic performance, together with higher unemployment, led the Government and the Central Bank to adopt, in early 1997, a series of restrictive fiscal and monetary measures designed to revert these trends and restore macroeconomic equilibrium. These measures have resulted in substantially higher real domestic interest rates, the implementation of mechanisms to discourage external borrowing, stricter limits on overall public indebtedness, and severe budget cuts, primarily affecting the public sector investment program.

1.11 Within this difficult overall context, three interconnected trends have particular importance for FINDETER. **First**, competition has greatly increased in the financial services industry; Government deregulation has removed many of the differences among the five types of IFIs (banks, financial corporations, leasing companies, finance companies, and savings and loans), and has allowed IFIs to enter new lines of financial business. Increasingly, all are competing for the others' formerly protected markets. Removal of regulatory barriers and national ownership requirements has permitted the entry of foreign banks. Also, both IFIs and Colombian companies are increasingly raising funds on international markets, an alternative that creates competition between the local and international markets. Most of the formerly public banks have become private, and are competing more aggressively. This much greater competition has resulted in compressed lending margins. **Second**, the capital markets have grown in importance and are expected to continue expanding, albeit gradually, offering new sources of longer-term liabilities. In particular, the privatization of the social security system is channeling large amounts of resources to private pension fund administrators. **Third**, new Government regulation requires IFIs to develop a much greater sophistication in managing exchange rate, term, interest rate, and liquidity risks. Colombian IFIs are currently struggling to create systems to manage these risks, many for the first time. In sum, these changes have created a much more competitive environment, which offers FINDETER both risks and opportunities, which are further explored below.

D. The changing regulatory environment of municipal financial markets

1.12 **The credit market**. Because of the fast growth of subnational indebtedness during the 1990s, and the central government's concerns for the fiscal impact of such a rise, a series of regulations were adopted to limit expansion of the credit market. On the demand side, the GOC limited local governments' borrowings

to the level where debt service reached 30 percent of gross income. 5/ On the supply side, it increased the required debt-service coverage ratios of IFIs on loans to municipalities from 120 percent, then to 130 percent, and finally to 150 percent; and set the conversion factor for weighting the risk of loans to local government at 150 percent, in contrast to most corporate loans weighted at 100 percent.

1.13 These regulations reduced the attractiveness to IFIs of that institution's single loan product, which has remained unchanged since 1990. In particular, the limits to onlending rates and the greater capital requirements substantially cut the profitability of FINDETER loans for IFIs that are already highly leveraged. One indication is that a portion of subprojects approved by FINDETER are not being financed because of lack of IFI interest in brokering the credit.

1.14 FINDETER loans have also become less competitive to local government entities. A few IFIs now offer large local governments interest rates below those of FINDETER (in part, because some IFIs at the moment have access to resources that are cheaper than those available through FINDETER rediscounts), although FINDETER continues to offer much longer terms. Facing pressures to produce infrastructure during their three-year terms, many mayors choose IFIs' quick processing and disbursement over the narrowing interest rate and term advantage of FINDETER loans.

1.15 In sum, FINDETER loans have become less attractive to its two main clients, the IFIs and local governments, because it has not responded effectively to the changes in its regulatory and market environment. The institution has recently succeeded in reducing the length and complexity of its loan application process somewhat; however, it has made no other changes in its products. Moreover, as its market share has stagnated, the organization has come to view IFIs as unfair competition, rather than as partners in local government lending.

1.16 **The bond market**. The development of capital markets and institutions and the lifting of Colombia's prohibition in 1991 on local government bonds, has resulted in an emerging market for municipal paper in Colombia, one of the first in Latin America. However, bonds still account for a modest share of local government credit (5 percent to 18 percent between 1991 and 1997). The largest municipalities dominate this market, although some intermediate ones have also issued bonds. Thus far, most emissions have been made in the national market to refinance existing municipal debt,

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5/ Until the enactment in December 1996 of Law 358, which allows municipalities to borrow until debt service reaches 40 percent of savings.

but a few large municipalities have plans to issue debt on international markets.

1.17 Bond issues on local and international markets represent an important opportunity for FINDETER. The organization's strong equity position (see discussion in chapter III) — 48 percent of its funding — and the low credit risk of its assets, which consist overwhelmingly of commercial bank debt, would make a properly structured issue highly attractive on Colombia's capital markets, and help this market develop. An international issue by FINDETER could have favorable characteristics that would promote both Colombia's track record to investors and local government lending. 6/ However, FINDETER has lacked the financial staff and a liabilities strategy necessary to pursue this opportunity wisely. Here, too, the organization has yet to adapt to changing markets and regulations.

1.18 **Private sector participation in urban services**. The Constitution of 1991 gave municipalities responsibility for managing urban services. Law 142 of 1994 has made this mandate operational. The law: (a) requires that service companies adopt business accounting and management practices, including self-financing of capital investments; (b) sets deadlines for conversion of urban service providers into public-, mixed-, or private-sector enterprises, and (c) establishes commissions to regulate each service.

1.19 FINDETER, however, is not yet prepared to assist local governments in complying with this key law. The organization has lent overwhelmingly to the central administration of municipalities, and relatively little even to public-sector urban service companies. It has made virtually no loans to private urban service providers. GOC strategy calls for FINDETER to galvanize private-sector participation in urban services through both technical assistance and finance. However, the organization currently largely lacks the staff capacity and mechanisms to provide such services.

E. FINDETER's potential in the new environment

1.20 The dynamism of the credit and capital markets and the changes in the regulatory environment have outpaced FINDETER's response capacity to date. And yet these same changes provide the institution with an important opportunity to develop new roles and products, in order to become a more efficient instrument of municipal finance and development. To do so, it must capitalize on its strengths, and overcome some weaknesses.

6/ A two-day workshop organized by the Bank that joined FINDETER with the international investment community conducted as part of project preparation, resulted in the organization requesting and receiving bids from three investment banking firms for structuring an issue on international markets.

1.21 **Strengths**. FINDETER has an established history with its municipal clients. Its US$1 billion in loans have financed critical physical investments that include water and sewerage systems (35 percent of loans in 1995), urban roads (29 percent), schools (17 percent), and parks and markets (19 percent). The organization has virtually no late payments and no defaults on its portfolio. The terms of FINDETER loans still compare favorably with most available elsewhere, either through the other loans of commercial banks or through the emerging municipal bond market. Although the interest rate differential between FINDETER and other IFIs has narrowed, the length of FINDETER loans (8 to 12 years) continues to be much longer than that of IFIs (typically, three to five years), providing a better match for the economic life of the infrastructure financed. 7/

1.22 In addition, FINDETER has achieved a strong financial position. Equity now accounts for 48 percent of its funding, compared with Superbancaria norms that require a minimum of 9 percent for financial institutions. Thus, FINDETER has ample room to leverage its equity with more loans, and to innovate carefully both in making loans (assets) and raising funds (liabilities).

1.23 FINDETER also has strong public sector support. The GOC has repaid the debt service on much of the Banks' project lending for FINDETER, in order to contribute to the capitalization of the organization. Because of its track record and knowledge of local government, the GOC has looked to FINDETER to administer an increasing portion of its infrastructure grant programs (cofinancing) to municipalities. It has also given FINDETER a prominent role in its social sector strategy, and is counting on FINDETER to help galvanize private-sector participation in urban services.

1.24 **Weaknesses**. Despite these strengths, however, studies conducted as part of project preparation have identified weaknesses, which can be categorized in three broad areas: (a) FINDETER's operation as a second-tier bank; (b) the quality and sustainability of sub-projects, and (c) technical assistance delivery.

1.25 **Operation as a second-tier bank**. Although, FINDETER is a second-tier financial institution, it has only recently begun to meet three critical challenges that lie at the heart of this function. First, it needs to further its capacity to meet the needs of its two key clients, commercial banks and local service providers. Its single loan product has remained unchanged for the six years since the organization's founding, even though the regulation and markets affecting urban service provision have changed drastically.

7/ However, the effectiveness of its current long-term financing is hampered by the lack of any debt-indexation mechanism in the context of a relatively high (but stable) inflation economy.

Second, the organization has only begun to manage many of the risks of banking, including term risk, liquidity risk, and – most important of all – exchange rate risk. Yet the organization does not have systems to manage these risks. Overall, FINDETER must hone its capacity as a second-tier bank, through financial innovation in its assets and liabilities, and by managing risks much better.

1.26 In addition, strengthening the banking function requires separating its grant management from lending. The sheer volume of the cofinancing resources managed by FINDETER through its grant funds – for urban development, for roads, and, most recently, for social investment – has increased greatly in the past three years. And central government increasingly designates these grants for use by specific local governments on pre-defined projects before they reach FINDETER, thus increasing the potential for politicizing their use.

1.27 **Quality and sustainability of subprojects**. FINDETER has tried to carry out many of the tasks of the subproject cycle with its own staff. This and other problems (detailed in chapter III) have led the institution to perform unevenly in managing its subproject cycle and therefore in ensuring the quality and sustainability of subprojects. Appraisal methods that had been developed for the first Municipal Development Program (MDP) financed by both Banks were, in some cases, used incompletely, with the result that many subprojects, especially in the water sector, suffered from technical, financial and institutional shortcomings.

1.28 **Technical assistance and institutional strengthening**. Apart from preinvestment assistance linked to subproject preparation, FINDETER has done little to facilitate technical assistance and institutional strengthening more broadly to its municipal clients. Yet, the organization spends large sums of money in its technical assistance function, which has primarily focused on preinvestment support. FINDETER estimates that its total operational costs have increased from 2 percent to 4 percent of its loan portfolio from 1993 to the present. This burden blunts the organization's competitive edge as a second-tier bank. Nevertheless, Colombia lacks and badly needs an organization that coordinates technical assistance to help local governments modernize and meet the great changes required by new urban service regulation, such as Law 142.

F. Program strategy

1.29 The proposed program will assist FINDETER to reestablish itself to lead and positively influence infrastructure lending and municipal development. Together with the financing of local government urban service investments, the program will focus on promoting and supporting changes in the three areas that lie at the core of the organization's mission: (a) perfecting its operation as a second-tier bank; (b) ensuring the quality and sustainability of sub-

projects, and (c) improving technical assistance to local governments.

1.30 **Operation as a second-tier bank.** The program will assist FINDETER in improving its second-tier banking capacity. On the asset side, it will help the organization to serve better its two key clients: IFIs and local governments. This will require that FINDETER develop the capacity to innovate in its financial products. Among the innovations to its asset products identified during preparation are: (a) capitalizing a portion of the nominal interest rate of its loans in order to make real payments more evenly distributed over the life of the loan; 8/ (b) freeing the interest rate that FINDETER allows IFIs to charge to some or all categories of local government borrowers; (c) reducing FINDETER's margin — with a corresponding reduction in the organization's costs — to become more competitive; (d) automatic rediscounting for selected local governments and IFIs; (e) loans denominated in U.S. dollars, and (f) selective use of guarantees for projects with private-sector participation. Interviews with IFIs and local governments during project preparation show that such products are likely to appeal strongly to those organizations.

1.31 On the liability side, the program will support FINDETER to diversify its funding to private-sector sources, not just government and multilateral banks. Specifically, the program will assist the institution to develop and implement a funding plan to access Colombian and international markets. Possibilities include securitization of part of FINDETER's existing portfolio, packaging debt (i.e. as a bond bank) for subprojects of groups of small and medium-sized local governments, and issuance of debt based on FINDETER's strong balance sheet.

1.32 To diversify its liabilities effectively, FINDETER must manage a variety of risks that the organization has so far largely ignored. The program provides technical assistance for FINDETER to better manage its exchange rate risk, qualify its first-tier lenders, manage term risk, negotiate with the international investment community, and develop financial performance indicators.

1.33 Banking is largely a relationship business. Hence, improving FINDETER's relationship with its client IFIs and local governments is just as important as financial innovation. The project will help in establishing a system of account management of these relationships.

8/ Such an instrument would substantially drop nominal payments in the first years of the loan (compensated by increased payments in later years), and would be highly competitive, as are UPAC mortgage loans in Colombia that use the same principle.

1.34 These key banking challenges require that FINDETER greatly strengthen its financial staff as well as its cost accounting and risk management systems. The program will continue the support provided during project preparation to: (a) establish cost centers for its different departments, and (b) quantify, rationalize, reduce, and better link its administrative costs – particularly its technical assistance – to the organization's products and services.

1.35 **Quality and sustainability of subprojects**. The program proposes that FINDETER largely withdraw from the details of the physical design and evaluation prior to approval of subprojects. Instead, local governments and IFIs will contract consultants to perform these tasks, guided by FINDETER manuals and funded, when necessary, by FINDETER predevelopment loans. FINDETER's predevelopment assistance will concentrate on: (a) developing subproject evaluation and analysis tools, particularly citizen participation, demand studies, environmental management guidelines, and cost-efficiency criteria; (b) disseminating and explaining these tools to its client local governments and IFIs, and (c) conducting spot checks of a sample of its subprojects in order to verify compliance with its manuals and guidelines.

1.36 As requested by GOC, FINDETER intends to pay special attention to the water and sanitation sector. The program will support FINDETER in adopting changes to improve subproject quality and performance in water and sanitation. These reforms assist service providers to comply with Law 142 and, hence, become financially autonomous and self-financing, and to operate on a business-like basis. They include: (a) requiring that borrowers have or develop a management plan, and (b) supporting local governments in forming autonomous, self-financing service companies.

1.37 **Technical assistance and institutional strengthening**. The program will assist FINDETER in nurturing and responding to demand for technical assistance from local governments, rather than imposing a pre-conceived supply. In particular, the program will support FINDETER to: (a) separate its technical assistance/institutional strengthening and cofinancing functions from its banking functions; (b) promote and facilitate provision of technical assistance through third parties on a contractual basis, such as consultants, universities, and regional municipal development institutes, and (c) establish an urban services information bank that collects and disseminates data on successful experiences through workshops, courses, a periodic newsletter, consultations with mayors, and other fora.

G. Bank strategy and the project's relationship to other IDB programs

1.38 The proposed program fits well within the Bank's strategy for Colombia, which has at its center the consolidation of the decentralization process through the strengthening of subnational entities. The operation complements other Bank-supported

initiatives that seek to strengthen regional, departmental and municipal capacity in the health, education and transport sectors. It complements, in particular, the Program for Strengthening Subnational Entities (CO-0155), which has as its main objective to strengthen subnational tax systems and support selected entities to restructure their finances.

H. Rationale for Bank's participation

1.39 Continued IDB and IBRD financing remains an important source of long-term capital for municipalities, since Colombia's capital market has thus far not mobilized an adequate level of resources for long-term investments, such as those contemplated under the proposed project. Furthermore, the Banks' participation is expected to help maintain strict standards of subproject quality, as well as provide critical support to the executing agency in the ongoing process of institutional change in order to reestablish its active role in the municipal credit market.

1.40 During the period of project preparation, the participation of the Banks, through a strategic planning exercise 9/ and other studies, has already facilitated the identification of an institutional vision and strategy for FINDETER. Armed with a deeper understanding of the rapidly changing municipal credit environment, and with a new vision of its future, FINDETER is set to reestablish its leadership position in local infrastructure lending and municipal development.

9/ Led by FEDESARROLLO, a Colombian consulting firm which also produced the document "El Mercado de Crédito Territorial y las Estrategias de Participación de FINDETER", December 1996.

II. THE PROJECT

A. Objectives

2.1 The primary goal of the proposed project is to contribute to the consolidation and expansion of the municipal credit market by enhancing FINDETER's capacity to finance municipal infrastructure. More specifically, the Second Municipal Development Program (SMDP) will: (a) help FINDETER become an efficient second-tier financial institution; (b) promote the financing of high quality and sustainable infrastructure investments, and (c) create and develop a demand-driven technical assistance facility within FINDETER, separate from its banking functions.

B. Project description

2.2 The project consists of three components: (a) investments in infrastructure; (b) municipal institutional strengthening, and (c) institutional strengthening for FINDETER.

1. Infrastructure investments (US$163 million)

2.3 This component includes investments in eligible municipal sub-projects. Through the rediscounting of financial intermediary loans to local governments and public service providers, whether public or private, FINDETER will support investments to rehabilitate, improve or expand urban infrastructure and local services in sectors under local government responsibility including water and sewerage, urban and nonurban roads and traffic management, environmental protection (including drainage and flood control), solid waste management, slum improvement, bus terminals and river wharves, market places, parks and recreational facilities, slaughterhouses, local telephone networks, and educational and health facilities.

2. Municipal institutional strengthening (US$20 million)

2.4 This component includes the financing of municipal capacity building activities in the areas of municipal management and provision of municipal services. Through this component, the project will support technical assistance for improving the overall management of municipal governments, especially in: (a) financial management; (b) planning, programming, budgeting, and execution of investment programs, including their environmental aspects, and (c) improving the management capacity of entities responsible for household service provision (especially in the water and sanitation sector), where they have to comply with Law 142, which requires the entities to become financially autonomous and self-financing, and to operate on a business-like basis. The component would also support the purchase of equipment in connection with institutional

programs for improving the management capacity of local governments or entities responsible for service provision.

3. <u>FINDETER's institutional strengthening</u> (US$5 million)

2.5 This component will finance several activities to hone the capacity of FINDETER to perform its role as a second-tier financial institution and promote municipal development in support of its strategic plan. These activities include the contracting of consulting services to make possible: (a) the diversification of financial products and funding; (b) improvement of risk management capacity; (c) development and implementation of a cost accounting system; (d) improvement of quality and sustainability of subprojects, and (e) enhancement of the capacity to promote municipal development. A detailed budget and preliminary terms of reference for each subcomponent is available in the project's technical files.

2.6 **Diversification of financial products and funding.** The consultancies to be carried out under this subcomponent will support: (a) the development of new financial products such as guarantees for private sector participation in the provision of municipal services, and different loan amortization schemes that are better suited for long-term maturity investments, among others, and (b) the diversification of its funding to include private sector sources through securitization of its existing portfolio, acting as a bond bank for groups of small- and medium-sized local governments, and/or issuance of debt based on FINDETER's strong balance sheet.

2.7 **Improvement of risk management capacity.** This subcomponent addresses the need for better risk management in support of FINDETER's strategy to access the Colombian and international capital markets. It includes technical assistance for: (a) developing and setting up systems to manage foreign exchange, liquidity and term risks; (b) refining its capacity to assess its first-tier lenders, and (c) developing financial performance indicators.

2.8 **Improvement of the cost accounting system.** In order to enhance FINDETER's competitiveness in the municipal credit market, it is imperative that it becomes more efficient in conducting its business. In this regard, the project will help FINDETER to improve its cost accounting system, so that it can identify the detailed costs for each of the products that it offers.

2.9 **Improvement of quality and sustainability of subprojects.** In order to improve the quality and sustainability of subprojects, this subcomponent will support FINDETER in: (a) developing and adjusting subproject analysis and evaluation tools, particularly citizen participation, demand studies, environmental impact, and cost-efficiency criteria; (b) disseminating and explaining these tools to its client local governments and financial intermediaries, and (c) conducting annual spot checks of a sample of its subprojects in

order to verify compliance with FINDETER manuals. This will provide a much needed change in the role that the organization has been playing in assisting local governments to design and evaluate subprojects by refocusing its efforts to guide rather than directly provide technical assistance for project design and evaluation.

2.10 **Promotion of municipal development**. This subcomponent will assist FINDETER in separating its institutional strengthening, technical assistance and cofinancing functions from its banking functions and allow it to position itself as a facilitator and promoter of municipal development by: (a) disseminating such information through seminars, newsletters, and other media; (b) improving its advisory capacity in areas related to municipal development and management, including private sector participation in the provision of municipal services, and (c) establishing strategic alliances with public and private entities involved in the provision of technical assistance services for optimal utilization of their capacity and to avoid duplication of effort.

C. Size of program

2.11 The following exercises were carried out to help determine program size: (a) projections regarding the indebtedness capacity of subnational entities, in light of the new Indebtedness Law, and under different scenarios; (b) estimates of the anticipated evolution of current income of departments and municipalities in the medium term; (c) estimates of expected demand for the financing of basic infrastructure investments from departments and municipalities, and (d) FINDETER's potential share in the subnational credit market, given the new financial products and credit terms and conditions that will apply in the SMDP. 10/

2.12 In recent years, the level of FINDETER's net disbursements to municipalities and other subnational entities, including IDB and IBRD resources under the MDP, has ranged between US$130 million and US$170 million per year. To determine whether the size of the proposed second stage of the program is appropriate, projections regarding net credit demand from the central administrations of municipalities and departments were carried out under two different scenarios. 11/

10/ These demand projections are based on the analysis of the subnational credit market carried out by FEDESARROLLO, mentioned in Chapter I, pages 63-101.

11/ It should be noted that these are conservative projections for net credit demand, as FINDETER intends to gradually increase approvals, through the participating IFIs, for projects carried out directly by public service companies and decentralized entities other than subnational central administrations.

2.13 Under the first set of projections, it is assumed that a new lending instrument, indexed credits with partial capitalization of the nominal component of the interest rate, is introduced by FINDETER 12/; under the second one, no indexed credits are offered during the loan execution period. The analysis of these two scenarios results in projections of average overall net credit demand by central subnational administrations of between US$750 million and US$600 million, respectively, for the period 1998-2000; this would imply an annual net credit demand of US$250 million, should the partial interest capitalization instrument be adopted, and of US$120 million, if it were not. Therefore, given the level of potential demand for net resources during the SMDP execution period, and the new credit policies likely to be adopted by FINDETER, the size of the proposed program, at an average level of US$40 million per year, including local counterpart resources, is considered to be appropriate.

D. Program cost

2.14 The Bank financing is part of a five-year program whose cost is estimated at US$200 million. The breakdown by investment category and source of funds is presented in Table II-1.

Table II-1
COSTS AND FINANCING OF PROJECT
(millions of US$ equivalent)

COMPONENT	IDB	IBRD	LOCAL	TOTAL	%
Municipal infrastructure investments	54.4	60.0	48.6	163.0	81.5
Municipal institutional strengthening	-	-	20.0	20.0	10.0
FINDETER institutional strengthening	5.0	-	-	5.0	2.5
Financial expenses	0.6	-	11.4	12.0	6.0
TOTAL	60.0	60.0	80.0	200.0	100.0
% by source of funds	30	30	40	100	

E. Financing plan

2.15 The Bank loan will account for 30 percent of total program cost. The IBRD will participate in the financing of the program with a loan of US$60 million. The remaining US$80 million will be local counterpart, with US$39.2 million coming from FINDETER,

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12/ Under this scenario, it is assumed that 60 percent of future subloans are financed using FINDETER's regular credit products, and the remaining 40 percent under the new partially indexed credit facility.

US$24.5 million from participating IFIs, and US$16.3 million from subborrowers. Each subborrower will be required to provide equity contributions of: (a) at least 10 percent of water subprojects; (b) between 30 percent to 50 percent for all telecommunications subprojects, and (c) between 10 percent to 20 percent for all other municipal investment subprojects. The rationale for this categorization is that projects such as telecommunications typically have larger shares of private sector funding with shorter terms, while water projects are typically long-term.

F. Terms and conditions of the loan

2.16 The IDB financing, in the amount of US$60 million, will be drawn from the Ordinary Capital resources. The following table shows the terms and conditions of the loan:

Table II-2 TERMS AND CONDITIONS OF THE LOAN	
Source of funds:	Ordinary Capital
Amount:	US$60 million
Terms:	
amortization period	20 years
grace period	5 years
commitment of funds	4½ years
disbursement	5 years
Interest rate:	Variable
Inspection and supervision:	1% of the loan amount
Credit fee:	0.75% per year on undisbursed amounts
Currency:	United States dollar from the Single Currency Facility

G. IDB-IBRD coordination

2.17 Operational coordination between the IDB and IBRD loans, which began with joint preparation of the operation and the present document, will include joint monitoring missions, periodic beneficiary assessments and participation in a midterm evaluation. Both Banks will finance the same subproject menu, follow similar procurement guidelines, and support and monitor FINDETER's credit regulations.

III. ORGANIZATIONAL FRAMEWORK AND PROGRAM EXECUTION

A. The borrower and executing agency

3.1 FINDETER will be the borrower and executing agency and the Republic of Colombia will be the guarantor of the loan. The borrower will deposit the resources of the loan in a special foreign-exchange account to be established in the Bank of the Republic. **The establishment of this special account will be a condition precedent to first disbursement.**

3.2 FINDETER is a financial organization with functional autonomy, which is linked to the central government through the Ministry of Finance. It was established in 1989 13/ as a result of the decentralization process and the restructuring of the Banco Central Hipotecario. It officially began operating in 1991 and currently has as its chief functions to: (a) finance subnational investments through a rediscounting mechanism, and (b) administer, through a trust facility, resources transferred to it by other public entities. The law and its statutes also allow other types of financial operations such as the issue of financial instruments, and the receipt of deposits form public entities. FINDETER's operations are subject to the regulations of the Superbancaria.

1. Financial aspects

3.3 FINDETER has an authorized capital of US$120.3 million comprised of 1 million shares. The Republic of Colombia owns 91.51 percent of the shares and the remaining 8.49 percent is owned by the 29 departments that comprise the Nation. According to its statutes, FINDETER does not distribute profits. Consequently, all profits are either transferred into statutory reserves, used to increase the capital, and as contributions to special programs. This, along with asset revaluation, and the government's program for capitalization, has given FINDETER a very strong financial position. Currently, its equity ratio is 62 percent. This translates into an important financial strength for FINDETER as it has ample margin for leverage. The principal performance indicators are presented in Table III-1 below. A more detailed financial analysis of FINDETER can be found in the project's technical files.

13/ Established by Law 57 of 1989, Statutes approved by Decree 789 of 1990 and modified by Decree 1916 of 1993.

Table III-1 FINDETER'S KEY PERFORMANCE INDICATORS (figures in thousands of current pesos)			
	1994	1995	1996
AVERAGE PERFORMING ASSETS	**240,946**	**327,256**	**402,091**
INCOME	**69,347**	**112,176**	**136,871**
% of Performing Assets	28.8	34.3	34.0
% of Total Assets	23.2	28.7	29.5
% of Portfolio	25.0	32.3	32.6
FINANCIAL EXPENSES	**23,752**	**44,115**	**16,242**
% of Performing Assets	9.9	13.5	4.0
% of Loans	18.3	29.0	11.8
% of Total Liabilities	14.4	23.8	9.2
OPERATION EXPENSES	**6,839**	**12,028**	**25,245**
% of Performing Assets	2.8	3.7	6.3
% of Portfolio	2.5	3.5	6.0
% of Income	9.9	10.7	18.4
OPERATING MARGIN	**38,756**	**56,033**	**95,384**
% of Performing Assets	16.1	17.1	23.7
% of All Assets	13.0	14.3	20.6
% of Equity	28.9	27.2	33.1
% of Income	55.9	50.0	69.7

PROFITABILITY ANALYSIS OF FINDETER (figures in% of income)			
	1994	1995	1996
Income	100.00	100.00	100.00
Financial costs	32.21	38.21	10.39
Gross financial margin	67.79	61.79	89.61
Operating expenses	13.49	13.03	19.59
Net operating margin	54.31	48.75	70.03
Monetary correction	32.33	31.24	37.12
Profit before taxes	21.98	17.52	32.91
Taxes	6.65	5.56	12.68
Net profit for year	15.33	11.96	20.22

2. Organizational aspects

3.4 The organizational structure with which FINDETER has been operating is presented in Annex III-1. Its highest authority is the Board of Directors, which has six members: (a) the Minister of Finance, who presides it; (b) the Minister of Economic Development; (c) the Economic Secretariat of the Presidency; (d) the Chief of the National Planning Department, and (e) two representatives of subnational entities. Senior management is led by the President of FINDETER, who is assisted by six senior executives in charge of the principal operational areas. As explained below, FINDETER is introducing changes in its organization in order to improve its operation as a second-tier institution. The key areas to be restructured are the financial management and loan processing departments. In addition, FINDETER is making organizational

modifications in order to facilitate changes in the content and delivery of the technical assistance it will offer to subnational entities.

B. Institutional framework for execution

3.5 FINDETER will continue to operate as a second-tier institution which rediscounts loans made to eligible subborrowers by IFIs. FINDETER will rediscount up to 85 percent of the loans granted by the IFIs, on terms and conditions specified in the program's credit regulations.

3.6 Subnational entities, consisting of local governments and their agencies or enterprises, including private or mixed capital companies operating on behalf of local governments, will be eligible subborrowers. The eligible financial intermediaries will be financial institutions that habitually receive and invest voluntary savings of the public, are supervised by, and are in good standing with the Superbancaria, and have been appraised by FINDETER, using criteria and methods satisfactory to the Bank, as being creditworthy, able to assess municipal credit risk, and having appropriate financial controls, especially with respect to portfolio performance. **FINDETER and each participating IFI will execute a promissory note and endorse it to FINDETER for rediscount, a model of which note will be submitted to the Bank as a condition prior to first disbursement.**

C. Program execution mechanisms

1. Credit regulations

3.7 The execution of the SMDP will be governed by a set of program credit regulations, which include FINDETER's operational manual. A preliminary version of this document has been reviewed and discussed during program preparation, and **a final text is to be submitted by FINDETER, to the Bank's satisfaction, as a condition precedent to first disbursement.** Changes in the program credit regulations during execution will be made only with the concurrence of the Bank. Eligible sectors for financing under the SMDP are: water and sewerage, urban and nonurban roads and traffic management, markets, parks and green areas, education and health facilities, environmental protection (including drainage and flood control, solid waste management, slum improvement, bus terminals and river wharves, slaughterhouses and local telecommunications. Subproject appraisal methods and criteria, including project preparation guidelines, are included in the operations manual, as well as procedures used by FINDETER's staff, intermediaries and subborrowers to ensure compliance with the project's regulations. These methods and criteria must be developed, and agreed upon with the Bank, for each sector, before subprojects in that sector can be financed with program resources.

3.8 Maximum individual subproject size for the SMDP will be US$15 million. Subprojects above US$10 million will be presented to the Bank's project team for ex ante review, while smaller subprojects will be reviewed by the Bank ex post by sample (see paragraph 3.16 below).

3.9 The credit regulations will also include, among others, the eligibility criteria for participating IFIs (see paragraph 3.6 above), criteria for applying variable rediscounting rates by sector (up to 85 percent, see paragraph 3.5), and the financial conditions of the subloans. FINDETER will rediscount credits at a variable rate to be determined semiannually and based on its funding costs. Maturity and grace periods for subloan amortization will be established for each sector of investment, with maximums of 12 and 3 years, respectively. Intermediaries will assume the credit risk and charge a spread to be determined by market conditions. During program execution, onlending terms and credit policies, as part of the program's credit regulations, can be changed only with the concurrence of the Bank.

3.10 The legal instruments for onlending will be: (a) subloan agreements between the IFIs and the subborrowers, and (b) if the financing plan includes contributions by third parties, sponsoring agreements between them and the subborrower. If one or more sponsors rediscount their loans to subborrowers, FINDETER could also rediscount those loans. **These agreements will be based on model legal documents that will be presented to the Bank as condition prior to first disbursement.**

2. <u>Processing of loan applications</u>

a. <u>Current project cycle</u>

3.11 Although FINDETER was founded as a second-tier financial institution, it has operated differently in practice. The project cycle for the current program has been the following:

a. At the beginning of the cycle, FINDETER operates as a first-tier development bank for the subnational sector. Local governments bring investment projects directly to FINDETER, for eventual financing, primarily through its nine regional offices.

b. FINDETER reviews the project, and since at this stage projects normally consist of an idea or outline, it assigns consultants or staff to work on project design and evaluation, a process that may take as long as 6 to 12 months.

c. Once FINDETER approves a project, it seeks out a commercial bank willing to provide credit. FINDETER's project approval carries with it a commitment to rediscount up to 85 percent of the commercial bank's loan to the subborrower. The commercial

bank normally evaluates the financial security behind the loan. It leaves to FINDETER all the analysis of the project's feasibility and economic returns. The commercial bank accepts the entire credit risk associated with the loan, as well as responsibility for loan servicing. FINDETER's share normally is the maximum 85 percent allowed by law.

d. FINDETER then monitors the execution of the projects it finances.

b. <u>Lessons learned</u>

3.12 During project preparation, lessons from FINDETER's experience to date were derived from a number of sources, including: (a) two independent ex post evaluations of the first MDP, based on the analysis of an indicative sample of subprojects financed with IDB and IBRD resources; (b) an evaluation of a technical assistance initiative financed by the IDB during the first stage; (c) external evaluations of an earlier water project [Programa de Ajuste Sectorial (PAS)] financed by the IBRD, and (d) IDB and IBRD project team field visits. These assessments pointed to the need to improve several aspects of the subproject cycle, particularly subproject appraisal, monitoring and ex post evaluation.

3.13 A summary of the shortcomings found in FINDETER's performance in the appraisal stage of the cycle includes the following: (a) uneven use of sectoral appraisal criteria and methods, and variability in the quality of analysis within and among sectors; (b) financial analysis limited to loan repayment capacity estimates; (c) overly long project processing periods, due to FINDETER's effort to do itself much of the analysis and preparation, without sufficient technical personnel; (d) absence of instruments such as unit cost systems with which carry out economic analysis, especially in the water sector. The evaluations also noted deficiencies in monitoring projects under execution and an absence of an ex post evaluation mechanism to assess quality and sustainability of works financed by FINDETER.

c. <u>Subproject appraisal, monitoring and evaluation in the new project cycle</u>

3.14 In the SMDP, FINDETER will focus on ensuring that the subprojects it finances comply with agreed upon economic, financial, institutional and environmental guidelines included in the new operations manuals. In order to do so without compromising its competitiveness, effectiveness and efficiency as a second-tier financial institution, however, FINDETER will withdraw from the detailed design and appraisal functions and rely on subnational entities to contract directly the specialized consultancies needed to carry out this task. The costs of these consultancies may be financed either as part of subproject costs, or be recognized as a counterpart investment. Consultants will use the sectoral guidelines and subproject design instruments provided by FINDETER.

FINDETER's role will be to: (a) develop and continually update project appraisal tools; (b) disseminate and promote these tools among potential borrowers and financial intermediaries, and (c) rapidly review and confirm that the appropriate analyses have been completed, in accordance with program operating regulations and existing sectoral policies. FINDETER is in the process of reviewing, completing and updating the guidelines and preparation manuals for each sector. 14/

3.15 Given the lessons learned during the first stage, and in order to improve subproject quality, FINDETER will: (a) ensure that new appraisal instruments and methods in each sector are applied consistently; (b) confirm that required demand studies are carried out, and that size and design of subprojects are based on projected demand for services; (c) verify that community consultations, especially with low-income groups, have been carried out, in order to ensure the capacity to pay of potential beneficiaries and/or identify the sources of subsidies, should these be necessary; (d) promote the creation of financially sound and self-sustaining public service companies, private or of mixed private/public ownership, with a scale of operation that makes possible the efficient operation and maintenance of the system in the long term, as well as cost recovery for services rendered, and (e) promote and disseminate sectoral appraisal guidelines and instruments among subnational entities, financial intermediaries, and consultants.

3.16 FINDETER will also seek to improve the appraisal, execution and monitoring of subprojects through: (a) the use of its information system to list and make available to its clients names and references of available consulting services in the different sectors; (b) inclusion of basic eligibility and selection criteria for consultants who will design and/or appraise subprojects, based on a points system that takes into account both technical capacity and previous performance; (c) require that participating financial intermediaries place greater emphasis on the supervision of projects, which would be contracted independently following procedures acceptable to the Banks, and (d) carry out ex post evaluations annually of no less than 10 percent of all subprojects financed each year, as part of a process of continuous feedback and adjustment of guidelines and methods.

3.17 Finally, recognizing that project quality and sustainability depend not only on appropriate design, but also on the success of the start up, implementation and management of the project, FINDETER will require the existence of a business plan – duly approved by the appropriate sectoral authorities – for each public service investment it finances. In the absence of such a plan, the subproject to be financed will include the development of a

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14/ In the water and sewerage sector this effort has been done in collaboration with the Water Regulatory Commission, of the Economic and Social Development Ministry.

business plan in order to ensure its financial sustainability and autonomy in the long term. FINDETER, following current national policy, will also seek to attract the participation of the private sector in public infrastructure investments and in the operation of public services. To do so, and with program resources, it will develop new products and financial services and will seek ways to assist municipalities to identify opportunities for private participation in the provision of public services.

3.18 The changes outlined above will be incorporated in the revised operations manual, to be presented as a condition prior to first disbursement.

D. Program procurement procedures

3.19 Acquisition of related goods and services and contracting of works, will be subject to the procedures stated in Annex B of the Loan Contract. International public bidding will be mandatory for acquisition of related goods and services that exceed US$350,000, and US$5 million for civil works. These limits are justified considering that in similar projects in the country, international participation is attracted when amounts exceed these limits. All bidding under the set limits will be done following national legislation, which requires public bidding or competition for acquisitions above US$153,000. 15/ Procurement of consulting services will also be done according to regular Bank procedures as stated in Annex C of the Loan Contract. To facilitate execution, the Bank will carry out its supervision in an ex post manner, in the cases of: (a) acquisition of goods and related services, and for civil works below the amount of international public bidding, and (b) selection and contracting in the case of contracts of US$50,000 equivalent, or less for individual consultants, and US$100,000 equivalent or less for consulting firms. This will be done in the understanding that Bank financing may be used only if those contracts meet Bank's requirements and procedures. A preliminary procurement plan appears in Annex III-2 of this document.

E. Disbursement schedule

3.20 The disbursement schedule for the program, by source of funds, is presented in the following table:

15/ National legislation (Law 80) sets variable limits according to the size of the annual budget of each public entity. The US$153,000 represents the maximum under the law.

Table III-2 DISBURSEMENT SCHEDULE (in thousands of US$ equivalent)							
Source	Year 1	Year 2	Year 3	Year 4	Year 5	Total	%
IDB loan	9,100	12,100	15,100	15,100	8,600	60,000	60
Counterpart	5,700	7,400	9,200	10,100	7,600	40,000	40
Total	14,800	19,500	24,300	25,200	16,200	100,000	100
%/year	15	20	24	25	16	100	

F. Recognition of expenditures and advance of funds

3.21 FINDETER has presented to the Banks a sample of subprojects to be financed by the SMDP, for the equivalent of approximately US$70 million. The subprojects were developed on the basis of appraisal criteria used during the first stage of the program, and were then reevaluated using appraisal guidelines substantially similar to those which will be in effect for the SMDP. This indicative sample of the various eligible sectors, subproject size and type of subnational entity to be financed through the SMDP, will serve both to determine the level of expenditures to be recognized by the Banks and to adjust subproject appraisal methods.

3.22 Up to a total of US$12 million (US$6 million per Bank) may be recognized as retroactive financing, once the definitive appraisal of the subprojects in the sample is completed using the new economic, financial, technical institutional and environmental appraisal criteria and instruments. Also, under the same conditions, up to US$12 million may be recognized as local counterpart.

3.23 A revolving fund will be established with resources from the Bank's loan to pay for projected expenditures. An advance of 5 percent of the financing, or US$3 million, is recommended.

G. Annual reviews and midterm review

3.24 Each year, by November 15, FINDETER, the Bank and the IBRD project teams, will carry out formal joint reviews of the program. The reviews will focus particularly in the goals, outputs and activities set forth in the logical framework (see Annex III-3). These reviews will provide a forum to assess program and subproject issues, and if necessary, will lead to the formulation of steps for remedial action.

3.25 One of the annual reviews will be a midterm review, to take place two years following the start of the program or when 50 percent of the loan resources have been committed, whichever comes first. **By midterm, under contractual obligation, FINDETER will have accomplished the following**: (a) committed 50 percent of the resources of the municipal strengthening component of the loan; (b) developed a risk management program; (c) developed a funding

plan, satisfactory to the Bank, that includes obtaining resources from the financial markets; (d) adopted a cost accounting system and begun to recover technical assistance costs, so that institutional administrative costs have been reduced to 3 percent of the portfolio balance; (e) approved terms of eight years or longer for 75 percent of all FINDETER subloans, and (f) complied with subproject norms and guidelines, as corroborated by an ex post assessment of a sample of a minimum of 10 percent subprojects approved under the program. In the event that the results of the evaluation are not satisfactory, FINDETER will take the necessary measures to correct deficiencies in order to achieve project objectives.

H. External audits

3.26 During the execution period of the loan, the executing agency will present to the Bank financial statements for the loan. These statements should be submitted annually within 120 days of the close of the fiscal year and should be certified by a firm of independent public accountants acceptable to the Bank.

I. Tariffs and cost recovery

3.27 FINDETER will include in the subloan agreements to be concluded with subborrowers receiving loans from program resources, the obligation that the tariffs or other charges applied for the respective service, shall generate revenues for the project involved that:

a. In the case of domiciliary service projects, such as water and sewerage, urban sanitation, and local telephone services, following the requirements and timetables under Law 142 of Public Domiciliary Services of 1994, will, at least, be sufficient to recover all fixed assets over their economically useful life, a reasonable level of profits for the service operator as regulated by the law, as well as the operating costs of the respective system, including those connected with administration, operation and maintenance. This will also be verified by the executing agency through the service operator's Management and Performance Plan [Plan de Gestión y Resultados (PGR)] mandated by Law 142, which should either have been approved by the competent authorities prior to subloan approval or be an integral component of the subproject to be financed using program resources.

b. In other cases of public service projects to be financed through tariffs, but which are not covered by Law 142, or for projects in which the investment must be recovered other than by means of tariffs, the agreements with the subborrowers should stipulate conditions that ensure recovery of the investment, in accordance with the agreed targets, and of all the operating, administration and maintenance costs, through charges, rentals, taxes or other contributions suited to the

purpose. The specific wording of this obligation must be in accordance with the requirement laid down for each particular sector, as detailed in the credit regulations.

3.28 The executing agency must verify, prior to the first disbursement from each subloan financed with program resources, that the respective subborrower has made appropriate arrangements with the competent national authorities to ensure compliance with the obligations detailed in the preceding paragraph.

3.29 The cost-recovery requirements laid down in the credit regulations are consistent with the relevant Bank policies and constitute an instrument of the GOC's decentralization policy, which seeks to encourage greater fiscal discipline and improved resource management at the local level.

J. Maintenance

3.30 Each subborrower will commit to operate and maintain the works and equipment financed with program resources in accordance with generally accepted technical standards, and to make available the resources necessary for their efficient operation. During execution of the program and for five years afterwards the Bank will be allowed to visit and inspect all projects and programs, and, if unacceptable levels of maintenance and upkeep are found, it will be the obligation of the agency involved to take all necessary steps to correct it.

K. Environmental and social impact

3.31 The analysis performed to prepare an Environmental and Social Impact Report concluded that the type of projects to be financed by the program – which cover a wide range but are expected to be concentrated in the urban roads, water and sewerage, and education sectors – have, in general, a beneficial environmental impact. In most cases, potentially negative environmental effects are known and can be mitigated through the use of procedures and instruments familiar to users and legally mandated by Colombian law, as well as through the sectoral guidelines and appraisal criteria used by FINDETER.

3.32 Evaluations of the first stage of the MDP identified some problems in the project cycle which affected subproject quality and sustainability. 16/ Important among these was the insufficient attention given to community participation in the design, execution and maintenance of the investments. For the SMDP, FINDETER is incorporating into its operations manual – specifically in the manuals used for the preparation and appraisal of subprojects, by

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16/ The conclusions of the evaluations of the first stage are summarized earlier in the chapter and highlighted in the Economic and Social Impact Report presented to the CESI.

sector – guidelines regarding community participation in subproject development and execution. FINDETER is also including in its credit regulations and in the subproject preparation manuals, which are disseminated among FINDETER clients, environmental norms and guidelines for all sectors eligible for financing, by type of subproject. FINDETER, per its operations manual, will ensure that in the contracting of works subborrowers include environmental measures, as well as sanctions for noncompliance of same. Finally, through the annual ex post evaluations carried out each year and financed by the program, FINDETER will monitor the environmental aspects mentioned and the level, type and effectiveness of community participation in the subproject cycle.

3.33 In addition, FINDETER's environmental specialist, recently contracted, will: (a) coordinate environmental aspects of FINDETER subloans with the Ministry of the Environment, to ensure consistency in the application of procedures; (b) assist FINDETER clients in complying with environmental norms and, especially, in incorporating environmental requirements in subloan contracts, and (c) monitor the use of criteria and instruments in all phases of the project cycle.

IV. PROGRAM FEASIBILITY, RISKS AND BENEFITS

A. Program feasibility

4.1 A strong **financial position** is currently one of FINDETER's chief advantages. With a low debt ratio, it has ample room to develop new financial instruments that will provide the necessary capital for continued operations. FINDETER has demonstrated that there is a solid demand for subloans. With the setting of adequate lending terms and conditions under the new program, it should not have any difficulties in placing the additional resources and regaining competitiveness in the municipal credit market. The introduction of new loan amortization modalities, such as the partial capitalization of the nominal component of the interest rate, is feasible, since similar instruments (the UPACs) have been in use in the Colombian market for a number of years. Finally, as the IFIs bear the entire credit risk of the loans to subnational entities, FINDETER is protected in this regard.

4.2 **Institutional viability.** FINDETER has demonstrated its commitment to the completion of an action plan for institutional change, subject of the country-Bank dialogue during project preparation and the focus of the institutional strengthening component of the program. The GOC has also shown support for the far-reaching operational reforms in FINDETER that will enable it to achieve greater efficiency in term transformation, develop new financial products and diversify its funding base to include capital market funds. Although the institution will require organizational changes to execute adequately the proposed program, these are considered attainable in a short period. Since its founding, FINDETER has reached an acceptable degree of institutional and operational capacity that the organization can well reorient towards the requirements of this program. With respect to the consulting services required to assist in the change process, there is an adequate availability of local consultants, or staff when required, to carry out the new activities envisaged by the project.

4.3 The program will provide subborrowers with loan resources to improve management and operational capacity. The program will also provide guidelines for institutional evaluation that will allow the subborrowers to identify weaknesses or needs in this area. Institutional parameters, to be included in project appraisal criteria, will be identified in the credit regulations and will permit an early identification of institutional weaknesses to be addressed before or during subloan execution.

4.4 Active participation of IFIs will be encouraged through more competitive credit terms and conditions. In addition, FINDETER will provide guidelines on subnational entity financial assessment and will make available an ample municipal database that will be easily accessible to IFIs that require it.

4.5 FINDETER is undertaking a review of the methods, guidelines and instruments it uses to ensure the appropriate **appraisal of subprojects**, both as a result of the lessons learned in the first stage of the program and the analysis of a sample of subprojects to be financed in the second stage.

4.6 On the basis of the evaluation of the first stage, the institution will adjust existing **economic appraisal** methods as needed, establish cost-efficiency parameters for each sector and type of eligible investment, and make the necessary changes in the project preparation manuals and sectoral guides. By using these revised criteria and mechanisms, the appraisal process will be speedier and more relevant, and will enhance efficiency in the allocation of investment resources at the subnational level, while taking into account the need to promote the competitiveness and effectiveness of FINDETER as a second-tier financial institution.

4.7 For the SMDP, FINDETER presented a sample of 70 subprojects for a total of US$72 million. The sample includes subprojects in all sectors financed by FINDETER, but a high proportion (almost 70 percent) is concentrated in the water, education and sewerage sectors. These sectors are likely to predominate in the execution of the SMDP. An evaluation of the sample, supported by two groups of independent consultants, using criteria substantially similar to those expected to be incorporated in the final credit regulations, identified a need to strengthen institutional and financial aspects in many of the subprojects. As a result of this assessment, FINDETER is reviewing and/or reformulating, in conjunction with municipalities or decentralized borrowing entities, several projects in the sample, to improve their design and ensure compliance with economic, financial, institutional and environmental requirements.

4.8 It is expected that, as a result of the review and reformulation process, about 45-50 subprojects from the sample, totalling some US$50 million, could eventually qualify for Bank financing, and that during the first year of the program, FINDETER could commit a further US$40 million to US$45 million, for total subproject approvals of some US$90 million in SMDP resources.

4.9 Project **sustainability** will be sought by using appropriate economic, institutional, financial and environmental criteria in the appraisal of subprojects. In the last analysis, however, sustainability will depend on the fiscal strength and creditworthiness of Colombian municipalities and public service providers that borrow from FINDETER. The institutional strengthening components of the project are designed to promote improved financial management, cost recovery and administrative reform of municipal entities which together will have the effect of strengthening their fiscal health as well as their ability to continue to borrow from FINDETER and from commercial banks and, in larger municipalities, to gain access to capital markets directly.

4.10 **Social and environmental viability**. The program's credit regulations will incorporate institutional and environmental appraisal criteria which will, on the one hand, ensure the environmental viability of the program and, on the other, incorporate the participation of the beneficiary communities in the choice and design of municipal investments to be financed.

B. Risks

4.11 A change of leadership within FINDETER could threaten the implementation of the changes agreed upon with the current management. However, the continued commitment and oversight of the central government regarding support of reforms within FINDETER in the event of a change in leadership would serve to mitigate this risk. At the operational level, the project faces the possibility that the subnational entities fail to operate and maintain properly the new or rehabilitated public works. This risk will be addressed by the program's financing of technical assistance for the subnational entities, by the implementation of Law 142's mandate to create service companies and place them on a business and financially sustainable basis, and by the expected increased role for the private sector in water supply, waste management and other sectors, which will improve efficiency in the medium and long term.

4.12 A different risk to the operation is posed by the Banco de la Republica's Resolution 5, in effect since June 1997, which requires a 30 percent deposit on disbursements of loans contracted in foreign exchange and therefore applicable to the multilateral banks' resources. The deposit, to be held for 18 months, would have increased the cost of the Bank's funding for the FINDETER subborrower. To reduce the effect of the resolution on demand for subloans, however, FINDETER has decided to absorb itself the cost of the retention. Recent analysis of the impact of this decision on FINDETER indicates that the net effect of the reserve requirement on its lending capability for the five years of the program, should it be maintained throughout the period, would be of 13.6 percent. Although the requirement will imply added financial costs for FINDETER, projected profits for the next five years would allow the institution to adjust easily to this rise in costs.

4.13 Concerning FINDETER's proposed role in intermediation, adverse moves by rating agencies or downgrading of Colombia's investment grade rating could reduce the attractiveness of FINDETER international issues. However, the rating agencies generally appear to be moving in the opposite direction – greater acceptance of subsovereign debt – while Colombia's standing appears solid. Similarly, new internal regulation could contract the market for local government credit and access to funding sources for this market. Most experts and the authorities believe, however, that the new local government indebtedness law has removed the need for harsher regulation. A decrease in central transfers to local governments or a substantial fall in household real incomes could

also adversely affect the feasibility of market-rate municipal credit, risks that are offset by GOC's strong committment to decentralization and to the stabilization of the national economy.

C. Benefits

4.14 The program will improve infrastructure and municipal services in Colombian cities and towns. It will also enhance the productivity of urban centers which generate the great bulk of national GDP – through improving the efficiency of their physical plant, resulting in increased land values in beneficiary areas. The implementation of solid waste system, marketplace, and slaughter-house investments, including sanitary precautions and sound waste disposal schemes, would help reduce the negative health and environmental impacts which result from the haphazard food processing and waste management arrangements now prevalent in many cities. Traffic management subprojects would yield savings of vehicle operating costs and help reduce congestion-related air contamination from vehicle exhausts. In addition to its impact on vehicle operating costs or land value, the paving and repair of urban streets would help reduce the production of dust particulates by vehicular traffic on unpaved or broken road surfaces, with beneficial effects on air quality and health.

4.15 As most infrastructure investments are likely to benefit the general population of municipalities and departments where FINDETER projects are financed, the program is not explicitly targeted to low-income groups. Nevertheless it is expected that certain categories of investments, such as markets and expansion programs in the water and sanitation sector, will have a highly positive impact on the urban poor, and particularly on lower-income women.

4.16 Subproject eligibility criteria would include a minimum economic rate of return of 12 percent where applicable and cost efficiency criteria in other cases. Indirect benefits would accrue from the revision of FINDETER's subproject appraisal criteria, resulting in: (a) the execution of more cost-effective projects; (b) greater community participation in municipal decision-making and design of projects; (c) the improvements of maintenance capacity; (d) the application of more transparent service pricing, and (e) improved institutional arrangements and human resource development.

4.17 Another category of benefits will result from the more focused and efficient leadership of FINDETER in the municipal market envisaged by the program, which will be achieved by the diversification of its financial products and funding base, longer term maturities for certain municipal investment projects, and the development of demand-driven advisory services. These changes will result in a deepening of the municipal credit market and will also yield a range of spin-off benefits to municipalities through better access to information and technical assistance that will ultimately translate into better quality of infrastructure projects and services. Another key long-term benefit will be the further

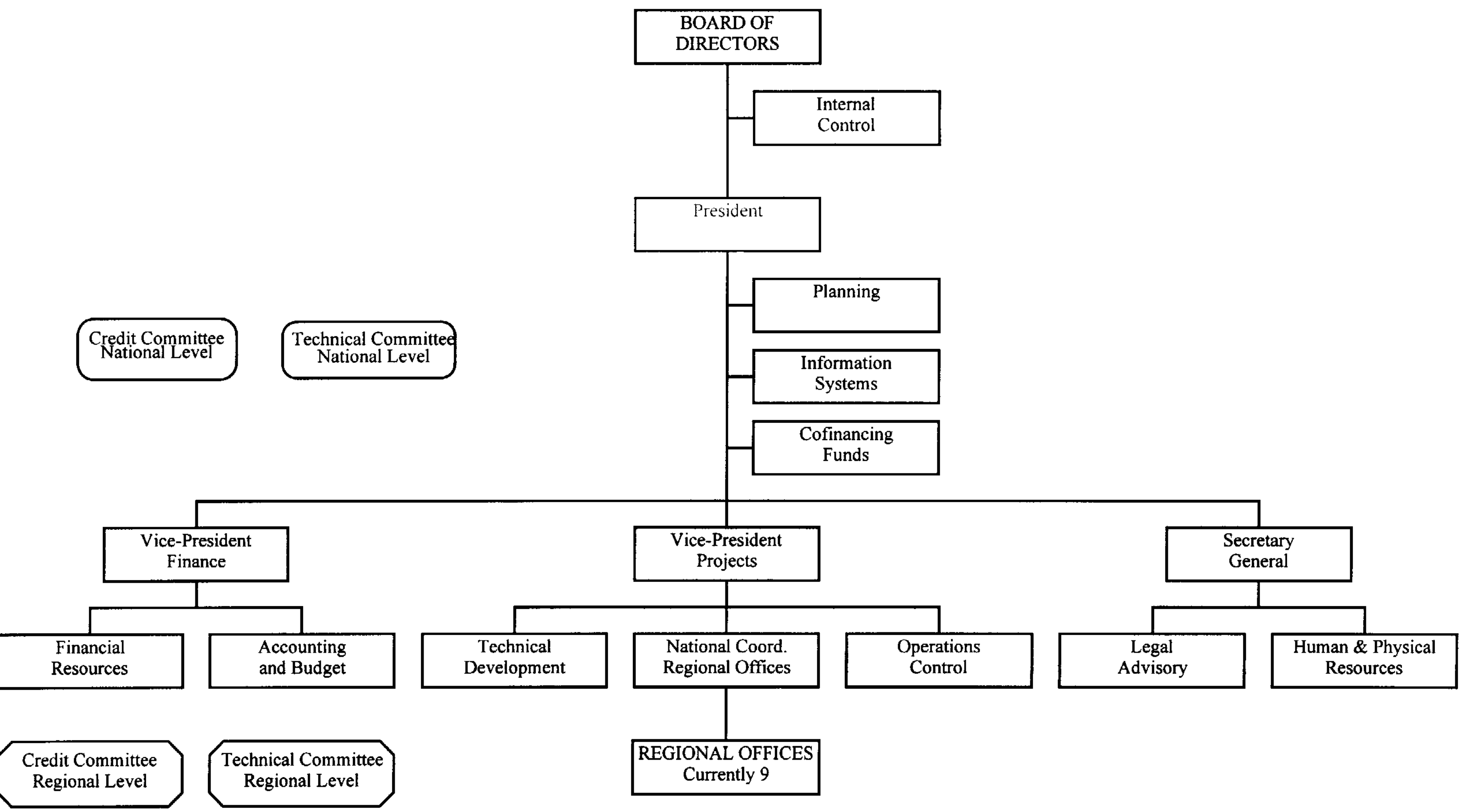
development of the municipal bond market which will benefit from the planned operational reforms of FINDETER as well as from a healthier municipal credit market. Both these achievements will promote sustainable financial and investment operations by local governments.

4.18 FINDETER's conversion into a financial innovator will result in better loan products for local governments, as the organization connects them with national and international sources of funding. These changes will deepen the municipal credit market and financial markets. The development of demand-driven advisory services will help improve the quality of infrastructure projects of local government, and increase the participation of the private sector in their provision. The development of FINDETER's second-tier functions – such as the creation of lending manuals and dissemination of these manuals to participating IFIs – will help IFIs to become better lenders for urban services and to local governments. Finally, the program's technical assistance to FINDETER will prepare the organization to better manage the risks of banking, develop a more market-based liability mix, lay the foundation for greater independence of the organization from government, and perhaps privatize in the medium term. Future Bank support of the institution will depend on the progress it has made towards achieving these goals.

MUNICIPAL DEVELOPMENT PROGRAM - I STAGE (LOAN 715/OC-CO)
WORLD BANK LOAN MUNICIPAL DEVELOPMENT PLAN (3336 CO PDT-WB)
INVESTMENT COMPONENT (1991-1997)
(US$ THOUSANDS)

	NUMBER OF PROJECTS	CREDIT IDB	CREDIT WB	CREDIT FINDETER	CREDIT IFIS	CREDIT TOTAL	LOCAL COUNTERPART	TOTAL
	8		523.9	99.7	117.3	740.9	472.3	1,213.2
	2	244.7		18.4	99.7	362.8	89.0	451.8
	4		326.3	62.1	73.1	461.5	337.0	798.5
ent	2		76.3	14.5	17.1	107.9	44.0	151.9
	6		414.3	[illegible]	92.8	585.9	262.2	[illegible]
	14		2,367.7	450.6	530.2	3,348.5	2,119.2	5,467.7
G	13	2,974.2	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	5		8,529.8	1,623.5	1,910.0	12,063.3	5,420.2	17,483.5
	63	34,730.3	20,340.3	6,485.5	13,856.0	75,412.1	50,574.4	125,986.5
	9	1,379.0	6,786.9	1,395.6	2,846.0	12,407.5	6,135.4	18,542.9
	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
	118	40,000.0	40,000.0	10,579.3	20,248.5	110,824.9	67,128.1	177,950.0

FINDETER - ORGANIZATIONAL STRUCTURE



TENTATIVE PROCUREMENT PLAN				
PROGRAM PROCUREMENT MAIN ACQUISITIONS (1)	FINANCING	METHOD	PREQUALI-FICATION	DATES
CIVIL WORKS (Subloans) US$110 million:				
1. Subloans of US$5 million or more.				
Estimated aggregate amount: US$22 million				
a. Year 1, US$3.9 million	IDB 30%	ICB	NO	I/98
b. Year 2, US$3.9 million	"	ICB	NO	II/98
c. Year 3, US$4.8 million	"	ICB	NO	II/99
d. Year 4, US$5.5 million	"	ICB	NO	II/00
e. Year 5, US$3.9 million	"	ICB	NO	I/01
2. Subloans of >US$350,000<US$5 million				
Estimated aggregate amount: US$77 million				
a. Year 1, US$11.5 million	IDB 30%	NCB	NO	I/98
b. Year 2, US$15.4 million	"	NCB	NO	II/98
c. Year 3, US$19.3 million	"	NCB	NO	II/99
d. Year 4, US$19.3 million	"	NCB	NO	II/00
e. Year 5, US$11.5 million	"	NCB	NO	I/01
3. Subloan of less than US$350,000				
Estimated aggregate amount: US$11 million				
a. Year 1, US$1.7 million	IDB 30%	LS	NO	I/98
b. Year 2, US$2.0 million	"	LS	NO	II/98
c. Year 3, US$2.8 million	"	LS	NO	II/99
d. Year 4, US$2.8 million	"	LS	NO	II/00
e. Year 5, US$1.7 million	"	LS	NO	I/01
GOODS (as part of subloans) US$47 million:				
1. Contracts of more than US$350,000				
Estimated aggregate amount: US$21 million				
a. Year 1, US$3.0 million	IDB 30%	ICB	NO	I/98
B. Year 2, US$4.3 million	"	ICB	NO	II/98
c. Year 3, US$5.1 million	"	ICB	NO	II/99
c. Year 4, US$5.4 million	"	ICB	NO	II/00
d. Year 5, US$3.2 million	"	ICB	NO	I/01
2. Contracts >US$50,000 but <$350,000				
Estimated aggregate amount: US$21 million				
a. Year 1, US$3.0 million	IDB 30%	NCB	NO	I/98
b. Year 2, US$4.3 million	"	NCB	NO	II/98
c. Year 3, US$5.1 million	"	NCB	NO	II/99
d. Year 4, US$5.4 million	"	NCB	NO	II/00
e. Year 5, US$3.2 million	"	NCB	NO	I/01
3. Contracts of less than US$50,000				
Estimated aggregate amount: US$5 million	IDB 30%			
a. Year 1, US$0.8 million	"	LS	NO	I/98
b. Year 2, US$1.0 million	"	LS	NO	II/98
c. Year 3, US$1.2 million	"	LS	NO	II/99
d. Year 4, US$1.2 million	"	LS	NO	II/00
e. Year 5, US$0.8 million		LS	NO	I/01
SERVICES: Aggregate estimate: US$31 million				
1. Design and supervision, US$6 million	IDB 30%	NCB	NO	----->
2. FINDETER institutional strengthening US$5 million	IDB 50%	NCB	NO	II/98
3. Inst. strengthening for municipalities	IDB 0%	NCB	NO	----->

ICB = International Competitive Bidding
NCB = National Competitive Bidding
LS = Local Shopping

DATES = Refer to semester of year
---> = during execution

(1) = The figures presented above are based on estimates of subloan demand projected according to results of the previous stage and on a sample of new projects. Figures will be adjusted each year.

LOGICAL FRAMEWORK			
PROGRAM SUMMARY	**VERIFIABLE INDICATORS**	**MEANS OF VERIFICATION**	**ASSUMPTIONS**
GOALS 1. Improved delivery of basic services so that the poor participate in growth 2. Strengthened capacity of local governments and public-private partnerships to provide urban services 3. Private-sector lead growth supported by providing infrastructure and improving utility services			
PURPOSE 1. Improved municipal infrastructure and services 2. Stronger financial and management capacity of urban service providers	- Loan portfolio for urban services increased by 10% per year in real terms - Financial sustainability achieved by at least 50% of subprojects financed by FINDETER, based on management plan at the end of the SMDP execution - Capacity of indebtedness improved or maintained by 90% of local governments receiving FINDETER loans by the end of SMDP execution based on the criteria of the Indebtedness Law for Territorial Entities - Less than 10% of subproject loans approved by FINDETER remained unlent by IFIs by January 1998	- FINDETER's loan records, and external audits - Surveys of local governments	- Real household incomes remain stable; do not decline by more than 10% - GDP remains stable; does not decline in real terms more than one year of project execution

LOGICAL FRAMEWORK			
PROGRAM SUMMARY	**VERIFIABLE INDICATORS**	**MEANS OF VERIFICATION**	**ASSUMPTIONS**
OUTPUTS			
1. Improved availability and terms of urban-service loans to client local governments and IFIs	- Plan for FINDETER to diversify its assets developed by third month of project - Plan for FINDETER to diversify its liabilities developed by sixth month of project	- Annual FINDETER reports - FINDETER studies and analytical reports - FINDETER loan processing records and audits	- Political or economic conditions do not deteriorate. The following could make raising private-sector debt or diversifying assets more difficult: a. Significant fall in real GDP or household incomes b. Decline in real transfers to local governments c. Change in regulation that contracts market for local government debt internally d. Change in international bond rating procedures or markets that affects market for Colombian debt negatively
2. Increased capacity of FINDETER to adapt to and improve local government credit market	- Reorganization plan for FINDETER formulated by ninth month of project, including: restructuring staff; separation of functions and promotion of private-sector participation	- FINDETER annual report - FINDETER loan processing records, audits - FINDETER studies	- FINDETER remains free of political interference that substantially compromises its reorganization
3. Enhanced management and financial capacity of local governments for urban service delivery	- Management plans for urban service improvement from 90% of client local governments of FINDETER in water and sanitation (and any other sectors with this requirement) received by FINDETER by midterm	- Survey of local governments and other studies; local government records	- Real household income remain stable; do not fall by more than 10% - Real GDP remains stable; does not decline more than one year during project execution - The implementation of Law 142 on public services continues without major interruptions - Real transfers to local governments remain stable; do not decline

LOGICAL FRAMEWORK			
PROGRAM SUMMARY	**VERIFIABLE INDICATORS**	**MEANS OF VERIFICATION**	**ASSUMPTIONS**
ACTIVITIES			
1. Improved local government urban service investment and greater connection with household demand	- Terms of at least eight years achieved on at least 75% of subproject loans after two years of SMDP execution - At least 80% of subproject disbursements scheduled by FINDETER achieved after two years of SMDP execution - Private sector participation in FINDETER loans increased to a at least 10% of new loans after two years of SMDP execution, and to 20% by the end of the program - The share of loans to service companies increased to 30% of new loans after two years of SMDP execution, and to 50% by the end of the program - 50% of urban service providers undertake one of the following activities by the end of the SMDP execution: (a) household market survey for urban services; (b) annual community-wide public meetings to prioritize urban investment, or (c) extensive involvement of CBOs in decision-making on local services	- Annual and periodic reports of FINDETER - Households surveys	- Interest and technical capacity of local government to measure demand, formulate appropriate subproject, and charge households - Institutional infrastructure of CBOs and NGOs capable of promoting and channelling household demand for urban services
2. Local governments strengthened by: (a) improved financial and management capacity, and (b) greater autonomy and private-sector participation in public service provision	- At least 50% of funds under this component committed after two years of SMDP execution - A minimum of 40% of committed resources used to support the creation of autonomous service entities in the water and sanitation sector, and for private sector participation after two years of SMDP execution	- Surveys of local governments - FINDETER loans records and audits	- Interest, and financial and institutional capacity of private sector developed - Evolution of Colombian regulation of and technical support for greater autonomy, and private-sector participation in urban services

LOGICAL FRAMEWORK			
PROGRAM SUMMARY	VERIFIABLE INDICATORS	MEANS OF VERIFICATION	ASSUMPTIONS
3. FINDETER strengthened through: (a) diversified products and private-sector sources of funding; (b) improved risk management capacity; (c) cost accounting system developed and implemented; (d) effective subproject review and monitoring systems, and (e) urban service information bank established and operating	- FINDETER's cost center and administrative accounting system developed by June 1998 - Charging client local governments for the technical assistance provided by FINDETER begun by 1999 - FINDETER will earn an annual return on its equity of not less than 5% for each of its fiscal years after December 1997 - Liabilities borrowed on national and international financial markets as needed throughout the program - Client IFIs and client local governments instructed in use of FINDETER manuals (for credit and for project preparation) by the end of 1998 - Information bulletins, workshops, and seminars on urban service provision prepared and marketed to client local governments by end of 1998 - A risk management program (including liquidity, term, and foreign exchange risk) developed by the end of 1998 - Account management of relationship with client IFIs established by the end of 1998 - The volatility of FINDETER's monthly profit/loss reduced after two years of execution of SMDP - A minimum of 10% of completed subprojects financed by FINDETER selected by random sampling and evaluated annually - New asset products developed by end of 1999 - New technical assistance products and modules suited to local government created by end of 1999	- FINDETER annual and periodic reports - FINDETER analytical studies and reports - FINDETER loan processing records and audits - Records of dissemination activities	- Continuing commitment of government and FINDETER's leadership to reform the organization

PROPOSED RESOLUTION

COLOMBIA. LOAN ___/OC-CO TO THE FINANCIERA DE DESARROLLO TERRITORIAL, S.A.
(Second Municipal Development Program)

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Financiera de Desarrollo Territorial, S.A., of Colombia, as Borrower, and the República de Colombia, as Guarantor, for the purpose of granting the former a financing to cooperate in the execution of the Second Municipal Development Program. Such financing will be for the amount of up to sixty million dollars of the United States of America (US$60,000,000) from the Single Currency Facility of the Ordinary Capital resources of the Bank, and will be subject to the "Special Contractual Conditions" and the "Terms and Financial Conditions" set forth in the Executive Summary of the Loan Proposal.