



Report No. AB56

Initial Project Information Document (PID)

Project Name	HONDURAS-Financial Sector Technical Assistance Credit
Region	Latin America and Caribbean Region
Sector	Banking (100%)
Project ID	P040177
Supplemental Project	
Borrower(s)	REPUBLIC OF HONDURAS
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1. Country and Sector Background

Persistent Weakness of Domestic Financial Institutions

The Honduran financial sector suffered undoubtedly a severe shock in October 1998, when Hurricane Mitch hit the country with devastating effects in terms of human lives and disruption of economic activity. Yet, current data suggest that the exposed weaknesses are still affecting Honduran financial institutions today, 5 years after the natural disaster, especially the problems with non-performing loans. Macroeconomic factors such as the deterioration of the prices of major export commodities (e.g. coffee) and the recession in the US have certainly contributed significantly to this persistent weakness of the banking sector. However, the following structural factors appear also to play a considerable role:

- a) Too many banks are competing for a limited market potential, and this is resulting in a situation of low cost efficiency & decreasing profitability in the sector.
- b) Risk management at many Honduran financial institutions is still at a very early stage, which is resulting in insufficient diversification, inadequate internal organization & business practices, as well as a high level of vulnerability to external shocks.
- c) Shortcomings in the legal & regulatory framework allow weak institutions to continue their operations longer than good prudential supervision would permit, giving them thereby the opportunity to accumulate more losses and further weaken.

Inadequate Framework for Financial Sector Supervision and Regulation

Current laws confer the oversight authority over the financial sector to the Comisión Nacional de Bancos y Seguros (CNBS) and the Central Bank of Honduras (BCH). Since 1999, the CNBS has made efforts to improve its "market coverage" and the quality of its oversight partly with technical assistance from the IMF and the IDB. Still, a recent diagnostic found banking supervision in Honduras could be improved in the following areas: (i) consolidated supervision, (ii) prudential norms especially those on capital adequacy, loan classification and provisioning, and corporate governance and risk management, and (iii) framework for prompt corrective action.

Structural Weaknesses in the Corporate Sector

Available data indicates that Honduran companies had until December 1999 a very high level of leverage with debt often reaching several multiples of equity endowment, as well as low levels of profitability. In the immediate post-Mitch period, profitability has been decreasing sharply and the average ROE had even turned negative for the selected companies of the commerce sector. Unfortunately, more recent information is not available to assess whether this deterioration of financial soundness in the corporate sector has continued. The persistent difficulties in the banking system, especially the substantial problems with non-performing loans, suggest however that the corporate sector remains weak. Anecdotal evidence suggests that a number of large companies are in need of some form of restructuring, but Honduras lacks an adequate framework for such corporate reorganizations. There is a widespread perception that said proceedings are very costly, complicated and time consuming which prevent debtors and creditors from using them. The lack of protection of creditors' rights is increasingly being perceived by financial institutions as a significant constraint on their lending business.

Systemic Risks related to Payments System Operation

Two payments systems were identified as systemically important in Honduras: the current banks-owned electronic check clearing house (CEPROBAN) and the funds transfer system associated with the accounts of financial institutions and the government at the Central Bank. These systems bear some systemic risks that need to be addressed as soon as possible. These risks include credit and liquidity risks, legal risks, operational risks, and custody & settlement risk for the special case of securities transactions.

Crisis in Agricultural Lending

The Honduran agricultural sector has been severely hit in recent years by a series of external shocks, such as Hurricane Mitch and the more recent drop in export prices for key commodities such as coffee. As a result of this evolution, a significant part of the non-performing loans in the portfolio of commercial banks are loans to the agricultural sector, which has led in turn to a dramatic decrease of agricultural lending over the past few years. Given the social and political significance of the agricultural sector in Honduras, policy makers have undertaken several attempts to revive lending to the sector, so far with little success. Anecdotal evidence suggests that these government interventions may be having instead some negative impact on the financial sector by contributing to a deterioration of the payment culture among existing borrowers.

Government Strategy:

The current Honduran government has clearly demonstrated its readiness for a constructive policy

dialogue on financial sector issues in Honduras. Some limited technical assistance is already being provided (i) in the context of the joint WB – IMF Financial Sector Assessment Program (FSAP), and (ii) with an existing PHRD grant. This collaboration with IDA has already yielded valuable results.

2. Objectives

The proposed project will support the development of the institutional capacity needed by the Honduran Authorities in order to address the vulnerabilities of the financial system. In this context, the project development objective is capacity-building for dealing with the current weaknesses of the banking system and improve its soundness, which is a prerequisite for sustainable growth and poverty alleviation. The project would achieve this objective by providing technical assistance for: (i) the design and implementation of a banking sector consolidation program, (ii) the institutional strengthening of the CNBS, (iii) the reform of the payments system, and (iv) the initiation of a public oversight function for the corporate sector. A financial sector adjustment operation is planned in FY04 to complement the proposed technical assistance operation and achieve the objectives defined in the Country Assistance Strategy.

3. Rationale for Bank's Involvement

The value added of IDA support for this project comes from the IDA's international experience in the design of financial sector reforms and assistance strategies. IDA has already provided valuable assistance to the CNBS with a PHRD grant. Further IDA assistance through this FSTAC would contribute to the effective implementation of the new legal and regulatory framework and the establishment of a mechanism to handle the capitalization and resolution of banks.

4. Description

The project consists of four components:

(i) Technical Assistance for Strengthening and Consolidation of Banking Sector:

The Bank Consolidation Program (BCP) will be developed to improve the soundness of the system and to give the proper incentives for consolidation, which should increase efficiency and enable a return to profitability.

(ii) Strengthening of CNBS:

Given the existence of a comprehensive IDB program, this project component will be very focused on activities directly linked to the implementation of the Bank Consolidation Program with the notable exception of money laundering issues.

(iii) Reform of Payment System:

The project will assist the authorities to develop a new strategy with consideration of all users' needs. Under this component, the project will carry-out an upgrade the current systems, including the launching of a special purpose large value payments system that will allow for the separation of large and low value payments, as well as possibly the establishment of a securities depository function.

(iv) Initiation of public oversight function for corporate sector and improvement of creditors' rights protection:

The suggested component will create a small oversight unit for monitoring the corporate sector soundness, improve the legal and institutional frameworks for insolvency and creditor rights as well as design efficient extra-judicial (or, if necessary, with minimal court intervention) mechanisms for corporate restructuring.

5. Financing

	Total (US\$m)
BORROWER	\$0.90
IBRD	
IDA	\$8.10
Total Project Cost	\$9 00

6. Implementation

The government agencies beneficiaries of this credit will be the CNBS and the BCH. The implementation will be done through a Project Implementation Unit (PIU) to be established within the CNBS.

7. Sustainability

Past attempts by Honduran authorities to address the difficulties in the domestic financial system have clearly not yielded the expected results. This experience has convinced most of the key project stakeholders in Honduras of the need to address the structural issues in the financial sector. Moreover, several members of the current Honduran administration are from the banking sector themselves, in terms of professional background, and have a clear understanding of the nature of the problems faced by the industry. Further, the IMF and the IDB are both working with IDA to support the government's efforts to strengthen the Honduran financial sector. Both institutions have been involved in the discussions related to the design and scope of the proposed project, and are providing complementary technical assistance to address the other issues identified by the FSAP diagnostic.

8. Lessons learned from past operations in the country/sector

Experience shows that governments frequently fail to prevent banking crisis for the following reasons: a poor diagnosis of bank problems and existing losses, lack of a comprehensive strategy to deal with a crisis, weak implementation capacity among financial authorities, unwillingness to dismantle vested interests, inadequate legal and regulatory framework, etc. The Honduras FSTAC has been designed taking these lessons into consideration. It focuses on capacity-building to ensure that Honduran authorities can implement the BCP and the new legal and regulatory framework to be created. Second, its sequential approach shows a certain level of pragmatism to ensure political consensus and broad support for the government's program. At the same time, clear milestones are set for each phase and detailed contingency planning will be done.

9. Environment Aspects (including any public consultation)

Issues : Not Applicable

10. List of factual technical documents:

N/A

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Note: This is information on an evolving project. Certain components may not be necessarily included in the final project.

Tables, Charts, Graphs:

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