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COSTA RICA

FINANCIAL SECTOR ASSESSMENT

October 2022

Prepared By
Finance, Competitiveness, and Innovation Global Practice and Latin America and Caribbean Regional Vice Presidency

A World Bank mission visited Costa Rica from July 5 to July 21, 2022, to update the findings of the Financial Sector Assessment Program (FSAP) conducted in 2008. This report summarizes the main findings of the mission, identifies key financial sector vulnerabilities, and provides policy recommendations.

CONTENTS

CONTENTS 2
Preface 3
Glossary 4
Executive Summary 5
Macrofinancial Context........ 11
A. Macro-financial Setting........ 11
B. Financial System Structure 12
C. Financial Sector Conditions and Vulnerabilities 15
D. Financial Inclusion, Access, and Household (Over)Indebtedness........ 19
Financial sector oversight Framework 22
A. Financial Sector Oversight Architecture 22
B. Banking Supervision and Regulation 22
C. Climate and Environmental Risk Management 26
Priorities for Financial Sector development........ 28
A. Role of the State in the Financial Sector 28
B. HH Indebtedness and Consumer Protection 35
C. Capital Market Development........ 39
D. Greening the Financial Sector 41
ANNEX 44

PREFACE

A World Bank team visited Cost Rica during Jul 5-15 to conduct an assessment under the Financial Sector Assessment Program (FSAP). The team was led by Mariano Cortes (Mission Chief) and Oliver Masetti (Deputy Mission Chief) and included Fiona Stewart, Jennifer Chien, Emma Renu Dalhuijsen, Marius Vismantas, Diego Sourrouille, Valeria Salomao Garcia (all World Bank) and Jose Garcia Barroso (Consultant for the IMF). The mission was supported remotely by Faruk Miguel Liriano. The mission assessed financial sector development, identified challenges and opportunities, and assessed the extent of compliance with Basel Core Principles for Effective banking Supervision. The mission also looked at issues related to the role of the State in the financial sector, household indebtedness and consumer protection, capital market development and greening the financial sector.

The mission met with Mr. Róger Madrigal, President of BCCR, Mr. Nogui Acosta, Minister of Finance, Ms. Rocío Aguilar Montoya, Superintendent of SUGEF and SUPEN, Ms. María Lucia Fernández Garita, Superintendent of SUGEVAL, and Mr. Tomás Soley Pérez, Superintendent of SUGESE, as well as other senior officials at the Central Bank, Ministry of Finance and Public Credit, and supervisory agencies, as well as staff in private and development financial institutions, and a number of other stakeholders.

The team would like to thank the authorities for the excellent cooperation and fruitful discussions.

GLOSSARY

ABC	Asociación Bancaria Costarricense
BANHVI	Banco Hipotecario de la Vivienda
BCCR	Banco Central de Costa Rica
BCR	Banco de Costa Rica
BN	Banco Nacional
BNV	Bolsa Nacional de Valores
BoD	Board of Directors
BP	Banco Popular y de Desarrollo Comunal
CBA	Cost-benefit analysis
CCSS	Caja Costarricense de Seguro Social
CIC	Central de Informacion Crediticia
CONASSIF	Consejo Nacional de Supervisión del Sistema Financiero
CRC	Costa Rica Colon
CREDES	Créditos de Desarrollo
DTI	Debt-to-income
EFF	Extended Fund Facility
EIR	Effective interest rate
EME	Emerging Market Economies
FCD	Fondo de Crédito para el Desarrollo
FCP	Financial Consumer Protection
FOFIDE	Fondo de Financiamiento para el Desarrollo
FONADE	Fondo Nacional para el Desarrollo
FSPs	Financial Service Providers
HH	Households
INS	National Insurance Institute
KFS	Key facts statement
MCS	Market conduct supervision
MEIC	Ministry of Economy, Industry and Commerce
MINAE	Ministerio de Ambiente y Energía de Costa Rica
MoF	Ministry of Finance
NDC	Nationally Determined Contributions
OPC	Operadoras de Pensiones Complementarias
SBD	Sistema Banca para el Desarrollo
SBR	Supervisión basada en riesgos
SINPE	Sistema Nacional de Pagos Electrónicos
SOB	State-owned banks
SUGEF	General Superintendency of Financial Institutions
SUGESE	General Superintendency of Insurance
SUGEVAL	General Superintendency of Securities
SUPEN	Superintendency of Pensions

EXECUTIVE SUMMARY

Costa Rica's financial system is at a crossroad facing short-term risks and critical challenges but also opportunities. The financial system has been resilient to the COVID-19 pandemic amid regulatory forbearance and widespread loan restructurings, but forward-looking asset quality estimates and thin capital buffers suggest lingering vulnerabilities. The scarring from the pandemic leaves the financial sector vulnerable to deal with risks from elevated indebtedness of households, dollarization and floating rate borrowing that are aggravated by the current macroeconomic juncture of rising interest rates, high inflation, a weakening exchange rate, and a worsening global context. Looming over the country are also climate change and environmental risks and the investment funding demands needed to help transition some sectors of the economy towards net zero carbon emissions. These features present also opportunities to further green the financial system and advance the development of capital markets, among others by incentivizing greater demand for local investments and utilizing the development potential of growing Pillar 2 pension assets. It is also time to carefully take stock of the State's footprint in the system—policies, ownership, and the *Sistema de Banca para el Desarrollo (SBD)*--to enhance financial intermediation efficiency and development while addressing distortions built over many years. Addressing these challenges would help the country achieve a more resilient inclusive growth trajectory undergirded by a deeper, more efficient, diversified, and greener financial system.

Ensuring financial stability, a pre-condition for development, requires first and foremost a strengthening of the supervisory framework of the banking sector. The current conjuncture of macroeconomic challenges, structural vulnerabilities and low banking sector buffers implies elevated risks to financial stability that require urgent strengthening of the supervisory framework. Since 2016 SUGEF has been engaged in the implementation of risk-based supervision (SBR for its initials in Spanish) but as currently practiced, this approach does not yet allow the supervisor to obtain a holistic and robust risk-profile view of supervised entities nor is conducive to SUGEF taking more timely supervisory action and enhancing bank soundness and system stability. Similarly, the consolidated supervision framework that is being put in place should be further developed by setting consolidated prudential limits and group-level capital ratio requirements. The strengthened bank capital framework coming into effect in 2025 should be complemented by giving SUGEF Pillar 2 statutory powers to call for capital-addons to better reflect the risk-profile of a bank. To be better prepared for an eventual crisis, authorities should introduce a recovery and resolution planning framework, especially relating to systemic banks.

At the same time the institutional setup and legal underpinnings for SUGEF's bank oversight function should be strengthened and legal lacunae addressed. The governance of COANSSIF and SUGEF could be strengthened by inter-alia establishing a robust fit and proper assessment process for CONASSIF board members and the SUGEF's Superintendent. The recommended legal changes aim to fill lacunae, remove uncertainties, and provide stronger tools to supervisors including by giving SUGEF powers to remove senior management and board members of banks, buttressing corrective

action including on AML/CFT matters and ownership and control frameworks, and extending the legal protection to all the staff of SUGEF involved in supervision.

Addressing the risks from households' indebtedness will require establishing a strong financial consumer protection framework. Multiple segments of the household sector are plagued by high debt and over-stretched debt servicing capacity, especially low-income borrowers. Consumers are vulnerable to currency depreciation and rising interest rates, as material shares of their loans are dollar-denominated and at floating rates. To limit risks to both the financial system and individual borrowers, a combination of actions is recommended. Priority should be to establish a strong financial consumer protection (FCP) framework based on a clear institutional mandate and resources for FCP. The FCP framework should include affirmative obligations on product suitability and responsible lending and stronger rules addressing aggressive marketing and sales, poor disclosure and transparency, data privacy gaps, and abusive debt collection. Multiple targeted actions can be taken to mitigate the risks of FX-denominated and variable interest rate loans, for example by requiring that financial service providers provide explicit warnings to consumers on associated risks of such loans, applying product suitability principles, and employing higher risk weighting.

Principles-based approaches on responsible lending should be complemented with carefully calibrated quantitative macro-prudential measures and steps to expand the regulatory perimeter to cover the unregulated credit market. FCP measures might not be sufficient to address the systemic risks of HH indebtedness and policy makers should explore complementing them by macroprudential tools such as a maximum debt-to-income (DTI) ratio, strengthening stress scenarios for assessing repayment capacity for FX-denominated and variable interest rate loans. To fully address concerns about over-indebtedness will also require expanding the regulatory perimeter to cover the unregulated credit market, as stronger regulation in the regulated sector could lead to further migration to unregulated credit providers. Finally, improvements in data availability through strengthening the credit information system as well as the development of an indicator system to monitor over-indebtedness will be necessary to get a more comprehensive picture of HH indebtedness and debt service capacity and calibrate responsible lending requirements and macro-prudential tools appropriately.

The Role of the State in the financial sector should be optimized to create a financial system that is free of competitive distortions and strong on development finance. Costa Rica's state-led economic development model of the past created a sizeable state footprint in the financial sector, but also over many years competitive distortions and inefficiencies. To enhance financial intermediation efficiency and development it is recommended to:

- *Level the playing field in financial services provision --irrespective of ownership.* Concrete actions include (i) the removal of the state-owned banks (SOBs) monopoly in deposit services provision to public entities; (ii) removal of government guarantee of SOBs liabilities replaced by the recently introduced limited deposit insurance (which would also contribute to a more balance currency funding mix for banks in the system); (iii) removal of state-owned financial institutions' (SOFIs)

earmarked profit transfers to government agencies/funds and adoption of a unified profit distribution rules for SOFIs.

- *Removing competitive advantages enjoyed by Banco Popular*. This should include (i) a gradual phase out of the 18-month deposit of pension contributions in Banco Popular (a competitive advantage in bank funding); ii) removal of its default pension fund administrator status (advantage in pension fund management); iii) and phase out the continued employer-funded capital injection (distorts risk taking, performance incentives and capital allocation).
- *Transform SBD into a regulated second-tier development finance institution.* The transition should be gradual and positive features of the SBD should be maintained while the funding model should no longer be based on financial repression. During the transition, private banks' mandatory contributions to SBD should be reduced and only provided as refinancing at market rates when SOBs demonstrate by evidence that they have placed qualifying development credits.
- *Review the state ownership in financial intermediaries*. The government could consider making the two state-owned banks solely commercial, competing on a level playing field, by inter-alia carving out development focused/public policy operations and moving them to a development finance intuition. More fundamentally, divestments could also be carefully considered for the purposes of market listing, share trading, market value discovery, with proceeds shoring up public finances.[1]

A range of interlocking reforms are needed to support the development of domestic capital markets. Capital market development in Costa Rica is hampered by multiple factors, including crowding out by the government, limited private domestic investment opportunities, domestic banks lending at relatively long tenors, tax disincentives discouraging international investors, domestic pension funds strong preference for sovereign risk and investments abroad, domestic issuers favoring domestic private placements or external funding. The under development of local capital markets, beside limiting its impact in Costa Rica's development, also implies risks for the economy overall including bank maturity mismatches, lack of reliable sovereign-risk yield curve and price discovery, and lack of local investment opportunities for pension funds. A key building block for spurring capital market development are reforms to the government bond markets to enable the creation of a benchmark yield curve, as well as removing tax disincentives for foreign investors, and greater coordination on issuance between the central bank and Treasury. For the non-government markets, introducing a wider range of options for trading (I.e. allowing some OTC trades) and issuance reforms (e.g., a 'hybrid approach' with some form of private placements), as well as gradually introducing market makers could encourage issuers and help to deepen markets. On the institutional investor side, reforms to the pension fund management and investment regulations can support capital market development through incentivizing greater demand for local investments and utilizing the development potential of growing Pillar II pension fund assets. This includes basing the choice of default provider on long-term investment performance and introducing a life-cycle investment approach.

[1] After the conclusion of the FSAP Development Module mission work, the government announced in August 2022 its intention to privatize one of the state-owned commercial banks.

Financial sector resilience to natural disasters and particularly climate change- and environmental-related risks should be strengthened. Costa Rica is vulnerable to natural disasters (geophysical, hydrometeorological) and climate change- and environmental-related risks and these risks figure already importantly in the work agendas of financial sector authorities. However, a coherent cross-authority supervisory strategy is not yet in place and supervisors are not yet properly equipped to engage in the supervision of climate-related and environmental risks. It is thus recommended to establish a formal coordination mechanism between the authorities, set up a joint supervisory and regulatory roadmap, and develop and implement individual but harmonized strategies for climate and environmental risks integration into supervisory practice. It will be helpful to include specific timelines and objectives in relation to issuing supervisory guidance, conducting a top-down exposure exercise of the banking sector's vulnerability to climate risk to inform supervisory priorities, and enhancing climate risks analysis/stress testing capabilities.

Costa Rica is a global frontrunner in terms of climate and environmental ambitions, but interventions are needed to further stimulate green finance. The country has one of the few *Nationally Determined Contributions (NDCs)* globally which is said to be 1.5°C compatible and guided by its National Decarbonization Plan, it is pursuing a whole-economy low-carbon transformation. However, the potential of the financial sector to capitalize on Costa Rica's image as a green leader seems underutilized, leaving opportunities in international markets untapped. To scale-up green finance authorities should start assessing the apparent lack of domestic investor interest in green finance products, and collectively feed into the development of an action plan to scale up green finance demand. This should be supported by building a comprehensive and consistent climate and green finance information architecture, enhancing climate-related disclosure practices, and harmonizing the different taxonomies and classification systems. Leveraging its image as a 'green' leader, Costa Rica could benefit from exploring more innovative green financing approaches, including the development of a "green country label" for public sector bond issuance as well as performance-linked products and blue bonds. To address the challenge of low insurance penetration, relevant authorities could promote opportunities to expand micro- and parametric insurance for climate risks building on the recently published national disaster risk finance strategy.

Table 1: Key Recommendations

		Responsible entity	Timeframe*
	Banking Supervision (Basel Core Principles Assessment)		
1	Strengthen CONASSIF and SUGEF governance by inter-alia establishing a robust fit and proper assessment process for CONASSIF board members and the SUGEF's Superintendent	MoF, CONASSIF, SUGEF, BCCR**	NT
2	Strengthen legal protection of SUGEF's supervisors	MoF, CONASSIF, SUGEF**	NT
3	Amend the corrective actions framework pertaining to overall prudential supervision as well as AML/CFT so that the sanctioning process is effective	MoF, CONASSIF, SUGEF	NT
4	Amend the legal framework granting SUGEF powers to replace senior management and board members of banks	MoF, CONASSIF, SUGEF**	NT
5	Strengthen SBR framework by increasing focus on individual risks, incorporating consolidated supervision, and enhancing the exercise of judgement	SUGEF	NT
6	Introduce a recovery and resolution planning framework especially relating to systemic banks	CONASSIF, SUGEF	NT
	Supervisory response to climate-related and environmental risks		
7	Establish a formal governance structure and coordination mechanism between the authorities and set out a joint supervisory/regulatory strategy on climate-related and environmental risks	CONASSIF, BCCR,	ST
8	Develop and implement individual strategies for the integration of climate risk into supervisory/regulatory practice including issuance of supervisory guidance	SUGEF, SUGESE, SUPEN, SUGEVAL	MT
9	Carry out a top-down exposure exercise of the banking sector's vulnerability to climate risk and enhance vulnerability analysis/stress testing capabilities building on initial banking and insurance (climate) stress-testing work	BCCR, SUGEF, SUGESE	ST-NT
	The Role of the State		
10	Address distortions that unlevel the playing field between state-owned and private banks by a) phasing out mandate for public deposits to exclusively go to SOBs; b) phasing out unlimited sovereign guarantee on SOBs' liabilities; c) replacing parafiscal charges on SOBs profits with a single annual dividend transfer, and d) exempting SOBs from public procurement rules	Congress	NT
11	Remove competitive advantages for Banco Popular by a) phasing out the 1.25% transfer of Pillar II pension allocations, b) phase out the 0.25% transfer to fund BP's capital, and c) end BP's preferred claim in payroll deductions	Congress	ST
12	Eliminate *Popular Pensions* as the default provider for Pillar II pensions of workers that do not actively chose an OPC	SUPEN**	ST
13	Reduce mandatory contributions to SBD's FCD - and only as refinancing at market rates when SOBs demonstrate by evidence that they have placed qualifying development credits	Congress, SBD	ST
14	Transform SBD into a regulated second-tier development finance institution	Congress, SBD	MT
	Household indebtedness and financial consumer protection		
15	Pass draft bill on financial consumer protection (FCP) to establish a comprehensive high-level legal framework for FCP	Congress	ST

16	Establish a clear institutional mandate and resources for FCP covering credit markets, including expanding the regulatory perimeter to cover non-regulated credit providers, while building up market conduct supervision capacity	CONASSIF**	NT
17	Issue more detailed rules on product suitability and responsible lending, fair marketing and sales practices, enhanced disclosure and transparency, data privacy, and debt collection	SUGEF, MEIC, PRODHAB	MT
18	Explore leveraging macroprudential tools such as a maximum debt-to-income (DTI) ratio, strengthening stress scenarios for assessing repayment capacity for FX-denominated and variable interest rate loans	SUGEF	NT
19	Consider revising or removing Anti-Usury Law	MoF	NT
20	Establish a more comprehensive credit information system that covers all credit providers and includes positive data and negative data, alternative data, and levels of indebtedness	Congress, SUGEF	ST
21	Develop indicator system to monitor over-indebtedness	BCCR, SUGEF	NT
Capital markets			
22	Facilitate offshore issuance of public debt through reforming the requirement for two-thirds majority in Congress for each issuance's placement	Congress	ST
23	Improve coordination on issuance between BCCR and MoF	BCCR, MoF	NT
24	Introduce hybrid issuance approach for private securities for qualified investors	SUGEVAL**	NT
25	Award default mandate to OPC pension funds manager for a fixed period based on long-term investment performance criteria	SUPEN**	NT
26	Introduce life-cycle investment approach (asset class limits, remove 'tiers') for OPC funds	SUPEN	NT
Green finance mobilization			
27	Harmonize the different taxonomies and classification systems already in place and/or currently being developed	MoF, BCCR, CONASSIF	NT
28	Conduct an assessment at the retail, project, and market level to determine which regulatory interventions are needed to stimulate green finance demand	MoF, MINAE, SUGEF, SUGEVAL	NT
29	Explore more innovative green financing approaches, including the development of a "green country label" for public sector bond issuance, performance-linked instruments, adaptation instruments and biodiversity credits	MoF, MINAE, SUGEVAL	MT
30	Promote opportunities to expand micro- and parametric insurance for climate risks	MINAE, MoF, SUGESE	NT

** ST (short term) = within one year; NT (near term) = 1–3 years; MT (medium term) = 3–5 years.*

*** Measures require legal changes made by Congress.*

MACROFINANCIAL CONTEXT

A. Macro-financial Setting

1. Economic activity started to recover from the contraction caused by the COVID-19 pandemic. The COVID-19 pandemic hit Costa Rica hard and aggravated pre-existing economic weaknesses. Economic growth, which had already decelerated from an average of 4 percent in 2010-2017 to 2.5 percent in 2018-2019, turned sharply negative in 2020. The real GDP contraction of 4.1 percent in 2020 was the deepest recession in four decades. The sharp contraction in economic activity led to a jump in the already structurally high unemployment rate from 12.4 percent in 2019 to 24 percent in Q2-2020 and a 5.5 ppts increase in the poverty rate to 16.1 percent in 2020[2]. Driven by a successful vaccination campaign (80 percent of the population have received at least two doses of the Covid-19 vaccine) and recovery in exports and private consumption, economic activity bounced back in 2021, with GDP exceeding pre-pandemic levels and both unemployment as well as poverty rates falling back to 2019 levels.

2. Inflation and exchange rate pressure increased sharply in recent months triggering a sharp reversal in the monetary policy stance. Inflationary pressures have increased substantially over the past year as pent-up demand, supply chain bottlenecks, and the impact of Russia's invasion of Ukraine on food and fuel prices pushed the CPI inflation to 11 percent in June 2022. By early July 2022, the CRC/USD exchange rate had depreciated by 10 percent (YoY) bringing the cumulative depreciation since the beginning of the pandemic to 21 percent. To restore price stability and relieve exchange rate pressures the Banco Central de Costa Rica (BCCR) reversed its very accommodative policy stance taken during the initial phase of the pandemic and raised policy rates from 0.75 percent in early December 2021 to 5.5 percent in July 2022.

3. Public debt levels increased during the pandemic buttressing "nexus" risks for the financial system. The government's fiscal response to the pandemic was primarily focused on cash transfers to low-income households (*Bono Proteger*) as well as increased transfers to the social security fund and health-related spending.[3] At 1.3 percent of GDP in 2020 the size of fiscal support measures was significantly smaller than the LAC average (5.9 percent of GDP). However, in combination with a sharp drop in tax revenues the fiscal deficit widened to 8.4 percent of GDP in 2020 and public debt increased by 11 percentage points to 67 percent of GDP. The fiscal performance improved in 2021 as strong revenue yields and restrained spending helped to reduce the deficit and stabilize the public debt ratio. An important step for strengthening fiscal prospects was the enactment of the public employment law in March 2022, which by improving public employment efficiency is estimated to generate savings of 0.5 percent of GDP.[4] Nevertheless, public debt remains close to the 70 percent of GDP debt distress threshold for EMEs and sovereign-financial sector "nexus" risks are significant given the material exposure of financial intermediaries (banks, pension fund managers, insurance companies

[2] Refers to '*Indice de Pobrez Multimencional (IPM)*'. The poverty line is set at US$ 5.5/day PPP.
[3] IMF (2021). Costa Rica Article IV.
[4] World Bank (2022). Macro and Poverty Outlook

and investment funds) to the sovereign. Three-quarters of the public debt stock is held domestically, primarily by pension funds and banks. FX risk is considerable as 40 percent of the debt is denominated in US$ including a US$ 1.5 bn Eurobond issued in 2019. The public debt management plan assumes continued access to international markets and recurring international bond issuance over the coming years, which might become more challenging amid the ongoing rapid tightening of global financial conditions.[5] To mitigate financing risks the IMF approved a three-year US$1.75 bn Extended Fund Facility (EFF) in February 2021; the arrangement was recently extended through July 2024. Strict adherence to the fiscal rule is critical to avoid further build-up of risk in the financial system as two-thirds of elevated public sector gross borrowing requirements are expected to be sourced domestically.

B. Financial System Structure

4. Costa Rica's large financial sector is bank-centric and characterized by a strong public sector footprint. Total financial sector assets stood at 141 percent of GDP at the end of 2021 (Table 2). The largest sector is the banking sector, which consists of 15 banks that account for 55 percent of total financial sector assets. The banking sector is concentrated as the combined market share of the largest five banks stands at 80 percent. The largest two banks, *Banco de Costa Rica* (BCR) and *Banco Nacional de Costa Rica (BN)*, are state-owned commercial banks and account for 44 percent of total banking sector assets.[6] Additionally, there are two public banks created by special laws, *Banco Popular y de Desarrollo Comunal (BP)* that is the fourth largest bank, and a second-tier housing bank (*Banco Hipotecario de la Vivienda-BANHVI*).[7] The largest private banks operating in Costa Rica are subsidiaries of Colombian or Canadian banks and only two of the private banks are majority domestically owned. Bank business models are focused on lending as credit accounts to roughly 60 percent of total assets. The largest lending segments are loans to firms (34 percent of total credit) and housing loans (30 percent of total credit), followed by consumption loans[8] (28 percent of total credit). The credit market is segmented by currency denomination with public banks dominant in the Costa Rica Colon (CRC) segment and foreign banks in the dollar segment (see ¶ 12 for more details on dollarization). Banks, including public banks, are often part of financial groups that in addition to the bank include investment fund companies, brokerage houses, pension fund managers or insurance companies. The set of regulated financial intermediaries also includes 8 non-bank credit providers as well as 21 credit and savings cooperatives with combined assets of roughly 19 percent of GDP. An increasing share of credit is also estimated to be originated by unregulated credit providers, such as retail stores and supermarkets.

[5] Costa Rica is a sub-investment grade rated country.
[6] These two banks are the sole shareholders of the International Bank of Costa Rica incorporated in Panama which is focused on trade-financing with the bulk of the assets in Costa Rica and Panama and activities in many other countries.
[7] BANHVI is the lead agency and governing body of the National Housing System benefiting from an unlimited and state guarantee. It provides counter-guarantees to mutual savings and loan associations.
[8] Including credit card and car loans

Table 2: Financial sector structure (December 2021)

	Number	Assets		
		CRC bn	% of total	% of GDP
Banks	15	31,431	55.0	78.8
State-owned commercial banks	2	14,050	24.6	35.2
Public banks created by special law	2	4,185	7.3	10.5
Private banks	11	13,196	23.1	33.1
Non-bank credit providers	8	3,413	6.0	8.6
Credit and savings cooperatives	21	4,120	7.2	10.3
Pension fund administrators*	6	10,242	17.9	25.7
Insurance companies	13	2,762	4.8	6.9
Investment fund companies	14	4,451	7.8	11.2
Total		**56,419.0**	**100**	**141.4**

* Includes only *Operadoras Pensiones Complementarias (OPC)* that manage Pillar II and III.

Source: SUGEF, SUPEN, SUGESE, SUGEVAL

5. The large and complex pension system faces significant challenges with contributions already falling short of benefits payments in the first pillar.[9] Costa Rica has a multi-pillar pension system. The first pillar (*Régimen Básico*) is a public, mandatory defined benefit scheme managed by the *Caja Costarricense de Seguro Social (CCSS*) and partially funded by contributions of employers and employees as well as a public subsidy. It provides the national old age, disability, and survivor pensions (RIVM).[10,11] Since 2011, individual contributions fall short of benefit payments; the reserve is projected to start being deployed around 2023 and become exhausted around 2030. Authorities are exploring reforms to stabilize Pillar I while extending coverage to workers in the informal sector.

6. Pillar II pension fund assets have grown strongly over the past years, but allocations remain concentrated in public and foreign securities amid limited private domestic investment options. The pension system's mandatory, defined contribution individual account system (Pillar II) is managed by six pension fund managers (*Operadoras de Pensiones Complementarias-OPCs).* [12] The default OPC appointed by law is *Popular Pensions* owned by BP, which has a market share of approximately 40 percent. The system's contribution rate is set at 4.25 percent of workers' salary but a unique aspect is that 1.25 percent is not transferred directly to the pension funds but allocated to *Banco Popular* for a period of 18 months before being sent to an individual's pension account with an OPC. Pillar II (and Pillar III) assets under management doubled from 13 percent of GDP in 2015 to 26

[9] This FSAP, including the technical note on capital markets, focuses on the 'second pillar', mandatory private pension schemes under the ROP system. The first pillar IVM and other parts of the overall pension system in the country are not covered in depth.

[10] The CCSS scheme can be replaced for groups in the public sector (*Regímenes Básicos sustitutos*). The two other providers are the teachers' pension fund, and the Board of Pensions and Retirement of the Magisterium National (JUPEMA) and the judicial sector pension fund (FPJ). These schemes have separate contribution and benefit provisions.

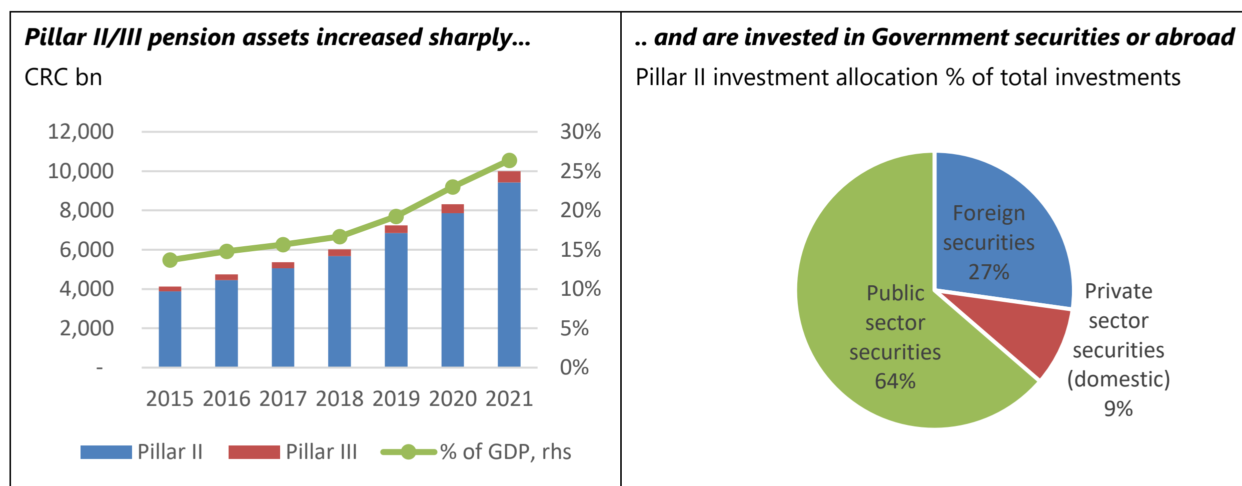
[11] There is also a means tested social assistance scheme providing a minimum income guarantee, operated by CCSS and funded with resources from the *Fondo de Desarrollo Social y Asignaciones Familiares* and some specific taxes

[12] Only 5 of the 6 OPCs manage Pillar III assets.

percent of GDP in 2021 (see Figure 1). Investments are heavily geared towards public sector securities (64 percent) and foreign investments (27 percent) while private domestic investments are low, primarily due to very shallow equity and private debt markets and scarce investment opportunities (see ¶ 8). These investment patterns not only suggests that rapidly growing assets under management of institutional investors are not yet significantly contributing to economic development and savings leave the country, but the concentration in public securities also creates risks for the funds as movements in Treasury yields have immediate impacts on the returns and sustainability of the pension funds while building up sovereign-financial sector Nexus risks.

7. The insurance sector is small – particularly the life market - and remains dominated by a state-owned insurance company. Premiums accounted for 2.3 percent of GDP and assets for 6.9 percent of GDP in 2021. The market is dominated by the non-life segment (automotive, health and fire insurance), which accounts for over 80 percent of gross written premiums. Around 22 percent of premiums are reinsured, and investments are concentrated in government bonds. The market was liberalized in 2008 but is still dominated by the state-owned *National Insurance Institute (INS)*, which accounts for 66 percent of total premiums. Private companies are growing in some market segments (notably health insurance).

Figure 1: Pension fund assets and investments



Source: SUPEN

8. Capital market activity is dominated by the primary issuance of public debt, with corporate debt and equity markets being underdeveloped. Capital market activity is organized via a single stock exchange, the *Bolsa Nacional de Valores* (BNV).[13] Government issuance on the domestic market totaled 15 percent of GDP in 2021, with the Ministry of Finance (MoF) and the BCCR being the main issuers. In contrast to the public sector, corporate bond issuances are very rare. As of April 2022,

[13] The Costa Rican legal framework establishes a market principle focused on secondary market trading of both public debt and securities of any other private issuer, which implies that all transactions in this market must be carried out on the stock exchange and through an authorized brokerage firm.

40 issuers were registered, dominated by the financial sector, with tenors between 3.5-5 years, around 55 percent in local currency, with limited secondary market trading. The equity market is small with a market capitalization of 3.6 percent of GDP and only 10 listed firms. Retail investment is limited, with institutional investors (mainly pension funds) dominating. Fourteen investment fund management companies manage third party assets equivalent to approximately 10 percent of GDP in money market funds, and real estate investment trusts, with venture/capital at risk funds recently authorized.

9. Retail payment systems are accessible and widely used, while the FinTech sector is growing. Electronic payments channeled through the central bank operated *Sistema Nacional de Pagos Electrónicos* (SINPE) have been growing rapidly over the past years and have become the dominant form of payments. This includes the cellphone based *SINPE Movil* application that allows instant low-value P2P transfers and payments for free.[14] The use of *SINPE Movil* has grown exponentially since the beginning of the pandemic. The high popularity and reported efficiency of *SINPE* has reduced the use of cash. The FinTech sector has grown in recently years to around 45 entities.[15] Most FinTechs are specialized in payments and transfers services and only a small number is offering lending or digital banking services. There is currently no BigTech operating in Costa Rica. Authorities have not yet issued separate regulations for FinTech but created a multi-agency FinTech working group (*Grupo FinTech*) with representatives from BCCR, CONASSIF and all superintendencies to study market trends and coordinate initiatives. Additionally, authorities set up an innovation center (*Centro de Innovacion*) to support new technology startups in the financial sector.

C. Financial Sector Conditions and Vulnerabilities

10. Credit growth recovered from the pandemic but remains sluggish. Private sector credit declined in nominal and real terms in early 2020. While nominal credit growth returned in the second half of 2020, growth rates have been substantially lower than in the pre-Covid period.[16] The recovery in credit growth has been particularly weak in the consumer credit segment, which was also affected by the introduction of a stringent usury law in 2020 (see ¶ 15 and 6715), while it has been stronger in the mortgage and corporate loan segments. Nominal credit growth during the pandemic kept pace with nominal GDP growth and the private sector credit to GDP ratio thus remained stable at around 57.9 percent in 2021.

11. Financial soundness indicators have remained stable throughout the pandemic amid widespread restructurings, but forward-looking asset quality estimates suggest lingering risks. Official NPL figures, which rely solely on back-ward looking 90 days past due criteria, have remained broadly stable throughout the COVID-19 pandemic and stood at 2.3 percent of total loans in May 2022. Asset quality was supported by widespread loan restructurings. Almost 60 percent of the loans

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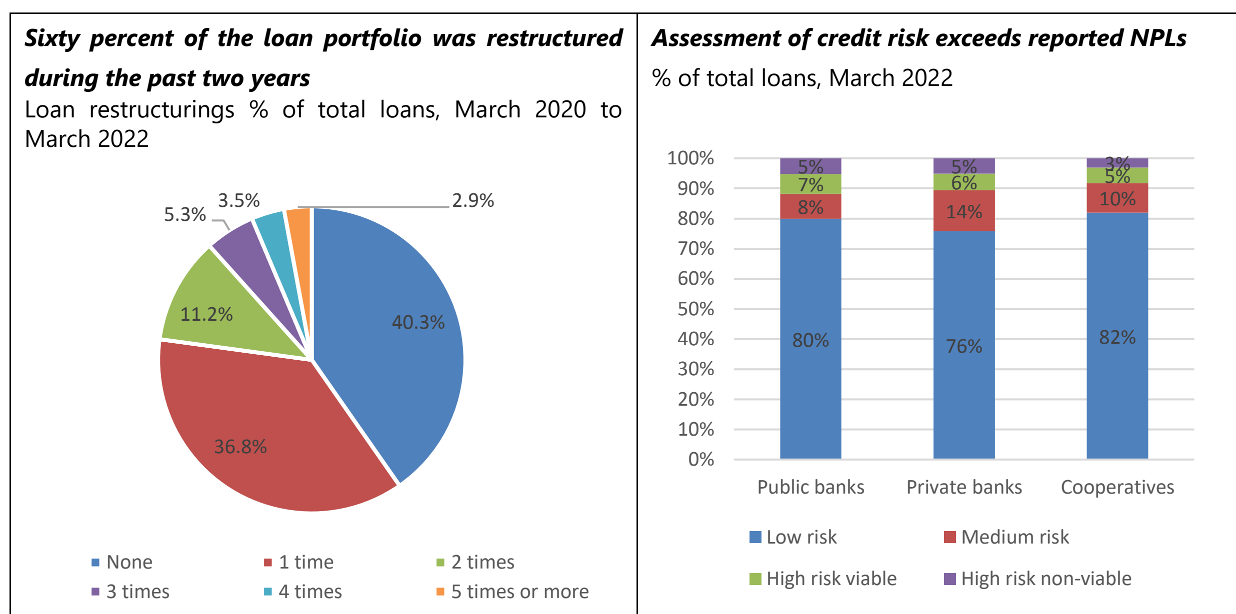
[14] Transactions are free below a threshold of CRC 100,000 per day.

[15] According to *Centro de Innovacion (CIF) Costa Rica* (2022).

[16] Monthly credit growth (yoy) averaged 3.1 percent between July 2020 and March 2022 compared to 8 percent in 2016-2019.

volume was restructured throughout the pandemic and 11.6 percent of the loan portfolio saw more than three restructurings. To get a better sense of underlying asset quality challenges hidden by the forbearance measures, SUGEF requested banks to report their own risk assessment of the credit portfolio. This self-reporting exercise shows that as of March 2022 4.8 percent of the credit portfolio was rated as *'high-risk, non-viable'* and another 5.7 percent as '*high-risk, viable*'. The share of loans assessed as high-risk is highest for state-owned banks at 11.8 percent (5.2 percent *'high-risk, non-viable'* and 6.6 percent *high-risk, viable')* but the comparability of the figures across banks is limited as SUGEF did not provide uniform parameters and scenarios for the assessment. These numbers are significantly higher than the reported NPL numbers as only 44 percent of the loans identified as *'high-risk, non-viable'* and 1.5 percent of the loans classified as *'high-risk, viable'* are classified as non-performing based on the 90 days past due criteria. These observations also suggest that provisioning at around 4.4 percent of total loans (193 percent of the reported NPL ratio) might not fully cover the actual credit risk. Concerns over system stability are aggravated by relatively low capital adequacy ratios of state-owned banks (13.2 percent of RWA as of May 2022) and private banks (13.8 percent of RWA).[17]

Figure 2: Credit risk in the banking sector



Source: SUGEF

12. Risks from high household indebtedness and dollarization have increased amid a weakening exchange rate and rising interest rates. These structural vulnerabilities are closely interlinked as household debtors are the majority of unhedged FX borrowers and the sharp depreciation of the CRC/US$ exchange rate in combination with higher interest rates increases the debt service burden for households, while inflation and underemployment are eroding disposable household income.

[17] Minimum regulatory CAR is set at 10 percent.

- **Dollarization.** While the share of US$ denominated credit has been on a downward trend over the past years, credit dollarization remains high at 36.9 percent in May 2022. The system-wide figures hide large differences between private and state-owned banks. While for state-owned banks US$ denominated credit accounts for 29.8 percent of their total credit book, for private banks it accounts for 67 percent (see Figure 3). Fifty-six percent of FX credit is directed to corporates and the largest recipients are large and medium-sized corporates. However, 43 percent of FX credit is directed to individuals that in most cases have no matching income in US$ and are thus classified as '*deudores no generadores de ingresos en divisas*'. The largest share of FX credit volume to individuals is directed to housing credit followed by car loans. These two product categories also exhibit the highest share of dollarization: 65 percent of all car loans (in terms of volume) as well 38 percent of all housing loans are denominated in US$. The recent depreciation of the CRC exchange rate against the US$ means that the local currency cost of serving and repaying FX credit has increased substantially. The depreciation combined with high inflation has also increased the demand for saving in US$ and the share of FX deposits has increased by 7 ppts over the last year to 44.4 percent of total deposits.[18] The high demand for safe-haven savings in US$ presents structural challenges for de-dollarization.

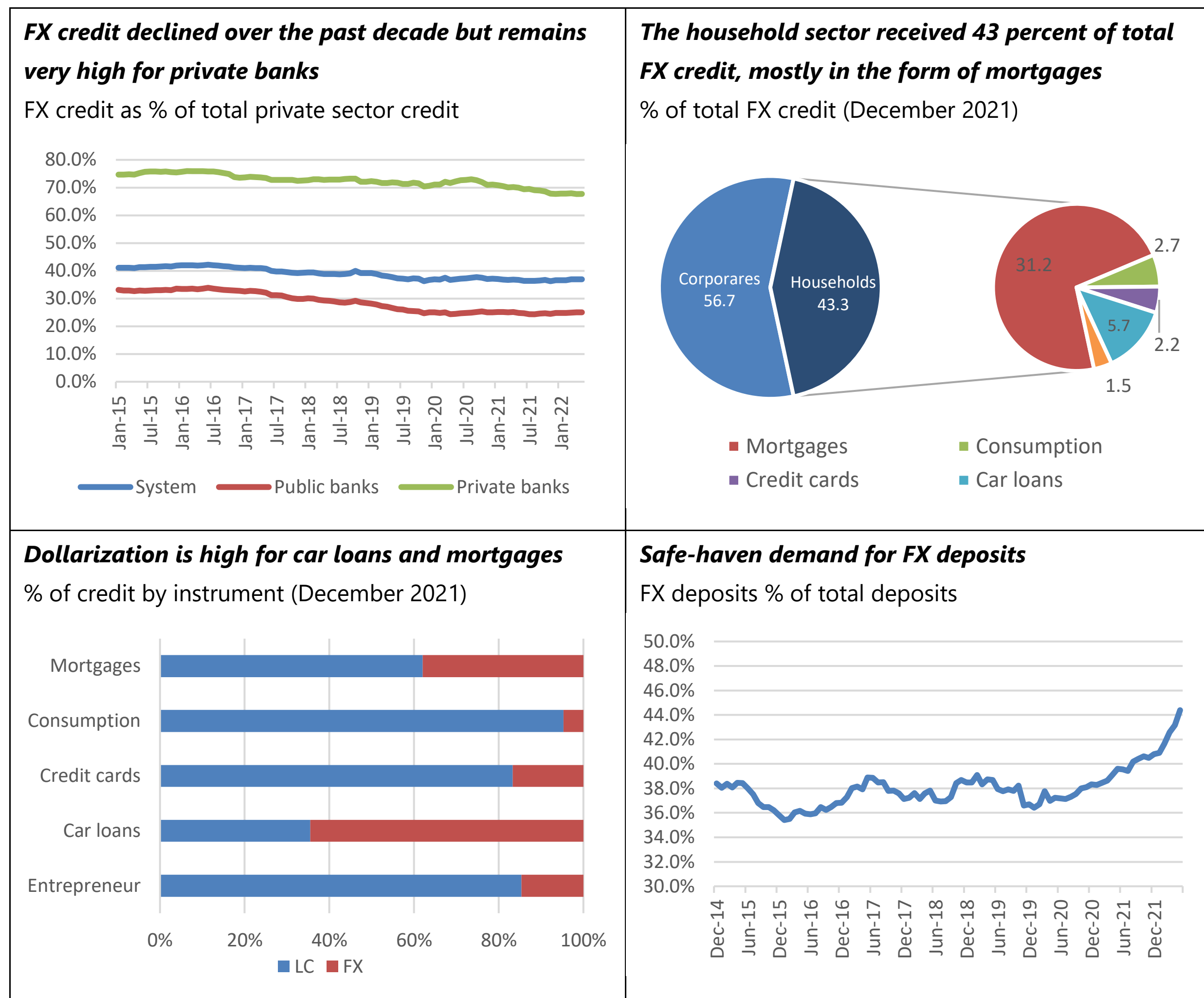
- **Household indebtedness.** Dollarization of many retail loan products adds to the risks stemming from high and rising household (HH) indebtedness. While no comprehensive data on HH indebtedness are available due to gaps in the credit reporting systems (see ¶ 15), debt solely from regulated financial institutions increased by 7 ppt over the past decade to 37 percent of GDP and is higher than in most LAC peer countries. Mortgage and consumption loans account for roughly half of banks' credit portfolio meaning that shocks to household sector debt service capacity, such as inflation-eroding disposable income, can have a strong impact on asset quality and ultimately banking sector stability. Risks are amplified by a high share of variable rate loans (68 percent of total) that are often adjusted on a monthly basis. Research by BCCR shows a high pass through of policy rate changes to retail lending rates and it is thus likely that the sharp increase in the monetary policy rate (+475 basis point y-o-y) will result into higher debt servicing costs for households in the near future.

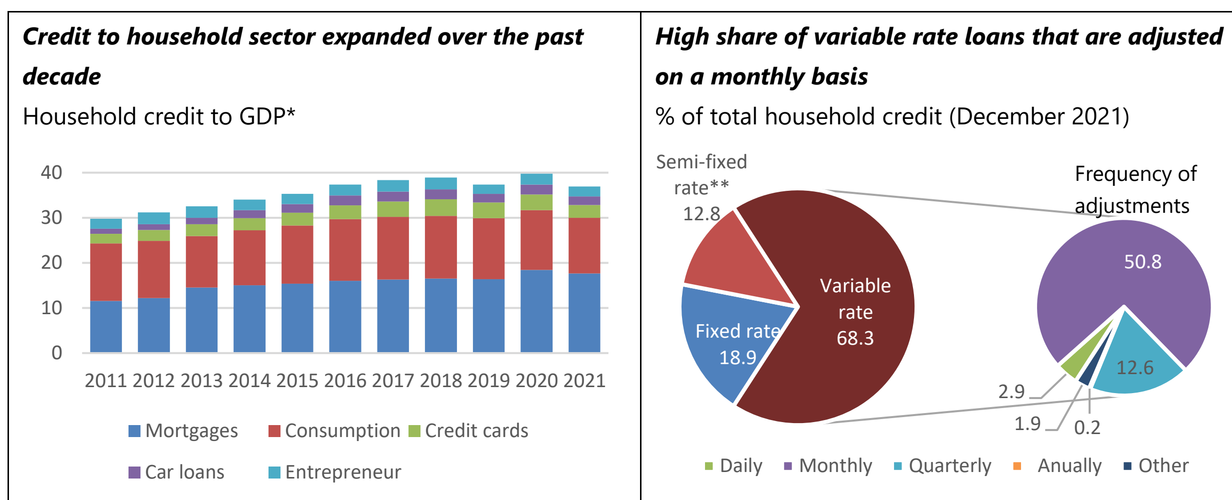
13. **The financial sector is exposed to physical risks stemming from extreme climate events and natural hazards while transition risks are low due to Costa Rica's 'green economic structure'.** Due to a combination of geographic variations and economic factors, Costa Rica is highly vulnerable to extreme climate events and natural hazards. Key hazards include floods and landslides, cyclones, storm surges, sea level rise and geophysical risks. With the country's severe risk to sea level rise, flood events pose the highest climate-related risk to Costa Rica's economy. This vulnerability is exacerbated due to the presence of populations in vulnerable areas. Seventy eight percent of Costa Rica's population and 80 percent of GDP resides in areas at high risk of multiple hazards. In turn, these vulnerabilities pose risks to the stability of the Costa Rican financial system, as these climate-related

[18] The increase in the ratio is also due to valuation effects stemming from the depreciation).

hazards may translate into losses impacting the country's financial institutions. In contrast, transition risks appear low as Costa Rica is responsible for only 0.02 percent of global GHG emissions, and circa 99 percent of its energy use comes from renewable sources, the majority of which is hydropower. Nonetheless as key emitting sectors, decarbonization of transport – which has historically been underfunded – and agriculture remain key challenges.

Figure 3: Dollarization and household indebtedness





*Source: SUGEF, BCCR. Note: * includes only credit from regulated financial entities; ** semi-fixed loans have fixed rates for the first months to turn variable later.*

D. Financial Inclusion, Access, and Household (Over)Indebtedness

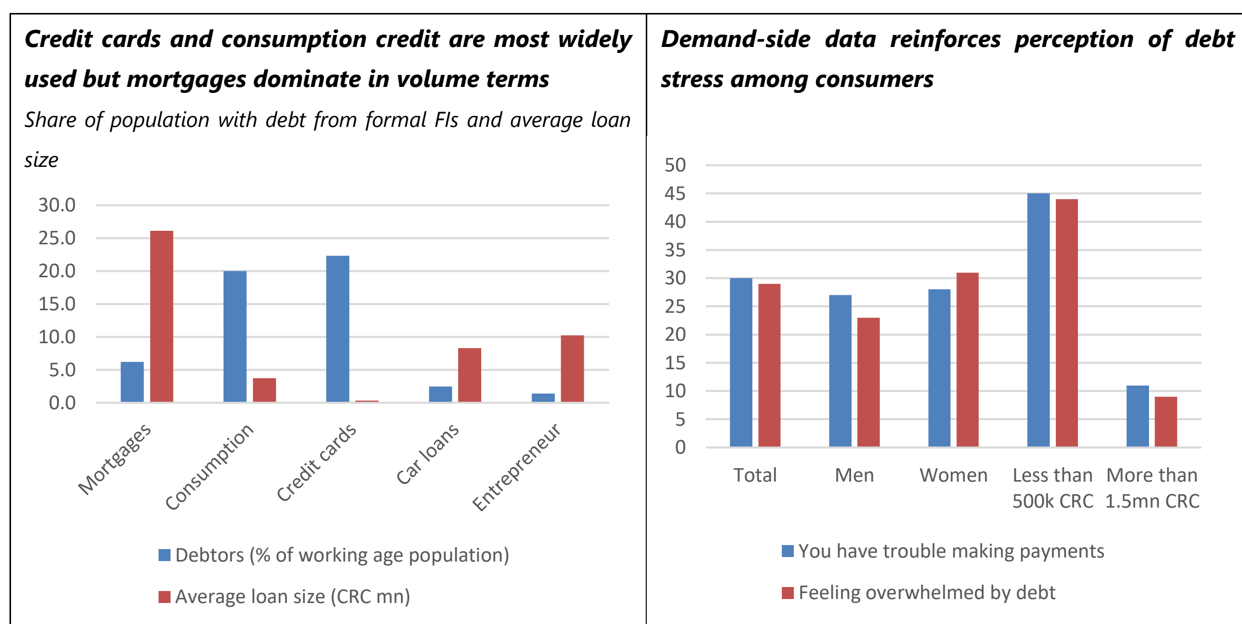
14. Access to financial services exceeds most regional peers, but disparities remain as women, poor households, and those with lower education show persistently low access and use levels. Sixty-eight percent of the adult population report having an account with a formal financial institution, and more than half of the adult population owns a debit card. These numbers exceed most regional peers and suggest relatively wide-spread access to financial services. However, the aggregate numbers hide large and, in some cases, increasing heterogeneities within the country as access indicators are significantly lower for women (61 vs 76 percent for men), adults with only primary education (52 vs 80 percent for adults with secondary or higher education) and the poor (57 percent for the bottom 40 percent of the income distribution compared to 76 percent of the top 60 percent of the income distribution).[19]

15. Access to credit from financial institutions declined in the wake of the pandemic and the introduction of a stringent usury law in 2020 as more individuals are seeking credit from unregulated sources. Findex survey data indicate that the share of adults that borrowed from a formal financial institution declined from 21 percent in 2017 to 17 percent in 2021, while the share of adults that borrowed from any source increased from 36 percent to 38 percent over the same period suggesting that more households are obtaining funding from outside the formal financial system. These developments came against the backdrop of the Covid-19 pandemic as well as the passing of a stringent usury law in 2020 that sets interest rate caps for all credit operations. Caps are only differentiated by currency and separate levels apply to micro-lenders. The interest rate caps are binding, and authorities estimate that the number of credit operations in the formal financial sector declined by around 400k within one year of the implementation of the law (see ¶ 67).

[19] Data taken from World Bank Findex 2022.

16. While many households cannot get any credit from the formal financial system, some Costa Rican households who have access to credit find themselves at risk of excessive indebtedness. The most widely used type of household credit are credit cards (22 percent of the working age population) and consumer loans (20 percent of the working age population), but the average size of these forms of credit is small. Roughly 6 percent of the population has a mortgage but the average outstanding mortgage balance at CRC 26mn (~US$38,000) is by far the largest of the different household debt instruments. SUGEF data further indicates that 26.1 percent of individual borrowers have two loans, 11.7 percent have three loans, and 6.7 percent have four or more loans. These numbers only include debt from regulated financial institutions and do not account for the large and growing share of debt coming from unregulated sources. The size of the unregulated credit sector is estimated to range from 30-40 percent of the regulated credit sector. It has reportedly grown significantly in recent years and the usury law is also apparently driving consumers to the unregulated credit sector, though hard data on the sector is lacking**.** The unregulated credit sector is quite diverse, consisting of large nation-wide appliance stores, smaller hardware stores, finance companies, loan sharks, pawnshops, and solidarity associations, among others. Some unregulated credit providers are estimated to be larger than banks outside the Top-5. Anecdotal information indicates that abusive market practices are more prevalent in the unregulated sector among certain providers, including aggressive sales and abusive debt collection practices.

Figure 4: Household indebtedness



Source: SUGEF, Survey on Indebtedness of the People of Costa Rica, Office of the Financial Consumer.

17. Demand-side surveys indicate a high perception of debt distress among consumers. Survey data show that 30 percent of households experience troubles in meeting their payment obligations and feel overwhelmed by debt. The perception of debt distress is highest for low-income households and women. The average debt-to-income (DTI) ratio for Costa Rican debtors in one

demand-side survey was 52.5 percent, increasing to 73.4 percent for the lowest income segment (those making less than CRC 300,00 per month).[20]

18. Country experiences show that a range of factors can contribute to consumer's over-indebtedness, including supply-side factors, demand-side factors, and infrastructural issues. Supply-side factors can include irresponsible lending (e.g., lending more than a borrower can repay), aggressive sales, and non-transparent products. Demand-side factors can include behavioral biases, poverty, low financial literacy, unexpected events, and reductions in income. Infrastructural issues can include a rise in interest payments due to exchange rates and variable interest rates and weaknesses in credit infrastructure.[21] Many of these factors are currently present in Costa Rica.

19. Poor market practices are contributing to over-indebtedness in Costa Rica. Aggressive marketing and sales practices appear to be used by some credit providers, including aggressive targeting of salaried individuals and over-selling of loan products to consumers who do not want or need them. Anecdotal evidence suggests that the practice of sending unsolicited, pre-approved credit offers to both current and new customers is widespread. Several credit providers noted that they use DTI ratios of 50 percent to 80 percent when assessing a consumer's capacity to repay, exceeding customary over-indebtedness assessment thresholds of 30-50%. Misleading and aggressive advertising practices were also observed, including advertising zero percent interest loans (that are in fact commission-based) and emphasizing instant or rapid approval. There are also various weaknesses in disclosure practices, including effective interest rate (EIR) not being calculated in a consistent manner or displayed prominently, terms and conditions not being disclosed in a user-friendly format, and risks rarely being conveyed to consumers.

20. There are also significant gaps in the credit information system, limiting the ability of prospective lenders to fully assess the existing debt load of potential borrowers. A major gap is due to the unregulated credit sector as SUGEF's *Central de Informacion Crediticia (CIC)* does not include information from unregulated credit providers. While some unregulated credit providers have registered with SUGEF and are able to access CIC data,[22] they are not required to report their own data in turn. This situation represents a significant missed opportunity to expand the coverage of the credit information system. Private credit bureaus have entered into agreements with unregulated credit providers to collect data,[23] but the reliability of such data is unclear, and coverage is incomplete.

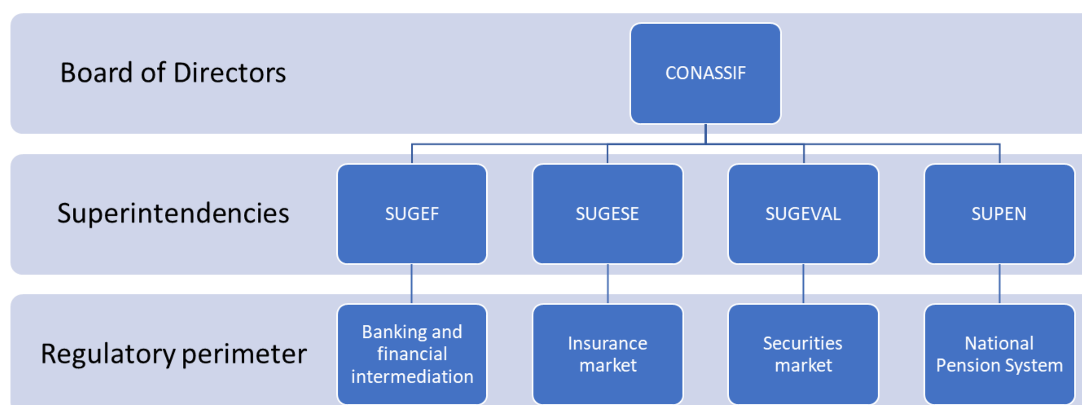
[20] Indebtedness of the People of Costa Rica. Office of the Financial Consumer, May 2021.
[21] Davel, Gabriel. 2013. "Regulatory Options to Curb Debt Stress." Focus Note 83. Washington, D.C.: CGAP.
[22] 1,903 registered credit providers who are not supervised by SUGEF currently have access to CIC through this special arrangement.
[23] Equifax indicated that it collects data from 1,200 unregulated credit providers.

FINANCIAL SECTOR OVERSIGHT FRAMEWORK

A. Financial Sector Oversight Architecture

21. The supervisory and regulatory architecture of the Costa Rican financial system is composed of four supervisory bodies and a coordinating council. The National Council for Supervision of the Financial System (*Consejo Nacional de Supervisión del Sistema Financiero, CONASSIF*), comprised of the BCCR Governor, the Minister of Finance and five independent members selected by the BCCR, constitutes the senior steering body of the supervisory and regulatory system of Costa Rica.[24] It is headed by a President elected from the five independent members for a two year term. CONASSIF leads and coordinates the four superintendencies: *General Superintendency of Financial Institutions (SUGEF*), *General Superintendency of Securities (SUGEVAL)*, *Superintendency of Pensions (SUPEN)* and *General Superintendency of Insurance (SUGESE)*. CONASSIF is the only authority to issue guidelines and regulations proposed by the four financial sector supervisors. The superintendencies are autonomous bodies, operationally independent and financially assisted by the BCCR, while being under the direction of CONASSIF. Coordination and information exchange across the different superintendencies and BCCR are facilitated by a *Commission of Financial Stability (CEF)*.

Figure 5: Institutional framework



B. Banking Supervision and Regulation[25]

22. The Costa Rican framework for banking supervision has been undergoing an ambitious agenda of legal and regulatory reform and, since 2016, a fundamental change in supervisory approach. The legal and regulatory framework provides SUGEF with powers to authorize banks, conduct ongoing supervision and address compliance with laws and regulations. Further, guided by

[24] For discussion related to SUPEN the Minister of Finance is replaced by the Minister of Labor.

[25] This subsection of the Aide Memoire draws on the Detailed Assessment Report of Compliance with the Basel Core Principles for Effective Banking Supervision. The assessment was undertaken by the FSAP team during the second mission.

international standards and best practices, amendments have and are being introduced to AML/CFT and corporate governance regulations (already in force), and to the definition of regulatory capital. , Consolidated supervision regulation and an expected loss provisions framework are also being introduced. However, shortcomings relating to the ability to undertake timely corrective actions and to address safety and soundness concerns warrant the authorities' attention. In June 2016, SUGEF began the process of implementing a risk-based supervision approach (*Supervisión basada en riesgos*, "SBR") to substitute the previous CAMELS-based methodology. The shift to SBR triggered a change of paradigm with profound implications in terms of organizational transformation, capacity development and staff training, methodological change and build-up of procedures and guidelines that, whilst it has been progressing it is not fully concluded.

23. CONASSIF and SUGEF rely on a solid accountability framework but with room to strengthen operational autonomy and governance and buttress effectiveness. The designation of the independent members of CONASSIF and the Superintendent of SUGEF are not subject to detailed fit-and-proper criteria, and they are all directly appointed by the BCCR without further scrutiny. Finally, departing from standards, the reasons for the dismissal of CONASSIF members or the Superintendent are not required to be publicly disclosed. Despite never been used, the BCCR power to determine general credit policies could potentially interfere with CONASSIF and SUGEF's mandate, as well as the broad power to regulate the creation, operation and control of financial entities. Also, SUGEF does not have its own external communication unit (it relies on BCCR's), which undermines its standing as an operationally autonomous institution and blurs its public profile.

24. The Costa Rican authorities have made significant progress in strengthening legal protection for supervisors, but further enhancements are required on the road to a more complete and effective legal protection. Current legal arrangements foresee that CONASSIF and SUGEF must bear all the defense costs of CONASSIF members, the Superintendent, senior management of SUGEF and other officers with decision-making powers. However, the law is silent when it comes to the legal protection of former CONASSIF members and former Superintendents, and the remaining SUGEF staff involved in supervision. Nor is it explicit in protecting supervisors or providing civil liabilities coverage in case of omissions made in good faith.

25. SUGEF bank authorizations and ownership control frameworks need strengthening. CONASSIF and SUGEF have the necessary powers to set criteria and reject applications for new entities. The authorization process inter-alia includes procedures for verifying ownership structure, governance of the bank and its wider group, as well as assessing business plans, financial projections, risk management, internal controls and other factors. Nevertheless, there are requirements that need strengthening, inter alia the ability of shareholders to provide additional support, and information requirements for significantly influential non-controlling shareholders. The regulatory framework does not define controlling interest and SUGEF does not have the power to review, reject or impose prudential conditions on any proposals to transfer significant ownership or controlling interests in existing banks to other parties. There is a draft regulation (under public consultation) which defines controlling interest in a suitable way. It is also advisable to legally require banks to immediately notify

any transfers of significant ownership or controlling interests and to establish procedures and criteria for evaluating these cases.

26. Up to now, SUGEF has been in general well-staffed and its budget commensurate with its current activities, but challenges are foreseen. Due to legal changes limiting budgetary increases and new tasks added to SUGEF's mandate and emerging risks, the current staff/budget is likely to become insufficient for SUGEF to properly discharge its functions. This is particularly apparent in what refers to highly specialized skills which are becoming increasingly essential for some of its activities. It is advisable to grant more flexibility to SUGEF's budget and reconsider the role of the BCCR in the hiring plans and processes of SUGEF.

27. SUGEF continues to transition to a full-fledged SBR and achieving greater effectiveness requires additional development. Shifting the supervisory approach to a risk-based framework is a lengthy process of organizational change, methodology development and implementation, and cultural transformation. Already SUGEF generally deploys supervisory resources on a proportionate basis, considering the risk profile and systemic importance of banks. However, further enhancing supervisory effectiveness requires inter-alia the attainment of a comprehensive perspective of the bank, its risk profile, and a strongly grounded assessment of the effectiveness of bank policies and practices (e.g., corporate governance, risk management, capital planning). In turn, this calls for a more intense focus on actual implementation (and not just on the selected business lines) during onsite inspections, making sure that risks beyond credit are not overlooked, and keeping sight that the main addressee of supervision is the group (for banks belonging to a financial group). Structural risks (IRRBB, liquidity and funding risk, FX structural risk) should be explicitly considered in the risk matrix. Finally, supervisors should be empowered to exercise their expert judgement more frequently on substantive issues.

28. The Costa Rican corrective powers' framework needs substantial strengthening to be conducive to timely addressing banks' unsafe and unsound practices. To be sure, the corrective framework has clearly improved thanks to the 2019 reform of the BCCR Law, but deficiencies remain: (i) the powers to impose corrective actions and precautionary measures are not clearly established in the law and some key supervisory powers are missing (particularly the power to order the removal of members of the Board and senior managers of banks and the power to impose more stringent prudential limits and requirements on individual banks); (ii) the legal preconditions to use supervisory measures and intervention powers leave no discretion to SUGEF's expert judgement and the supervisor may be unable to use these powers during a crisis; and (iii) sanctions are not proportional to the infractions making their use not credible. Legal uncertainty over the powers of the supervisor is always a critical issue. The legal possibility of suspension of the effects of the supervisors' challenged actions, and the retroactive effects of the annulment decisions could have very severe implication on the management of crisis and bank distress. It is advisable to regulate a separate appeal procedure for, at a minimum, the most serious supervisory measures and intervention or resolution decisions without the possibility of suspension of execution and in which the annulment of the decision can only result in a monetary indemnification of damages, but never in the reversal of the legal effects of the original decision.

29. Costa Rica should introduce a recovery and resolution planning framework especially relating to systemic banks. The SUGEF's supervisory model does not yet require banks to prepare recovery plans and integrate them within their risk management frameworks, nor to promote, in coordination with CONASSIF's resolution planning and resolvability assessment activities. The deployment of these tools would help banks and supervisors to be better prepared for a crisis.

30. SUGEF has an effective framework in place for cooperation and collaboration with relevant domestic authorities and foreign supervisors. Arrangements for cooperation and collaboration domestically with other superintendencies are anchored by regular meetings through a committee. In addition, there are formal arrangements for information sharing in place among the Superintendencies and between the SUGEF and the BCCR. The latter should be revised so that there is more flexibility in updating the set of regular information shared. Arrangements with foreign supervisors are supported by a liaison committee, established through a CCSBSO multilateral MoU, which has enabled a very active exchange of information and bilateral MoUs. Arrangements with foreign supervisors may be improved by including provisions related to crisis management in their bilateral MoUs.

31. The consolidated supervision framework that is being established needs further strengthening. Until recently SUGEF's consolidated supervisions powers were very limited, and consolidated supervision was an ad hoc monitoring of group risk. Consistency of governance and policies, contagion and reputation risks have not been steadily monitored, albeit SUGEF has taken supervisory action to address them on occasions. Recent legal amendments grant enough powers to SUGEF to carry out consolidated supervision in all banks, but important lacunae remain. For example, there are no consolidated prudential limits or liquidity requirements. Also, Costa Rica does not have a true consolidated capital ratio for banking groups and conglomerates in place, rather an aggregation of individual capital ratios, which is not calculated on the basis of the group's consolidated financial statements and whose breach does not trigger corrective action or sanctions.

32. The bank capital framework and the supervision of capital management should be further developed. Capital regulation to be in force in 2025 introduces a systemic risk capital surcharge for D-SIBs, a capital conservation buffer and a leverage ratio. These requirements should be complemented in legislation by granting SUGEF Pillar 2 powers to call for additional capital based on its discretion and expert judgement, for example to better fit the risk profile of a bank. Supervision of bank capital management should be improved by building up analytical and statistical capabilities to critically appraise the methodologies and stress tests used by banks, and by requiring banks to be anticipative in planning their capital adequacy needs by promoting the use of internal capital adequacy assessment report (ICAAP).

33. Liquidity and market risk requirements should be redesigned and recalibrated to adapt them to the Costa Rican context. Elements to consider could include lack of depth, transactional frequency and liquidity of Costa Rican securities markets, debt markets with mostly public debt and public agencies' debt issuances, dollarization, fiscal situation, state guarantee of public banks, and the

recent introduction of the yet not fully funded deposit guarantee scheme. The countercyclical provision has proven to be a useful tool during the pandemic shock and authorities could consider preserving it (and if necessary, recalibrating it to fit with the new expected loss framework).

34. CONASSIF and SUGEF have been assigned clear functions and rely on broad powers in relation to AML/CFT. The regulatory framework is fairly comprehensive although some shortcomings remain. SUGEF's AML/CFT supervisory approach is focused on regulatory compliance and the existence of policies and processes, as well as systems' reviews and sampling. It would benefit further by the exercise of supervisory judgement for the assessment of the effectiveness of policies and processes in certain areas. In addition, although in principle relying on strong sanctioning powers and having at their disposal the ability to impose hefty fines, in practice the effectiveness of the framework is weakened--minimum fines are already significantly high, which ends up resulting in very few fines being applied, and even in those cases litigation has been the norm. Other aspects that merit enhancement include the need for requirements for, inter alia: material events to be reported to SUGEF; CDD policies to require an understanding of the purpose and nature of the business relationship; banks not to establish (or continue) correspondent banking relationships with banks that do not comply with minimum international standards on AML/CFT; adequate screening policies and processes to ensure high ethical and professional standards in the case of agency or outsourcing relationships.

C. Climate and Environmental Risk Management

35. All superintendencies, the BCCR and CONASSIF have started engaging on the topic of climate-related and environmental risk, and commitment of the boards and superintendents is high. However, while there is (ad-hoc) interaction (e.g., as part of the *Grupo de Análisis Estratégico de Cambio Climático*), coordination between authorities could be improved. A coherent cross-authority supervisory strategy is not yet in place, although different initiatives to start addressing these risks are being undertaken.[26] These include numerous capacity building and awareness raising initiatives across authorities and the financial sector, mostly supported by external partners. Nonetheless, supervisors are not yet properly equipped to engage in the supervision of climate-related and environmental risks. Except for the BCCR, which has recently hired a fulltime staff member and appointed an interim person to coordinate the GAECC and internal governance arrangements, there are currently no full-time resources, or a specific team dedicated to the topic within any of the institutions. Authorities mentioned that a key obstacle to properly addressing this topic is the availability of financial and human resources, preventing them from keeping the desired pace to address these topics.

36. The assessment of the impact of climate and environmental risk on the Costa Rican financial sector is still at its early stages. BCCR, SUGEF and SUGESE are working to build up their stress testing capabilities, often supported by international partners. However, more work is needed to deepen the understanding of the impact of climate and environmental risks on the financial sector. Data quality and availability to inform the assessment remains a key issue, although commendable

[26] Since the mission, the superintendencies have established a Sustainability and Climate Change Committee and are working on the development of a joint roadmap to coordinate activities across the authorities.

efforts to build data capabilities internally and externally have been undertaken. Conducting a top-down exposure assessment of the sector's vulnerability to climate risk will be an important first step to inform the supervisory strategy and identify priorities. This can be followed by more advanced stress testing exercises in the longer term.

37. The authorities have not yet formally issued supervisory guidance to the sector, and the integration of climate and environmental risk into supervisory practice is still limited. However, CONASSIF has recently approved reforms to several regulations to transpose Law N° 10051 to '*Promote financing and investment for sustainable development through the use of thematic public offering securities*' into sector regulations. For example, an 18-month transitional period was established for banks to reformulate their investment and risk management policies to include ESG considerations, including climate change. Several authorities are developing draft regulations related to climate-related and environmental risk. Similarly, authorities have had discussions with institutions clarifying that climate risks may be expected to be covered under existing regulations, including under the corporate governance code.

38. Establishing a formal coordination mechanism between the authorities and setting out a joint supervisory and regulatory roadmap on climate-related and environmental risks will be key in moving the agenda forward. A coordination mechanism with a clear mandate, regular interaction, governance structures and potentially including technical (industry) working groups could help ensure that momentum on the topic is maintained. Similarly, the authorities could benefit from developing and publishing a coherent cross-agency strategy, to ensure harmonization in embedding climate and environmental risk, and Law N° 10051 into supervisory practice. Further incorporation into regulatory and supervisory frameworks may require the allocation of more dedicated resources on this topic.

39. The superintendencies could equally benefit from developing and implementing individual strategies for the integration of climate risk into supervisory practice. The authorities have shown commitment to enhance the sector's response to climate risks and some have a specific reference to climate or environmental objectives in their strategic plans or started developing a plan in line with the FSB's Roadmap for addressing climate-related financial risks. However, a detailed internal strategy which provides a clear roadmap to further integrate climate and environmental risks into their supervisory frameworks is mostly not yet in place. These strategies should be designed in line with international guidance and good practice and based on the rapidly evolving work of the global standard setters. In particular, it will be helpful to include specific timelines and objectives in relation to issuing supervisory guidance, conducting a high-level risk assessment to inform supervisory priorities, and improving and harmonizing the data available for analyzing climate risks. Membership in the *Central Banks and Supervisors Network for Greening the Financial System (NGFS)* could provide further support to the prudential supervisors.

40. The first-time enactment of a comprehensive national disaster risk finance strategy is an important step in strengthening Costa Rica's preparedness to deal with the financial aftermath of natural disasters. The *Costa Rica Disaster Risk Financial Management National*

Strategy[27] provides for the first time the strategic objectives in the field of disaster risk finance management. Authorities are currently working on a long-term implementation plan for the strategy and are developing a methodology for the quantification of the contingent liabilities from disasters and the evaluation and optimization of the National Emergency Fund.

PRIORITIES FOR FINANCIAL SECTOR DEVELOPMENT

41. Costa Rica is at a crossroad facing critical challenges as well as opportunities that if sized upon would help the country achieve a more resilient inclusive growth trajectory undergirded by a deeper, more efficient, diversified, and greener financial system. In the near term, financial system stability is in part linked to the resilience of households as they face rising interest rates and currency depreciation from, in some cases, an already stressed position. At the same time, consolidation of the fiscal gains achieved in 2021 would help buttress public debt sustainability and lessen financial sector-sovereign nexus risks. Looming over the country and financial system are climate change and environmental risks and the investment funding demands needed to help transition the economy towards net zero carbon emissions in the medium-term. These challenges present a major opportunity to carefully green the financial system and diversify the balance sheet of institutional investors managing rapidly growing Pillar 2 pension assets. It is also an opportunity to enhance the efficiency of financial intermediation and development finance interventions by inter-alia levelling the playing field through (i) a revamping of the *Sistema de Banca para el Desarrollo* (SBD), (ii) addressing distortions built up over the years, and (iii) a careful reexamination of the role of the state as owner of major financial intermediaries in the system. Sustainable financial sector development requires a multipronged approach for dealing with the various underlying drivers of households over indebtedness and addressing major gaps in financial consumer protection.

A. Role of the State in the Financial Sector

42. Costa-Rica's state-led economic development model of the past created a sizeable state footprint in the financial sector which continues to this day. The state-dominated economy was historically served by state monopolies in the financial sector. The liberalized, private sector-led economy is now served by a liberalized financial sector – but in the latter, the state's dominance is still very large, and the inertia of the legacy model has created a unique development finance framework. The state continues to regulate allocation of a material size of financial system flows – including through developmental mandates on private market participants. The two state-owned banks (SOBs) and the publicly owned Banco Popular together cover over 50 percent of the banking sector by assets, while INS collects around two thirds of the total premiums in the insurance sector.

[27] Enacted by Executive Decree No. 43,663-H on June 30th. 2022 and available at https://www.cne.go.cr/rectoria/politicangr/documentos/Estrategia-Nacional-de-Gestion-Financiera-del-Riesgo-de-Desastres-de-COSTA-RICA(3)%20(2).pdf

43. The state footprint, from the points of view of public finance and developmental impact, requires thorough and regular reviews and evidence-based assessment for its effectiveness. It does not appear that a rigorous cost-benefit analysis (CBA) or another measurement of efficacy of the state's presence in the equity of financial institutions and in mandatory financing flows has been performed recently. To be sure, over the last few years, the *financial performance* of public financial institutions has been sound - a positive from the macro-fiscal and public asset management perspective.[28] Both SOBs and INS have clean audit reports, which is positively contrasted to many qualified/negative reports for non-financial SOEs in Costa Rica. However, the strong financial performance has been underpinned by various competitive distortions, especially for Banco Popular which does not even fall under direct state ownership (see ¶ 45-48). Therefore, a CBA of the distortions might help uncover systemic inefficiencies and suggest options for more impactful allocation of public equity capital and incentives.

44. The long-term vision should be a system free of competitive distortions and strong on development finance. The current performance of the financial sector in Costa Rica has potential for optimization and higher efficiency, especially seen through the lens of developmental impact and state's footprint. Future development of the financial system in Costa Rica should not rely on financial repression[29] and instead, fully rely on (i) competitive market mechanisms and (ii) selected and targeted public sector interventions to incentivize private actors. Public development policy mandates should not be *imposed* on the private players, but rather a set of reformed state interventions would nudge but do not coerce the private part of the market. The system should instead rely on (i) transparent flow of public finance for development purposes and (ii) institutions and instruments fit-for-purpose and free of financial repression. The following paragraphs provide ideas and options on how this vision can be achieved by focusing on the four key areas of the state's footprint in Costa Rica. These are (i) competitive asymmetries/distortions; (ii) Banco Popular; (iii) SBD; and (iv) state ownership of the two largest banks in the system – BN and BCR and the largest insurer -INS.

Competitive asymmetries and distortions

45. Various distortions and asymmetries unlevel the playing field between public and private banks. Some can be seen as favoring the public institutions, while others as burdening them. For example, the mandate on public sector agencies and firms to hold their deposits exclusively with SOBs creates an uneven playing field for private banks and, by pushing private banks out of CRC funding and into FX business/dollarization direction, creates financial stability issues. The unlimited public guarantee on SOBs' liabilities is another legacy from the past, when the social contract between the state and the public meant the state taking full liability for its monopoly in the banking system.

[28] In the past there have been failures of SOBs, for example in 2017 Banco Credito Agricola de Cartago was filing when it was taken over by one of the commercial SOBs, or in 1994 when Banco Anglo Costarricense failed.
[29] Financial repression occurs when governments take measures to channel to themselves or developmental priorities funds that, in a deregulated market, would go elsewhere.

Table 3: Competitive asymmetries

	State-owned banks	Private Banks	Banco Popular
a. Sovereign guarantee[30]	Yes	No	No
b. Deposits from state-owned enterprises	Yes	No	No
c. Income tax	30%	30%	30%
d. Income tax over interest paid.	8%	8%	Not applicable[31]
e. Minimum regulatory reserve requirement	15%	15%	15% over demand deposits only[32]
f. Other regulatory reserves	50%	10%	Not applicable[33]
g. Bank toll (FDC)	Not applicable	17%	Not applicable
h. Payroll deductions	No	No	Yes
i. Public procurement law	Applicable	Not applicable	Applicable
Para-fiscal contributions	**38%**	**5%**	**33%**
Financing Fund for Development (FOFIDE)	5%	Not applicable	5%
CONAPE	5%	5%	5%
CNE	3%	Not applicable	3%
INFOCOOP	10%	Not applicable	Not applicable
FODEMIPYME	Not applicable	Not applicable	5% + 9 billion CRC
FONDOS ESPECIALES	Not applicable	Not applicable	15%
New contributions to social security IVM[34]	15%	Not applicable	Not applicable

Source: Own elaboration based on Academia Centroamericana (2018) *Asimetrías Regulatorias en el Sistema Financiero Costarricense.*

46. On the other hand, some of the distortions do not work in favor of SOB's nor for the MOF treasury's financial management. Mandated net income and profit tax transfers/parafiscal charges have created entitlement for the recipients as well as inefficiency and inflexibility for the national treasury. Most, if not all, of the earmarked transfers (parafiscal charges) are enshrined in different laws and are therefore difficult to change or eliminate, requiring changes in the laws and intervention of the parliament, with political economy issues emanating from the process. Furthermore, public procurement rules applicable to INS and SOBs decrease operational efficiency of their commercial operations vis-à-vis their private competitors. Differently from policymaking institutions (e.g., ministries) and non-commercial public agencies, state-owned financial institutions compete in open market with private players and the burden of stringent public procurement rules impinge on their operational competitiveness.

[30] The sovereign guarantee to depositors and holders of government securities is governed by Article 4 of the *Ley Organica del Sistema Bancario Nacional*, which applies to state-owned commercial banks only.
[31] Article 23 c of the *Ley del Impuesto sobre la Renta (N° 7092).*
[32] SOBs and private banks' deposits are subject to a minimum regulatory reserve requirement of 15 percent. In the case of Banco Popular, this regulatory reserve applies to its demand deposits only – see Article 63 of the Central Bank Organic Law.
[33] Banco Popular does not have additional regulatory reserve requirements apart from the minimum regulatory reserve.
[34] On May 22, 2018, the Legislative Assembly approved a bill to strengthen the Pension Regime for Disability, Old Age, and Death (IVM) of the Costa Rican Social Security Fund through a contribution of 15 percent of the net profits of public companies (reform of Article 78 of the Worker Protection Law) including state commercial banks.

47. Solutions to the wide-spread asymmetries and distortions should be guided by a vision of the financial system operating on a level footing, irrespective of ownership, and on a streamlined relationship between public financial institutions and the state. Public entities should be able to shop around the financial system for best offers for their financial management needs, and SOBs and private banks should compete for their business on equal terms. With the new deposit guarantee system, the legacy public guarantee on SOBs' liabilities can be removed without any monetary or financial stability impact, given the current soundness of those banks. Profit distribution rules for the state-owned financial institutions should be unified, with dividend decisions left to their boards of directors (BoDs) to make, based on the financial performance of each institution and strategy (e.g., organic growth plans). Similarly, procurement rules for state-owned financial institutions should be adopted by their BoDs and should be fit for a competitive commercial environment. Overall, the long-term strategy of the state vis-à-vis its commercial market institutions should be based on (i) the Expectations Notes[35] and achievement of agreed objectives, and (ii) single annual dividend transfer, if applicable, to the treasury. Government agencies and funds, which are currently funded by earmarked para-fiscal contributions from the public financial institutions should be funded directly from the national budget for transparency and efficiency reasons, with annual allocations as part of the regular fiscal budgeting process.

Banco Popular

48. Banco Popular (BP) is an important player in the system, with a long history and good performance[36] but its business model and performance success are based on distortive practices of funding its capital and liabilities. BP's funding model is materially reliant on the transfers of Pillar II pension savings of all formal Costa Rican workers. The flow of 1.25 percent of the total annual payroll of the country's formal workers to BP stays as deposits on its balance sheet for up to 18 months.[37] In addition, the flow of 0.25 percent of the total annual payroll becomes a permanent capital contribution to BP. No other bank in the system has such privileges. As a result, being the fourth largest bank by assets, BP has the largest capital among all banks, in nominal terms (US$1.24 billion in May 2022), arguably leading to capital inefficiencies. BP is also the only bank which is allowed to deduct payrolls of their customers on priority basis in case of loan servicing delinquencies, which seems to entice risky lending behavior.[38] Funding also benefits from the fact that BP is only required

[35] Expectations Notes, recommended by OECD, are annual memorandums of understanding between the government and state-owned commercial entities, setting up government's expectations and performance targets for the BoDs and management of the SOEs, including financial institutions. In Costa Rica, the Expectation Notes are being prepared, on a non-mandatory basis, by the Presidency-based unit in charge of state ownership of SOEs. Ideally, the Notes should become mandatory as soon as possible.

[36] It has generally sound financial soundness indicators, with non-performing loans low and on a downward trend at 2.6 percent as of December 2021. It is profitable, with ROE similar to the two SOBs albeit substantially lower than private banks. It has a strong capital base and high CAR.

[37] A recent regulatory change requires Banco Popular to pay interest (TBP + 160bps) on those funds albeit at well below market interest rates. Accrued interest is capitalized and transferred to the pension account of employees at the chosen pension fund manager.

[38] The maximum debt-to-income ratio used by BP in the credit underwriting process of up to 80 percent exceeds that of most other financial institutions.

to hold minimum regulatory reserves for demand deposits, while all other types of deposits are exempt, creating incentives to classify deposits in a way that eludes the reserve requirement. This treatment of deposits only benefits BP. There do not seem to be sufficient growth opportunities for BP to leverage its strong - and automatically growing - nominal capital which receives new ever higher annual contributions[39] in line with the growth of the total national payroll. Unlike a private entity with clear ownership, there is no direct mechanism for BP to reduce its capital to an optimally efficient level as it does not distribute profits due to its peculiar "public ownership" structure.

49. A plan to bring BP into full competition with other banks and ensure its capital optimization would go a long way towards leveling the playing field in the banking and pension funds management systems. Key parameters of a robust plan would include three features: (i) the 1.25 percent transfer of Pillar II pension allocations would be phased-out, moving BP into regular liability financing activities; (ii) the 0.25 percent transfer to fund BP's capital would be phased-out, moving BP into regular equity raising activities. Privileges for payroll deductions and exemptions from reserve requirements should be ended immediately. The impact of the reduced pensions savings flows to BP would be that each annual reduction would immediately start going into the Pillar II pension fund selected by a worker. Authorities should ensure as soon as feasible a very transparent right of choice of a Pillar II pension fund manager by all employees, by regularly informing all Costa Rican workers about their right of choice/change, and particularly focusing on new labor market entrants by eliminating a nearly-default option for BP's Pillar II pension fund manager.

Sistema Banca para el Desarrollo (SBD)

50. The Costa Rican development banking system administered by SBD was created in 2008 with multipronged objectives, including fostering financial inclusion and enhancing finance to MSMEs and farmers.[40] SBD is comprised of four different funds that are fed by mandatory contributions from private and state-owned banks as well as government transfers:

a. National Fund for Development (*Fondo Nacional para el Desarrollo* - FONADE) accounts for 28 percent of SBD's total available funding, sourced from the government budget and other trusts. This fund is managed by an SBD Governing Council's technical secretariat.
b. Financing Fund for Development (*Fondo de Financiamiento para el Desarrollo* - FOFIDE) represents 11 percent of SBD's total available funding. It is funded by 5 percent of the annual net profits of the SOBs and managed by each bank.
c. Credit Fund for Development (*Fondo de Crédito para el Desarrollo* - FCD) is SBD's largest fund with 39 percent of the total available funding. It is financed by the transfer of 17 percent of private banks' demand deposits and is managed by SOBs.
d. Credits for Development (*Créditos de Desarrollo* - CREDES) is 22 percent of SBD's total available funding and represents development credit portfolio of private banks. CREDES is an alternative to the mandatory allocation of 17 percent of private banks' demand deposits to FCD - private-owned

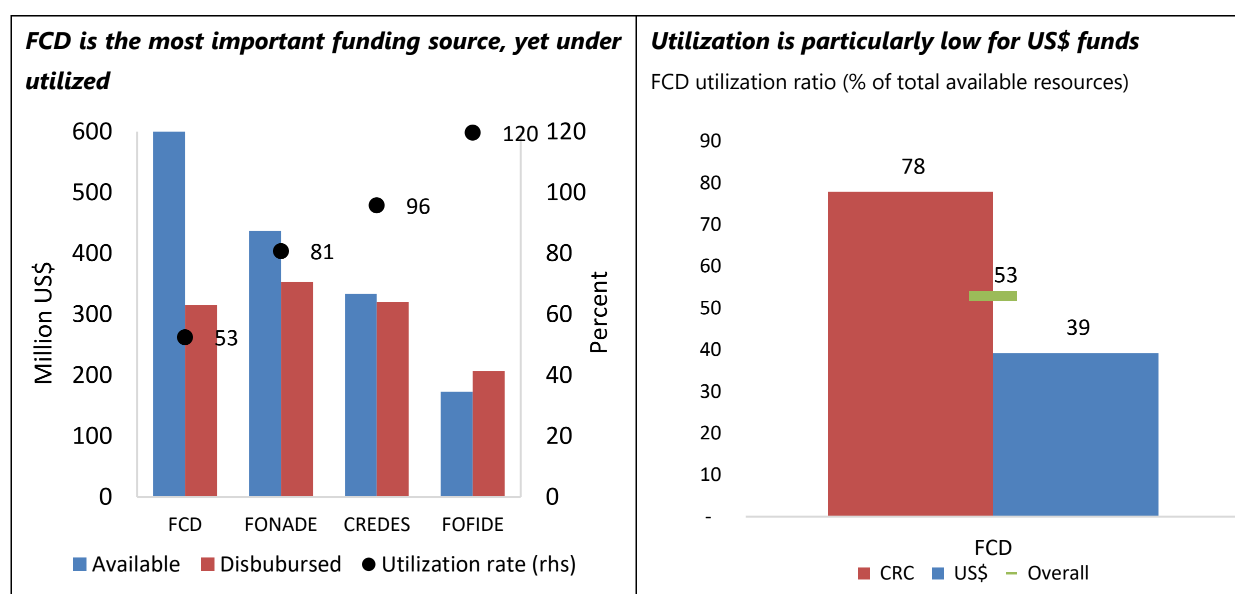
[39] E.g., in 2021 BP received US$45.7m of new capital from the annual 0.25 percent flows.
[40] See Law No. 8634. Art. 4 enumerates the SBD objectives.

banks can instead choose to (i) have at least four bank agencies or branches outside *Region Central* and (ii) allocate at least 10 percent of their credit portfolio to SBD target beneficiaries.

The total funding of SBD is small, equivalent to about 3.2 percent of banking sector assets.

51. SBD has been a good transitory system for development finance but should continue its evolution into a better optimized structure. It has important positive aspects, such as the guarantee fund and the entrepreneurship development network, as well as its targeting of the underbanked part of the MSME universe. However, flow-wise funding seems unnecessarily complex and too operationally dependent on inflexible laws and public banks. The FCD is the most questionable component of SBD. It is built on financial repression (the 17 percent deposit transfer from private to SOBs at below market cost) and is not being used efficiently. Only US$300m out of US$580m has been allocated for development lending, with the unallocated portion benefiting the state and the rest of SBD (see Figure 6). The reason for the big gap in FCD allocation is the FX part – while private banks transfer a substantial part of the 17 percent in FX, SOBs can't place FX credits to the target micro and small firm segments due to their unwillingness to take credit risk of unhedged MSMEs.

Figure 6: Utilization of SBD funds



Note: Data as of December 2021

Source: SBD

52. The ultimate vision for SBD could be to transform itself into a regulated development finance institution (DFI). A viable solution would be a second tier DFI, fully owned by the State, and engaged in wholesale finance on both sides of the balance sheet (no retail deposits, funding through bond issuance and institutional credit lines; on the asset side, credit lines to last-mile lenders, investments in development-focused securities, and guarantees issued to financial institutions on a portfolio basis). BANHVI, the second-tier housing finance institution in Costa Rica, could be seen as a precursor to a larger DFI. The new DFI could be created by merging SBD and the development finance

parts of SOBs, plus variety of trust and special funds of the government set up for developmental purposes.

53. In the meantime, the priority should be to start eliminating financial repression present within the SBD: (i) the 4-branch opening requirement for private banks for CREDES qualification should be dropped; (ii) a maximum limit on private bank deposit transfer should be put at e.g., no more than 10 percent - and only as refinancing of SOBs by private banks at market rate when SOBs demonstrate by evidence that they have placed qualifying development credits.

State's Ownership of SOBs and INS

54. While privatization of state-owned financial institutions only for privatization's own sake is not a compelling argument, there needs to be a critical assessment of the government's ownership of two universal commercial banks – Banco Nacional and Banco Costa Rica - with no unique strategies in a competitive market despite their long history of state ownership. Fiscal income from dividends of a commercial enterprise on its own is not a viable argument for public ownership. It could be argued that the state equity currently in SOBs could deliver stronger developmental impact if used in more development-focused programs. The current level of equity in the two SOBs – book value around US$2 billion, market value potentially higher due to their market positions and franchise values – could presumably be (in total/part) invested in better-targeted long-term development activities. Mobilizing that equity through (partial/full) divestment should be accompanied by a careful consideration of options for the allocation of proceeds including the funding of development finance activities, ideally through a public DFI. In any case, going forward, the government could consider making the two banks fully commercial, leveling the playing field in the banking sector by addressing the existing distortions and asymmetries. Besides the observations provided in previous paragraphs, it would also require the carve-out of development focused/public policy operations in SOBs moving them to the DFI if/once it is set up upon the reform of SBD. Minority divestments could also be considered, for the purposes of market listing, share trading, and market value discovery (and upgrading the know-how in case of a minority institutional divestment to a global bank).

55. Divestment or a full privatization of SOBs - if so decided - would need to abide by certain approaches and principles in order to optimize the government's exit. Ideally, the following principles would apply. A partial or full exit would happen from a position of financial strength rather than weakness of the banks. The Government's exit should not create any preferred market position or treatment to the new owners, whether retail or strategic/corporate ones. While in principle the government can exit through the stock market, by listing and selling SOB shares to any interested buyer, higher value for the government and, eventually, for the economic development of the country would be created by selling majority stakes of banks' capital to strategic investors, preferably private financial groups – outright ownership control in a major bank adds a premium to the sales price, streamlines bank governance, and adds transparency for the purposes of supervision. In case of a transfer of full ownership control, the government may wish to include some employment protection clauses for the SOBs' staff – but such clauses should not be onerous on the new owners and should

be time-bound, e.g., 1-2 years; the sales price would be a function of such clauses, with the taxpayers of Costa Rica ultimately paying for such protections.

56. The government should also keep an eye on the efficacy of public capital invested in INS. Competitiveness in the market for the benefit of consumers and the economy at large should also feature in the considerations. The Costa Rican insurance market has been in transition for the past 13 years from the full state monopoly of INS, with private insurers gaining around a third of the total market, and higher shares in individual segments and products. Given the still dominant market share of INS there is no immediate rationale to privatize it. Even if there was a private buyer, creating a dominant private player of this size may not contribute to market development. However, the government may consider partial divestment of INS in the medium term, through a combination of share floating and attracting a qualified investor (e.g., a global insurance company) as a minority shareholder – to benefit from global know-how, especially given INS' regional expansion ambitions and establish market discipline and transparency. In the meantime, the market should be maintained free and open from competitive distortions. A review of regulatory pricing of products may be in order to ensure it does not entrench INS' dominance and allows entry of private insurers in product lines historically – and currently – dominated by INS, including workers' comp and mandatory auto insurance.

57. The Unit in Charge of SOE Oversight at the President's office needs to be empowered and equipped with professional capacity. It should (i) develop public ownership policies, (ii) issue binding Expectations Notes to SOE BoDs, including the state-owned and public financial institutions, and (iii) conduct cost-benefit analysis/other assessments of efficacy and efficiency of public capital invested in the SOEs, including the SOBs and INS.

B. HH Indebtedness and Consumer Protection

58. Addressing the multiple factors that are contributing to over-indebtedness in Costa Rica will require a similarly multi-pronged, holistic approach. While certain systemic and structural issues may be difficult to address directly, there are a number of concrete actions which can be taken to prevent increasing over-indebtedness, including regulatory and supervisory measures on the supply-side and financial literacy initiatives on the demand-side. Efforts should also be undertaken to help those currently in debt stress as well and to more actively monitor over-indebtedness on an ongoing basis.

59. The first priority should be to establish a strong financial consumer protection (FCP) framework by passing the draft bill on FCP, which should include the principle of product suitability. Costa Rica currently lacks an overarching FCP framework, with only a limited set of rules in place on select FCP topics (and little monitoring or enforcement of such rules). A comprehensive FCP law should be passed that addresses the core principles of FCP,[41] including the principle of

[41] An advanced draft bill has already been developed but has not yet been submitted to Congress.

product suitability, which is currently missing in the version of the draft bill reviewed by the WB FSAP team. The FCP framework should apply equally to the banking as well as non-bank sector.

60. In parallel, it will be important to establish a clear institutional mandate and resources to operationalize the FCP legal framework. Ideally, SUGEF should be empowered to take on this role for all credit products and providers as it has the most appropriate technical expertise. Market conduct supervision capacity will need to be built up to effectively monitor and enforce compliance with new rules. The authority designated for FCP with respect to the credit market could also develop an indicator system specifically to monitor over-indebtedness trends.[42]

61. Specific rules on responsible lending should be put in place to complement the high-level principles in the FCP bill. Responsible lending rules should focus on affordability and appropriateness, requiring financial service providers (FSPs) to assess that a consumer has the ability to repay a loan and that the loan is appropriate for the consumer's specific needs and circumstances. For example, to reduce the likelihood of over-indebtedness, the OECD recommends requiring providers of consumer credit to assess a consumer's ability to repay based on relevant information (including likely costs and risks of the credit) before a transaction is concluded and noting that credit should not be granted if the credit is clearly not affordable by the consumer or is likely to have a significant adverse effect on their overall financial situation.[43]

62. Rules on disclosure should be expanded and enhanced in order to achieve transparency for consumers. Current rules on disclosure focus primarily on the content of information to be disclosed. However, the format and manner in which information is disclosed is as important as the content in order to achieve transparency. FSPs should be required to disclose key information in user-friendly formats and using plain language. Developing a standardized key facts statement (KFSs) for common retail credit products can be useful for this purpose, as the KFS can be designed and tested to facilitate consumer comprehension and standardized across FSPs to allow for easier comparison. Clearer guidance should be provided on what fees and charges to include in effective interest rate (EIR), which should capture all known, upfront and recurring interest, fees, and charges expected to be incurred over the duration of loan, including for mandatory third-party services.[44] In addition, FSPs should be required to disclose the total cost of credit, which is essentially the equivalent of EIR in a monetary amount and which is often easier for consumer to comprehend than EIR. Disclosure and transparency rules will also need to be adapted as more sales shift to digital channels, which pose new types of challenges in achieving transparency.

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[42] For further information, see Indicators to monitor over-indebtedness. EFIN Working Group on Over-Indebtedness, December 2016. Also see Bhattacharya, Dwijaraj, Amulya Neelam, and Deepti George. Detecting Over-Indebtedness while Monitoring Credit Markets in India. Dvara Research, January 2021.

[43] OECD Recommendation on Consumer Protection in the field of Consumer Credit, 2018.

[44] For example, the EU Consumer Credit Directive defines "total cost of credit" as follows: *"all the costs, including interest, commissions, taxes and any other kind of fees which the consumer is required to pay in connection with the credit agreement and which are known to the creditor, except notarial costs; costs in respect of ancillary services relating to the credit agreement, in particular insurance premiums, are also included if, in addition, the conclusion of a service contract is compulsory in order to obtain the credit or to obtain it on the terms and conditions marketed."*

63. A range of other FCP provisions should be utilized to address credit-specific concerns. In particular, explicit restrictions should be placed on overly aggressive marketing and advertising practices, such as the use of unsolicited, pre-approved credit offers. Approaches with respect to consumer consent could be enhanced, for example by requiring clear, informed, and limited consent; requiring actively opting-in to cross-marketing; and making it easy for consumers to opt-out at a later date. Advertising and marketing rules could be strengthened to require balanced presentation of credit offers that do not trivialize costs and risks. Rules could be put in place to ensure that compensation policies for sales staff, particularly those based on commission, do not create incentives that conflict with consumer welfare. Any potential data privacy issues that may be contributing to unsolicited credit offers should be investigated and addressed. Finally, debt collection rules should be enhanced to restrict abusive practices, apply to unregulated credit providers, and establish FSP responsibility and liability for the misbehavior of debt collection agencies acting on their behalf.

64. A combination of approaches can be utilized specifically to mitigate the risks of FX-denominated and variable interest rate loans. On the regulatory side, policymakers could consider requiring that FSPs provide explicit warnings to consumers regarding the risks of FX-denominated and variable interest rate loans. Similar approaches have been taken in other jurisdictions with respect to short-term, high-cost consumer credit. FSPs could also be required to provide illustrations showing the impact of changes in reference rates or exchange rates on the repayment amount and total debt. On the supervisory side, consideration could be given to increasing the risk weighting of (unhedged) FX-denominated loans. SUGEF could also provide clearer guidance on the expectations of supervisors when assessing how unhedged borrowers' risks are managed at FSPs.

65. Policymakers may wish to complement principles-based approaches on responsible lending with quantitative macro-prudential measures. FCP measures alone will not be sufficient to prevent the build-up of (systemic) risks from HH indebtedness and dollarization and should be complemented by carefully designed macro-prudential tools. Such measures can include the implementation of a maximum debt-to-income (DTI) ratio. For FX-denominated loans and variable interest rate loans, the DTI ratio should also be calculated under stressed values of the exchange rate and interest rates to ensure debt service capacity in periods of significant CRC depreciation and high inflation.[45]

66. To fully address concerns about over-indebtedness, steps will need to be taken to extend the regulatory perimeter to cover the unregulated credit market for FCP purposes. While there are no easy solutions, there are three logical options that could be explored with respect to regulatory architecture. A first option and the most preferable one would be to move unregulated credit providers under SUGEF's jurisdiction, which will provide the benefits of SUGEF's stronger technical expertise as well as allow for consistency and a level playing field for all credit providers. A

[45] For a more comprehensive discussion on macroprudential tools and processes see IMF (2018). Costa Rica. Financial Sector Stability Review (FSSR).

tiered, proportionate, risk-based approach will need to be utilized, such as only requiring registration and reporting for smaller entities and reserving more intensive FCP regulation and market conduct supervision for larger entities. A second option would be to establish a new, separate authority responsible for FCP for the entire financial sector, which would obviously be a significant undertaking. A third option would be to move unregulated credit providers under the oversight of the Ministry of Economy, Industry and Commerce (MEIC),[46] which would be sub-optimal given limited resources and technical capacity at MEIC.

67. Policymakers should consider revising the Anti-Usury Law to allow for more flexibility. The interest rate caps established by the 2020 Anti-Usury Law[47] are only differentiated between regular credit and micro credit[48] and thus provide very little flexibility to account for different risk profiles across providers and lending instruments. Caps are binding and their introduction curtailed growth of consumer credit, most noticeably with respect to credit cards where almost 400k cards (13.6 percent of total) were closed, as FSPs have shifted to lower-risk customers. At the same time, interest rate caps have led some consumers who are now excluded from the formal sector to turn to the unregulated credit sector. In other countries, interest rate caps are useful and non-distortive when they restrict usurious levels of interest that are significantly above ordinary commercial levels, but this is not the case in Costa Rica. Authorities should thus consider revising the Anti-Usury Law to mitigate unintended effects on financial inclusion and the expansion of the unregulated credit sector.

68. In parallel, a more comprehensive credit information system should be established. It is understood that initiatives to create a more comprehensive credit information system have been discussed in the past, but limited progress has been made to date. Efforts to make concrete progress should be accelerated given the significant gaps in the credit information system, though obviously any efforts will need to be aligned with policy approaches towards covering the unregulated credit sector. The credit information system should be enhanced to include all credit providers, including currently unregulated entities, and to include positive and negative data and data from alternative sources, among other important enhancements. In the interim, SUGEF could consider requiring registered credit providers to report to the CIC, with appropriate steps taken to ensure the quality of data.

69. On the demand-side, financial literacy and debt counseling resources should be strengthened to help credit consumers. Efforts should be enhanced to develop targeted financial literacy initiatives aimed at preventing over-indebtedness, employing innovative approaches and channels to reach a greater number of target consumers. For example, initiatives should leverage behavioral insights and just-in-time approaches to send targeted messages to prospective loan customers via multiple channels, such as via FSPs and government agencies.[49] To assist consumers

[46] The WB understands this is the main option currently being considered.
[47] Law No. 9859 of 2020, which added articles to Law No. 7472 on the Promotion of Competition and Effective Defense of the Consumer of 1994.
[48] Microcredit is any credit that does not exceed a maximum amount of 1.5x the base salary of clerk 1 of the judiciary. Credit cards are excluded from microcredit caps.
[49] For more information, see A Change in Behavior Innovations in Financial Capability. Center for Financial Inclusion, April 2016.

that are already in a state of over-indebtedness, particularly given the high numbers of consumers currently in the judicial collection process, greater support could be given to expanding the availability of debt counseling services in Costa Rica as well as addressing the backlog in debtor's court.

C. Capital Market Development

70. Numerous barriers have been hampering capital market development – including the crowding out by other sectors and notably a lack of other domestic investment opportunities. These include high levels of issuance by the government which crowds out demand for private issuers. Domestic banks lend at relatively long tenors (including to commercial clients and for infrastructure projects), which reduces the need for corporates to go to the bonds markets. Tax disincentives discourage international investors who could potentially be attracted by the country's 'green' brand. Notably, the domestic pension funds have not been contributing to the development of the local capital markets, largely due to a lack of suitable investment opportunities.

71. The demand for funding from domestic issuers - which does exist in the country - is not utilizing formal capital markets channels. The formal market issuance requirements are relatively restrictive and previous incentives to use listed markets were removed. This is said to have caused some issuers to go overseas or to access capital via private placements. Unlike other emerging markets, Costa Rica does appear to have a range of potential domestic issuers, but they are not accessing capital via formal market routes. The overall legal structure hampers adopting an emphasis on market development. None of the supervisory bodies have an explicit mandate for market development and the nature of the legal code and potential legal liabilities for supervisors encourages a focus on compliance and arguably does not encourage a market development mindset.

72. The lack of local capital markets implies risks for the economy overall. The long-term lending by bank implies an asset liability mismatch and the lack of a government benchmark yield curve hampers the pricing of financial instruments. This is compounded by a lack of price discovery and a lack of liquidity in private markets and stifles investment in innovation and opportunities. In turn this lack of local investment opportunities causes the pension funds to invest more overseas.

73. A range of interlocking reforms are needed to support the development and unleash the potential of domestic capital markets - starting with reforms to the government bond markets to enable the creation of a benchmark yield curve. Facilitating the government's offshore issuance through reforming the requirement for two-thirds majority in Congress for each placement issuance is needed to allow for better issuance planning. In turn, this will help the government with cashflow management. Issuance by both the Ministry of Finance and the BCCR should be better coordinated and issuance of same maturity bonds by both entities, particularly at the short end of the curve, should be avoided. This would help to avoid competition for investors and reduce market fragmentation and pricing distortions (e.g., having two yield curves). Further, leveling the playing field between local and international investors by eliminating double taxation for non-residents is needed to attract foreign investors. The government could explore how to capitalize on the strength of the

country's 'green' reputation though labeling all sovereign bonds as 'green' or issuing types of label or performance-linked bonds (see ¶ 83).

74. For the non-government markets, introducing some trading and issuance reforms could encourage issuers and help to deepen markets. Some OTC trading - for example reported large block trades between institutional investors – could support market development. Following an on-going pilot introducing primary dealers for government bonds, gradually introducing a market maker system for secondary market trading also for non-public issues could help deepen markets. Introducing a 'hybrid approach' could also help attract issuers. This could be achieved either through differentiated public issuance rules for qualified investors (minimum information requirements) and /or private placement rules for institutional investors (trade reporting).

75. Structural reforms to the pension funds system can also support capital market development through incentivizing greater demand for local investments. Reforms should include allocating the full 4.25 percent mandatory contributions immediately to individual pension accounts rather than parts of it being parked at *Banco Popular* for 18 months (see ¶ 4932). The mandate for the default provider within the system could be reformed and awarded for a fixed period based on long-term investment performance. The amount of capital which the pension funds are required to hold could also be capped, which may focus marketing budgets available to the funds and help reduce the current high levels of switching between providers. Reducing the fee paid to CCSS, which operates the collective contribution mechanism for all funds, would further reduce costs to members and overall performance.

76. Reforming the investment regulations and risk management of the pension funds would also help to incentivize long-term investment and spur market development. The current classification of investment instruments by 'tiers' should be replaced with more straightforward asset class limits. Requirements for sufficient investment knowledge at the OPC governing board level should be implemented to replace the current requirement to 'demonstrate' knowledge of individual investments, which acts as a disincentive for funds to diversify into new areas. A simple overseas investment limit is also suggested (removing the requirement to demonstrate higher estimated returns than are available from domestic investments). Allowing the OPC to invest some percentage of their funds through private placements could provide access to more investment opportunities. Introducing a life-cycle investment regime would require funds to invest more in long-term instruments for the younger cohorts of members which would help spur demand for equities and long-maturity fixed-income investment.

77. Over the medium-term, the market for life-insurance should be developed to provide a compliment to pension funds' long-term, domestic assets. Current regulations should be reviewed with a view to creating a more attractive environment for new entrants (including capital charges and tax treatment of life products). Support for market development could also be provided via financial education programs at the industry and regulator-level, as well as via national programs. Longer-term, splitting composite insurance companies into general and life insurers could be considered as this has been shown to support the development of the life market in other countries. In order to ensure that

life insurance assets are invested in long-term assets, SUGESE should ensure capital charges reflect underlying risk of assets when new risk capital regulations are introduced

D. Greening the Financial Sector

78. Costa Rica is generally considered as a global frontrunner in terms of climate and environmental ambitions. This is partly due to it having one of the most extraordinary natural environments on earth. The country accounts for only 0.03 percent of the earth's surface, but it contains nearly 6 percent of the world's biodiversity. Almost 60 percent of the country's surface is now covered with forests, compared to only half of that in 1985 – as it managed to reverse deforestation through developing innovative green financing solutions. Over 26 percent of its national territory is protected by the National Conservation Area System, which is among the highest nature conservation ratios in the world. The total value of Costa Rica's natural capital is estimated at around 23 percent of GDP. Equally, it has one of the few *Nationally Determined Contributions (NDCs)* which is said to be 1.5°C compatible. Guided by its National Decarbonization Plan, it is pursuing a whole-economy low-carbon transformation. The National Adaptation Plan sets ambitious objectives to enhance the country's resilience to climate change. The soon to be published adaptation financing plan will be an important factor determining the success of Costa Rica's adaptation efforts.

79. Many green finance-related initiatives have been deployed to date, although developments seem to have slowed after early days innovations such as the Payments for Environmental Services Program and debt-for-nature-swaps. The Law N° 10051 (*Promote financing and investment for sustainable development through the use of thematic public offering securities*) is showing to be a key driver for the development of the green finance market, including through requirements for the integration of ESG considerations in investment policies. However, harmonization and coordination between authorities could be strengthened and market players have raised the question of how this will be regulated in practice. Several taxonomies are currently in use or under development by authorities, risking fragmentation of standards and definitions. With support from the World Bank, efforts are starting to work towards a harmonized national taxonomy. The potential of capitalizing on Costa Rica's image as green leader is underutilized, leaving opportunities in international markets untapped. At the same time, the BCCR has taken steps to lead by example through integrating sustainability considerations in its international reserves management practices. While still in its early stages, SUGEF is contributing to the development of the green finance information architecture through the development of data infrastructure and guidance to track the banking sector's green finance flows.

80. The green bond market remains small, despite initiatives and incentives by the regulator and BNV being in place. Three green bonds have been issued to date, with a combined outstanding value of around USD 175 million. This constitutes only 0.3 percent of total issuance and 1.1 percent of the Latin American and Caribbean green bond market. Issuance as a share of GDP is low compared to peers. Only one green investment fund is registered in the country. The general limited development of the Costa Rican capital market is an inhibiting factor in realizing growth in the green bond market,

with large companies generally not issuing in the domestic public market. Compliance with international standards, excessive domestic regulation, overprotection of investors, and costs of independent verifications have been cited as disincentives for green bond issuers to come to the market, while fiscal incentives are insufficient.

81. Lack of green finance demand at the retail, project and market level is a key challenge. Supported by international credit lines or the SBD, Costa Rican banks are offering green loan products at preferential rates, but client uptake remains limited. Similarly, while high-level sectoral investment objectives for climate mitigation have been defined, demand to finance climate mitigation projects – in addition to adaptation and broader nature-related projects – is lagging. The absence of coherent frameworks, definitions and standards, and a lack of knowledge, data and information prevents identification and assessment of green finance opportunities and may impact market integrity. The low level of awareness among domestic investors, including pension funds and insurers, is further impeding demand for green financial products at the market level, and providing a disincentive for potential issuers. Supply of green finance does generally not seem to be a constraining issue, although access to long-term financing remains challenging. Climate-related disclosure practices are at a nascent stage, with no formal disclosure expectations in place and only one Costa Rican entity officially supporting the recommendations of the FSB *Taskforce on Climate-related Financial Disclosures (TCFD)*, hindering market transparency.

82. To scale-up green finance, authorities are encouraged to assess which regulatory interventions are needed to stimulate green finance demand. MoF and SUGEF, potentially supported by the banking association (ABC), could conduct a market assessment to obtain insights into the current lack of demand by retail customers for green finance products. Similarly, MoF and MINAE could evaluate the lack of demand at the project level, focusing on the barriers constraining project preparation and pipeline development. To address entry barriers, SUGEVAL (and BNV), could map the constraining factors for issuers to enter the green bond market. The demand side analysis could be complemented by assessing the lack of domestic investor interest in green finance products. Collectively, this could feed into the development of an action plan to scale up green finance demand focusing on the identified barriers at the retail, project and market level.[50] This should be supported by building a comprehensive and consistent climate and green finance information architecture, enhancing climate-related disclosure practices across the financial sector, and harmonizing the different taxonomies and classification systems. More generally, regulatory guidance on green finance needs to ensure clarity, proportionality and harmonization, to foster transparency and competition and avoid overregulation – while remaining cognizant of the importance of reducing the risk of greenwashing.

83. Leveraging its image as a 'green' leader, Costa Rica could benefit from exploring more innovative green financing approaches, including the development of a "green country label" for public sector bond issuance. MoF, MINAE, and SUGEVAL could assess the feasibility of all debt

[50] This may require a compromise, ensuring the superintendencies operate within their mandate which does not have a provision for market development, while recognizing the importance of these measures for the Costa Rican financial system.

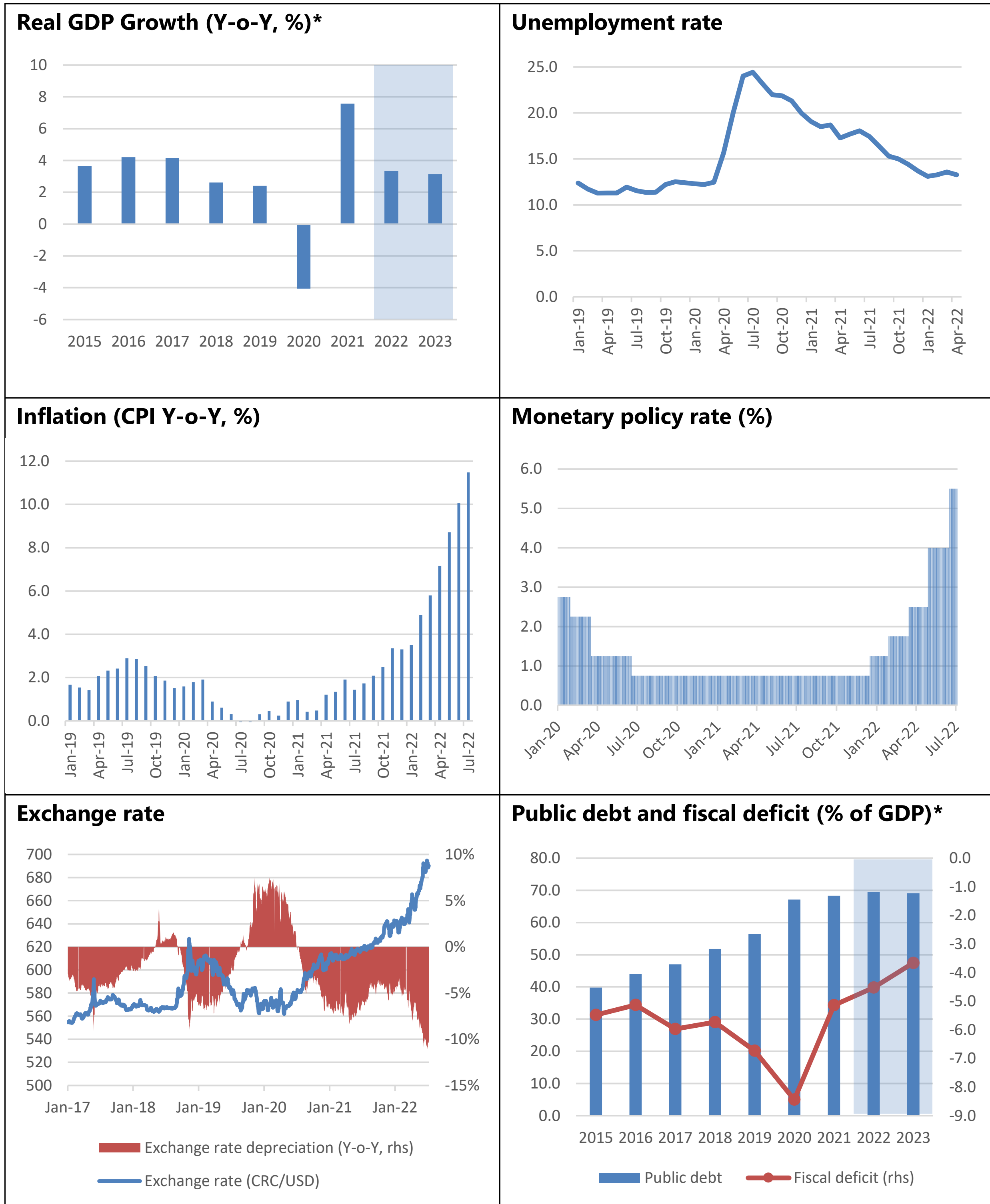
issued by the Costa Rican government to qualify as green in line with international standards and evaluate which debt instruments beyond green bonds could be used to mobilize green finance. This includes performance-linked products, such as sustainability-linked bonds – in addition to blue bonds being a real opportunity given the importance of mobilizing funding for protecting coastal marine areas. Exploring different mechanisms to involve the private sector could also be instrumental in promoting the business case for adaptation finance. Instruments like biodiversity credits could be of further specific value to Costa Rica, capitalizing on its biodiversity-rich natural environment while simultaneously providing financial benefits.

84. To address the challenge of low insurance penetration, relevant authorities could promote opportunities to expand micro- and parametric insurance[51] for climate risks building on the recently published national disaster risk finance strategy. As scaling up financing for adaptation and resilience will be a key challenge, there is a need to support the development of inclusive and affordable natural disaster protection, particularly for low-income households and climate-vulnerable smallholder farmers, to build financial resilience to risks arising from climate-related natural disasters.

[51] In 2019, legal criteria were issued clarifying that the current legislation allows the offer of parametric insurance and in April 2022 the first parametric insurance was registered.

ANNEX

Figure A1: Macro-financial developments



Source: BCCR, IMF; Notes: * Forecasts based IMF WEO database April 2022

Core Financial Soundness Indicators

	Dec-19	Dec-20	Dec-21	May-22
Regulatory capital to risk-weighted assets				
State-owned banks	13.9	13.0	13.1	13.2
Private banks	14.2	13.5	13.2	13.8
Regulatory tier 1 capital to risk-weighted assets*				
State-owned banks	NA	NA	11.0	10.9
Private banks	NA	NA	8.7	8.8
Non-performing loans to total gross loans				
State-owned banks	3.0	3.2	2.8	2.9
Private banks	2.2	2.0	1.9	1.8
Provisions to non-performing loans				
State-owned banks	103.1	124.8	152.6	153.6
Private banks	163.6	215.6	211.5	225.8
Return on assets	1.0	0.6	0.9	1.1
Return on equity	6.8	4.6	6.1	8.2