FINANCIAL SECTOR ASSESSMENT
COSTA RICA

MARCH 2003

LATIN AMERICA & THE CARIBBEAN REGION VICE PRESIDENCY
FINANCIAL SECTOR VICE PRESIDENCY

BASED ON THE JOINT IMF-WORLD BANK FSAP REPORT

1. **This Financial Sector Assessment (FSA) summarizes the FSAP report for Costa Rica.** The FSAP included two missions to San José in October 22–29 and December 5–13, 2001.[1] The FSAP results were discussed extensively with the authorities during a full-day wrap-up meeting at the end of the second mission. They were also discussed in September 2002 with relevant authorities of the new administration during a World Bank visit to San José, and in November 2002 in the context of the IMF Article IV Consultation. The final FSAP report was completed in August 2002.[2] *The diagnosis and assessment in the FSAP report, and hence in this FSA, are based on information available as of end-2001.* However, Box 1 summarizes (without evaluating) relevant reforms undertaken by the authorities during 2002.

I. MACRO-FINANCIAL VULNERABILITIES

A. Macroeconomic Background

2. **Costa Rica has a historical record of substantial output growth with low macroeconomic volatility, but short term prospects remain uncertain.** Costa Rica's average yearly output growth (3.5 percent) in the last two decades exceeded that of most of its neighbors while inflation (23 percent) was relatively moderate by Latin American standards. Notwithstanding volatile terms of trade, output and real exchange rate volatilities in Costa Rica are much below those of most Latin countries (Figure 1). Costa Rica's sovereign bond ratings are among the best in the region (Table 4). This good performance has been anchored on a stable policy environment (with fiscal and monetary policies having avoided stop-go patterns) and a high and growing integration into the world economy (Figure 2). A stable political system—with a long democratic tradition, generally effective institutions, relatively low

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[1] The FSAP was led by Augusto de la Torre (WB/LCR) and Alain Ize (IMF/MAE). Other members of the team were Jorge Cayazzo, Armando Morales, Karl Driessen (all IMF/MAE), Sergio Martin (IMF/WHD), Katharine Christopherson (IMF/LEG), Yira Mascaro, Mario Guadamillas, Juan Ortiz (all WB/LCSFP), Alberto Musalem (WB/FSD), Joaquin Bernal (Banco de la República, Colombia) and Ruben Marasca (Banco Central de la República, Argentina). José Benjamin Escobar, Ross Delston (both IMF/LEG), and José Antonio Alepuz (WB/LEGPS) provided inputs from headquarters. The FSAP team gratefully acknowledges the excellent hospitality, cooperation, and openness of the Costa Rican authorities and technical counterparts.

[2] The international standards and codes formally assessed under the Costa Rica FSAP were: the Code of Good Practices on Transparency in Monetary and Financial Policies, the CPSS Core Principles for Systemically Important Payment Systems; and the Basle Core Principles for Effective Banking Supervision.

income inequality, a burgeoning middle class, and a strong education system—has also contributed to a favorable environment for growth. However trend GDP growth has declined since the early 1990s. A temporary growth spurt in the late 1990s was associated with large investments by Intel in the computer technology sector, but the recent world downturn in this sector accentuated the output decline since 2000 (Table 3, Figure 2).

3. **The stable macroeconomic environment masks some sources of tension, not least in respect of public sector debt but also with regard the external accounts.** The fiscal deficit widened during the late 1980s and mid-1990s, reflecting depressed tax revenues and a significant increase in pension expenditures (Table 3, Figure 2). It resulted in a steady growth of public debt to a current level of around 40 percent of GDP—most of which is domestic debt. In turn, substantial interest payments on public debt added to the overall fiscal deficits, notwithstanding the small primary surplus for the central government. The latter (0.7 percent of GDP during 1999–2001) is insufficient to ensure a reduction over time of the debt to GDP ratio, even under the assumption of GDP growth of 4.5 percent, equal to its average during the last decade (Figure 2). Contingent pension liabilities and the negative capital of the central bank (see below) shed further doubts on the sustainability of public debt under a non-inflationary environment. Fiscal imbalances and unfavorable terms of trade have contributed to a rising trend in the external current account deficit since 1996 which, however, were financed during the late 1990s by large foreign direct investments (including by Intel) (Figure 3).

4. **The monetary and exchange rate regime promotes dollarization and limits the scope for relative price adjustments.** The revealed objective of Costa Rica's exchange rate policy has been to preserve external competitiveness, subject to the constraint of ensuring the credibility of the crawling peg through an adequate level of international reserves. To this end, Costa Rica has followed since the early 1980s a somewhat flexible exchange rate crawl, in the sense that the rate of crawl has been regularly adjusted (usually on a yearly basis) to compensate for differentials of past inflation between Costa Rica and its main trading partners.[3] In addition, the central bank has adjusted interest rates upwards to defend international reserves in times of turbulence. This regime commands considerable credibility in Costa Rica and may be credited for having avoided large real exchange rate overvaluations and currency crises. However, by *trading short-term real certainty against long-term nominal uncertainty* (through the systematic targeting of the real exchange rate, rather than inflation), the current regime promotes dollarization.[4] It has induced agents to view the exchange rate as the best predictor of inflation and the dollar as an attractive store of value. Limits to transparency in monetary policy (which partly results from inconsistencies between the central bank's de-facto policy objectives and their legal underpinnings[5]) have further tightened the link between inflationary expectations

[3] Since August 1982, there have not been any jumps in the exchange rate and adjustments in the peg have become nearly continuous since January 1985.

[4] It does not follow that some dollarization would not have obtained under a different exchange rate regime. Dollarization in Costa Rica also appears to reflect other factors, including increasing international integration and uncertainties about public sector debt sustainability in a non-inflationary environment—which undermines the role of the colon as a store of value (fostering deposit dollarization) and raises the domestic real interest rate (contributing to loan dollarization).

[5] The Central Bank's Charter specifies that the central bank should stabilize the internal *and* external value of the currency, neither of which is achievable under the current monetary regime.

and the exchange rate. The high pass through of exchange rate movements to prices limits the ability to induce a real depreciation at a moderate cost in terms of inflation.

Box 1. Salient Measures Adopted During 2002

Bank Supervision

- *Joint Supervision of Offshore Banks*. During 2002 SUGEF made considerable progress in signing Memoranda of Understanding (MOU) with the supervisory authorities of countries where Costa Rican offshore banks are incorporated. To date, MOUs have been signed with Panama, Colombia, El Salvador, Honduras, and Dominican Republic. (For a description of offshore banking in the case of Costa Rica, see text paragraph 7.) Costa Rican offshore banks are required eventually to move to jurisdictions with which an MOU has been signed. Per the MOUs, SUGEF can conduct on-site inspections of Costa Rican offshore banks, jointly with the local supervisors. SUGEF can do the same with respect to Costa Rica offshore banks incorporated in the U.S., even though a formal MOU has not yet been signed with the U.S. A joint on-site inspection of a Costa Rican offshore bank incorporated in Panama was conducted in 2002.
- *Capital Requirements.* In mid-2002, CONASSIF approved a Capital Adequacy Norm that details the manner in which financial groups, included public bank based groups, are to calculate capital adequacy on a solo and a consolidated basis. SUGEF does not have legal power *directly* to regulate and supervise offshore banks and certain onshore non-bank financial intermediaries (e.g., leasing, factoring, and credit card companies). However, the Capital Adequacy Norm addresses part of this limitation *indirectly*. It requires the holding company of a financial group to hold capital equivalent to at least 20 percent of the assets in the mentioned onshore non-bank intermediaries. Such capital requirement can be reduced to 10 percent, at the discretion of SUGEF, if the intermediaries voluntarily accept to be subject to SUGEF's onsite inspection.
- *Risk Management*. The Federal Reserve of Atlanta and the Office of the Comptroller of the Currency provided technical assistance to SUGEF to strengthen its capacity to assess risk management and other internal systems in financial institutions (including strategic planning and management information systems). In addition, a new regulation on credit risk deriving from dollar lending to non-dollar earners has been prepared and is expected to be approved soon by CONASSIF.
- *Information Requirements and Accounting Standards.* On January 1st, 2003, a new chart of accounts, that generally follows International Accounting Standards, came into effect.
- *Anti-Money Laundering.* On December 2001, the SUGEF issued new guidelines for "Know Your Customer" rules establishing the minimum standards that are to be complied with by Costa Rican institutions.

Securities Markets

- *Money market development.* Procedures for the transfer of securities used in repos were simplified and improvements were introduced to facilitate information availability. The Stock Exchange is in the process of changing the technological platform to facilitate the integration of the *Mercado de Liquidez* and the MIB.
- *Regulation.* The supervisory roles of SUGEVAL and the Stock Exchange were clarified. Disclosure requirements for broker-dealers were enhanced and mark-to-market valuation of investment funds introduced.

5. **The exchange rate crawl, together with the central bank's negative capital, combined with the weak fiscal situation, limit the capacity to further reduce and stabilize inflation.** The credibility cost for the central bank arising from its negative net worth,[6] combined with backward-looking nature of the crawl and the high pass through, tends to perpetuate inflation. Inflation hit a floor of about 10 percent for the last three years (Figure 3).

[6] The central bank's negative capital (liabilities exceed the value of assets) arose historically as a result of quasi-fiscal operations, including the assumption of impaired assets in the context of certain bank failures.

Bringing inflation down would require breaking the inertia of the current exchange system *and* a fiscal effort to replace inflationary taxation by sounder means of finance. However, in the absence of the central bank's recapitalization, inflation is needed to finance central bank losses and, thus, keep its negative net worth from spiraling away.[7] Assuming that the real interest and growth rates remain at their last five-year average, it is estimated that an inflation rate of at least 15 percent would be needed to stabilize the ratio of the central bank's net worth to GDP.

B. Financial System Structure and Trends

6. **The financial sector is deep relative to other countries in the region and, though centered on banking intermediation, increasingly diversified.** It is organized around financial groups that often include, in addition to an onshore bank, an offshore bank (see below), a stock broker, an investment fund, an insurance commercialization firm, a pension fund, and a mortgage company. Gross assets of financial institutions reached 72 percent of GDP in June 2001, which is high by Latin American standards (Table 1). While banks account for the lion's share of financial sector assets (77 percent), investment funds (mutual funds and pension funds) have grown rapidly in recent years (to 10.4 percent of financial sector assets and to the equivalent of 34 percent of bank deposits as of September 2001) as a result of reforms that have clarified the legal and regulatory framework for mutual funds and created a privately-administered, "second pillar" pension system. Banks' activity has increasingly focused on lending to the private sector (the share of loans in banks' total *onshore* assets rose from 43 percent to 48 percent between January 1998 and June 2001) while the assets of investment funds have concentrated nearly exclusively in government debt securities (Figure 4).[8]

7. **Offshore banking (which mainly serves domestic residents) is unusually large in Costa Rica, but its growth has tapered off during the last few years.** Offshore banks account for about 24 percent total banking system assets (Table 1). Unlike the more typical offshore systems, Costa Rica's offshore banks are licensed in foreign (mainly Caribbean) jurisdictions *but* conduct most of their deposit-taking and lending activities with Costa Rican residents and are, therefore, fully woven into the country's domestic financial and economic activity. This type of offshore operations are a salient feature among private financial groups (assets of private offshore banks are equivalent to 41 percent of the assets of private onshore banks and to 100 percent of the assets of their corresponding onshore banks, as against 11 percent for public banks). As onshore banks are legally allowed to take dollar deposits and make dollar loans, offshore banks are mainly used for tax avoidance and regulatory arbitrage. Offshore banks grew rapidly in the initial stages of private banking (the banking sector was a state monopoly until the mid-1970s), in response to high unremunerated reserve requirements (over 28 percent in 1995) and reflecting private banks' search for a competitive edge against public banks. Offshore banks' growth is tapering off (information on offshore banks is limited; it became available since end-2000), following a substantial reduction in reserve requirements

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[7] A recent effort by the government (in January 2001) to recapitalize the central bank brought its yearly losses down from 1.8 percent of GDP in 2000 to 1.4 percent of GDP in 2001.

[8] Higher yields and high liquidity of mutual funds explain their success. However, increasing competition between banks and funds have tended to depress funds' yields relative to those of term deposits over the last two years, suggesting that funds' growth may have reached an inflexion point.

(to 9 percent at end-2001), concerns about the negative connotations of offshore banking, and aggressive competition in the dollar funding market by mutual funds and public banks.

8. **The already high degree of financial dollarization is on an increasing trend**. At present, 45 percent of deposits (50 percent of loans) of the onshore banking system is dollar-denominated (Figures 4 and 5). The share of dollar loans in the onshore loan portfolio of private banks is, at 60 percent, higher than in public banks (40 percent). As all operations of offshore banks are in dollars, about 60 percent of loans of the consolidated (onshore and offshore) banking system are dollar denominated. The consolidated private banking system (adding the onshore and offshore segments) is much more dollarized than the public system—over 75 percent of private bank loans are in dollars, compared to 47 percent in the case of the consolidated public banks. The authorities estimate that about half of onshore dollar loans are to debtors whose incomes are not in dollars (Table 6), which understates the problem given that a nontrivial fraction of the (dollar) loans of offshore banks is likely to be non-dollar earners (data do not exist to establish that proportion). Financial dollarization may be generally fostered by ongoing international financial integration. But, as mentioned earlier, it is accentuated by the exchange rate regime, which rises nominal (colon) uncertainty. Yield curves are steeper for the colón than for local dollars, suggesting that uncertainty over real yields rises as the maturity of colón instruments rises (Figure 5). The rapid increase in dollar funding has enabled dollar loans to grow faster than dollar deposits. Deposit dollarization has grown despite a shift in interest rate differentials in favor of colón deposits caused in part by the relative abundance of local dollars. The increase in the funding cost of colón loans, together with high intermediation spreads in local currency (see below), has raised the cost of colón loans, inducing dollar loans to expand across the board, including to consumer loans and mortgages. The higher debt service burden of colón loans (deriving from high nominal interest rates and flat amortization schedules) further depresses their demand.

9. **The capital market is narrow and centered on public securities and repo operations.** The dominant security in this market is domestic public debt paper (issued by the Treasury and Central Bank) of short duration (less than one year), with most trading (80 percent) consisting of repo operations. Partly due to the small size of the country and concentrated ownership patterns, the market for private securities is undeveloped. There is only a handful of private debt securities, mainly issued by the financial sector, with limited trading. The equity market is nearly non-existent. The capital market has performed basically two functions: orthodox finance of the public sector and money market activity.[9]

10. **The public sector has a pervasive presence in Costa Rica's highly concentrated financial system, limiting competition.** The onshore banking system continues to be dominated by public banks, which include three state-owned commercial banks (Banco Nacional, Banco de Costa Rica, and Banco Nacional de Cartago), and a special-charter bank (Banco Popular) in principle owned by all Costa Rican workers. They account for about

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[9] Money market activity takes place through two markets: i) the *Mercado de Liquidez*, in which brokerage houses conduct very short-term repos with public sector securities; and ii) the MIB (*Mercado Interbancario de Dinero*) in which banks and the central bank conduct inter-bank repos, also with public securities. This segmentation derives historically from legal provisions that give stock brokers a monopoly in secondary market trading and registry of securities. Arbitrage between the money markets has increased following the recent introduction of the MIB and the central bank's lending and deposit facilities, but trading in the MIB remains limited.

75 percent of total banking deposits (Table 1). Consequently, banking concentration, albeit declining, continues to be high, even by Latin American standards (Table 5). The public sector has a monopoly of the insurance sector, through the INS, and dominates the pension and mutual fund industry (for instance, five out of the nine pension fund managers, which jointly account for about 75 percent of all pension fund assets, are owned by public sector institutions).

11. **However, the banking system has become more diversified in recent years, with private banks continuing to gain market share and forcing public banks to adjust.** Onshore private banks include 17 banks (3 mergers took place during 2000 and one was underway in 2001), 10 of which have at least a 50 percent share of foreign capital (from the U.S. and Central American countries). They have expanded their share in onshore banking, following the authorization (in 1996) to open sight deposits (albeit conditioned to depositing 17 percent of such deposits in partially remunerated accounts in state-owned banks). Notwithstanding their substantially higher cost of funding, due to their more limited presence in the retail market and lack of deposit guarantee (in stark contrast with the explicit state guarantee enjoyed by all public bank deposits), the private banks' share of onshore bank lending rose from 33 percent in early-1998 to 42 percent in August 2001 (Figure 4), as they countered their local funding handicaps with more aggressive lending in dollars, a rapid increase in funding through external lines of credit, better service, and quicker product innovation. Competition from private banks has driven the public banks to expand their dollar lending and compete more aggressively for dollar funding. As a result, the contrast between the asset structure of public and private banks, while still sharp (with public banks concentrating in colón lending to small borrowers and colón-denominated public securities while private banks focus on dollar operations with the larger and more sophisticated customers), has thus tended to become less pronounced.

12. **While volatile, credit growth has accommodated demand, with foreign financing playing a buffer role.** Aggregate credit growth has incurred deep fluctuations during the last decade, mostly reflecting the business cycle (Figure 5). Setting aside a short pause in 1995, the deposit base has grown continuously, exceeding until the mid 1990s private credit by a comfortable margin, thereby providing an ample liquidity buffer to accommodate fluctuations in credit growth. While the growth of public debt from the mid-1990s onwards started to crowd out private lending and exert pressures on funding, external lines of credit quickly filled much of the gap. Thus, credit fluctuations have been mostly demand-driven, with funding passively accommodating credit needs.[10]

13. **The high colón intermediation spreads reflect uneven regulatory and tax treatment, crowding out, and market segmentation.** High spreads between colón deposit and lending interest rates (at about 12 percentage points, on average) in the onshore banking system partly reflect uneven taxation and regulation across currencies.[11] They also reflect a crowding out of colón credit by the predominantly colón-denominated domestic public debt. Finally, they reflect the use of currency denomination as a vehicle for price discrimination, as colón

[10] Econometric analyses of the relative importance of supply and demand factors in the determination of credit fluctuations confirm this interpretation.

[11] Private offshore (dollar) deposits are not subject to reserve requirements and withholding taxes, and onshore dollar deposits in public banks are exempted from withholding taxes.

customers are generally less sophisticated than dollar customers and have less access to alternative financial outlays. The notable differences between the average size of colón deposits and loans clearly illustrate such market segmentation (Figure 5).

C. Financial Sector Vulnerabilities and Risks

14. **Reported prudential indicators depict a generally healthy onshore banking system** (Table 2)**, but some caution is needed in interpreting these indicators.** Onshore banks report high ratios of capital to risk-weighted assets (CAR), 14 percent for public banks and 16 percent for private, above the required minimum CAR of 10 percent. Banks have remained profitable over the last years, with real returns on assets around 2 percent and on equity of around 10 percent. However, the lack of on-site verification of the financial accounts and asset quality of offshore banks sheds doubts on the related onshore banks' capital adequacy. The capital adequacy in the case of public bank based groups is affected by insufficient provisioning of large labor-related contingent liabilities (such as severance payments obligations to employees).[12] Non-performing loans (NPLs)—defined as loans in arrears for 90 days or more, including loans under judicial collection proceedings—have oscillated around 5 percent during 2000-2002 for onshore public commercial banks and around 1.5 percent for onshore private banks, with no discernible trend.[13] Although the reported provisions coverage of NPLs is strong (around 80 percent for onshore public banks and 110 percent for onshore private banks), the high percentage of loans reclassified as a result of on-site inspections (about 30 percent of revised loans) suggests deficiencies in banks' own risk management practices, particularly in the case of some public banks. Inconsistencies across different sets of data on NPLs also shed some doubts on the reliability of banks' financial statements.[14]

15. **Dollarization raises the banking system's vulnerability to shocks.** Financial dollarization limits the scope for using monetary policy to moderate output and credit cycles. The reliance on interest rates to preserve the exchange rate regime and counteract adverse shocks heightens interest rate volatility and pro-cyclicality (interest rates increase during downturns), thereby compounding the adverse effects of economic slumps on borrowers' debt servicing capacity. Banks' exposure to liquidity risk is similarly enhanced by the high dollarization of bank deposits and the fact that quantity adjustments (deposits and international reserves), rather than price (exchange rate) adjustments, constitute the first line of defense against adverse systemic shocks. Finally, the dollarization of bank loans to non-dollar earners exposes banks to credit risk should the exchange rate be devalued abruptly (see below).

16. **Credit risk could rise abruptly under a credit crunch scenario.** Credit fluctuations have not put the system at risk because, as noted earlier, they have been mostly demand-driven. The reported soundness of loan portfolios is not independent of the fact that borrowers have not

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[12] In mid-2002, a 9-year adjustment timetable was introduced for public banks to gradually constitute provisions for these labor-related liabilities.

[13] NPLs excluding loans under judicial collection proceedings are significantly lower (around 0.4 percent for private banks and 1 percent for public banks), without a discernible trend in this case indicator either.

[14] For example, the share of problem loans reported to the SUGEF for prudential purposes by banks tended to different and often lower than that reported in banks' audited financial statements. After the FSAP mission, the SUGEF reports to have addressed these data inconsistencies.

experienced a contraction in net lending flows, i.e., of credit flows net of interest payments. However, a credit crunch scenario resulting from an abrupt contraction of domestic or external funding or a heightened perception of risk by local bankers, could result in a sharp increase in NPLs. While the potential for a deterioration of credit portfolios is difficult to measure econometrically,[15] the widespread use of revolving credit lines in corporate lending (which are prone to "ever greening") suggests that a scenario of supply-led credit contraction could have a severe impact on loan quality.

17. **Banks are (indirectly) exposed to interest rate risk and, particularly, to exchange rate risk.** Banks are not directly exposed to interest rate risk, due to the widespread use of floating lending rates. However, this shifts risk to borrowers (who are often less equipped to bear such risks than banks or investors) and heightens banks' indirect exposure to interest rate risk by accentuating their exposure to credit risk.[16] In addition, some banks use their own interest rate indices to adjust their floating rates on loans, a practice that lacks transparency and is prone to discretionary adjustments. Similarly, banks' direct exposure to the risk of currency depreciation is not significant, as the scope for holding short open dollar positions is limited by regulation.[17] However, banks are indirectly exposed through their borrowers (Table 6). Banks are aware of the risks associated with lending in foreign currency to borrowers who do not receive dollar incomes and have taken some steps (in terms of screening and collateral) to mitigate such risks. Nonetheless, the large cost differentials between colón and dollar loans and the implicit exchange rate guarantee provided by the crawl encourage a systematic underestimation of the risks associated with dollar contracts.

18. **Liquidity in the onshore banking system is high but has been declining and is unevenly distributed.** Both systemic liquidity (hard-currency liquid assets of onshore banks plus international reserves of the central bank) and idiosyncratic liquidity (domestic or external liquid assets held by individual onshore commercial banks) are reasonably high. However, liquidity has declined in recent years as the monetary authorities reduced reserve requirements and banks expanded their lending operations (Figure 7). Also, liquidity is unevenly distributed across banks. While public banks are generally quite liquid, reflecting their large holdings of Costa Rican government securities, the liquidity of some private banks lies much below the average for the system. The short average maturity of bank deposits (75 percent of deposits have a less than three-month maturity), some shortcomings of the inter-bank money market (see below), and the lack of deposit insurance for private banks increase the risk that some banks may encounter funding difficulties in a situation of turbulence. This can be compounded by the adverse impact of interest rate increases (which would likely accompany such turbulence) on the price and liquidity of government securities.

[15] Stress tests based on econometric techniques (particularly to estimate the magnitude of the impact of shocks on the quality of bank loans) could not be reliably run because of data limitations, as the series for non-performing loans was inconsistent, unavailable for a sufficiently long period, and with insufficient variability.

[16] Although corporate leverage in Costa Rica does not appear to be particularly high by international standards (Figure 7), caution is needed in view of the limited coverage of the available data.

[17] By regulation, banks should maintain a *long* dollar position of between zero and one hundred percent of capital. However, banks cannot alter their position by more than 0.5 percent of capital per day.

19. **Vulnerabilities could increase by the intensification of competition.** Pressures on banks' profits are likely to increase due to greater competition between private banks and public banks, banks and mutual funds, and onshore and offshore banks. The growing importance of institutional investors and the shift towards dollar intermediation can exacerbate competitive pressures. This can lead to a profit squeeze, particularly for public banks, whose franchise value is being eroded by their migration towards dollar markets (where unit costs are higher and intermediation margins are narrower, and where the state guarantee is likely to be less relevant) and the envisioned introduction of a deposit insurance for private banks. Profit pressures could induce weaker institutions to take on excessive risks, particularly given the shortcomings in the bank resolution framework (see below).

II. Risk Management

A. Liquidity Management

20. **The segmentation of the money market and somewhat opaque monetary signals limit the effectiveness of day-to-day liquidity management.** The money market is segmented (see footnote 8), its depth is limited, and interest rate volatility (across time and across markets), while declining, continues to be substantial. Volatility is due in part to the rationing of liquidity injections in the central bank's lending facility, and to the absence of an active liquidity policy. (The regulation of liquidity takes place ex-post through the broad corridor set by the central bank's standing facilities.) Monetary policy signals are focused on longer term instruments, typically six-month central bank bills (BEMs), sold in the same auctions as treasury instruments. This causes the yield curve to be arbitrarily determined and the distinction between monetary policy and public debt management to be blurred.

21. **There is room to enhance monetary management under the current crawling-peg system.** A lower inflation would facilitate monetary management by reducing uncertainty in real interest rates and limiting incentives for dollarization. An essential condition to achieve sustainable inflation stabilization is that the central bank be recapitalized, so as to eliminate its operating losses. The strengthening of the primary fiscal surplus would be necessary to achieve this recapitalization without exacerbating problems for public debt sustainability. This recapitalization would also provide an opportunity to replace the central bank bills by treasury bills as the instrument of choice for monetary operations, thereby contributing to deepen the market for short-term public securities. Communications between the central bank and the market can be further strengthened through more ample explanations of monetary goals and policy decisions, and through tools (market-based or survey-based) to assess market expectations.[18] The deepening of the inter-bank money market would require eliminating the use of rationing clauses in the day-to-day liquidity injection facility as well as measures to further develop the infrastructure for trading and registry of public securities. Finally, the development of an active day-to-day open market intervention capacity (based on effective liquidity forecasts) would be needed to limit the volatility of money market interest rates and gradually shift the focus of monetary policy towards the shorter end of the yield curve.

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[18] Commendable efforts have already been taken to strengthen central communication with the public, including through the introduction of a regular inflation report. However, the authorities face a major challenge in applying such tools to a regime which is inherently much less transparent than inflation targeting.

22. **Impressive progress has been achieved as regards payments system infrastructure.** Progress was notable in strengthening the legal and operational underpinnings of the payments system, including through the introduction in 1999 of a real time gross settlement system (the TEF), which has led to a sharp reduction in the use of checks for large payments. Costa Rica fulfills most of the Core Principles for Systemically Important Payments Systems. However, the possible gradual reduction in reserve requirements, together with a continuing shift of payments towards real time settlements, could eventually constrain the growth of the TEF and increase the risk of settlement failures in the multilateral netting systems, including checks. Mitigating such risks would require developing liquidity enhancing arrangements (such as intra-day repos) and increasing the reserve funds set aside for the check clearing system.

B. Prudential Management

23. **Some features of the organizational arrangements for the regulation and supervision of the financial system—centered around CONASSIF—appear to be limiting the effectiveness of prudential oversight.** The National Council of Financial System Supervision (CONASSIF) is a Board that oversees three supervisory agencies: the General Superintendency of Financial Entities (SUGEF), the General Superintendency of Securities (SUGEVAL), and the Superintendency of Pensions (SUPEN). CONASSIF's legal mandate endows it with broad responsibilities and strong powers in regulation and supervisory enforcement, and is clearly of an "executive" nature.[19] However, its structure and resources are more congruent with a "consultative" role. The superintendents do not have voting power, nor do they have the legal authority to set priorities for its agenda. The five Board members with voting power are not necessarily experts in the field and are dedicated only on a part-time basis.[20] There are insufficient restrictions to minimize potential conflicts of interest.[21] As a result, CONASSIF members may lack the time, and potentially also the independence, to carry out their responsibilities. Legally unable to "delegate" functions to the superintendents, CONASSIF constitutes an additional layer in the decision making process that can hinder the effectiveness of key decisions, particularly as regards supervisory enforcement and troubled bank resolution. Moreover, CONASSIF is naturally inclined to focus on the systemic dimensions of prudential oversight and, hence, tends to pay insufficient attention to investor protection matters, which are central to the responsibilities of SUPEN and also, to a lesser degree, of SUGEVAL and SUGEF.

24. **Legal reform is recommended to better align the mandate of CONASSIF with its capacity to fulfill it.** Legal clauses to prevent conflicts of interest should be clarified and tightened. As regards the structure and functions of CONASSIF, one alternative would be to

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[19] CONASSIF appoints the superintendents, the deputy superintendents, and the internal auditors of the three supervisory agencies, as well as their general governing rules, annual budgets, internal audits, and annual reports. CONASSIF also approves prudential regulations, authorizes mergers, issues cease and desist orders, intervenes banks and requests the liquidation of banks, withdraws banking licenses, etc.

[20] CONASSIF members comprise the Minister of Finance, the President of the Central Bank, and other 5 persons appointed by the Board of the Central Bank. They are typically dedicated on a part-time basis, as their remuneration is limited to a maximum of 50 percent of the salary of the *Contralor General de la República*.

[21] For instance, bank stockholders that are not simultaneously members of a bank board of directors could be CONASSIF members, and so could staff members of external auditing firms that audit domestic banks.

maintain its current composition and the part-time dedication of its members *but* reduce its powers and responsibilities, making it more of a consultative or coordinating Board. An arguably superior alternative would be to: (i) change the composition of CONASSIF (e.g., to include the three superintendents, the president of the central bank, and a fifth member, all with voting power); (ii) require full-time dedication of its members, and (iii) focus its role on, say, four main functions—approving regulations that are consistent across financial sub-sectors, granting and removing licenses, coordinating supervisory actions by different agencies in the oversight of the various entities of a financial conglomerate, and acting as an appeal instance with regard to enforcement measures. Under either alternative, the independence of the president of the central bank and the superintendents should be maintained and strengthened.

25. **Financial conglomerates are not supervised on a fully consolidated basis, which explains the under-compliance with several Basle Core Principles.** Financial conglomerates are obligated by law to adopt a holding company structure and report their financial statements on a consolidated basis. However, important entities within such conglomerates fall legally outside the regulatory and inspection powers of the SUGEF. The most salient case is that of offshore banks, which are not regulated and supervised by the Costa Rican authorities and whose real situation can be known only through agreements with foreign supervisors.[22] Similarly, onshore entities such as leasing, factoring, and credit card companies are not legally subject to oversight by the SUGEF. The legal imposition of a holding company structure on private financial conglomerates, intended to provide clarity to company organization, may result in unnecessary rigidities.[23] The lack of fully consolidated supervision, which is one of the main causes for Costa Rica's under-compliance with a number of Basle Core Principles for Effective Banking Supervision, is a major source of vulnerability. It needs to be addressed through legal reform as a matter of priority.[24]

26. **Regulatory innovations are recommended to address other risks identified in Section I.C.** Given the volatility of credit, the authorities should consider introducing counter cyclical provisioning requirements, similar to those recently enacted by the Bank of Spain.[25] Counter cyclical provisions—which would be additional to generic and specific provisions—would be built in times of fast credit growth, enabling banks to convert such provisions into specific provisions as loans deteriorate during the downswing phase of the credit cycle. In view of the high (indirect) exposure of banks to currency risk, consideration should also be given to establishing relatively tighter loan classification and provisioning rules for dollar loans to the non-tradable sector. At the same time, the regulation on open foreign exchange positions should be revised to limit the total range within which banks can adjust their position, while eliminating the limit on the daily changes in position. As reserve requirements are reduced, the

[22] As of end-2001, the SUGEF had agreements with supervisors in 2 out of the 4 foreign jurisdictions in which Costa Rican offshore banks were incorporated. Such agreements had not yet been implemented in practice.

[23] Alternative organizational structures that allow vertical as well as horizontal integration without a sacrifice of transparency could be better suited to the business strategies of some financial groups. Until September 2001, public financial groups were subject to a different treatment, as they were not required to report consolidated accounts nor organize themselves as a group (via a holding).

[24] In 2001, CONASSIF created a Working Group to identify the legal and regulatory changes that would be needed to ensure the full consolidated supervision of financial conglomerates.

[25] See Bank of Spain, Circular No. 9/1999 of December 17, 1999.

authorities should consider introducing explicit liquid asset requirements that include, at least in part, safe and liquid foreign assets. Finally, to limit banks' exposure to (indirect) interest rate risk, transparency standards for the setting of floating rates should be raised. The effective implementation of all of these regulations would require the incorporation of offshore banks under fully consolidated supervision.

27. **While competition between private and public commercial banks has increased, significant regulatory and tax asymmetries remain.** The privileges of public banks include the state guarantee on all their liabilities (no explicit deposit insurance exists for private banks), the tax exemption of their dollar deposits, and the requirement on private banks to deposit (at sub-market interest rates) at least 17 percent of their short-term deposits in state banks in order to be entitled to take demand deposits.[26] One special-charter public bank is explicitly exempted from the legal reserve requirement, and benefits from a captive source of almost costless funding.[27] On the other hand, the capacity of state banks to compete is hindered by their legal status as public entities (which makes them akin to a government ministry) and by their governance structure (politically appointed boards of directors). As a result, they have difficulties in adopting profit maximization as the objective of their business strategy and the role of their boards of directors is unclear. In addition, they face cumbersome public sector procurement guidelines and inflexible personnel and salary policies. And their management is saddled with the restriction of being able to "do only what is permitted by law" (while private bankers can "do whatever is not prohibited in the law") and with the responsibilities attached to the management of public funds (which, for instance, makes it difficult to recognize losses in securities investments). These asymmetries are mostly grounded in the law and create an uneven playing field that complicates prudential oversight and distorts incentives.

28. **SUGEF should review and suitably modify its bank rating scheme.** SUGEF's bank assessment system (whose results are not disclosed to the public) relies heavily on a rigid weighting of CAMEL-type ratios and mixes two distinct objectives: determining differences in financial strength between viable banks under normal conditions and triggering prompt correction and/or intervention of potentially unviable banks under extraordinary conditions. As a result, it performs neither of the two functions well. Under normal banking conditions, it gives undue weight to quantitative indicators and does not discriminate between banks with different business strategies, thus creating incentives for banks to "window dress" their balance sheets in order to display "adequate" ratios. At the same time, it is excessively rigid and unrealistic in triggering correction, intervention, or resolution of troubled banks, under extraordinary conditions.[28] As a result, most banks end up being classified as "normal," which renders the rating system of little use, while creating the false impression that problems are being detected and corrected at an early stage. It is recommended that SUGEF modify its rating

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[26] Private banks that choose not to raise demand deposits must open offices in under-served locations.

[27] A part (1 percent of salaries) of the contributions to the privately-administered pension funds must first be deposited for 18 months in that special-charter bank at a sub-market rate of interest. In addition, employers must contribute ¼ of a percent of their wage bill to this bank's capital in an unrequited manner.

[28] For instance, intervention of a bank is triggered if its capital falls below 8 percent of risk-weighted assets, or if a bank falls in category 3. Formal rehabilitation (*saneamiento*) plans are automatically required for banks in categories 1 and 2. Only banks in the *normal* category avoid corrective actions, but there is no useful system to differentiate between banks in the *normal* category.

tools to better handle the "normal" relationship with regulated banks—e.g., through a refinement of the CAMELS system that would emphasize the assessment of the banks' own capacity to manage risks prudently and the use of memoranda of understanding to correct relatively minor problems. Such tools should be different than those used to manage the "extraordinary" relation with troubled banks that are in need of prompt correction or resolution.

29. **The authorities should also redesign the system of penalties and address certain voids in prudential and accounting norms.** Penalties consist of very high fines and/or drastic actions, such as the suspension of operations of the bank. There is no graduated system that matches stiffer penalties with graver infractions. As a result, infractions by bankers tend to be, in practice, not penalized, which undermines enforcement and supervisory credibility. Legal changes should be introduced to establish a graduated, realistic system of penalties. To foster discipline, the authorities should also consider disclosing penalties and other enforcement measures. In addition, there is room for improvement as regards some accounting norms (e.g., aspects of consolidation of financial statements, the treatment of certain off-balance sheet items, securitized assets, the sale of repossessed collateral financed by the seller bank, the amortization of non-financial assets, and loan write-offs). Also, SUGEF should require information on restructured loans (to better detect "ever greening").

30. **Supervisory practices have strengthened considerably in recent years (despite the mentioned legal and institutional constraints) but there is room to improve banks' own risk management systems and foster greater market discipline.** Noticeable progress has taken place in bank supervision. Further progress would hinge not only on the intensification of training programs but also on greater institutional support for supervisors. At present, the supervisory approach is insufficiently geared at promoting market monitoring of banks (which is fundamentally undermined by the state guarantee of public banks) and at inducing improvements in banks' own risk management systems. The authorities should accelerate the shift to a risk-based supervisory approach that puts more emphasis on the evaluation of the quality of bank management (internal controls, risk management policies, etc.). In particular, they should introduce incentives for banks to correctly classify and provision their loans ahead of the SUGEF inspections. They should also facilitate the monitoring of banks by the private sector by continuing to enhance disclosure reporting. There is ample room to strengthen the oversight of supervisors over external auditors and enhance the complementarity of their work. To enhance debtor screening and monitoring while strengthening supervision, the debtor information system maintained by SUGEF should continue to improve in terms of coverage, quantity (and reliability) of information, and ease of access to it by the credit institutions.

31. **Prudential oversight of securities markets has registered remarkable progress, but the division of functions between SUGEVAL and the Stock Exchange should be clarified and accounting and disclosure issues pertaining to mutual funds addressed.** SUGEVAL has led a major modernization of securities markets regulation and has brought under its oversight previously unregulated funds (e.g., CAVS and OPABs) that grew in the past as substitutes to bank deposits and to avoid legal reserve requirements. However, the self-regulatory role of the Stock Exchange should be more clearly defined, ensuring that it is complementary to the oversight function of SUGEVAL. Also, stricter disclosure requirements are needed for investors to better understand the risks they take, including through the so-called leveraged repos. At the same time, mark-to-market requirements need to be introduced for

mutual and pension funds. (The absence of mark to market does not constitute at present a severe practical problem, given the short-duration of assets in fund portfolios. However, its impact will become more severe as longer-duration instruments become available.)

32. **Important progress has been made in strengthening the anti money laundering legislation.** Reforms approved by Congress in early 2002 aligned the anti-money laundering law closer with international standards. However, there are some remaining areas for improvement. In particular, the power granted to the Costa Rican Drug Institute (CRDI) to receive the proceeds of its investigations (all assets confiscated in a money laundering case) should be reviewed, as it may lead to conflicts of interest. The Financial Intelligence Unit (FIU) of the CDRI should be oriented more towards the analysis of financial information (it is presently focused on fighting drug trafficking).

C. Crisis Management: Banking Safety Nets

33. **The lender of last resort function suffers from a few design problems and the operational arrangements for its implementation can be improved.** Neither of the two LOLR facilities established in the law has ever been used. Design problems with the first LOLR facility (*redescuento ordinario*) include an arguably too short maturity (30 days), too high an access limit (up to 50 percent of the bank's financial assets, net of provisions and obligations to the central bank), and lack of explicit provisions to preclude access to LOLR liquidity to insolvent banks. Such facility is also affected by operational problems. A ranking of acceptable guarantees is not defined; there are no criteria to determine differential discounts or haircuts to various classes of guarantees; and there is no role defined for external auditors or the SUGEF in the review of guarantees. The second LOLR facility (*préstamo de emergencia*) is available only to intervened banks; hence, it carries a risk of being abused to support clearly insolvent banks. The authorities should eliminate this latter LOLR facility and improve the design and operational arrangement of the first facility.

34. **The current framework for prompt correction and intervention of troubled banks, which is distorted by the large presence of public commercial banks, also requires reform.** Enforcement of prompt correction on public banks is generally problematic—i.e., vulnerable to political interference. With regard to private banks, simple and effective triggers (based on clear indications of capital deficiencies, chronic illiquidity, or reckless bank management) for prompt correction should be established. As mentioned earlier, SUGEF's current bank rating system is impractical for that purpose. In addition, the legal definition of intervention, which requires the assumption of the bank's management by a SUGEF-appointed interventor, is a potentially cumbersome and risky process. While the decision to intervene rests with CONASSIF, there is no mechanism to involve its members at an early stage in the dynamically complex process of assessing the desirability and monitoring the application of an intervention. Moreover, as the authorities perceive high legal risks in administering an intervened bank, they have in all past cases opted to suspend the operations of intervened banks. Thus, interventions have inexorably marked the beginning of liquidations. For prompt correction, the authorities should rely on well-defined, time-bound, and tightly supervised regularization plans, implemented by the bank's own administrators, and encourage private sector solutions (recapitalization, mergers, acquisitions). The authorities should consider legal reforms to strengthen the prompt correction framework and suitably modify the definition of intervention.

35. **The system of bank closure and resolution should be revamped and linked to the planned introduction of a limited deposit insurance.** The resolution of any public bank would require a special law. And the framework for private bank closure and resolution is inadequate. The latter consists of a cumbersome liquidation of the bank's entire balance sheet (managed by the SUGEF under the same legal framework applicable to the insolvency of non-financial corporations), which fails to limit contagion risk and the unnecessary destruction of asset value. Legal reforms should be introduced to allow purchase and assumption (P&A) operations—i.e., the transfer of deposits of a failed bank (immediately upon its closure) to existing sound banks, funded by (i) the simultaneous transfer (possibly to a trust) of the good assets of the closed bank *plus* (ii) a contribution from the deposit insurer determined by a least-cost or less-cost criterion. P&A techniques would help ensure that only a "residual" balance sheet (with the bad assets and non-deposit liabilities[29] of the failed bank) is sent to liquidation, thereby limiting the contagion risk of a bank closure.[30] The reform of the bank resolution framework should be linked to the planned introduction of a limited deposit insurance.

36. **The authorities should introduce some modifications to the draft bill that proposes the creation of separate deposit insurance funds for private and public banks.** The draft law does not propose to eliminate the unlimited state guarantee for public banks, reflecting the authorities' understandable concerns that adverse depositor reactions could undermine the stability of public banks. It rather proposes two limited deposit insurance schemes (with separate funds) for private and public banks. The deposit insurance fund for public banks, although redundant, would ensure immediate payout to small depositors of a closed public bank, while the state guarantee would ensure that the rest of the bank's creditors are made whole later on, in the liquidation process.[31] Separate insurance funds for public and private banks appear appropriate given the circumstances, but the draft law should be revised to ensure that the coexistence of separate funds would be transitional. That is, that a single insurance scheme would be in place once the competitive playing field is fully leveled. During the transition, the deposit guarantee for public banks would be set to converge to the same coverage limit applicable to private banks. To better align incentives and foster monitoring, greater participation should be given to private banks in the governance and administration of their deposit insurance fund. Also, the draft bill needs to provide greater flexibility in setting premiums (including scope for implementing risk-based premiums at some suitable time in the future) and more specific guidance with respect to the insurance fund's initial capital, the fund's borrowing authority (against future premiums), and the desirable (maximum) level of the fund. Moreover, it is recommended that the draft bill be introduced *after* consolidated

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[29] The residual balance sheet could also contain some fraction of uninsured deposits in case available assets are not enough to fund their transfer under a purchase and assumption-type operation.

[30] Legal reforms could also establish a framework for managing the extraordinary case of a too-big-to-fail bank through intervention cum open-bank assistance, provided that the shareholder's property rights are previously written down, that the determination of a too-big-to-fail a case is made by authorities at the highest level (including the Minister of Finance), and that any open-bank assistance does not affect the deposit insurance fund and is, instead, financed through government debt explicitly incorporated in the budgetary process.

[31] Under current legal arrangements for public banks, the state guarantee on these banks' liabilities is explicit but of a subsidiary nature—i.e., it comes into effect to fill the gap only after the liquidation of the failed bank's assets has proven insufficient to meet all its liabilities.

supervision is fully in effect and supervisory capacity is enhanced, and be widened to include a simultaneous, suitable reform of the bank exit framework (see above).

D. Crisis Management: Corporate Insolvency and Creditor Rights

37. **Corporate reorganization and liquidation proceedings are hampered by a slow judiciary, excessive protection of debtors, disincentives for creditor participation, and lack of effective out-of-court workouts.** Corporate rehabilitation and insolvency procedures are fully administered by the courts, which leads to major inefficiencies and delays, given that judges are overburdened and lack the necessary expertise. Creditors have no active role to play and, hence, have little interest in participating, particularly considering the protracted nature of the process (the verification of claims alone can take several months). While undue benefits are provided to debtors that file for rehabilitation (including reduced interest payments and up to three-year stays on claims against their assets), debtors' incentives to abuse these benefits have been dampened by the risk that rehabilitation may derive in insolvency and be declared fraudulent. The legal framework does not enable workable out-of-court restructurings—only unanimously approved out-of-court creditor agreements are accepted by a court. And there are technical voids in the current legislation—e.g., there are no netting rules for financial contracts.

38. **A comprehensive legal reform of corporate reorganization and liquidation procedures is thus needed.** A reform project should consider creating specialized courts for corporate insolvency/rehabilitation—with judges that have the necessary expertise in economic and financial matters—or moving substantial parts of the process outside the courts. (A draft bill under preparation leans in the latter direction; it would enable a major role for out-of-court "conciliators".) The scope for abuse by debtor corporations should also be reduced—e.g., by limiting the "stay of payments and foreclosures" only to the period until a reorganization plan is approved. The process of verification of claims should be shortened (e.g., by presuming the validity of claims in the debtor's balance unless otherwise proven). Creditors should be given a more active role in the process (e.g., by being allowed to formulate the "rehabilitation plan", which is currently only formulated by the debtor). The automatic investigation into "fraudulent bankruptcy" should be eliminated. Netting rules for financial contracts should be introduced. The rapid approval of extra-judicial agreements should be facilitated.

39. **While the framework for secured lending is broadly adequate, operational and enforcement problems significantly limit the use of collateral for the mobilization of credit.** As a result, the supply of credit is lower and its cost higher than otherwise. The problems are mainly related to the lengthy and unpredictable judicial process which completely governs the execution of guarantees. Delays largely result from overburdened courts, whose services are provided free of cost to the user. The authorities should thus consider creating specialized courts that charge reasonable judicial fees, or moving parts of the process outside the court system. (A draft bill under preparation proposes a privately administered procedure for the auctioning of collateral.) They should also consider amending the civil and commercial codes so that, in the event of default, the creditor is allowed to: repossess (through peaceful means) the collateral, sell it (through a private sale) at market price, or use it to cancel its claim on the debtor (so long as the market value of the collateral does not exceed the value of the claim). Suitable regulations should be issued to enhance the usefulness and reliability of the

"guarantee trust" (*fideicomiso de garantía*), by ensuring that the assets in such trusts are excluded from the bankruptcy estate in case of liquidation.

III. TOWARDS A SUSTAINABLE FINANCIAL SECTOR DEVELOPMENT

A. Issues in Banking Structure

40. **The simultaneous large presence of public banks and unsupervised private financial activities (mainly offshore banking) reflects an ongoing, incomplete, and potentially unstable process of liberalization, which needs a permanent resolution.** The entry of the private sector into finance has not been accompanied by the exit of, or a well-defined exit strategy for, public financial entities. Instead, it has featured the gradual widening of competition through incremental dismantling of "privileges" enjoyed by public banks and their affiliates. As a result, private financial entities, which initially competed among themselves in businesses not dominated by public banks (such as offshore banking and fund management), have been increasingly competing with public banks in common markets. Complex political economy dynamics heighten the difficulty of a comprehensive solution. Private banks profit from the wide intermediation margins of public banks and, thus, push for the elimination of remaining public bank "privileges", including through the introduction of a deposit insurance scheme for private banks. In response, public commercial bank managers correctly argue that such elimination of "privileges" would imply a slow death of public banks under the pressures of competition (which may destabilize financial markets and would raise the ultimate fiscal cost), unless the governance and administrative constraints on the public banks' capacity to compete are simultaneously lifted. The large presence of unsupervised private financial activities, particularly offshore banking, is also unsustainable, given its corrosive effect on incentives and market discipline.

41. **A suitable reform requires a clear medium-term objective on the future of public banks and offshore banks, to be achieved in the context of a well-defined transition.** Ways should be found to bring offshore banks fully under consolidated supervision. Given the strong and conflicting lobbies, the authorities may wish to take advantage of opportunities to "bundle" legal reforms. For instance, the draft legal reform to introduce a limited deposit insurance for private banks could be proposed jointly with a revamping of the bank resolution framework and the establishment of full consolidated supervision of financial conglomerates. The medium-term objective should be the complete elimination of obstacles to a level playing field. To bring offshore banks fully under consolidated supervision, SUGEF could, for instance, condition the maintenance of the onshore bank license to the signing of an agreement whereby the banker accepts to subject her offshore bank fully to the regulation and supervision by SUGEF.[32] Beyond this, the authorities should consider introducing a pre-announced timetable for phasing out offshore banking, that is, for the full establishment and enforcement of the *sound principle that a Costa Rican license would be required to take deposits in Costa Rica.* As regards public banks, converting their legal status into that of a joint stock company (*sociedad anónima*) appears as a necessary step to free public commercial banks from the administrative and governance constraints on their capacity to compete, as well as to explicitly unburden them from any development banking function. This would also enable the elimination of the full

[32] This alternative has the risk that pressures would mount to extend the deposit insurance to offshore deposits.

state guarantee on their liabilities and pave the way towards these banks' eventual privatization. To further promote competition, remaining barriers to the entry of foreign banks (they could operate in Costa Rica only through subsidiaries but not branches) should be removed at a suitable time.

B. Issues in the Development of Securities, Pensions, and Insurance Markets

42. **The authorities' long-term strategy—to develop a liquid market for public sector, colón-denominated debt securities, as a precondition for the development of the market for private debt and equity securities—faces major challenges.** Despite advances in domestic public debt management, liquidity in the public-sector debt market is hampered by low levels of standardization (55 percent) and immobilization (68 percent).[33] Moreover, under the current monetary and exchange rate arrangement that favors dollarization, the initial cost of developing a market for long-term, fixed interest rate, colon-denominated public-sector debt securities is likely to be high. The Costa Rican securities markets do not provide at this stage an alternative to banks, in terms of resource mobilization for private-sector companies. The small size and high concentration of family ownership in the corporate sector undermines incentives for private companies to "go public" by issuing tradable securities. More fundamentally, a small country like Costa Rica may not be able to provide the economies of scale and of agglomeration needed for a self-sustaining development of a market for private securities. Even in the shorter run, the future shape of Costa Rica's centralized securities market is uncertain, given that the repo-based money market operations (which account for the bulk of secondary market transactions in the Exchange) are most likely to migrate to the inter-bank market as a result of the widening use of the real time gross settlement system and of soon-to-be-introduced reforms to securities clearance and settlement processes.

43. **Therefore, realistic objectives should be set for the local securities markets.** In the shorter-term, certain pressing issues should be addressed. Greater standardization and de-materialization of public-sector debt securities is crucial. The authorities should consider systematically issuing (standardized) colon bonds, including CPI-indexed, with a view to develop the market for long-duration public debt in local currency. The monopoly of broker-dealers over securities transactions and custody should be broken and de-mutualization of the Exchange considered.[34] As regards the medium-to-long term, there is ample room to raise corporate governance standards, key to mobilizing long-term resources in pension funds towards private sector finance. Emphasis should be placed on the continuous improvement of the enabling environment—particularly with respect to the legal, accounting, informational, and contract-enforcement infrastructure. This would facilitate the broadening of access to financial services for the Costa Rican population, regardless of whether services are provided by the banking system or by securities markets, by domestic or foreign financial entities.

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[33] The same practical effect of de-materialization of securities is achieved through a macro-security *immobilized* in the central depository. The de-materialization of securities would be implemented with the launch of planned reforms to securities clearance and settlement arrangements.

[34] This is necessary to enable the development of market makers and appropriate risk management systems (i.e., a securities lending facility and a guarantee fund within the Exchange) to ensure that the planned reforms can ensure delivery-versus-payment and settlement finality in a netting-based securities clearing system.

44. **As regards pensions, the reform introduced in 2000 was a major step forward, but needs to be complemented by further actions to ensure the viability of the first pillar.** The financial viability of the first (defined-benefit) pillar, administered by the Costa Rican National Social Security Administrator (CCSS), requires changes in its over-generous benefits that, fortunately, the CCSS has the legal authority to make on its own.[35] This could be achieved with an unchanged contribution, by increasing the minimum retirement age for males and females, lowering the accumulation factor to obtain a reduced pension relative to the base salary, and introducing an actuarially fair penalty for early retirement.[36] To avoid opportunistic increases in reported earnings by the self-employed as they approach retirement age, the base salary should be calculated as the average of salaries over a longer period of time. These changes should be phased in as pension funds under the second pillar mature. The CCSS should outsource the investment of its funds within a policy that would permit diversification (including internationally), consistent with its fiduciary responsibilities.

45. **Reforms are needed to enhance the developmental role that the second and third pension pillars can play through long-term financial markets.**[37] As mentioned earlier, reforms to CONASSIF should be considered to ensure a better balance between systemic prudential concerns and investor protection concerns—the latter being crucial in pension markets. SUPEN should be legally authorized to play a role in the determination of the fees charged by the CCSS for the centralized collection of contributions to pension funds. Private pension fund administrators should be given the legal option to choose a collection agent (currently, the CCSS has the monopoly in collection). The tax treatment of voluntary pension funds should be simplified, and the double taxation of employees' mandatory contributions to the second pillar eliminated. The regulations on the investment of pension funds (currently invested mainly in government debt securities) should be gradually liberalized, to allow risk reduction through diversification, including internationally, as suitable private securities become available domestically. Steps should be taken to reduce the dominant market share held by fund administrators belonging to public commercial banks. For instance, public-bank related pension funds should not enjoy a privilege in being assigned undecided workers.

46. **A reform strategy is needed for the liberalization of the insurance sector, which at present constitutes a state monopoly.** Costa Rica is the only country in the world where the state has a monopoly over the insurance sector—through the National Insurance Institute (INS).[38] This has stunted the development of domestic insurance markets and fostered inefficiencies, limiting consumer choice. (Upper income households, however, tend to satisfy their demand for insurance products, particularly life insurance, in international markets.) A reform strategy is needed to liberalize the sector in an orderly way. The reform should revamp the insurance legislation to allow private sector entry into the industry, possibly beginning with

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[35] In the absence of changes, the first pension pillar would begin to incur operational losses around 2010 and would run out of cash reserves towards 2025.

[36] The recommendations aim at ensuring the long-run sustainability of the first pillar and do not rule out its use as a redistributional instrument, if so desired.

[37] The second pillar is a mandatory, defined-contribution system of fully capitalized, privately administered individual retirement accounts. The third pillar consists of voluntary savings in pension funds.

[38] Commercial banks have been recently allowed to market the insurance products of the INS.

the life insurance and annuities businesses, where the INS has little activity. This is necessary, among other things, to eliminate the inconsistency that arises from the coexistence of privately managed pension funds, on the one hand, and a state monopoly in life and annuity business, on the other. Such a market structure undermines credibility in the pension system to the extent that the accumulated balances in privately administered (mandatory) pension funds become, at the time of retirement, a captive source of business for the INS. The INS should be transformed into a joint stock company (*sociedad mixta del Estado*), whose shares would be listed and subsequently sold. Efforts should be made at speeding up the approval of the bill currently in Congress to create a regulatory agency (or function within an existing agency) for the insurance sector, and consideration should be given to creating the Office of the Ombudsman. In addition, INS investment regulations, policies, and strategies should be amended to bolster its role as institutional investor. In particular, it should avoid maturity and currency mismatches and add flexibility to its investment policy (currently, INS investments are concentrated on government paper, real estate, and housing loans), so as to lower risk through diversification, including internationally. It should adopt a policy of greater disclosure (including the dissemination of the recently completed report by an external auditing firm). It should maintain separate accounts for the reserves associated with life insurance, which are essentially the property of the insured. Finally, investment income on these reserves should be tax exempt, in line with better international practices.

IV. AN AGENDA FOR REFORM

47. **The authorities may wish to incorporate the recommendations in this FSA into a coherent reform agenda, which would require the adoption of key strategic decisions.** Some reforms can and should proceed in parallel, within a coherent plan that sets out priorities, identifies complementarities, allocates institutional responsibilities, provides for coordination mechanisms, and establishes suitable timetables. Considerable technical assistance may be required. Appendix I (at the end of this document) summarizes the recommendations. The classification of a recommendation as "medium term" is often because it would require legal changes, which should not be construed to imply that it is less urgent or of lower priority. Rather, priorities should be set in light of the following considerations:

- Certain strategic policy decisions constitute a prerequisite to an internally consistent structural reform agenda. These decisions concern, importantly, the possible shift to a new monetary and exchange rate regime, the future of offshore banks and public banks, and the liberalization of the insurance sector. In all cases, leveling the playing field between public and private banks appears to be a key strategic priority.
- Regarding prudential oversight, most urgent are reforms to establish fully the consolidated supervision of financial conglomerates and to strengthen the supervision of onshore banks. Suitable modifications to the functions and/or structure of CONASSIF are also needed, albeit with less urgency, to ensure the effective functioning of financial system supervision.
- The strengthening prudential oversight should also include prudential buffers (such as counter-cyclical and currency-specific provisioning requirements, and liquidity requirements) to limit the financial system's exposure to systemic risk, particularly if the current monetary regime is maintained.

- With respect to the financial system safety net, it is essential that the planned introduction of a (limited) deposit insurance scheme be accompanied by strengthened supervision and the establishment of an effective bank failure resolution framework.
- Reforms to ensure viability of the defined-benefit (first) pillar of the pension system, while not pressing in the short-run, need to be introduced to ensure that they can be gradually phased in, in time to keep public debt under control.
- Reforms to improve the functioning of securities, pensions, and insurance markets carry relatively less urgency, but are essential for development. Over the medium-term, reforms should aim not only at financial stability and depth, but also at broadening access to financial services. This requires continuous strengthening of the enabling environment through improvements in the legal, accounting, informational, and contract-enforcement infrastructure, and in tax treatment.

Table 1. Costa Rica: Financial System Structure, June 2001

	Number	Assets (in billions of colones)	Percent of Total Assets
A. Banks	31	2,945	77.0
Private	26	1,233	32.2
Onshore	17	731	19.1
Offshore	9	502	13.1
State-owned and special charter	5	1,712	44.7
Onshore	4	1,520	39.7
Offshore (BICSA)	1	192	5.0
B. Other	45	324	8.5
Credit unions and co	30	177	4.6
Finance companies	13	32	0.8
Bahnvi, Caja ANDE	2	115	3.0
C. Investment funds	34	557	14.6
Collective Investment	25	404	10.6
Pension funds	9	153	4.0
Total financial system		3,827	100.0
As a percent of GDP		71.7	

Sources: SUGEF, SUGEVAL, BCCR, and staff calculations.

Table. 2. Costa Rica: Indicators for the Banking Sector 1998–2001
(In percent, unless otherwise indicated)

	December 1998	December 1999	December 2000	August 2001
Capital Adequacy				
Regulatory capital to risk-weighted assets				16.1
Public banks				17.4
Private banks				17.0
Asset Composition and quality				
Loans to specific sectors (as percent of total)				
Consumption	25.4	24.0	22.6	24.5
Housing	13.4	15.1	16.1	20.6
Commerce	17.4	16.0	16.6	16.1
Foreign exchange loans to total loans	31.0	37.6	47.1	50.3
NPLs to gross loans1/	17.8	13.5	14.4	11.7
NPLs to gross loans 2/	3.1	4.6	4.0	2.9
NPLs net of provision to capital 3/	66.8	52.6	61.4	49.2
Earnings and Profitability				
ROA	1.2	1.6	1.5	1.8
ROE	12.3	17.0	14.7	17.1
Interest margin to gross income 4/	29.7	29.9	32.4	35.9
Noninterest expenses to gross income 5/	31.2	33.3	33.4	35.9
Personnel expenses to noninterest expenses 6/	62.1	60.3	55.8	57.1
Spread between reference loan and deposit rates 7/	9.9	11.9	12.2	11.8
Liquidity				
Liquid assets to total assets 8/	13.7	11.8	11.1	10.5
Liquid assets to total short-term liabilities 9/	45.2	38.0	31.7	29.4
Customer deposits to total (non-interbank) loans	170.0	160.0	150.0	140.0
Foreign exchange liabilities to total liabilities	44.8	46.1	47.2	51.0
Sensitivity to market risk				
Duration (or average repricing period) of liabilities 10/				2
Net open position in foreign exchange to capital	44.0	48.0	58.0	64.0

Sources: SUGEF, banks' balance sheets and staff calculations.

1/ Loans in arrears more than one day.
2/ Loans in arrears more than 90 days, including loans under judicial collections proceedings. The figure in the last column corresponds to December 2001.
3/ Based on loans in arrears more than one day.
4/ Net interest income/operating income.
5/ Noninterest expenses/operating income.
6/ Personnel expenses (personnel expenses plus other administrative costs plus other operating expenses
7/ Weighted average rates published by the BCCR (includes public banks).
8/ Cash plus deposits at the central bank plus remittances in transit plus other liquid assets over total assets.
9/ Core liquid assets/short-term deposits.
10/ Rough estimate provided by the BCRD (in months).

Table 3. Costa Rica: Selected Macroeconomic Indicators, 1996-2001

(As of January 16, 2002)

Total population (end-2000) 3, 943, 204
GDP per capita (2001) US$4,060

	1996	1997	1998	1999	2000	Prel. 2001
Demand and supply (Constant prices)						
GDP (percentage change)	0.9	5.6	8.4	8.2	2.2	0.3
GDP (in US$ mln)	11,846	12,829	14,096	15,797	15,949	16,362
Prices and incomes (percentage change)						
GDP deflator	15.8	14.9	12.1	15.0	6.5	9.2
Consumer prices (end of period)	22.4	11.2	12.4	10.1	10.2	11.0
Consumer prices (average)	26.3	13.2	11.7	10.0	11.0	10.6
Monetary and credit data						
Monetary base	17.0	26.8	12.6	39.0	-11.8	15.1
Money (M1)	19.8	40.8	14.2	26.4	16.4	20.2
Broad money (M2)	26.7	17.9	24.4	20.8	20.6	13.9
Domestic credit	25.2	27.5	51.9	18.2	31.3	19.6
Interest rates						
Yield on government bonds	24.5	17.9	24.0	17.4	15.0	17.0
6-month rate	24.6	18.5	24.5	18.3	15.5	17.0
Public finances (in percent of GDP)						
Central government financial balance	-2.4	-1.2	-1.2	-2.2	-2.6	-2.4
Central bank losses (-)	-1.6	-1.4	-1.2	-1.6	-1.8	-1.2
General government financial balance	-4.0	-2.5	-2.3	-3.8	-4.4	-3.7
Balance of payments (in US$ mln)						
Trade balance	-249	-498	-399	615	-205	-1184
Current account	-300	-481	-522	-694	-751	-816
Foreign direct investment	421	402	607	614	404	442
Portfolio investment	-224	40	16	244	-23	437
External sector (in US$ mln)						
Colones per US$ (end of period)	220.1	244.3	271.4	298.2	318.0	341.5
Public sector external debt	2,859	2,640	2,872	3,057	3,151	3,099
Net international reserves 1/	693	910	760	1,240	1,086	1,098
Net international reserves (months of domestic imports of goods and services)	1.8	2.0	1.7	2.7	2.4	2.5
Central bank short-term liabilities	0.8	0.8	0.0	0.0	0.0	0.0
External interest payments to exports	14.0	15.3	10.2	11.6	13.5	14.9

Sources: Central Bank of Costa Rica; Ministry of Finance; and Fund staff estimates.

1/ Excludes bilateral claims under negotiation with neighboring countries, which in the official statistics are classified as part of international reserves.

Table 4. Sovereign Ratings, (October, 2001).

	Moody's		S & P	
Latin America	Rating	View	Rating	View
Chile	Baa1	-	A-	-
Barbados	Baa2	-	A-	-
Mexico	Baa3	o	BB+	o
El Salvador	Baa3	-	BB+	-
Trinidad & Tobago	Baa3	-	BBB-	-
Uruguay	Baa3		BBB-	-
Costa Rica	Ba1	o	BB	o
Panama	Ba1	-	BB+	-
Dominican Republic	Ba2	-	BB+	-
Guatemala	Ba2	-	BB	-
Colombia	Ba2	-	BB	oo
Peru	Ba3	oo	BB-	-
Jamaica	Ba3	-	B+	-
Bolivia	B1	-	B+	-
Brazil	B1	-	BB-	oo
Paraguay	B2	-	B	oo
Venezuela	B2	-	B	-
Honduras	B2	-	nr	-
Nicaragua	B2	-	nr	-
Cuba	Caa1	-	nr	-
Ecuador	Caa2	-	CCC+	oo
Argentina	Caa3	-	SD	-

Source: J.P. Morgan.

Table 5. Market Concentration in the Banking Sector, Selected Countries

Indicator	Share of the five largest banks in total assets (in percent)
Costa Rica*	
January 1998	85
December 1999	81
December 2000	77
August 2001	74
El Salvador (December 1999)*	73
Honduras (December 1999)*	51
Mexico**	82
Argentina*	38
Brazil**	52
Chile**	47
Germany**	17
United States**	35

Sources: * Superintendency of Banks of Costa Rica, El Salvador, and Honduras.
** Merrill Lynch (2001, Latin American Bank Stock. Monthly January. Data as of December 2000.

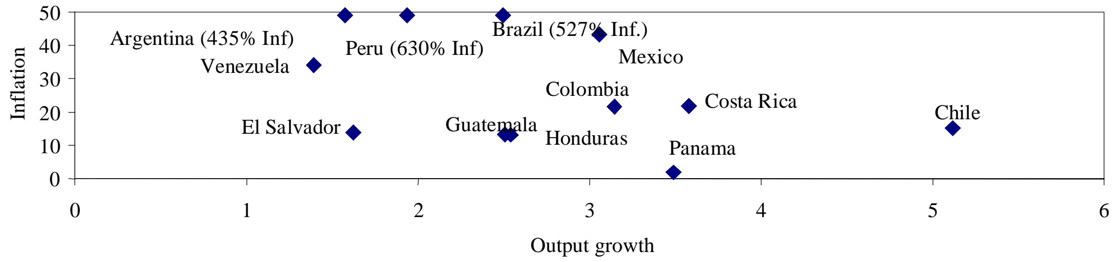
Table 6. Costa Rica: Composition of Foreign Currency On-Shore Loan Portfolio, March 2001

	Type of Borrower		
	Exporters	Other Forex Revenue Earners	Non Forex Revenue Earners
Public Banks	21.5	25.7	52.8
Private Banks	29.0	24.6	46.4
Total Commercial Banks	26.1	25.0	48.9

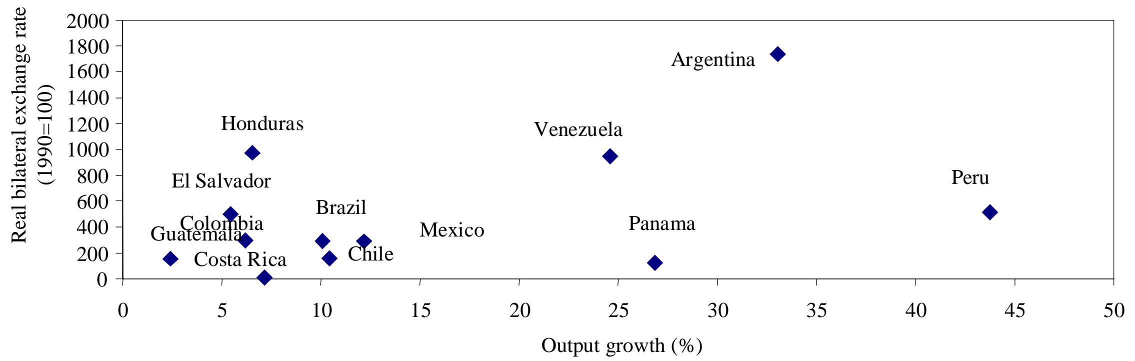
Source: SUGEF.

Figure 1. Costa Rica: Macroeconomic Volatility

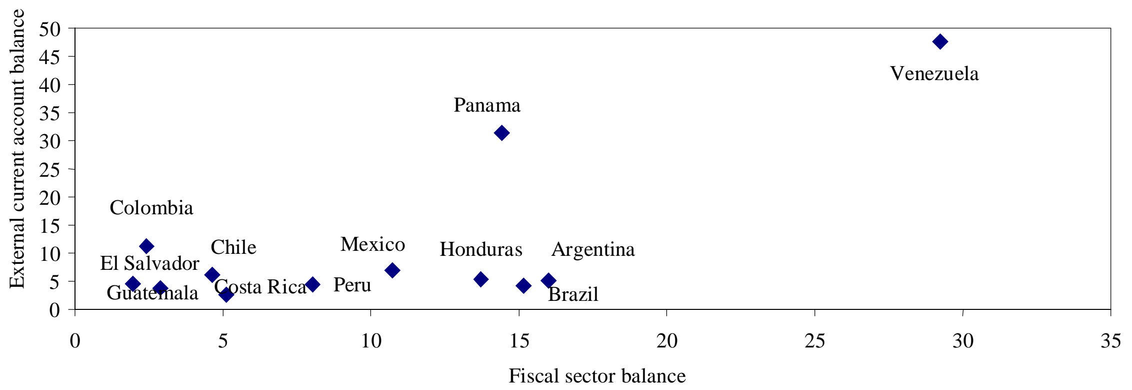
A. Average output growth and inflation, 1980-2000.
(In percent)



B. Output growth and real bilateral exchange rate volatility, 1985-2000.

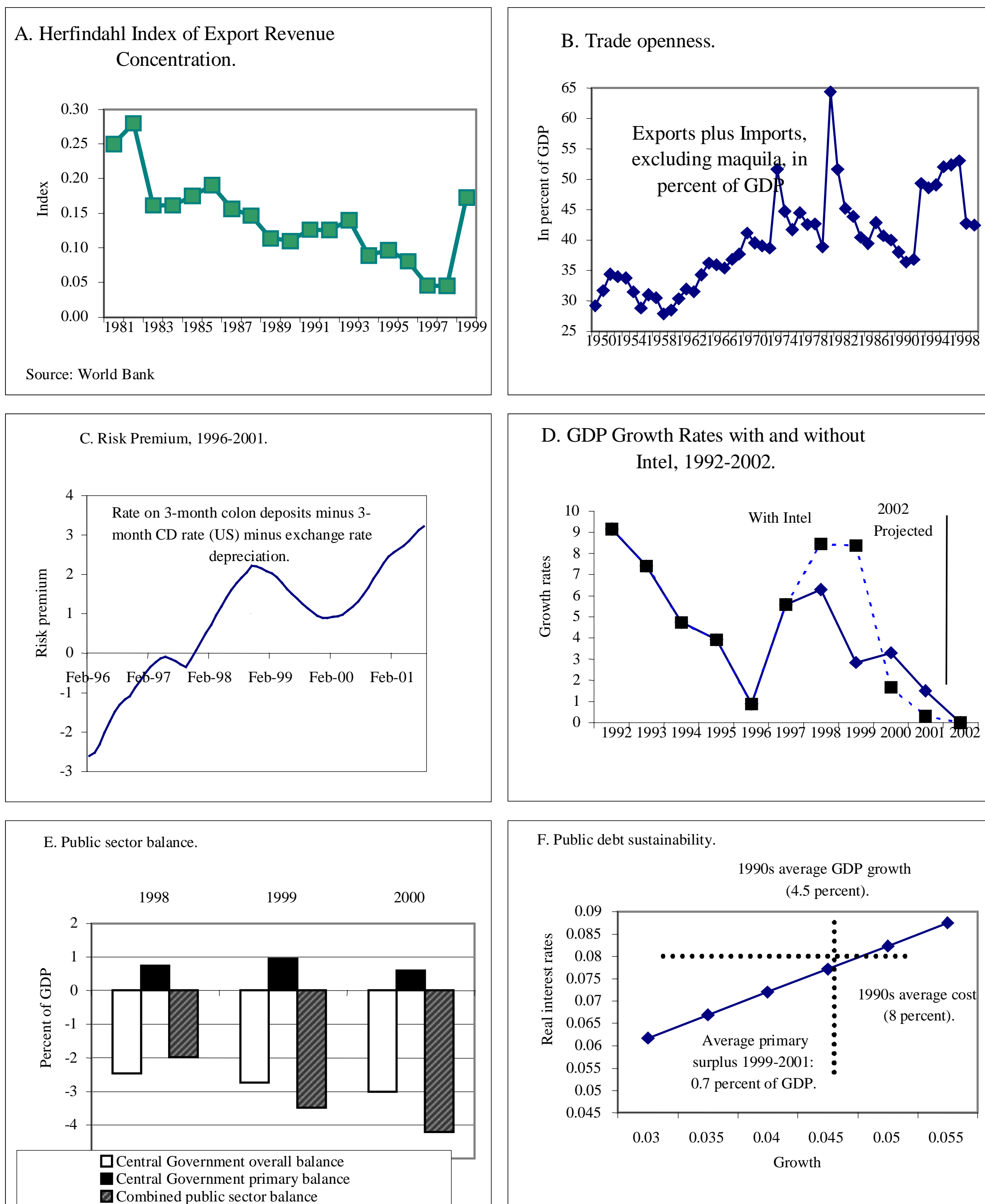


C. Fiscal sector balance and external current account balance volatility, 1985-2000.



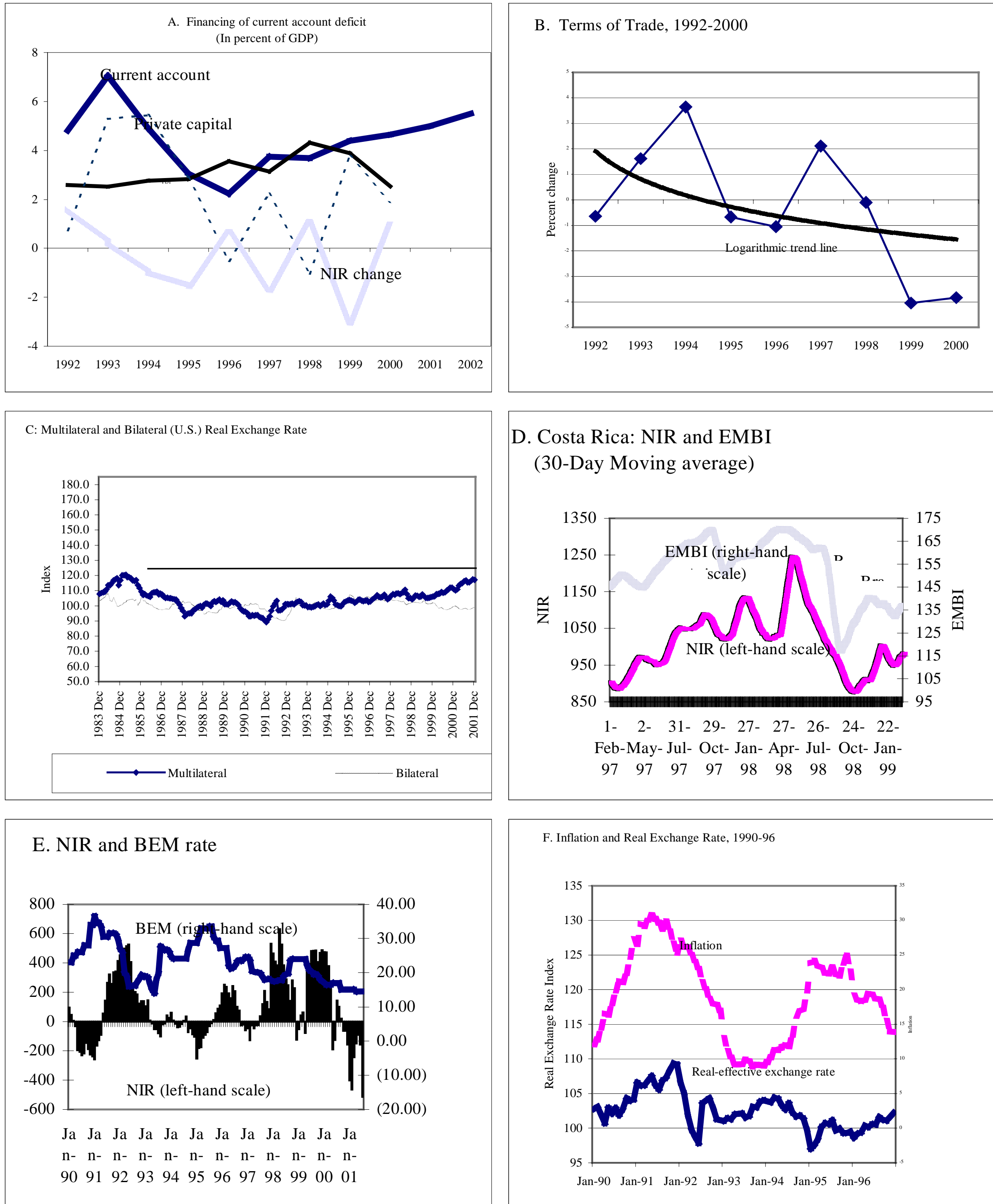
Sources: Central Bank of Costa Rica, National Sources, IFS and staff calculations.

Figure 2. Costa Rica: Main Macroeconomic Indicators



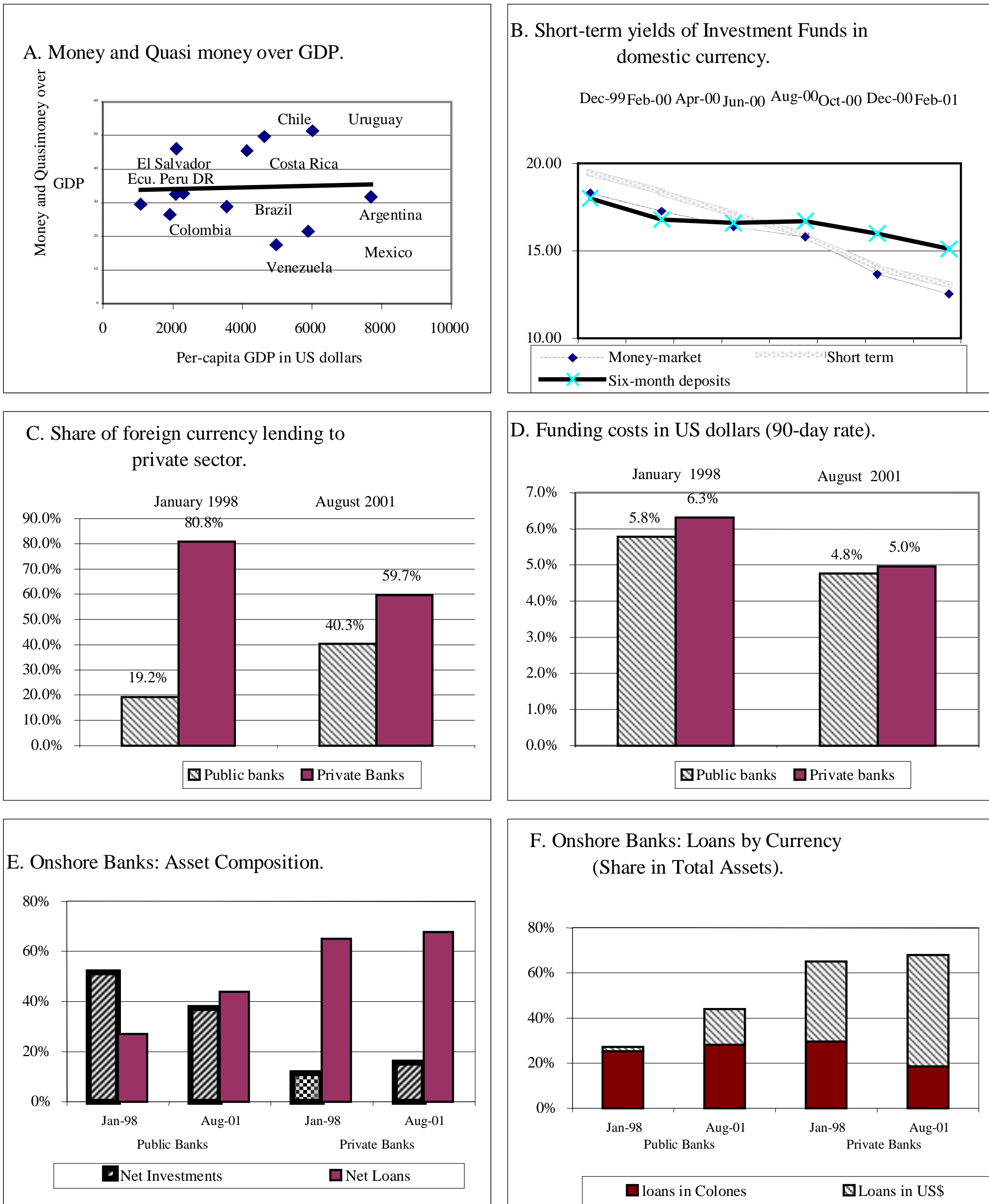
Sources: Central Bank of Costa Rica (unless otherwise specified), and staff calculations.

Figure 3. Costa Rica: External Indicators



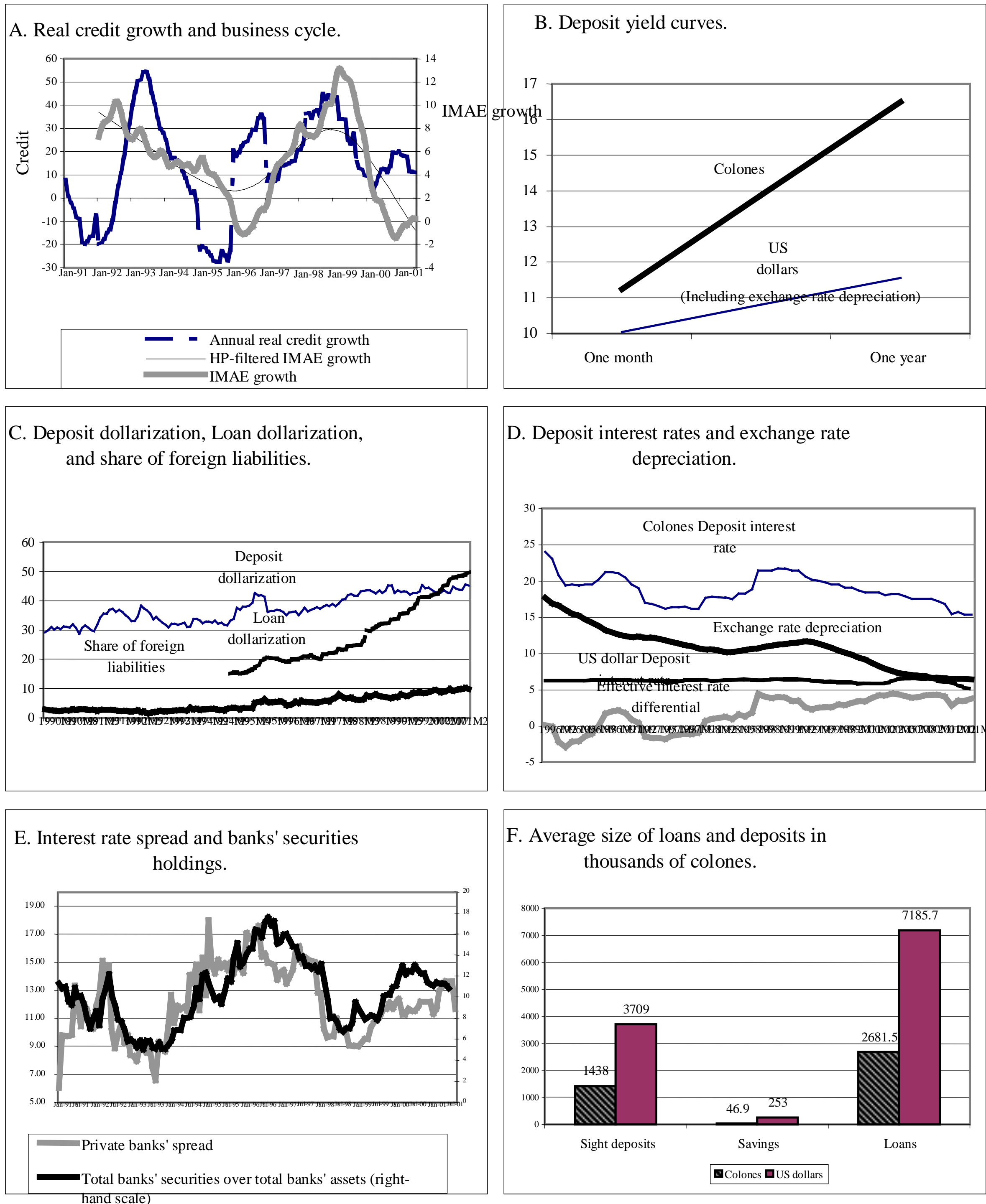
Source: Central Bank of Costa Rica, IFS, JP Morgan and staff calculations.

Figure 4. Costa Rica: Financial Indicators I



Sources: Central Bank of Costa Rica, SUGEF, SUGEVAL, IFS, and staff calculations.

Figure 5. Costa Rica: Financial Indicators II.



Sources: Central Bank of Costa Rica, Banco de Costa Rica, and staff calculations.

Figure 6. Costa Rica: Sources of Credit Growth

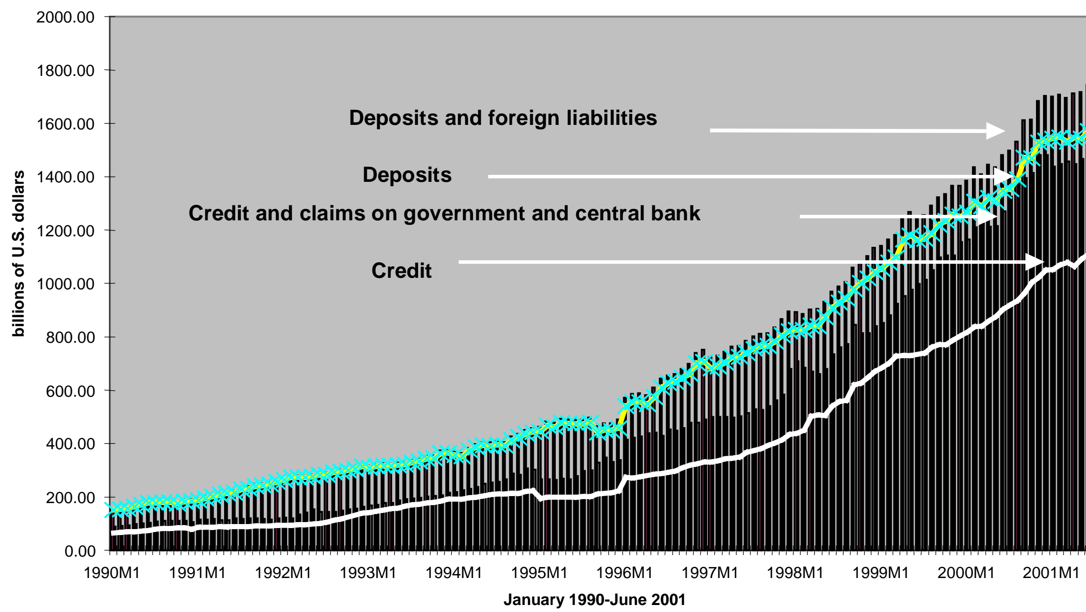
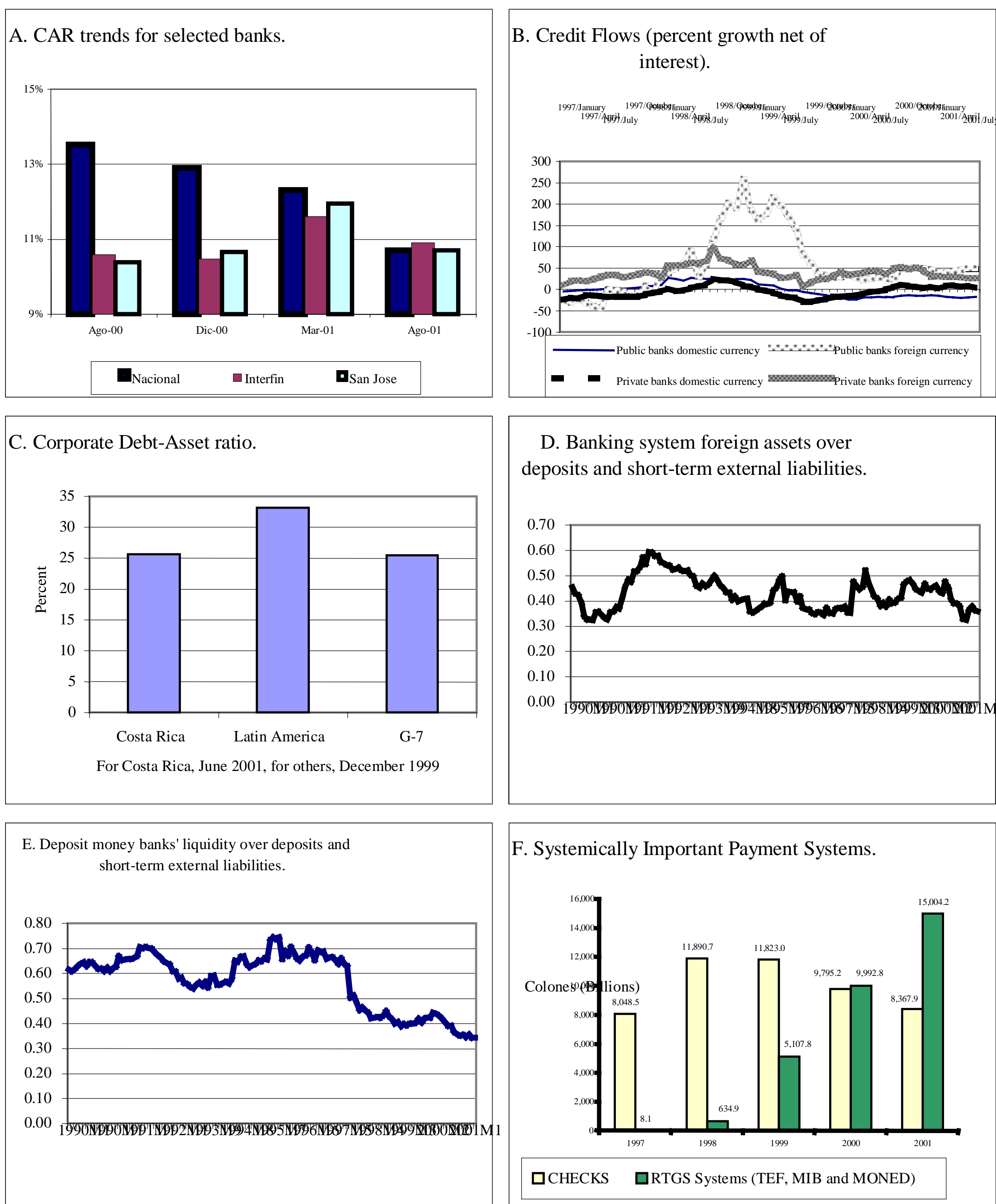


Figure 7. Costa Rica: Financial Indicators III



Sources: Central Bank of Costa Rica, SUGEF, SUGEVAL, IMF-MAE/TN/01-2, and staff calculations.

V. Appendix I

Costa Rica: Summary of FSAP Recommendations

	Short Term	Medium Term
A. Improving liquidity management and deepening the money market		
• Enhance communications between the central bank and the market	X	
• Eliminate rationing clauses in day-to-day liquidity injections by the central bank	X	
• Develop an active open market intervention capacity		X
• Increase reserve funds set aside to ensure settlement finality for cleared checks	X	
• Introduce repo-based mechanism of intra-day liquidity for the payment system		X
• Introduce book entry system and associated securities clearance/settlement reforms	X	
B. Strengthening prudential management		
• Introduce prudential measures to limit exposure to systemic risk	X	
• Modify the functions and/or structure of CONASSIF		X
• Clarify the self-regulatory role of the Stock Exchange		X
• Reform Law to establish full consolidated supervision of financial conglomerates		X
• Eliminate asymmetries in the regulatory treatment of public and private banks		X
• Modify the current SUGEF system to rate banks	X	
• Increase supervisory focus on banks' own risk management systems, in part through incentives for banks to classify and provision correctly their loans	X	
• Enhance the complementarity of the work of bank supervisors and external auditors		X
• Improve the coverage and reliability of information of, and facilitate access to, the debtor information system maintained by SUGEF		X
• Establish a graduated system of penalties, and disclose enforcement actions		X
• Address certain voids in banking system prudential and accounting norms	X	
• Strengthen institutional support for mid-level supervisory decisions	X	
• Bring *asociaciones solidaristas* under the oversight of SUPEN		X
C. Strengthening crisis management		
• Eliminate the *préstamo de emergencia* LOLR window and improve design and operational arrangements of the *redescuento ordinario* LOLR window	X	
• Introduce a simple and effective system of triggers for prompt correction and manage it within regularization (*saneamiento*) plans	X	
• Introduce an efficient system of bank closure and resolution and link it to the proposed establishment of a limited deposit insurance scheme		X
• Revise the draft deposit insurance law before its submission to Congress	X	
• Create specialized courts for corporate reorganization/insolvency process or move substantial parts of the process out of the judiciary		X
• Limit period of "stay on payments", presume validity of balance sheets in verifying claims, give salient role to creditors, remove presumption of fraudulent bankruptcy		X
• Enable voluntary, extra-judicial corporate restructuring agreements		X
F. Fostering sustainable financial sector development		
• Convert public commercial banks into stock-based corporations		X
• Intensify efforts to standardize public sector debt securities and develop a market for CPI-indexed, colon-denominated public sector debt securities	X	
• Eliminate the monopoly of broker/dealers on securities transactions and custody, and consider the de-mutualization of the Stock Exchange		X
• Raise disclosure, accounting, and corporate governance standards		X
• Intensify efforts to assess the feasibility of regionalization of securities and other financial markets across Central America		X
• Change the parameters of the defined-benefit, first pillar of the pension system so as to ensure its financial viability	X	

	Short Term	Medium Term
• Give SUPEN a role in setting the fees charged by the CCSS for the centralized collection of contribution to pension funds, and give the latter an exit option		X
• Simplify tax treatment of voluntary pension funds, eliminate double taxation of employees' mandatory contribution to second-pillar pension funds, and exempt from taxes the income from investment of reserves associated with life insurance		X
• Gradually liberalize the investment policies of pension funds		X
• Eliminate the privilege that pension funds of public banks have vis-à-vis undecided workers	X	
• Liberalize the insurance sector, beginning with allowing the entry of private insurance companies in the life and annuities businesses		X
• Significantly raise disclosure and transparency of the INS, increase flexibility in its investment policy, and separate the accounts of reserves for life insurance	X	
• Convert the INS into a joint stock corporation and then list it in the Exchange		X
• Create a supervisory agency (or a function within an existing agency) for insurance		X
• Create specialized courts that charge reasonable fees for the collateral repossession process, or move substantial parts of the process out of the judiciary		X
• Give creditor greater leeway to peacefully repossess or sell the collateral		X
• Issue regulations for "guarantee (or collateral) trusts"	X	

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