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Costa Rica: Financial System Stability Assessment

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COSTA RICA

Financial System Stability Assessment

Prepared by the Monetary and Exchange Affairs and Western Hemisphere Departments

Approved by Stefan Ingves and Anoop Singh

February 11, 2003

This Financial System Stability Assessment (FSSA) is based on the work of the joint IMF/World Bank mission that visited Costa Rica as part of the Financial Sector Assessment Program (FSAP) during October 22–29 and December 5–13, 2001. An effort has been made to integrate important measures subsequently taken by the Costa Rican authorities (or under preparation) to address some of the key issues identified in the FSAP, particularly as regards the strengthening of the bank oversight framework (Section I-B and Box 1). Nonetheless, this assessment mostly reflects the state of the Costa Rican financial system and its supervisory oversight ***as of the dates in which the FSAP team conducted its work in the field.*** The findings of the FSAP mission were discussed with the authorities in November 2002 and January 2003, as part of the 2002 Article IV Consultation.

The FSAP team was headed by Alain Ize (IMF/MAE) and Augusto de la Torre (WB/LCR) and included Messrs. Jorge Cayazzo, Armando Morales, Karl Driessen (all IMF/MAE), Sergio Martin (IMF/WHD), Ms. Katharine Christopherson (IMF/LEG), Ms. Yira Mascaro, Messrs. Mario Guadamillas, Juan Ortiz (all WB/LCSFP), Alberto Musalem (WB/FSD), Joaquin Bernal (Banco de la Republica, Colombia) and Ruben Marasca (Banco Central de la República Argentina). Messrs. Jose Benjamin Escobar and Ross Delston (both IMF/LEG) and José Antonio Alepuz (WB/LEGPS) participated in the FSAP study from headquarters.

Subject to caveats on the quality and completeness of the information on which this report is based, the Costa Rican financial system exhibits some immediate strengths deriving from an environment with limited historic volatility and a predominant state participation in financial intermediation. Nonetheless, important underlying macro and structural tensions could undermine the stability of the system in the event of a major shock, or compromise its medium-term sustainability should tensions continue to accumulate. Main sources of tension are, on the macroeconomic front, a large fiscal deficit and a high public debt, a high and rising dollarization, and a somewhat rigid exchange rate regime; on the structural front, a still substantially unequal playing field between public and private financial institutions, and a large presence of offshore banks that are only partially supervised and regulated by the Costa Rican supervisory authorities. Key strategic policy decisions are needed to address these potential vulnerabilities in a comprehensive and coordinated manner. The regulatory measures and legal reforms taken during 2002 (or currently under discussion) constitute important foundations that will need to be fully implemented and followed up until the two objectives of achieving consolidated supervision and leveling the playing field are fully met. Reforms are also warranted to better manage risk, including the introduction of prudential buffers, a further strengthening of the supervision of onshore banks, and an in-depth reform of the financial system safety net. Reforms in the area of securities, pensions, and insurance are less immediately relevant to financial stability yet essential for sustainable financial development.

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SECTION I. STAFF REPORT ON FINANCIAL SECTOR ISSUES

I. OVERALL STABILITY ASSESSMENT

A. The Situation as of end-2001

1. **The Costa Rican financial sector is well intermediated, yet centered on traditional banking intermediation, largely dominated by public institutions and still influenced by sizable offshore private banks.**[1] Total assets of financial institutions reached nearly 72 percent of GDP in June 2001, with banks accounting for 77 percent of financial system assets (Appendix Table 1). While investment (mutual and pension) funds have grown very rapidly in recent years, the capital market remains narrow and essentially centered on public securities. The public sector has a pervasive presence in Costa Rica's financial system, limiting competition. The banking system includes three state-owned commercial banks, and a special-charter bank, that together account for about 60 percent of total banking deposits. Consequently, banking concentration, albeit declining, continues to be high. The public sector also has a monopoly of the insurance sector and dominates the mutual and pension fund industry. Although private onshore banks (which include 17 banks, 10 of which have foreign majority ownership) have gradually expanded their share in onshore banking intermediation, offshore banking is still important (accounting for over one third of private banks' assets). While offshore banks grew very rapidly in the initial development stages of private banking in Costa Rica, their growth has recently tapered off.

2. **Subject to important caveats on the quality and completeness of the information (see below), the supervised Costa Rican financial system exhibits some strengths.** The onshore banking system generally reports relatively high liquidity, moderate profitability, high ratios of capital to risk-weighted assets (about 15 percent on average), and limited nonperforming loans (Appendix Table 2).[2] The strong participation of public banks, which enjoy the trust of the public and whose liabilities are fully guaranteed by the state, provides an additional measure of stability in the short run. The relative stability of the financial sector partly reflects macroeconomic policies that have avoided stop-go patterns, high and growing integration into the world economy (including relatively good access to international capital markets) and a stable political environment, underpinned by a long democratic tradition, generally effective institutions, a burgeoning middle class, a strong educational system, and relatively low income inequality.

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[1] Unlike the more typical offshore systems, Costa Rica's offshore banks are licensed in foreign (mainly Caribbean) jurisdictions but conduct most of their deposit-taking and lending activities with Costa Rican residents and are, therefore, fully woven into the country's domestic financial and economic activity.

[2] An analysis of onshore banks shows that, with one exception, increased provisioning of past-due loans to more prudent levels would result in some deterioration of their capital adequacy ratio, but banks would remain above the required minimum.

3. **However, caution is needed in interpreting available data.** As of end-2001, a substantial part of the financial system (particularly offshore banking) was not subject to regulation and supervision by the Costa Rican supervisory authorities, which hindered the reliability of financial statements and, by allowing regulatory arbitrage, could undermine the effectiveness of prudential oversight. In addition, there were some supervisory weaknesses in the part that was supervised, particularly as regards the quality of information on asset quality and verification. The coverage and quality of banks' financial statements was uneven, and their own risk management systems appeared to need strengthening on the whole to fully reflect the risks (credit, interest rate, currency, and liquidity risks) to which they were exposed.[3]

4. **Important tensions are building up, which, if not addressed, could undermine the stability of the system in the medium term.** As described in the staff report for the Article IV consultation, the macroeconomic framework has weakened and important macroeconomic sources of potential systemic vulnerability could materialize in the event of major shocks and be difficult to manage in view of the high financial and real de-facto dollarization combined with the crawling peg system. Concerns over the Costa Rican financial system's exposure to systemic risk would increase in the medium term, if tensions in the system continue to accumulate. Growth has trended down in recent years, both the current account and the fiscal deficits have been rising, and the public debt has grown to high levels relative to GDP. There are also contingent public sector liabilities associated with the first-pillar of the pension system, the negative net worth of the central bank and potential quasi-fiscal exposures arising from public banks. In view of the large (albeit declining) weight of public securities on the asset side of banks' balance sheets, solvency problems in the public sector could spill over to the financial sector. At the same time, while the crawling peg enjoys credibility and can be credited, so far, for having helped stabilize the exchange market, it has fostered dollarization (both financial and real) by trading off long-term nominal price uncertainty in favor of short-term real exchange rate certainty. By limiting the ability to produce a real exchange rate devaluation at a moderate inflation cost, real dollarization is eroding away the scope for exchange rate flexibility. By exposing the solvency of debtors (and, hence, of banks) to an erosion in case of a discrete devaluation, financial dollarization is raising the vulnerability of the financial system. At the same time, it gives rise to "fear of floating" on the part of policy makers, thereby compounding the rigidity of the exchange rate arrangement. The limited scope for monetary policy further contributes to vulnerability by magnifying credit fluctuations, interest rate volatility, and systemic liquidity risk. Finally, the weakness of the nominal anchor makes the costs of developing a market for long-duration colón-denominated debt very high.

5. **Thus, important macroeconomic reforms appear to be needed to ensure a sound and sustainable development of financial institutions.** A comprehensive reform of the

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[3] The limited availability of statistical data on banks' financial conditions also hampered the analysis of systemic vulnerability by limiting the scope for macro-oriented stress testing.

public sector (see the staff report for the Article IV consultation), including a reform to the parameters of the pension system's first pillar and an effort to increase the fiscal primary surplus on a steady basis are clearly necessary, not just to reduce inflation, but also to enable the re-capitalization of the central bank and adequate management of quasi-fiscal exposures in public banks, while keeping the debt-to-GDP ratio under control. In addition, the authorities should assess whether their current monetary and exchange rate framework, is sufficiently well suited to the necessary and growing integration into world financial markets.

6. **At the same time, a number of medium term structural vulnerabilities also need to be addressed, including pervasive distortions stemming from the simultaneous large presence of public banks and not fully regulated financial entities—particularly private offshore banks.** This prominent feature of the industrial organization of Costa Rica's financial sector reflects an ongoing, yet incomplete, process of de-nationalization of finance. It has not been accompanied by the exit (or a project for the exit) from financial markets of public banks and their affiliates, but has rather featured a gradual dismantling of their "privileges". The regulatory reach has lagged behind these developments. As of end-2001, the consolidated supervision of financial conglomerates was not yet fully grounded in the law, and certain financial entities were still outside of the scope of prudential oversight. Moreover, the playing field remains substantially uneven. While public banks enjoy a full state guarantee (there is no deposit insurance for private banks), their capacity to compete is severely hampered by their legal statute (which makes them akin to a government ministry) and governance (politically appointed boards of directors). This situation provides ample scope for regulatory arbitrage and discrimination, potentially undermining the effectiveness of prudential oversight and regulatory enforcement.

7. **Despite the uneven playing field, competition has rapidly intensified, increasing incentives for weaker financial entities to take undue risks, thus putting a premium on developing an ambitious program of prudential consolidation.** Pressures on profit margins stem from tougher competition across the board. Private banks and their affiliates are now competing head-to-head with public banks and their affiliates in increasingly common lines of business. At the same time, competition is intensifying between funds and banks, among funds, between private banks, and between onshore and offshore banks. The prospects for a profit squeeze appear to be stronger in the case of public banks, as they continue to migrate into the dollar market (where intermediation margins are narrower and the franchise value of the state guarantee less significant) and face the threat of additional competitive pressures deriving from the planned introduction of a deposit insurance for private banks. In turn, downward pressures on margins could induce weaker institutions to take on excessive risks, potentially undermining the soundness of the system. Thus, to limit financial vulnerability, the increase in competition arising from financial deepening and the gradual leveling of the playing field should go hand-in-hand with a strengthening of risk management practices and prudential oversight.

8. **Prudential consolidation should include reforms of the legal and institutional framework, the regulatory and supervisory frameworks, and the safety net.** As regards bank oversight, more effective buffers against systemic risks need to be built, such as counter-cyclical provisioning requirements, special reserves on dollar loans to the nontradable sector, and liquidity requirements. Reforms should also promote risk-based, fully consolidated

supervision. The Superintendent of Financial Entities (SUGEF) should: (i) introduce a more graduated internal rating system for banks (CAMEL) and separate its CAMEL-based system from the system of triggers for prompt correction and bank resolution; (ii) introduce a graduated scheme of penalties; and (iii) encourage the improvement of banks' own risk management systems. As regards legal and institutional arrangements, the mandate of the National Council for the Supervision of the Financial System (CONASSIF, the Board that rules over the three supervisory agencies) should be better aligned with its capacity to fulfill it. Similarly, the legal monopoly of broker/dealers over securities transactions and custody should be eliminated. For the insurance sector, the office of the Ombudsman and a supervisory agency (or a function within an existing agency) should be created. This program of reform should be supported by a comprehensive review of the safety net (including the frameworks for the lender of last resort function, prompt corrective actions, bank intervention and resolution, and deposit insurance) to ensure that banks in difficulty are promptly brought back to health or rapidly and effectively closed.

9. **At the same time, progress towards healthier competition in financial markets and a sounder regulatory environment should continue and include a medium-term reform strategy on the future of the public banks and offshore banks.** The medium-term objective should be the complete elimination of obstacles to a level playing field, in the context of the full enforcement of consolidated supervision of financial conglomerates. A well-designed transition would need to be pre-announced to achieve this goal. Public banks should be converted into joint stock companies, as a necessary step towards the elimination of the state guarantee they enjoy and to facilitate the eventual exit of the state from financial intermediation. Offshore banks should be phased out, or else, subjected to fully consolidated supervision and regulation. The authorities should take advantage of opportunities to "bundle" legal reforms. For instance, the introduction of a (limited) deposit insurance for private banks should incorporate the establishment of an efficient bank closure and resolution framework, and be linked to the simultaneous passage of legislation that would enable full consolidated supervision of financial groups, on the one hand, and the conversion of public banks into joint stock companies converging towards the same limited deposit insurance coverage as private banks, on the other. To further promote competition, remaining barriers to the entry of foreign banks (at present they can operate in Costa Rica only through subsidiaries but not branches) should be removed at a suitable time.

10. **The financial system reform program should also include a medium-term strategy to promote financial deepening and broader access to financial services.** Such a program will require realistic objectives for the local securities markets, an enhanced role for pensions and insurance as institutional investors, and continuous improvements in the contractual environment. Further standardization and dematerialization of public sector debt securities is crucial to the development of a more liquid market, which is in turn necessary (but far from sufficient) for the eventual development of a market for private sector securities. So is the establishment of a yield curve through the issuance of longer-duration, colón-denominated, standardized public sector debt. The development of a CPI-based financial index and the issue of CPI-indexed public bonds for longer maturities are key priorities to help develop and deepen colón intermediation. The rapid growth of mutual funds and fast accumulation of long-term savings in pension funds offer an opportunity that should be harnessed. This would require fiscal reform to reduce the public sector's reliance on such funds for its own financing

needs, and an upgrading of corporate accounting, disclosure, and governance (including minority shareholder protection) standards. The authorities should intensify efforts to assess the feasibility of regionalizing securities and other financial markets across Central America. All along, emphasis should be placed on continuous improvements in the contractual environment. Key in this respect would be more effective frameworks for secured lending and corporate reorganization and bankruptcy.

11. **A coherent and comprehensive reform agenda needs to be put in place.**[4] Reforms should proceed in parallel, within a coherent plan that sets out priorities, identifies complementarities, and establishes suitable timetables. Key strategic policy decisions include the possible shift to a new monetary and exchange rate regime, the promotion of CPI-based financial indexation as an alternative to dollarization, the future of offshore banks and public banks, and the liberalization of the insurance sector. In all cases, fiscal strengthening, the recapitalization of the central bank and the leveling of the playing field between public and private banks appear to be key strategic priorities. Essential reforms in the area of prudential oversight include the introduction of fully consolidated supervision and regulation of financial conglomerates, the strengthening of the supervision of onshore banks, and the introduction of prudential buffers. With respect to the financial system safety net, the planned introduction of a deposit insurance scheme should be accompanied by an effective bank failure resolution framework. Reforms in the area of securities, pensions, and insurance are less immediately relevant for financial stability but yet essential for sustainable financial development. Medium-term improvements in the tax code, and the legal, accounting, informational, and contract-enforcement infrastructure would broaden access to financial services and contribute to financial deepening and stability.

B. Measures Already Adopted or Under Preparation Since end-2001

12. **In response to concerns raised by the FSAP mission, the authorities have recently adopted (or are currently working on) important reforms.** Measures taken during 2002 to strengthen bank and market oversight, which are summarized in Box 1, include in particular efforts to enable consolidated supervision. The supervisory authorities have been empowered to obtain and verify information from offshore subsidiaries of Costa Rican banks located in countries with which Memoranda of Understanding (MOU) have been agreed (several such agreements have already been signed) and will restrict the location of offshores to countries with which such MOU are in effect. In addition, a new regulatory framework was introduced that details the manner in which financial groups, including public groups, are to calculate capital adequacy *on a solo and consolidated basis*. To supplement these efforts, draft amendments to the central bank and banking law, aiming at leveling the playing field between private and public banks, were presented to Congress at end-2002. Among other, these amendments seek to: (i) enhance the administrative autonomy of public banks (albeit falling short of converting them into joint-stock companies); (ii) introduce a limited coverage,

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[4] Appendix III provides a summary of main short- and medium-term recommendations.

privately funded, deposit insurance for private banks; (iii) reduce to 10 percent (down from 17 percent) the share of private banks' deposits which they must transfer to public banks in the form of partially remunerated deposits; and (iv) eliminate the special status of Banco Popular as regards reserve requirements. The authorities also intend to increase capital requirements on dollar loans to non-dollar earners and have instructed banks to curtail these operations.

Box 1. Salient Measures Adopted During 2002

Bank Supervision

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

Securities Markets

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

13. **These measures constitute important steps that will need to be followed up until the twin objectives of a level playing field and consolidated supervision and regulation**

are fully met. The inclusion of the offshore subsidiaries of Costa Rican financial groups into SUGEF's regular program of onsite inspections and the relocation of subsidiaries in countries with which MOU have been signed constitute fundamental steps that, once fully implemented, should help ensure the quality of the information on which SUGEF bases its assessments. However, legal reforms are likely to be needed to ensure full consolidated supervision of financial groups, including their nonbank and offshore subsidiaries. In particular, to limit the scope for regulatory arbitrage (which would be crucial to strengthening prudential buffers), additional steps (including legal reforms) will be needed to ensure that financial groups subject their offshore subsidiaries to the same (or higher) prudential norms as their onshore counterparts. Likewise, the measures to ensure that public banks are adequately capitalized and the playing field is leveled are important steps in the right direction. However, they fall short of establishing fully uniform competitive conditions across banks. Subjecting all banks to the same administrative and legal status and the same deposit insurance are particularly important goals that will require further action. To ensure full consistency and policy complementarity, a reform of the legal and regulatory framework for bank exit should be prepared and preferably integrated with the legal amendments on deposit insurance currently under discussion.

II. Short-Run Stability Analysis

A. Macroeconomic Background and Vulnerabilities

14. **Costa Rica's record of substantial output growth with low macroeconomic volatility compares favorably with that of most Latin American countries.** Over the last two decades, Costa Rica's average yearly output growth (3.5 percent) exceeded that of most of its neighbors while inflation (23 percent) was relatively moderate (Appendix Table 3, Figure 1-A). This good overall performance was anchored on a remarkably stable macroeconomic environment, notwithstanding volatile terms of trade. Average output and real exchange rate volatilities were much below that of most neighboring countries (Figure 1-B). This largely reflected steady macroeconomic policies (Figure 1-C), that avoided stop-go fiscal policies and sharp balance of payments crises, as well as a high and growing integration into the world economy, as reflected by increasing trade diversification and trade openness (Figures 2-A and B). A stable political system, with a long democratic tradition, generally effective institutions, relatively low income inequality, a burgeoning middle class, and a strong education system have also contributed to create a favorable environment for sustainable growth.

15. **As a result, Costa Rica benefits from good access to the world's capital markets and moderate risk premia.** As of October 1, 2001, Costa Rica's sovereign ratings were exceeded only by a few Latin American countries with investment grades (Appendix Table 4). Reflecting this favorable assessment, the spreads over US treasuries paid by Costa Rica in recent sovereign debt issues were moderate, at around 380 basis points over U.S. measures in 2001. At the same time, the total perceived risk premium (i.e., the sum of country risk, currency risk, and banking risk) on colón deposits in the local banking system, albeit rising, has remained quite low in recent years (Figure 2-C).

16. **However, the macroeconomic framework has weakened and vulnerabilities have increased in recent years.** Trend output growth has declined since the mid 1990s (see

Annex I in the staff report for the Article IV consultation). A temporary growth spurt in the late 1990s was largely associated with large investments by Intel in the computer technology sector, but the recent world downturn in this sector accentuated the slowdown in output growth during 2000-2002 (Figure 2-D). The fiscal deficit has risen, reaching nearly 6 percent of GDP in 2002, reflecting increasing current government spending and a surge in public investment and an increase in the quasi-fiscal losses of the central bank (see below). It resulted in a steady growth of public debt, to a current level of around 50 percent of GDP. Contingent liabilities associated with the negative net worth of the central bank, large liabilities under the state pension system and potential quasi-fiscal liabilities in public banks may further complicate the public debt situation (for a discussion of the public debt dynamics, see Box 5 in the staff report for the Article IV consultation).

17. **The fiscal imbalances, as well as unfavorable terms of trade and real exchange rate trends, have contributed to a rising trend in the current account deficit since 1996.** The current account deficit of the balance payments has risen to about 5.5 percent of GDP, most of which financed by large foreign direct investments (including by Intel), and borrowing in international markets. However, Costa Rica's capital account is exposed to external shocks. Notwithstanding its small size and the low development of its capital market, which limit its attractiveness to large foreign institutional investors, Costa Rica is affected by external turbulence as illustrated by the close correlation between the general EMBI index and the central bank's international reserves holdings in recent years (Figure 3-D). Indeed, local investors' portfolios appear to be highly sensitive to country risk. So far, the Central Bank has been able to rapidly replenish its reserves by raising interest rates, as illustrated by the clear linkages between interest rates and NIR (Figure 3-E) as well as between non-FDI private capital inflows and NIR (Figure 3-A). However, it is not clear whether such access to international capital markets would remain open in the absence of much needed reforms.

18. **At the same time, the monetary and exchange rate regime promotes dollarization and faces increasing rigidities that limit the scope for relative price adjustments.** The revealed objective of Costa Rica's monetary and exchange rate policy has been to preserve external competitiveness, subject to the constraint of ensuring the credibility of the crawling peg through a "minimum" level of international reserves. To this end, Costa Rica has followed since the early 1980s a exchange rate crawl, with the rate of crawl being regularly adjusted (usually on a yearly basis) to compensate for differentials of past inflation between Costa Rica and the U.S.A. In addition, the Central Bank has adjusted interest rates upwards to defend international reserves in times of turbulence. This regime may be credited for having avoided large real exchange rate overvaluations followed by currency crises and sharp nominal exchange rate adjustments (for a description of competitiveness trends see the staff report for the Article IV consultation). However, by *trading short-term real certainty against long-term nominal uncertainty* (through the systematic targeting of the real exchange rate, rather than inflation), the current regime promotes dollarization, both financial and real. Indeed, it has induced agents to view the exchange rate as the best predictor of inflation and preferred benchmark for price and wage indexation. The lack of transparency of monetary policy (which

partly results from inconsistencies between the central bank's de-facto policy objectives and their legal underpinnings) has further tightened the link between inflationary expectations and the exchange rate.[5] In turn, the high pass-through limits the ability of the central bank to induce a real depreciation at a moderate cost in terms of inflation, as illustrated by two recent inflationary episodes (during 1991–92 and 1994–95) during which an active use of the crawl failed to produce durable real exchange rate adjustments and yet caused substantial inflationary outbursts (Figure 3-F).[6]

19. **In addition, the crawl, together with the central bank's negative net worth and the weak fiscal situation, hamper stabilization.** The backward-looking nature of the crawl and the very high pass through tend to perpetuate inflation. Thus, while inflation in Costa Rica declined somewhat during the late 1990s, it appears to have hit a floor of about 10 percent for the last three years. In addition to breaking the inertia of the current exchange system, bringing inflation down to world levels (of around 2 to 3 percent) would also require a fiscal effort to replace inflationary taxation by sounder means of finance. As the central bank incurs large operating losses (resulting from nonperforming or low yielding assets and sterilization costs), inflationary gains have prevented its real negative net worth from spiraling out of control. Notwithstanding a recent effort by the government (in January 2001) to recapitalize it (which brought yearly losses down from 1.8 percent of GDP in 2000 to 1.4 percent of GDP in 2001), its financial situation remains weak.[7]

B. Financial Sector Structure and Trends

20. **The financial sector is well intermediated and increasingly diversified, yet still centered on traditional banking intermediation.** The Costa Rican financial sector is dominated by financial groups that often include, in addition to an onshore bank, an offshore bank, a stock broker, an investment fund, an insurance commercialization firm, a pension

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[5] The Central Bank's Charter specifies that the central bank should stabilize the internal *and* external value of the currency, neither of which is achievable under the current monetary regime. The weaknesses in the legal and institutional framework governing monetary policy in Costa Rica are described in greater detail in the Code on Monetary and Financial Transparency (Section II-V).

[6] A recent Fund study finds that the pass through of exchange rate movements on prices in Costa Rica is among the highest in the world. See Choudhri, Ehsan U. and Hakura, Dalia S., *Exchange Rate Pass-Through to Domestic Prices: Does the Inflationary Environment Matter?*, IMF Working Paper WP/01/194.

[7] With real interest rates and growth rates remaining at their average level during the last five years, an inflation rate of at least 15 percent would be needed to stabilize the ratio of the central bank's net worth to GDP.

fund, and a mortgage company.[8] Total assets of financial institutions (including offshore banks) reached nearly 72 percent of GDP in June 2001, which is high by Latin American standards (Appendix Table 1 and Figure 4-A). While banks still account for the lion's share of total financial sector assets (77 percent), investment funds (both mutual funds and pension funds) have grown very rapidly in recent years (to 10.4 percent of total financial sector assets and to the equivalent of 34 percent of bank deposits as of September 2001) as a result of reforms that have clarified the legal and regulatory framework for mutual funds and created a private, "second pillar" pension system (see Section IV-B). The growth of investment funds was fed in part by transfers from off-balance sheet trust funds formerly administered by banks (fiduciary funds) and/or their associated stock brokers (OPABs and CAVs[9]) and, most importantly, by transfers of bank term deposits and public securities (on either side of banks' balance sheets). Thus, banks' activity has increasingly focused on loans to the private sector (the share of loans in banks' total assets rose from 42.6 percent to 48.3 percent between January 1998 and June 2001, without considering offshore banks) while, due to the scarcity of private paper, investment funds have concentrated their portfolios nearly exclusively in government obligations.[10]

21. **The capital market is narrow and essentially centered on public securities.** The capital market is dominated by domestic public debt securities (issued by the Treasury and Central Bank) of short duration (less than one year), with most trading (80 percent) consisting of repo operations. Due to the small size of the country and the lack of adequate infrastructure development, the market for private securities is essentially undeveloped, with only a handful of securities, mainly issued by the financial sector, trading in very limited amounts in the open market. The equity market is nearly nonexistent. The capital market has performed basically two functions, orthodox finance of public debt and money market activity. Brokerage houses have played an important role in both of these markets.

22. **The public sector has a pervasive presence in Costa Rica's highly concentrated financial system, limiting competition.** The banking system continues to be dominated by

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[8] In some cases, the group gravitates around a financial corporation (*financiera*), rather than an onshore bank.

[9] *Operaciones de Administración Bursátil* (OPABs) and *Cuentas de Administración de Valores* (CAVs) are short-term investment portfolios administered by brokerage houses on account of third parties. Some offer minimum returns guaranteed by the brokerage houses' equity. They are due to be phased out by 2003.

[10] While the higher yields, combined with high liquidity, of mutual funds explains their success, the declining stock of public securities held by banks and increasing competition between banks and funds have tended to depress their yields relative to that of term deposits over the last two years, suggesting that their growth may have reached an inflexion point (Figure 4-B).

public banks, which include three state-owned commercial banks (Banco Nacional, Banco de Costa Rica, and Banco Nacional de Cartago), and a special-charter bank (Banco Popular), in principle owned by all Costa Rican workers. They still account for about 75 percent of total banking deposits, with the two dominant public banks (Banco Nacional and Banco de Costa Rica) accounting for 37 percent and 22 percent, respectively. Consequently, banking concentration, albeit declining, continues to be high, even by Latin American standards, thereby limiting competition (Table 5). The public sector has a monopoly of the insurance sector, through the INS, and dominates the pension and mutual fund industry (for instance, five out of the nine pension fund managers, which jointly account for about 75 percent of all pension fund assets, are owned by public sector institutions).

23. **However, the banking system has become more diversified in recent years, with private onshore banks continuing to gain market share.** Private banks presently include 17 banks (three mergers took place during 2000 and one was in process at the time the FSAP was conducted), ten of which have at least a 50 percent share of foreign capital. They have gradually expanded their share in onshore banking intermediation, following the authorization (granted in 1996) to open sight deposits (albeit conditioned to depositing 17 percent of such deposits in partially remunerated deposits in state-owned banks). Notwithstanding their substantially higher cost of funding, due to their more limited presence in the retail market and lack of deposit guarantee (in stark contrast with the state guarantee enjoyed by all public bank deposits), their share of onshore bank lending rose substantially in recent years (from 33 percent in early 1998 to 42 percent in August 2001) as they countered their local funding handicaps with more aggressive lending (concentrated in commercial, consumption and housing loans, most of them in dollars), a rapid increase in funding through external lines of credit, better service, and quicker product innovation.

24. **The competition of private banks has obliged public banks to adjust.** The competition from private banks has driven the public banks (particularly Banco Costa Rica) to follow suit, expanding their dollar lending to the private sector (Figure 4-C) and competing more aggressively for dollar funding, thereby attracting some of the funds formerly deposited in private offshore dollar accounts and narrowing the gap in funding costs during the last three years (Figure 4-D). The contrast between the asset structure of public and private banks, while still sharp (with public banks concentrating in colón lending to small borrowers and colón-denominated public securities while private banks focus on dollar operations with the larger and more sophisticated customers, including corporations), has thus tended to become less pronounced (Figures 4-E and F).

25. **Following an earlier phase of very rapid growth, offshore banking has apparently stabilized during the last few years.** Offshore banks account at present for about one fourth of total banking system assets. They are a predominant feature among private financial groups (assets of private offshore banks are equivalent to 41 percent of the total assets of private onshore banks and to 100 percent of the assets of their corresponding onshore banks, as against only 11 percent for public banks). Offshore banks have been widely used as a conduit

for tax and regulatory evasion (as evidenced by ample use of back-to-back arrangements), with limited (or complete lack of) physical presence in the offshore centers and a very similar profile of intermediation to that of their onshore counterparts (i.e., most loans are to Costa Rican customers).[11] They grew very rapidly in the initial development stages of private banking in Costa Rica, as a response to high unremunerated reserve requirements (28.3 percent in December 1995) and a search by private banks for a competitive edge against public banks. While detailed information on offshore banks is limited (information has become available only since end-2000, following the recent introduction by the supervisory authorities of reporting requirements on all entities of financial groups), it appears that the growth of offshores is tapering off following a substantial reduction in reserve requirements (to 9 percent at end-2001), increasing concerns from bank owners for the negative connotations of offshore banking, and more aggressive competition in the dollar funding market by both mutual funds and public banks.

26. **While volatile, credit growth has accommodated demand, with foreign financing playing a buffer role.** Aggregate credit growth has incurred deep fluctuations during the last decade, mostly reflecting the business cycle (Figure 5-A). Setting aside a short pause in 1995, the deposit base has grown continuously, exceeding until the mid 1990s private credit by a comfortable margin, thereby providing an ample liquidity buffer to accommodate fluctuations in credit growth. While the growth of public debt from the mid-1990s onwards started to crowd out private lending and exert pressures on funding, external lines of credit quickly filled up much of the gap. Thus, credit fluctuations continued to be mostly demand-driven, with funding passively accommodating credit needs (Figure 6).[12]

27. **However, the capital inflows have accentuated the already substantial financial dollarization.** As in the case of real dollar indexation (i.e., the pass through), the substantial financial dollarization has been primarily caused by the stark contrast between the weakness of the nominal anchor for the colón and the attractiveness of the dollar (resulting from the de-facto real exchange rate targeting).[13] Yield curves are much steeper for the colón than for local dollars, reflecting the rapidly rising uncertainty over real yields as the maturity of colón instruments rise (Figure 5-B). The recent increase in dollarization of onshore bank deposits

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[11] The fact that offshore banks pay a *positive* spread over onshore deposit rates would suggest that they benefit local financial groups at least as much as they benefit their customers. It also raises some doubts on claims that the demand for offshore deposits is primarily a response to country risk.

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

[13] The use of an optimal portfolio hedging model (i.e., based on inflation and real exchange volatilities) yields an underlying dollarization ratio of about 40 percent, which is broadly consistent with observed (onshore) levels of dollarization.

and loans (to about 45 percent of total) probably reflects in part (no hard data exist) some repatriation of offshore deposits and loans. However, loan dollarization grew at a much faster pace than deposits due to the rapid increase in foreign (dollar) funding (Figure 5-C). The inflow of foreign dollars also induced some increase in deposit dollarization notwithstanding a shift in interest rate differentials in favor of colón deposits caused by the relative abundance of local dollars (Figure 5-D). In turn, the increase in the funding cost of colón loans, together with very high intermediation spreads in local currency (see below), raised the cost of colón loans to high levels, inducing dollar loans to expand across the board, including to consumer loans and mortgages. The higher debt servicing burden of colón loans (deriving from high nominal interest rates and flat amortization schedules) further depressed their demand.

28. **The high colón intermediation spreads reflect uneven regulatory and tax treatment, crowding out, and market segmentation.** The higher colón intermediation spreads partly reflect uneven taxation and regulation across currencies.[14] They also clearly reflect (particularly for private banks) a crowding out of colón credit by the predominantly colón-denominated domestic public debt (Figure 5-E). Finally, they may reflect the use of currency denomination as a vehicle for price discrimination, since colón customers generally have less access to alternative financial outlays. The notable differences between the average size of colón deposits and loans clearly illustrate such market segmentation (Figure 5-F).

C. Short-Run Financial Sector Stability Analysis

29. **Subject to the caveats mentioned below, reported prudential indicators as of end-2001 depict a generally healthy onshore banking system.** Onshore banks report high ratios of capital to risk-weighted assets (CAR), 14 percent for public banks and 16 percent for private, in both cases largely above the required minimum CAR of 10 percent, with only three banks reporting a CAR below 11 percent (Figure 7-A). The reported quality of loan portfolios is high (95 percent of the portfolios is classified in the two highest categories). Banks have remained moderately profitable over the last few years, with returns on assets around 2 percent and returns on equity (adjusted for inflation and exchange rate depreciation) of around 10 percent.

30. **However, caution is needed in interpreting these indicators.** First and foremost, the lack of on-site verification of the financial accounts and asset classification of offshore banks by the Costa Rican supervisors shed doubts on the accuracy of their reporting and provisioning adequacy.[15] Capital adequacy was open to question in the case of public groups due to the lack

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

[15] On-site verification of reporting by offshore subsidiaries of Costa Rican banks (which, as explained in Box 1, started during 2002) should largely resolve this issue in the future, once this task is generalized to all offshores and becomes fully integrated with the regular schedule of onsite inspections.

of a norm ensuring that banks meet minimum capital requirements on a solo basis and insufficient provisioning of large contingent liabilities (such as severance payments obligations to employees).[16] Furthermore, the high percentage of loans reclassified during on-site inspections in both onshore private and public banks (about 30 percent of revised loans) suggests the prevalence of a somewhat undisciplined risk management culture, such that bad loans are too often considered good loans until proven otherwise by the supervisors. Weaknesses in the quality of accounting statements, derived from insufficient cross-checking of accounts and weak oversight by the supervisory authorities of the work of external auditors, also shed some doubts on the reliability of banks' financial statements.

31. **Moreover, the current monetary and exchange rate regime raises the banking system's vulnerability to shocks.** The regime exposes the banking system to a mix of credit volatility, interest rate and liquidity risk, and currency risk.[17] Given the limited flexibility of the exchange rate, interest rates in Costa Rica are primarily devoted to maintaining minimum holdings of international reserves (recall Figure 3-E above). As the substantial real and financial dollarization limits the scope for using monetary policy to help moderate output and credit cycles, the banking system is vulnerable to credit cycles. At the same time, the reliance on interest rates to preserve the exchange rate regime and counteract adverse systemic shocks heightens interest rate volatility and introduces a counter-cyclical bias whereas interest rates increase during downturns, thereby compounding the adverse effects of economic slumps on borrowers' debt servicing capacity. Banks' exposure to liquidity risk is similarly enhanced by the high dollarization of bank deposits and the fact that quantity adjustments (deposits and international reserves), rather than price adjustments (exchange rate and interest rates) constitute the first line of defense against adverse systemic shocks. Finally, the dollarization of bank loans both limits the scope for discrete exchange rate adjustments and exposes banks to credit risk should the exchange rate be devalued abruptly.

32. **Credit risk could rise under a credit crunch scenario.** The credit cycles have not so far put the system at risk because, as already stressed, they have been mostly demand-driven. Indeed, the apparent soundness of loan portfolios can be traced back to the fact that borrowers have not experienced a contraction of net lending flows for a long period of time, i.e., of credit flows net of interest payments (Figure 7-B). However, a credit crunch resulting from an abrupt contraction of domestic or external funding or a heightened perception of risk by local

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[16] The new framework for capital adequacy introduced in mid-2002 (that requires that public banks meet minimum capital requirements on both a solo and consolidated basis within two and a half years), and the provisioning of existent contingent liabilities over a ten-year period should also gradually resolve this issue, as measures become fully implemented.

[17] Stress tests based on econometric techniques (particularly to estimate the magnitude of the impact of shocks on the quality of banks' loan portfolio) could not be reliably ran because of data limitations. In particular, the series for non-performing loans was inconsistent, unavailable for a sufficiently long period, and with insufficient variability.

bankers, could result in a sharp increase in nonperforming loans. While the potential for a deterioration of credit portfolios is difficult to predict econometrically (see footnote 18), the widespread use of revolving credit lines in corporate lending (which are prone to "evergreening") suggests that a supply-led credit contraction could have a severe impact on banks' loan portfolios.

33. **Banks' exposure to (indirect) interest rate risk appears to be important.** Banks are not directly exposed to interest rate risk, due to the widespread use of floating lending rates. However, this shifts risk to borrowers (who are often less equipped to bear such risks than banks or investors) and heightens banks' indirect exposure to interest rate risk by accentuating their exposure to credit risk.[18] Moreover, as mentioned earlier, interest rate volatility is accentuated by the crawling peg system.

34. **While still reasonably high, the banking system's liquidity has declined and is unevenly distributed.** Both systemic liquidity (defined as the ratio of external liquid assets to liquid liabilities of the consolidated banking system, including the central bank) and idiosyncratic liquidity (defined as the ratio of domestic or external liquid assets to liquid liabilities held by commercial banks) are reasonably high (Figures 7-D and E). However, liquidity has declined in recent years as the monetary authorities reduced reserve requirements and banks expanded their lending operations, partly on the basis of short-term external finance. Moreover, liquidity is unevenly distributed across banks. While public banks are generally quite liquid, reflecting their large holdings of public securities, the liquidity of some private banks lies much below the average for the system. The short average maturity of bank deposits (75 percent of deposits have a less than three-month maturity), the current shortcomings of the interbank money market (see Sections III-A and IV-B), and the lack of deposit guarantee for private banks increase the risk that some banks may encounter funding difficulties in a situation of systemic turbulence.

35. **Banks' balance sheets could be harmed in the event of a large discrete depreciation.** Banks' direct exposure to the risk of currency depreciation is not significant, as the scope for holding short open dollar positions is limited by regulation.[19] However, banks are indirectly exposed through their borrowers. Banks (and supervisory authorities) are aware of the risks associated with lending in foreign currency to borrowers who do not receive dollar incomes. Nonetheless, the large cost differentials between colón and dollar loans and the implicit exchange rate guarantee provided by the crawl encourage a systematic

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

[19] The regulation on banks' open position specifies that banks should maintain a *long* dollar position of between zero and one hundred percent of capital. However, banks cannot alter their position by more than 0.5 percent of capital per day.

underestimation of the risks associated with dollar contracts and promote moral hazard (expectations of bail outs in the event of a shift in the exchange rate regime). This has led to a situation where onshore dollar loans to borrowers who do not earn dollar incomes reach nearly half of total onshore dollar lending. The current shortcomings in banks' capacity to administer risk (see below), raise concerns as to whether such exposure is manageable.

36. **The vulnerabilities deriving from banks' exposure to systemic risk are likely to be compounded in forthcoming years by the risks associated with an intensification of competition.** Increased pressures on banks' profit margins are likely to arise from a number of sources, including greater competition between private banks and public banks, banks and mutual funds, and onshore and offshore banks. The increasing importance of institutional investors and the shift towards dollar intermediation, where margins are smaller, are likely to exacerbate competitive pressures. The prospects for a profit squeeze appear to be stronger in the case of public banks, as their franchise value could be eroded by their migration towards dollar markets (where unit costs are higher and intermediation margins narrower, and where the state guarantee is likely to be less relevant) and the planned introduction of a deposit insurance for private banks. In turn, the pressures on profits could well induce weaker institutions to take on excessive risks, potentially undermining the soundness of the system.

III. Risk Management

A. Liquidity Management

37. **A shallow and segmented interbank money market and somewhat opaque monetary signals limit the effectiveness of day-to-day liquidity management.** The Costa Rican money market is segmented (into three sub-markets), its depth is limited, and interest rate volatility (both across time and across markets), while declining in recent years, continues to be substantial. Market volatility is due in part to the rationing of liquidity injections in the central bank's lending facility, as well as to the absence of active open market monetary regulation operations (instead, the regulation of liquidity takes place ex-post through the broad corridor set by the Central bank's standing facilities). Due to the volatility of short-term interest rates, monetary policy signals continue to be focused on longer term instruments, typically six-month central bank bills (BEMs), which are sold in the same auctions as treasury instruments of similar maturities. This arrangement causes the yield curve to be arbitrarily determined (daily rates on the central bank's facilities are based on the six-month BEM rate) and the distinction between monetary and public debt management to be blurred. In addition to hampering the development of the local currency money and securities markets, hence contributing to dollarization, this results in opaque monetary signals.

38. **Notwithstanding the tight limitations implied by the crawl, important measures can be taken to enhance monetary management under the current regime.** While the current regime clearly limits the scope for targeting (and reducing) inflation, a lowering of inflation to low single digit levels would facilitate monetary management by reducing uncertainty in ex-ante real interest rates and limiting incentives for (real and financial) dollarization. *However, an essential condition to achieve sustainable stabilization is that the central bank be fully recapitalized, so as to eliminate its dependency on inflationary gains as a*

way to avoid its negative net worth spiraling out of control. The recapitalization would also provide an excellent opportunity to replace the central bank bills by treasury bills as the instrument of choice for monetary operations, thereby contributing to deepen the market for short-term public securities (see Section IV-B). At the same time, communications between the central bank and the market need strengthening.[20] The deepening of the interbank money market would require eliminating the use of rationing clauses in the day-to-day liquidity injection facility as well as measures to further develop the infrastructure for trading and registering public securities. Finally, the development of an active day-to-day open market intervention capacity would be needed to limit the volatility of money market rates and gradually shift the focus of monetary policy towards the shortest end of the yield curve.

39. **While impressive progress has been recently achieved as regards payments system infrastructure, some potential weaknesses concerning the management of settlement risk would need to be addressed.** Important progress was achieved in recent years in strengthening the legal and operational underpinnings of the payments system, including through the introduction by the Central Bank in 1999 of a real time gross settlement system (the TEF) which has led to a sharp reduction in the use of checks for large payments (Figure 7-F). While the payments system broadly fulfills at present most of the core principles for systemically important payments systems (as detailed in the CPSS assessment presented in Section VI), the gradual reduction in reserve requirements (to a uniform 5 percent in February 2002), together with the continuing shift towards real time settlements, could eventually constrain the growth of RTGS activity and increase the risk of settlement failures in the multilateral netting systems, including checks. Containing such risks would require developing liquidity enhancing arrangements (such as intra-day repos) and increasing the reserve funds set aside for the check clearing system.

B. Prudential Management

40. **A legal reform is needed to better align the mandate of CONASSIF with its capacity to fulfill it, as well as to limit potential conflicts of interest.** The legal mandate of CONASSIF, the Board that oversees three supervisory agencies (SUGEF, SUGEVAL, and the Superintendent for Pensions SUPEN), is clearly of an "executive" nature. However, its structure and resources are more congruent with a "consultative" role.[21] Moreover, there are

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[20] Commendable efforts have already been taken to strengthen communications with the public, including through the introduction of a regular inflation report. However, the authorities face a major challenge in applying such tools (which constitute an essential ingredient of inflation targeting) to a regime which is inherently much less transparent than inflation targeting.

[21] The superintendents do not have voting power, nor do they have the authority to set priorities for its agenda. Instead, the five Board members with voting power are not necessarily experts in the field and are dedicated only on a part-time basis.

insufficient restrictions to minimize potential conflicts of interest. As a result, CONASSIF members lack the time, and potentially also the expertise and independence, to carry out their responsibilities. Legally unable to "delegate" its functions, CONASSIF constitutes an additional layer in the decision making process that can hinder the timeliness and effectiveness of key decisions, particularly as regards supervisory enforcement and troubled bank resolution. To address these issues, legal clauses to prevent conflicts of interest should be clarified and tightened and the legal mandate of CONASSIF reviewed. One alternative would be to reduce its power and responsibilities, making it more of a consultative or coordinating Board. Another, arguably superior, alternative would be to change the composition of its board, require full-time dedication of its members, and refocus its role. Under either alternative, strengthening the independence of the president of the Central Bank and that of the superintendents would help foster the independence of CONASSIF.

41. **Regulatory innovations are needed to build up buffers against the systemic risks identified in Section II.** Given the volatility of credit growth and the potential for a credit crunch, the authorities should introduce counter cyclical provisioning requirements to build up provisions in times of fast credit growth and enable banks to convert such provisions into specific provisions as loans deteriorate during the downswing phase of the credit cycle. In view of the high (indirect) exposure of banks to currency risk, consideration should also be given to establishing special capital reserves against dollar loans to the nontradable sector. At the same time, the regulation on open foreign exchange positions should be revised to limit the total range within which banks can adjust their position, while eliminating the daily limits. Given the exposure to systemic liquidity risk and the drastic reduction in reserve requirements, the authorities should also introduce explicit liquidity requirements, at least part of which should be invested in foreign liquid assets. Finally, to limit banks' exposure to (indirect) interest rate risk, transparency standards for the setting of floating rates should be raised. However, the effective implementation of these regulations would require an overall strengthening of banking supervision, including, to avoid regulatory evasion, the incorporation of offshore banks under fully consolidated supervision (see below).

42. **Despite recent advances, the law still does not enable the supervision of financial conglomerates on a fully consolidated basis.** Private financial conglomerates are obligated by law to adopt a holding company organizational structure and report their financial statements on a consolidated basis. However, a number of important entities within such conglomerates fall outside the regulatory and inspection powers of domestic bank supervisors, including non-bank financial institutions and offshore banks. While they do not offer deposits to the public, non-bank financial institutions can nonetheless affect depositors indirectly by undermining the solvency of the banks with which they are associated. As for offshore banks, they cannot be regulated by the Costa Rican authorities and their real situation can be known by them only through agreements with foreign supervisors. Moreover, the legal imposition of a holding company structure on private financial conglomerates results in practice in unnecessary rigidities. The lack of consolidated supervision, which is one of the main causes for Costa Rica's limited compliance with the BCPs (see Section VII), is a major potential source of systemic vulnerability (including through risks of cross-contamination between institutions). It thus needs to be addressed as a matter of priority.

43. **While competition between private and public commercial banks has increased, significant regulatory and tax asymmetries continue to hamper financial system regulation and supervisory enforcement.** The privileges of public banks include the state guarantee on all their liabilities (no explicit deposit insurance exists for private banks), the tax exemption of their dollar deposits, and the requirement on private banks to deposit (at sub-market interest rates) at least 17 percent of their short-term deposits in state banks in order to be entitled to take demand deposits.[22] At the same time, the capacity of state banks to compete is hindered by their legal status as public entities (which makes them akin to a government ministry) and by their governance structure (politically appointed boards of directors). As a result, they have difficulties in adopting profit maximization as a key objective of their business strategy and the role of their boards of directors is unclear. In addition, they face cumbersome public sector procurement guidelines, tight oversight by the *contraloría,* and inflexible personnel and salary policies. At the same time, their management is saddled with the restriction of being able to "do only what is permitted by law" (while private bankers can "do whatever is not prohibited in the law") and with the responsibilities attached to the management of public funds (which, for instance, makes it difficult to recognize losses in securities investments). These asymmetries, which are mostly grounded in the law, create a significantly uneven playing field that complicates prudential oversight, and distorts incentives, thereby undermining financial system soundness. Thus, they need to be addressed as soon as possible. Once passed and implemented, the legal amendments that have been presented to Congress (see Box 1) will constitute important first steps in the right direction.

44. **The bank rating scheme used by SUGEF limits the effectiveness of prudential oversight.** SUGEF's bank assessment system (whose results are not disclosed to the public) relies heavily on a weighting of various CAMEL-type ratios which mixes two distinct objectives: determining differences in financial strength between viable banks under normal conditions and triggering prompt correction and/or intervention of potentially unviable banks under extraordinary conditions. As a result, it performs neither of the two functions in a fully satisfactory manner. The system in practice classifies all banks as "normal" and is, thus, of little use relative to its objectives but yet creates the false impression that problems are being detected and corrected at an early stage. The supervisory authorities should introduce more graduation in the rating of banks and separate the rating system for the "normal" relationship with regulated banks from the "extraordinary" relation within a suitable framework of prompt correction, intervention, and resolution of troubled banks (see below).

45. **Other weaknesses in bank regulation relate to the system of penalties and to certain voids in prudential and accounting norms.** Penalties consist of very high fines and/or very drastic actions, such as the suspension of operations of the bank. There is no graduated system that matches stiffer penalties with graver infractions. As a result, infractions by bankers are in practice not penalized, which seriously undermines enforcement and

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[22] In addition, one special-charter public bank (Popular) is explicitly exempted from the legal reserve requirement, and benefits from a captive source of almost costless funding.

supervisory credibility. Legal changes should be introduced to establish a graduated, realistic system of penalties. To foster discipline, the authorities should also consider disclosing penalties and other enforcement measures. In addition, certain voids in prudential and accounting norms should be addressed promptly.[23]

46. **While it has strengthened substantially in recent years, bank supervision could gain further by fostering improvements in banks' own risk management system and greater market discipline.** Noticeable progress has taken place in onsite and offsite supervision over the last years. Further progress would hinge not only on the intensification of training programs but also on greater institutional support for supervisors. However, the supervisory approach is insufficiently geared at promoting market monitoring of banks (which is undermined by the state guarantee of public banks) and at inducing improvements in banks' own risk management system, an area in which only few banks meet minimally adequate standards. Therefore, the authorities should accelerate the shift to a risk-based supervisory approach that puts more emphasis on the evaluation of the quality of bank management (internal controls, risk management policies, etc.). In particular, they should introduce incentives for banks to correctly classify and provision their loans ahead of the SUGEF inspections. They should also facilitate the monitoring of banks by the private sector through better disclosure and more accurate reporting of financial statements. In this context, there is ample room to strengthen the oversight of supervisors over external auditors and enhance the complementarities of their work. Finally, the debtor information system maintained by SUGEF should be improved in terms of coverage, quantity (and reliability) of information, and ease of access to it by the credit institutions.

47. **Substantial progress has been achieved as regards the oversight of securities markets.** Prudential oversight of securities markets has registered remarkable progress over the last years. SUGEVAL has led a major modernization of securities markets regulation and has brought under its oversight previously unregulated funds (CAVS and OPABs) that grew as substitutes to bank deposits and to avoid legal reserve requirements. Some important remaining issues, such as a better definition of the self-regulatory role of the Stock Exchange (ensuring that it was complementary to the oversight function of SUGEVAL) and stricter disclosure requirements and mark-to-market requirements introduced, were largely resolved during 2002 (see Box 1).

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[23] For instance, there are no clear accounting norms for the consolidation of financial statements and for the treatment of such key operations as off-balance sheet items, securitized assets, the sale of repossessed collateral financed by the seller bank, the amortization of non-financial assets, and loan write-offs. Also, SUGEF receives no information on restructured loans (which limits capacity to detect "ever greening") and existing norms on banks' foreign exchange positions address monetary or foreign exchange objectives rather than prudential concerns.

C. Crisis Management

48. **Aside from the problems associated with the dollar lender of last resort function mentioned in the staff report for the Article IV consultation, the colones lender of last resort (LOLR) function suffers from design problems and lacks adequate operational arrangements for its implementation.** Design problems with the first LOLR facility (*redescuento ordinario*) include an arguably too short maturity (30 days), too high an access limit, and lack of explicit provisions to minimize the risk of providing LOLR liquidity to outright insolvent banks. This facility is also affected by a number of operational problems that need to be addressed. The second LOLR facility could be eliminated.

49. **The current framework for prompt correction and intervention of troubled banks, which is distorted by the large presence of public banks, also requires reform.** Enforcement of prompt correction on public banks is vulnerable to political interference. With regard to private banks, simple and effective triggers for prompt correction should be established. In addition, the intervention of a bank, which requires the assumption of the bank's management by a SUGEF-appointed interventor, is a cumbersome and risky process. Moreover, as the authorities perceive high legal risks in administering an intervened bank that they do not own, they have in all cases opted to suspend the operations of intervened banks. Thus, interventions have inexorably marked the beginning of liquidations. For prompt correction, instead of relying on intervention, the authorities should rely on well-defined, time-bound, and tightly supervised regularization (*saneamiento*) plans, implemented by the bank's own administrators, and encourage private sector solutions (recapitalization, mergers, acquisitions). The SUGEF's intervention powers should mainly underpin the process of bank closure and resolution.

50. **The system of bank closure and resolution should be revamped and linked to the planned introduction of a limited deposit insurance.** At present, the intervention and resolution of a public bank requires a special law and the framework for private bank closure and resolution is inadequate (it consists of a lengthy and cumbersome liquidation of the bank's entire balance sheet which fails to limit contagion risks and unnecessary destructions of asset value). Legal reforms should promote purchase and assumption-type techniques that enable the rapid transfer of deposits of a failed bank to existing sound banks. Only a "residual" balance sheet should move on to liquidation. This reform should be linked (it is in effect a precondition) to the planned introduction of a limited deposit insurance scheme (see below).

51. **The authorities should consider the creation of separate deposit insurance funds for private and public banks as long as the coexistence of separate funds is transitional.** To better align incentives and foster monitoring, greater participation should be given to private banks in the governance and administration of their deposit insurance fund, greater flexibility provided in setting premiums and more specific guidance given with respect to the insurance fund's initial capital, the fund's borrowing authority, and the desirable (maximum) level of the fund. The deposit insurance for private banks should be introduced *after* consolidated supervision is fully in effect, and be widened to include a simultaneous, suitable reform of the bank exit framework, as described in the previous paragraph.

52. **Corporate reorganization and liquidation proceedings are hampered by a slow judiciary, excessive protection of debtors, disincentives for creditor participation, and lack of effective out-of-court workouts.** Corporate rehabilitation and insolvency procedures are fully administered by the courts, which leads to major inefficiencies and delays, given that judges are overburdened and lack the necessary expertise. Creditors have no active role to play and, hence, have little interest in participating, particularly considering the protracted nature of the process. Moreover, the legal framework does not enable workable out-of-court restructurings. A comprehensive legal reform of corporate reorganization and liquidation procedures is thus needed. It should consider creating specialized courts for corporate insolvency/rehabilitation or moving substantial parts of the process outside the courts. The process of verification of claims should be shortened and creditors given a much more active role in the process. The rapid approval of extra-judicial agreements should be facilitated.

53. **While the framework for secured lending is broadly adequate, operational and enforcement problems significantly limit the use of collateral for the mobilization of credit.** The problems are mainly related to the lengthy and unpredictable judicial process which completely governs the execution of guarantees. The authorities should consider creating specialized courts that charge reasonable judicial fees, or moving parts of the process outside the court system.

IV. Towards a Sustainable Financial Sector Development

A. Issues in Banking Structure

54. **The simultaneous large presence of public banks and private financial activities (including offshore banking) reflects an ongoing, incomplete, and potentially unstable process of liberalization, which needs a permanent resolution.** The entry of the private sector into banking and finance has not been accompanied by the exit of, or a well-defined exit strategy for, public commercial banks. Instead, the liberalization process has featured the gradual widening of competition through incremental dismantling of "privileges" enjoyed by public banks. As a result, private financial entities have been increasingly competing head-to-head with public banks in common markets while profiting from their inefficiencies (wide intermediation margins). Unless the governance and administrative constraints on the public banks' capacity to compete are lifted, the complete elimination of their remaining "privileges" could threaten their survival, potentially destabilize financial markets and raise the ultimate fiscal cost associated with the state guarantee of their deposits. Should it linger on, the presence of unsupervised private financial activities, particularly offshore banking, would also be unsustainable, given its corrosive effect on incentives and market discipline.

55. **A clear medium-term objective on the future of public banks and offshore banks, and a well-defined transition strategy, are needed.** Ways should be found to bring offshore banks under the full supervision and regulation of the SUGEF and a complete phasing out of offshore banking considered. *In all cases, the key benchmark should be that any bank intermediating in Costa Rica should be locally licensed.* As regards public banks, their legal status could be first converted into that of a joint stock company (*sociedad anónima*). **In** addition to leveling the playing field in terms of governance, this would also enable the

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

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

56. **Realistic objectives need to be set for the development of the local securities markets.** Under the current monetary and exchange rate arrangement, the cost of developing a market for long-term, fixed interest rate, colon-denominated public-sector debt securities is likely to be very high. The development of the public-sector debt market is also hampered by the low level of standardization and dematerialization. As regards the private securities markets, the small size and high concentration of family ownership in the corporate sector undermines incentives for private companies to "go public". Moreover, it is questionable whether a small country like Costa Rica would be able to provide the economies of scale and of agglomeration needed for a self-sustaining development of this market. Key measures to promote securities markets development could include: i) the introduction of a CPI-based financial index as an alternative to dollarization and the issuing of CPI-indexed, long-duration, public bonds; ii) further standardization and de-materialization of public-sector debt securities; iii) the breaking of the legal monopoly of broker-dealers over securities transactions and custody; iv) an assessment of the feasibility of regionalizing securities and other financial markets across Central America; and v) further improvements of the enabling environment—particularly with respect to the legal, accounting, informational, and contract-enforcement infrastructure.[24]

57. **As regards pensions, the pension reform introduced in 2000 needs to be complemented by further actions to ensure the viability of the first pillar and enhance the financial development role of the other two pillars.** As discussed in Box 4 of the staff report of the Article IV consultation, the financial viability of the first (defined-benefit) pillar requires changes in its currently over-generous benefits. The regulations on the investment of pension funds (currently invested mainly in government debt securities) should be gradually liberalized. Steps should also be taken to reduce the dominant market share held by fund administrators belonging to public commercial banks.

58. **A reform strategy is needed for the liberalization of the insurance sector, which at present constitutes a state monopoly.** Costa Rica is the only country in the world where the state has a monopoly over the insurance sector—through the *Instituto Nacional de Seguros* (INS). This has stunted the development of domestic insurance markets and fostered inefficiencies, severely limiting consumer choice. Thus, the insurance legislation should be revamped to allow private sector entry into the industry, possibly beginning with the life

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[24] Costa Rica's stable political environment and strong legal framework should facilitate meeting these objectives.

insurance and annuities businesses, where at present the INS has little activity. The INS should be transformed into a joint stock company. Efforts should be made at speeding up the approval of the bill currently in Congress to create a regulatory agency (or function within an existing agency) for the insurance sector, and consideration given to creating the office of the Ombudsman. Even before the legal reform, the INS can and should introduce administrative changes to increase its operational efficiency and bolster its role as institutional investor.

SECTION II. OBSERVANCE OF FINANCIAL SYSTEM STANDARDS

V. CODE OF GOOD PRACTICES ON TRANSPARENCY IN MONETARY AND FINANCIAL POLICIES

A. Transparency of Monetary Policy

59. Costa Rica follows a crawling peg regime—in operation since the mid-eighties—in the context of an open capital account. The main focus of monetary policy is on the real exchange rate, with a view to achieving external sustainability with growth.

Main findings

Clarity of roles, responsibilities and objectives of central banks for monetary policy

60. The ultimate objectives—to maintain internal and external stability of the national currency—and institutional framework of monetary policy in Costa Rica are specified in the central bank law. Dissemination occurs through its web site, and publications. Although the institutional relationship between fiscal and monetary policy is defined in law, in practice the monetary policy stance is difficult to identify, since open market operations also play a role in financing government operations. The law does not address the issue of how central bank capital should be maintained; in this context, an unpublished Memorandum of Understanding on recapitalization could be disclosed.

Open process for formulating and reporting monetary policy decisions

61. The principal means for formulating, reporting on, and explaining the monetary policy framework, instruments, and decisions is the annual Monetary Program, updated mid-year. The recently issued Inflation Report also provides an opportunity to more systematically convey and explain monetary policy to the public. More public information on meeting dates and explanation of policy decisions—including interest rate changes—at these meetings would be welcome. The authorities conduct public consultations when substantive changes to regulations are under consideration.

Public availability of information on monetary policy

62. Costa Rica subscribes to the Fund's Special Data Dissemination Standard (SDDS). While the BCCR publishes its foreign reserves daily and its balance sheet monthly (within 15 working days of the end of the month), the balance sheet in the annual report does not show sufficient detail.

Accountability and assurance of integrity by the central bank

63. The president of the BCCR appears several times per year before the government council to report on the objectives and conduct of monetary policy. Consideration should be given to formalizing these good practices. The monthly balance sheets are audited, although not by an independent external auditor; internal audit procedures are not disclosed. There is quarterly reporting on operating expenses and revenue. The standards for the conduct of staff—uniform for all civil servants—are publicly disclosed; annual reminders to file required financial statements are published in national newspapers.

Authorities' response

64. The authorities were in broad agreement with the assessment. On the issue of conflicting objectives (practice 1.1), there had been earlier attempts in 1991 and 1995 to pass central bank legislation with a single primary objective of price stability; however, this effort did not succeed. Regarding allocation of central bank profits (Principle 1.2.5), the authorities mentioned that the proposed central bank reform law contained provisions that would treat capital shortfalls and surpluses symmetrically, with a view to maintaining central bank capital at an adequate level. With regard to practice 3.2.1 (balance sheets and accounting standards), the central bank was considering the introduction of Generally Accepted Accounting Principles (GAAP) as its accounting standard.

B. Transparency of Financial Policies (Banking Supervision and Payment System Oversight)

General

65. The institutional structure governing banking supervision includes the central bank, the National Council of Supervision of the Financial System (CONASSIF), and the Superintendent of Financial Entities (SUGEF). SUGEF was created in 1995 as an autonomous ("decentralized") agency within the administrative structure of the central bank, with a governing board overseeing its activities. This governing board was replaced by the CONASSIF, also an administrative unit of the central bank, upon its creation in 1998. CONASSIF is the overarching supervisory authority for the financial sector, overseeing and coordinating the work of the superintendents of banks, securities, and pensions.

66. Oversight over the payment system is primarily vested in the BCCR by virtue of the central bank law; SUGEF has certain supervisory powers as well. Consistent with the approach taken in conducting the CPSS Core Principles assessment, only BCCR transparency practices in the area of payment systems oversight were evaluated, as the BCCR is the supervisory agency that oversees the main components of Costa Rica's payment system.

Main findings

Clarity of roles, responsibilities, and objectives of supervisory agencies

67. Overall, the financial agencies responsible for banking supervision in Costa Rica display a high level of transparency. Regarding clarity of roles and responsibilities—which

should contribute to facilitating accountability—the not yet fully crystallized relations between the CONASSIF and SUGEF, including the lack of modalities of accountability with regard to the actions specific to CONASSIF, seems to constitute an institutional weakness. CONASSIF and SUGEF explain responsibilities and objectives on their respective websites, and the SUGEF's authority to conduct financial policies is disclosed through legislation and the internet. The broad modalities of accountability for SUGEF are publicly disclosed, but those of CONASSIF are not clearly defined or disclosed. CONASSIF regulates information sharing between various superintendents.

68. Regarding payments system oversight, broad objectives are defined in the law, although there is uncertainty whether SUGEF plays a role in the supervision of payments systems not administered by the BCCR. The exact delineation of each agency's oversight responsibilities could be more clearly demarcated. General policy principles applicable to the payments system overseen by the BCCR (SINPE) are contained in the Blue Book, available to participants, which also contains applicable regulations.

Open process for formulating and reporting of supervisory policies

69. The process for formulating and reporting policies related to banking supervision is generally open, although greater transparency can be achieved in the area of supervisory information sharing and on reporting the pursuit of CONASSIF-specific objectives. The regulatory framework and operating procedures, as well as the fee structure, are widely available. Not all information sharing arrangements are currently disclosed. A consultation process, mandated by the law on public administration, precedes every significant change in financial policies. Although SUGEF is bound to publish an annual report, CONASSIF does not.

70. In the area of payments system oversight, regulations concerning SINPE operations are published in the SINPE Bulletin. Fees are published in the Blue Book. Public consultations ahead of significant changes are routine.

Public availability of information on supervision

71. The degree of public availability of information on financial policies is high, owing in part to the web sites of the agencies involved. SUGEF publishes a quarterly Bulletin that reports on the major developments of the banking sector, as well as aggregate and individual institution data. The publications program of CONASSIF includes a monthly Bulletin. Senior officials of CONASSIF and SUGEF are ready to explain the agency's objectives and performance, usually in the form of an interview at the request of the press. Regulations are widely available, including on the internet.

72. There is currently no section in the BCCR's annual report devoted specifically to payments system oversight. There is also no reporting on statistics on SINPE operations. Regulations related to payments system oversight are easily accessible over the internet.

Accountability and assurances of integrity by supervisory agencies

73. There are some shortcomings in the area of accountability and assurances of integrity in banking supervision, in particular regarding the publication of information operating expenses—which are published only in a summarized form as part of the General Accounting Office budget execution documentation, and the lack of published internal governance procedures at CONASSIF. Uniform civil servant standards on personal financial affairs exist as noted above.

Authorities' response

74. The authorities were in broad agreement with the assessment and recommendations. They noted that the draft Laws of the Central Bank and the Banking System addressed some of the weaknesses noted in the assessments, in particular providing greater clarity related to the role of SUGEF in supervising other payments systems.

Table 1. Key Recommended Actions to Improve Observance of IMF's MFP Transparency Code Practices—Monetary Policy

Reference Principle	Recommended Action
I. CLARITY OF ROLES, RESPONSIBILITIES AND OBJECTIVES OF CENTRAL BANKS FOR MONETARY POLICY	
1.1 Clarity of objective(s) and framework of monetary policy.	Clearly state primary objective of price stability.
1.2 Institutional relationship between monetary and fiscal operations.	Announce government borrowing requirement to generate a clear monetary policy signal.
1.2.4 Central bank involvement in the rest of the economy.	Remove inoperative and noncore responsibilities from the central bank law.
1.2.5 Disclosure of central bank profits and capital.	Address the issue of maintaining the central bank capital in the law. Disclose agreements with the government on recapitalization.
II. OPEN PROCESS FOR FORMULATING AND REPORTING MONETARY POLICY DECISIONS	
2.1 Clarity of framework, instruments, and targets.	Acknowledge potential conflicts between internal and external stability and explain hierarchy of objectives and instruments.
2.3 Changes in the setting of monetary policy instruments.	Explain changes in interest rates.
2.3.1 Disclosure of monetary policy decisions.	Disclose policy decisions more broadly.
2.4 Periodic public statements on progress toward achieving its monetary policy objective(s) as well as prospects for achieving them.	Publish monthly reports on the implementation of monetary policy.
III. PUBLIC AVAILABILITY OF INFORMATION ON MONETARY POLICY	
3.2.1 Central bank balance sheet	Include detailed balance sheet in annual report with appropriate accounting standards.

Reference Principle	Recommended Action
3.2.4 Foreign exchange reserve assets, liabilities and commitments.	The holding of official foreign assets in state-owned BICSA should be acknowledged.
IV. ACCOUNTABILITY AND ASSURANCES OF INTEGRITY BY THE CENTRAL BANK	
4.1 Appearance of officials before designated public authorities.	Current practices need to be formalized.
4.2.1 Audited financial statements.	Use an external independent auditor.
4.2.2 Internal governance procedures.	Disclose internal governance procedures (only subject to internal security constraints).

Table 2. Key Recommended Actions to Improve Observance of IMF's MFP Transparency Code Practices—Banking Supervision and Payment Systems Oversight[25]

Reference Principle	Recommended Action
V. CLARITY OF ROLES, RESPONSIBILITIES AND OBJECTIVES OF FINANCIAL SECTOR SUPERVISORY AGENCIES	
5.1 Objective(s) and institutional framework.	Acknowledge more explicitly in legal framework the objectives of CONASSIF. Further clarify responsibilities of BCCR and SUGEF on payment system oversight.
5.1.1 Disclosure of objective(s) of agencies.	Clarify role of agencies in the area of banking supervision.
5.1.3 Accountability.	More clearly work out modalities of accountability for CONASSIF.
VI. OPEN PROCESS FOR FORMULATING AND REPORTING OF FINANCIAL POLICIES	
6.1.5 Information sharing and consultation.	Disclose information sharing arrangements in banking supervision.
6.3 Public reports.	Require CONASSIF to publish an annual report.
VII. PUBLIC AVAILABILITY OF INFORMATION ON FINANCIAL POLICIES	
	Include a section in the annual report on the payment system.
VIII. ACCOUNTABILITY AND ASSURANCE OF INTEGRITY BY BANKING SUPERVISORY AGENCIES	
8.2.2 Internal governance procedures.	Develop and publish governance procedures for CONASSIF.
8.3 Operating expenses and revenues.	Include information on expenses and revenues of CONASSIF and SUGEF into their regular publications.

[25] With respect to the BCCR, only recommendations that relate to its responsibilities in the area of payment and settlement systems are presented in the table.

VI. CPSS Core Principles for Systemically Important Payment Systems

A. General

75. The systemically important payments systems (SIPS) assessed were the Real Time Gross Settlement (RTGS) System TEF (*Transferencia Electrónica de Fondos*), and the check clearinghouse CLC (*Compensación y Liquidación de Cheques*), both of which form part of the comprehensive payments system referred to as SINPE (*Sistema Interbancario de Negociación y Pagos Electrónicos)* managed by the Banco Central de Costa Rica (BCCR).

76. Although the relative importance of checks has declined steadily, CLC still is a systemically important payment system given its significant volume—the average daily value of payments processed at end-October 2001 is broadly the same as that of the RTGS system, at US$104 million. All transactions performed through SINPE settle in the reserve accounts held by system participants at the BCCR, in local or foreign currency. All banking and nondepository financial institutions *(Financieras)*, as well as mutually owned financial entities, are SINPE participants. At present, four brokerage houses (*Puestos de Bolsa*) are SINPE users while the rest are expected to become users by the end of 2001. Some nonfinancial institutions are also SINPE participants.

B. Main findings

Preconditions

77. The telecommunications infrastructure, technical infrastructure and security arrangements are of adequate quality. Minimum standards are promulgated and certification of both central and participant computer based terminals and communication lines are made by qualified central bank personnel. Failure recovery procedures are in place and prevent any loss in payment messages during periods of outage. The system's architecture contains sufficient built-in redundancy and back-up capabilities

Legal foundation (CP I)

78. SINPE's legal framework has some weaknesses: (i) risk management procedures and contracts might not be enforceable in all circumstances, especially in the case of bankruptcy of one or more system participants; (ii) there is no explicit legal recognition of netting arrangements; (iii) in case of insolvency, there is no clarity of the timing of final settlement; (iv) there is no explicit zero hour rule; and (v) there is no legal clarity on which is the authority empowered to regulate and oversee payment systems provided outside the BCCR.

Understanding and management of risks (CPs II-III)

79. A guarantee scheme is in place, requiring that each participant pledges securities at the central bank to ensure timely settlement of checks and other retail payment systems that clear on a multilateral basis and settle within the SINPE, based on a "defaulter pays" arrangement. In extreme cases, an automatic unwinding procedure is applied to recalculate the multilateral balances in case of failure of one of the participants.

80. Financial institutions are allowed to use their reserve requirements during the day for payment purposes. To limit the incentive to withhold payment orders, BCCR introduced a strict pay-in schedule to spread payment orders over the day. The pay-in schedule may limit the freedom of customers to conduct payments and face difficulties in the future as the intraday payment flows become larger and more unpredictable due to a foreseeable deepening of the financial markets. Overdrafts in the current account are not allowed; nor can the BCCR grant intraday loans to temporarily illiquid banks.

Settlement (CPs IV–VI)

81. For the CLC, the moment of final settlement is clearly defined. However, it might not be legally effective due to the problems outlined in Principle I. In addition, as the calculation of required collateral excludes extreme positions, it might be insufficient, triggering an unwinding. Should the largest participant fail to settle, other participants could become short despite their own collateral postings.

82. The BCCR's liquidity facility could run into difficulties in the case of a bank's insolvency as pledged securities may become frozen under current insolvency procedures. Also, since pledged securities are not subject to mark-to-market valuation, unexpected swings in interest rates can reduce the market value of the collateral and make it insufficient to fund a shortage when needed.

Security and operational reliability, and contingency arrangements (CP VII)

83. The technical infrastructure and security arrangements provided by the central bank are adequate. The system's architecture contains built-in redundancy and back-up capabilities typical of open systems. However, while business continuity arrangements are documented, they are not regularly tested.

Efficiency and practicality of the system (CP VIII)

84. There is still excessive reliance on check clearing for large value transfers. Even if the TEF system appears practical and reliable, the use of liquidity is not fully efficient, and there are potential risks of shortage of intraday liquidity that might have a negative impact on the practicality and overall efficiency of the system.

Criteria for participation (CP IX)

85. Access criteria are identified and are not discriminatory. It needs to be more carefully assessed whether the case of exclusion by one participant has been properly addressed.

Governance of the payment system (CP X)

86. Rules and regulations on the system and its operations are readily available, complete and up-to-date, with sufficient cooperation and coordination between participants.

Central Bank Responsibilities in applying the CPs

87. The BCCR offers a platform of co-operation and consultation for payments system reform through the Advisory Committee on Payment Systems and has disclosed its payment system policy objectives publicly though the Advisory Committee meetings. Coordination with other local supervising agencies exists through CONASSIF. Both the current and proposed new draft Law of the BCCR seem to restrict the scope of the oversight function to systems operated by the central bank, leaving it without the ability to oversee payment systems administered by other service providers.

C. Authorities' response

88. The authorities considered that some of the legal issues (CP-SIPS I) raised by the assessments had been already taken into account in the Draft Law Reforming the Organic Law of the BCCR. They did not fully agree with the comment as regards the method used for estimating the collateral that banks must pledge to the clearing house guarantee scheme. They indicated, however, that they would undertake some "stress test" simulations and, if necessary, would improve the mechanism. Concerning the potential liquidity risk in the RTGS (CP-SIPS III), the issue was totally new for the BCCR, which had just started considering alternatives to deal with it. A significant drawback was that the country did not have an automated CSD which implied that it will take some time before the BCCR is able to perform intraday repos. Additionally the lack of a deep money market limited the scope for interbank intraday loans. Nor did the authorities fully agree that the penalty imposed for noncompliance with the pay-in schedule was considered expensive by some participants and might face difficulties. The authorities did not agree either, that users' tariffs were high. They stressed that the tariffs, which had been accepted by participants, aimed at full cost recovery, in compliance with the goal of economic efficiency (CP-SIPS VIII). A tariff reduction could be envisaged as the volume of transactions increased in the future.

Table 3. Recommended Actions to Improve Observance of CPSS

Reference principle	Recommended action
Legal foundation	
	Address legal validation of multilateral and bilateral netting, protection against bankruptcy procedures and settlement finality. Clarify responsibilities for payments oversight.
Understanding and management of risks	
	Limit credit risks and protect the check clearing system against failures of potential participants. Strengthen analysis and management of intraday liquidity for the RTGS.

Reference principle	Recommended action
Settlement	
CP V and VI. Daily settlements	Undertake simulations to assess compliance with CP V. If needed, augment the guarantee fund. More frequent valuation of collateral would be advisable.
Security and operational reliability, and contingency arrangements	
CP VII. Security and operational reliability.	Update documentation and improve and test contingency arrangements .
Efficiency and practicality of the system	
CP VIII. Practical means of payments	Assess additional ways to enhance use of TEF.
Criteria for participation	
CP IX. Fair and open access.	Evaluate scope for exclusion of participant unable to settle.
Central bank responsibilities in applying the CPs	
Definition of payment system objectives . Compliance with core principles. Oversight of other payment systems. Coordination.	Disclose aggregate statistical information on SINPE and develop a policy statement on development strategy. Separate central bank functions as provider and overseer. Strengthen monitoring of other payment systems. Ensure full integration of SAC with the rest of payment system.

VII. Basel Core Principles for Effective Banking Supervision

A. Summary Assessment

89. Banking regulation and supervisory practices have experienced a notable strengthening during the last few years. As the banking system evolved from a public monopoly to market competition, the supervisory focus progressed in parallel, from a pure compliance-based framework towards risk-focused supervision. Nonetheless, much still remains to be done to bring the supervisory system into full compliance with the BCPs. The current limited level of compliance mainly reflects the absence of an adequate legal and regulatory framework for the consolidated supervision of banks and affiliated entities. Important weaknesses also exist as regards the legal framework, regulatory compliance and discipline, prompt corrective actions, and accounting and auditing issues.

B. Main Findings by Groups of Principles

Objectives, autonomy, powers, and resources (CP 1)

90. The supervision of the banking system is under the responsibility of the *Superintendencia General de Entidades Financieras* (SUGEF), which reports to the *Consejo Nacional de* Supervisión *del Sistema Financiero* (CONASSIF), which in turn is a dependency of the *Banco Central de Costa Rica* (BCCR). CONASSIF is the overarching supervisory authority for the financial sector, overseeing and coordinating the work of the superintendencies of banks (SUGEF), securities market (SUGEVAL), and pensions (SUPEN). The superintendents of each of these three agencies participate in meetings of CONASSIF, but

do not vote. Under the current framework, CONASSIF determines the basic supervisory policy and exercises significant oversight over the internal administration of SUGEF, SUGEVAL, and SUPEN. CONASSIF is embedded in the BCCR's organization, and its members do not serve on a full time basis.

91. The SUGEF is financed by the supervised institutions (20 percent) and the BCCR (80 percent). In practice, the BCCR approves the overall size of SUGEF's budget, which has occasionally not been sufficient to carry out off-site inspections and conduct adequate training programs. Although the budgetary allocation is decided by the SUGEF and the salary of supervisors appears sufficient to hire and retain staff, the SUGEF is constrained by very stringent norms for contracting external services, as all other public institutions in Costa Rica.

92. CONASSIF is empowered with the issue of prudential regulations, including accounting and auditing rules, definition of economic groups, mergers and acquisitions of banks, etc. The SUGEF can request from banks—but not from the offshore subsidiaries nor from the nonsupervised financial institutions that belong to a banking group—as much data as deemed necessary to carry out its duties.

93. **Assessment.** The Costa Rican legislation does not ensure a proper balance between the powers that CONASSIF enjoys and the requisites and dedication asked to its Board members. It does not clearly establish that Board members should not only possess sufficient banking experience but also be fully committed to the supervisory and regulatory tasks of CONASSIF, particularly considering that the superintendents lack voting rights. In addition, although CONASSIF provides in principle a vehicle for coordinating supervisory policies and procedures, in practice there is limited coordination among agencies responsible for financial markets supervision. Other major institutional and legal weaknesses include the fact that SUGEF is not empowered to request relevant information from offshore subsidiaries that are operating as banks in Costa Rica, thus preventing the supervisory authority from having a comprehensive view of the banking system. In addition, neither Costa Rica's general legislation for civil servants nor its financial legislation include any type of legal protection for the supervisory agency or its personnel.

Licensing and structure (CPs 2–5)

94. The law defines which financial institutions are authorized to intermediate funds from the public and which operations are allowed for each of the various types of financial institutions contemplated in the Law. The *Ley Reguladora de Empresas Financieras No Bancarias* (LEFNB) defines the permissible activities of supervised non-bank financial institutions (NBFI), ruling out the ability to raise sight and saving deposits from the public. Nonetheless, offshore subsidiaries of Costa Rican financial groups are able to raise deposits from the public without proper supervision.

95. CONASSIF licenses new banking institutions taking into account the opinion rendered by SUGEF. A BCCR resolution defines the criteria for the creation and mergers of banks and the authorization of banks and banking agencies and details the procedures and minimum requirements for the authorization of a banking institution. It also sets minimum initial capital requirements. While the BCCR has issued regulations covering requirements and procedures

for the initial authorization of new financial institutions, these no longer apply once institutions are operating and are not useful to monitor authorized institutions on a continuous basis.

96. CONASSIF lacks the legal authority to withdraw licenses granted to financial institutions once authorized, even if such licenses were granted based on misleading information (however, it can intervene the institutions).

97. **Assessment**. The supervisory authorities are unable to prevent "opaque" bank ownership structures, which hinder the assessment of compliance with *fit and proper* tests on an on-going basis. SUGEF also faces some limitations to obtain detailed information on the investments the original shareholders of a bank have in other enterprises or institutions, including in the economic group to which the new bank belongs. Moreover, the purchase of a significant share of a bank's capital does not need to be authorized by the supervisor (while the operation needs to be reported, the supervisors do not have the power to reverse it). Other weaknesses include the fact that, as nonregulated offshore banks are taking deposits from the public in Costa Rica, not all deposit taking institutions are de-facto licensed in Costa Rica.

Prudential regulations and requirements (CPs 6–15)

98. SUGEF lacks a suitable legal framework to ensure compliance of certain prudential regulations and norms. It does not have the power to enforce corrective measures at institutions that engage in unsafe or unsound banking practices, especially when this requires qualitative judgment. Nor does SUGEF have full access to information on a bank group (i.e. offshore banking and some domestic activities, such as leasing, factoring, and credit card lending), which makes it almost impossible to ensure compliance with laws and regulations in a consolidated manner—SUGEF lacks the authority to supervise and regulate financial activities carried out by financial groups, which represent a significant share of financial intermediation in Costa Rica.

99. **Assessment**. The lack of consolidated supervision hampers the capability of authorities to establish effective prudential regulations. Although financial private groups submit to SUGEF some general information on a consolidated basis, the latter is clearly insufficient for supervisory purposes. Moreover, present norms do not allow to effectively validate this limited information through on-site examination. This is an important flaw that undermines effective supervision and explains much of the under-compliance with the BCPs. The regulatory framework needs to be amended to adopt best international practices in this regards. There is also need for training programs to improve supervisors' grasp of risks other than credit risk. As regards Principle 15 (know your customer), the regulatory framework is in line with best international practices. However, although some provisions are in place for the reporting of offshore operations, the lack of consolidated supervision impedes SUGEF from verifying proper compliance with these rules.

Methods of ongoing supervision (CPs 16–20)

100. The SUGEF's organizational structure comprises three main supervisory areas—according to supervised institutions (private banks, public banks, and NBFI and

cooperatives)—and a unit of global risk, norms, and studies. The director of each supervisory area is responsible for both on-site supervision and off-site monitoring, which facilitates coordination between on- and off-site supervision.

101. **Assessment**. The supervisory process requires a more risk-focused supervision, both on a solo basis as well as on a consolidated basis. More substantial contributions from (and accountability of) external auditors are needed. Training programs to enhance the capabilities of supervisors are also required. Although there is no general requirement for banks to notify substantive changes in their activities or any material adverse developments, high officials of the SUGEF are generally informed in advance of major events in supervised institutions.

Information requirements (CP 21)

102. Financial information of banks and financial groups must be audited on a yearly basis. Audit reports are submitted to the SUGEF along with the *Carta de Gerencia* that contains recommendations on accounting practices and issues. The SUGEF does not meet periodically with external auditors of banks to discuss common concerns.

103. SUGEF lacks the legal authority to ensure that information from financial groups is verified through on-site examinations. It also lacks the authority to revoke the authorization of external auditors and has not issued guidelines on the scope and content of external audits. There is no open communication between supervisors and external auditors. Due to the lack of definition on procedures and accounting rules issued by the SUGEF, there is evidence that different banks book similar operations in different ways.

104. **Assessment**. There are several voids in accounting rules that allow banks to apply different criteria when recording similar operations, which in turn hinders the comparison of accounting information among banks. Moreover, the lack of accounting guidelines regarding prudential issues allows banks to "hide" their financial condition. In this context, there is ample room to strengthen the oversight of supervisors over external auditors and enhance the complementarities of their work.

Formal powers of supervisors (CP 22)

105. Article 155 of the Central Bank Law empowers the supervisors to sanction entities but not persons. The sanctioning regime includes monetary fines, suspension to operate in the foreign exchange market, and suspension to operate at all. Additionally, CONASSIF is empowered to withdraw banking licenses for major offences (Article 171-d of the Securities Markets Law).

106. Available remedial actions are established in a regulation (SUGEF 24–00) that also establishes the methodology to determine the financial condition of banks. According to this norm, capital adequacy is the main indicator through which banks are classified into one of four categories (*normal, irregularidad 1, irregularidad 2, and irregularidad 3.*) This classification also determines the corrective actions available to the authorities; only banks not classified as *normal*—which already entails a capital adequacy ratio below the minimum requirement—merit remedial action.

107. **Assessment.** The current legal framework does not provide an adequate Prompt Corrective Action system that ensures consistency in the supervisory response to banks undertaking unsafe and unsound practices. At the same time, there is no a graduated system that matches stiffer penalties with more serious infractions. As a result, infractions by bankers are not penalized in practice, which severely undermines the enforcement and supervisory credibility of the SUGEF. In addition, the range of possible actions available in case of bank insolvency (*irregularidad 3*) is quite narrow, as the only option is the intervention and liquidation of the bank. The legislation does not consider intermediate steps, such as barring individuals from banking, the transfer of assets and deposits to, or a take-over or merger with, healthier institutions, etc.

Cross-border banking (CPs 23–25)

108. The current regulation does not allow the supervisor to prohibit banks or financial groups from establishing operations in countries with secrecy laws or other regulations prohibiting flows of information deemed necessary for adequate supervision.

109. The SUGEF conducts the supervision of subsidiaries in Costa Rica of foreign banks based on the same regulations and similar supervisory procedures applied to domestic private banks.

110. **Assessment**. SUGEF is not empowered to supervise the foreign activities of financial institutions that belong to a Costa Rican financial group. At the same time, although there is no legal restriction in place, currently SUGEF does not share any kind of information on the domestic activities of the subsidiaries of foreign banks with the home country supervisor. Moreover, the law does not require, before issuing a license, to determine whether approval from the home supervisor has been received. Although the SUGEF has established a dialogue and agreements with some countries, an effective system of systemic information exchange is needed with all countries where Costa Rican financial groups have established agencies or subsidiaries. Indeed, the host supervisor of Costa Rican offshore banks does not provide any information on the operations related to those entities.

C. Authorities' Response

111. The authorities indicated that, while the assessment broadly reflected the current situation of bank supervision, it did not sufficiently reflect the efforts made during the last three years to strengthen it. Very important progress has taken place during the past few years in the area of consolidated supervision, including through better reporting requirements and closer links with foreign supervisors. In addition, the authorities thought that the assessment for Costa Rica was more severe than that for some neighboring countries, given what they knew about their legal framework and supervisory practices.

Table 4. Summary of Main Findings of Assessment of Implementation of the Basel Core Principles for Effective Banking Supervision

CPs Main Categories	Main Findings
Objectives, Autonomy, Powers, and Resources (CP 1)	Institutional arrangements create imbalances between the broad responsibilities and powers of CONASSIF and its legal structure and resources.
Licensing and Structure (CPs 2–5)	Supervisors cannot ensure that bank owners meet *fit and proper* test in on-going basis. In practice there are nonregulated deposit taking institutions in Costa Rica.
Prudential Regulations and Requirements (CPs 6–15)	Lack of consolidated supervision undermines effectiveness of prudential norms when banks belong to a nonregulated financial group.
Methods of Ongoing Supervision (CPs16–20)	Supervision needs to be more focused on a risk approach. Oversight of external auditors and training programs for supervisors need strengthening.
Information Requirements (CP 21)	Voids in accounting rules allow banks to apply different criteria when recording similar operations. Enhance complementarity of work of auditors and supervisors.
Formal Powers of Supervisors (CP 22)	Insufficient legal powers and tools for effective Prompt Corrective Action system.
Cross-border Banking (CPs 23–25)	Authorities are not empowered to supervise the foreign activities of financial institutions that belong to a Costa Rican financial group.

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

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

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

Table 2. Costa Rica: Financial Soundness Indicators for the Onshore Banking Sector 1998–2001

(In percent, unless otherwise indicated)

	December 1998	December 1999	December 2000	August 2001
Capital Adequacy				
Regulatory capital to risk-weighted assets				16.1
Public banks				17.4
Private banks				17.0
Asset Composition and quality				
Loans to specific sectors (as percent of total)				
Consumption	25.4	24.0	22.6	24.5
Housing	13.4	15.1	16.1	20.6
Commerce	17.4	16.0	16.6	16.1
Foreign exchange loans to total loans	31.0	37.6	47.1	50.3
NPLs to gross loans1/	17.8	13.5	14.4	11.7
NPLs to gross loans 2/	3.2	2.7	3.5	2.7
NPLs net of provision to capital 3/	66.8	52.6	61.4	49.2
Earnings and Profitability				
ROA	1.2	1.6	1.5	1.8
ROE	12.3	17.0	14.7	17.1
Interest margin to gross income 4/	29.7	29.9	32.4	35.9
Noninterest expenses to gross income 5/	31.2	33.3	33.4	35.9
Personnel expenses to noninterest expenses 6/	62.1	60.3	55.8	57.1
Spread between reference loan and deposit rates 7/	9.9	11.9	12.2	11.8
Liquidity				
Liquid assets to total assets 8/	13.7	11.8	11.1	10.5
Liquid assets to total short-term liabilities 9/	45.2	38.0	31.7	29.4
Customer deposits to total (non-interbank) loans	170.0	160.0	150.0	140.0
Foreign exchange liabilities to total liabilities	44.8	46.1	47.2	51.0
Sensitivity to market risk				
Duration (or average repricing period) of liabilities 10/				2
Net open position in foreign exchange to capital	44.0	48.0	58.0	64.0

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

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

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

(As of January 16, 2002)

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

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

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

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

Table 4. Sovereign Ratings, (October 2001)

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

Source: J.P. Morgan.

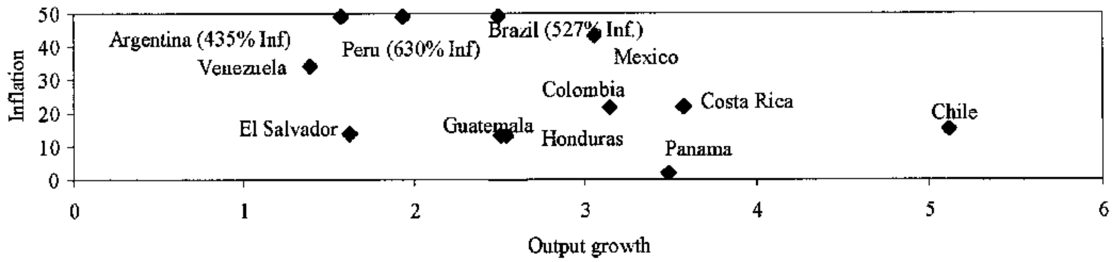
Table 5. Market Concentration in the Banking Sector, Selected Countries

Indicator	Share of the five largest banks in total assets (in percent)
Costa Rica 1/	
January 1998	85
December 1999	81
December 2000	77
August 2001	74
El Salvador (December 1999) 1/	73
Honduras (December 1999) 1/	51
Mexico 2/	82
Argentina 1/	38
Brazil 2/	52
Chile 2/	47
Germany 2/	17
United States 2/	35

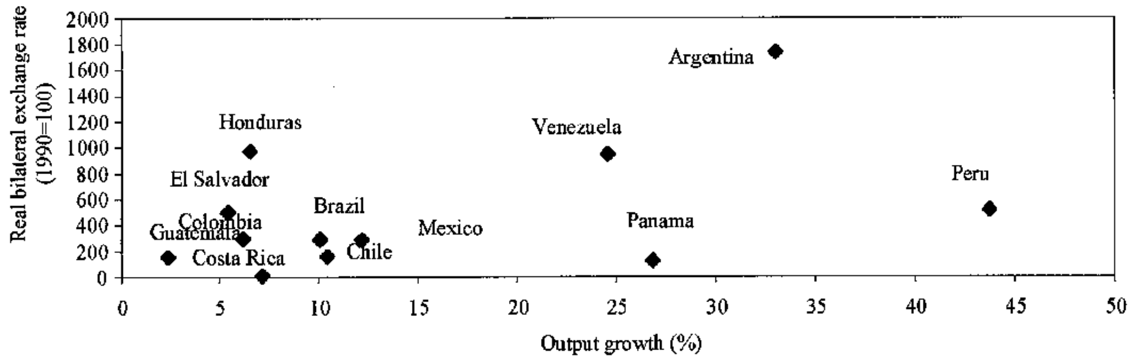
Sources:
1/ Superintendency of Banks of Costa Rica, El Salvador, and Honduras.
2/ Merrill Lynch (2001, Latin American Bank Stock. Monthly January. Data as of December 2000.

Figure 1. Costa Rica: Macroeconomic Volatility

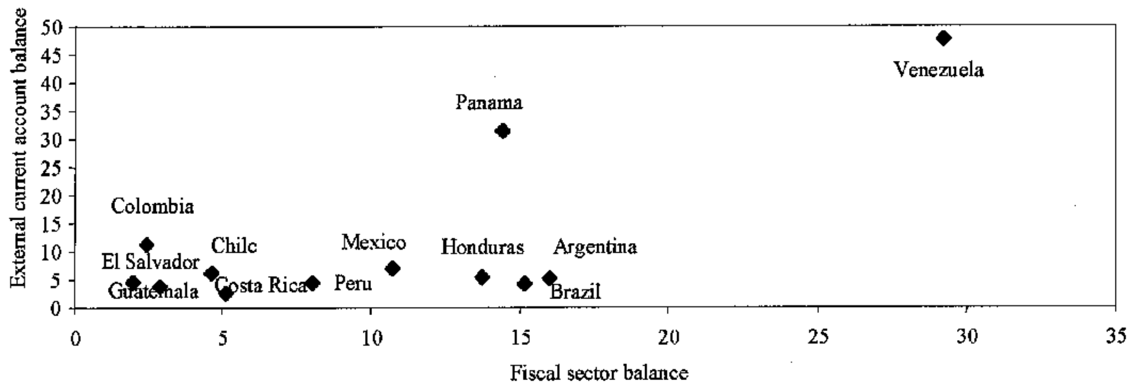
A. Average output growth and inflation, 1980-2000.
(In percent)



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

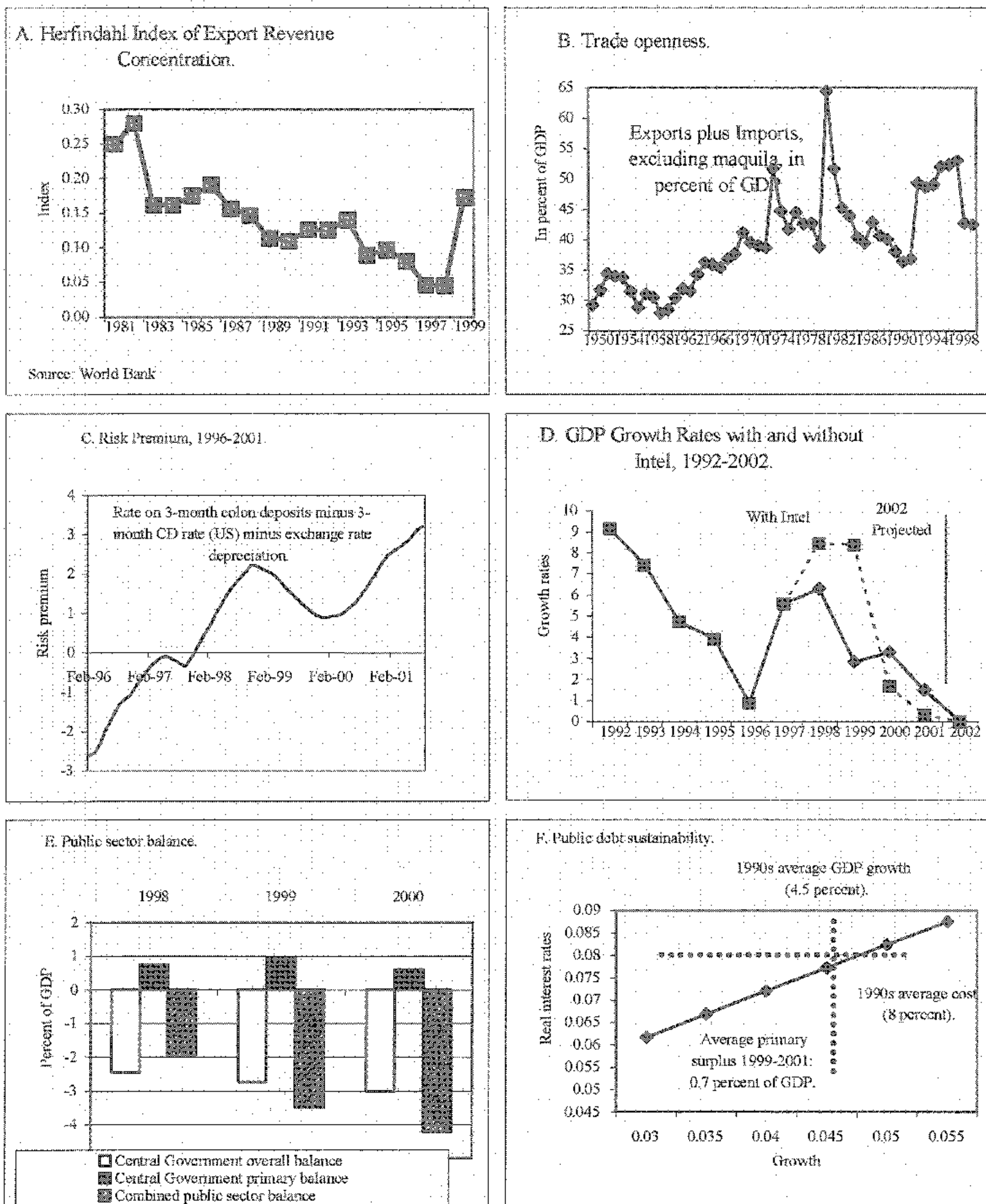


C. Fiscal sector balance and external current account balance volatility, 1985-2000.



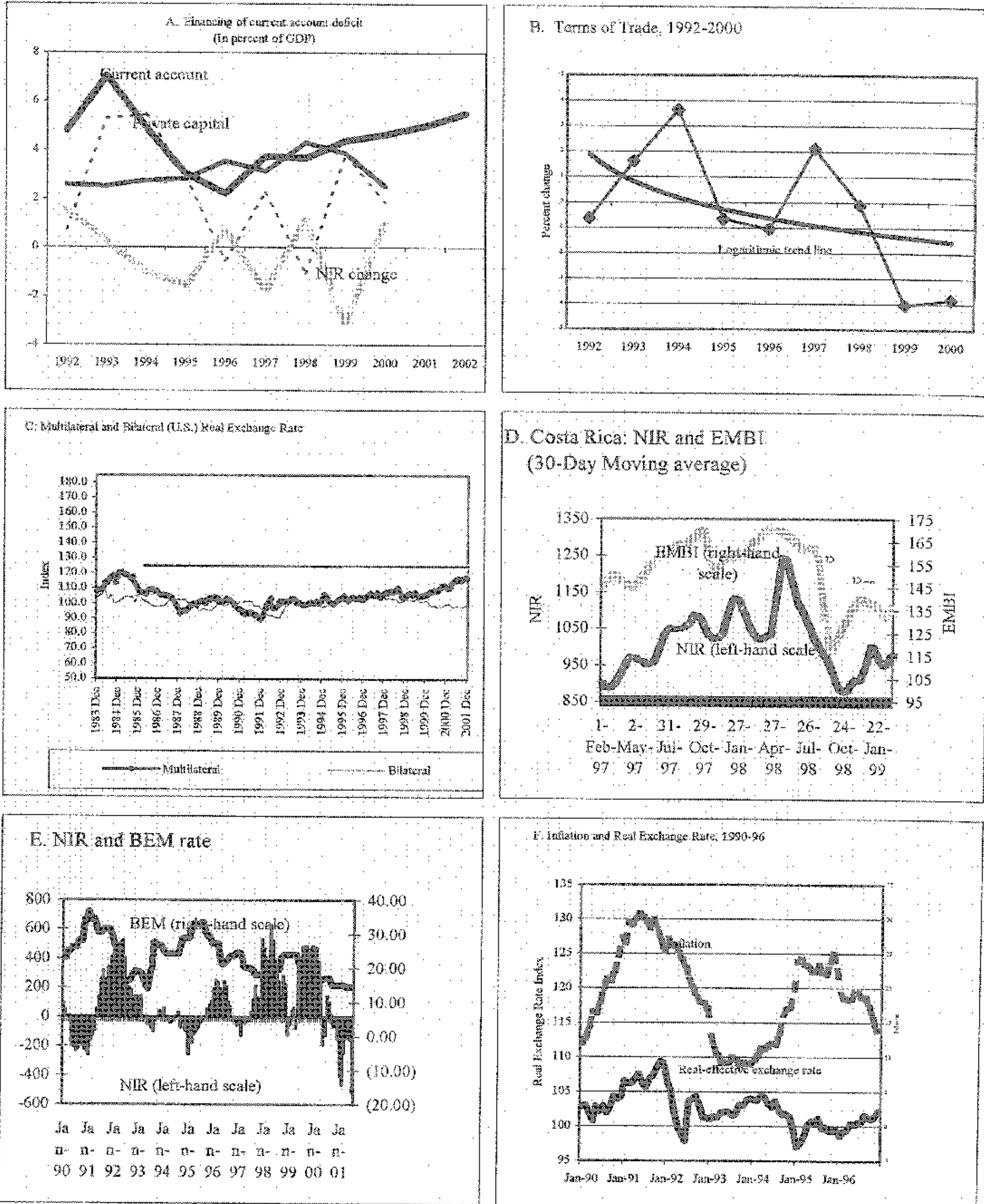
Sources: Central Bank of Costa Rica, National Sources, IFS and staff calculations.

Figure 2. Costa Rica: Main Macroeconomic Indicators



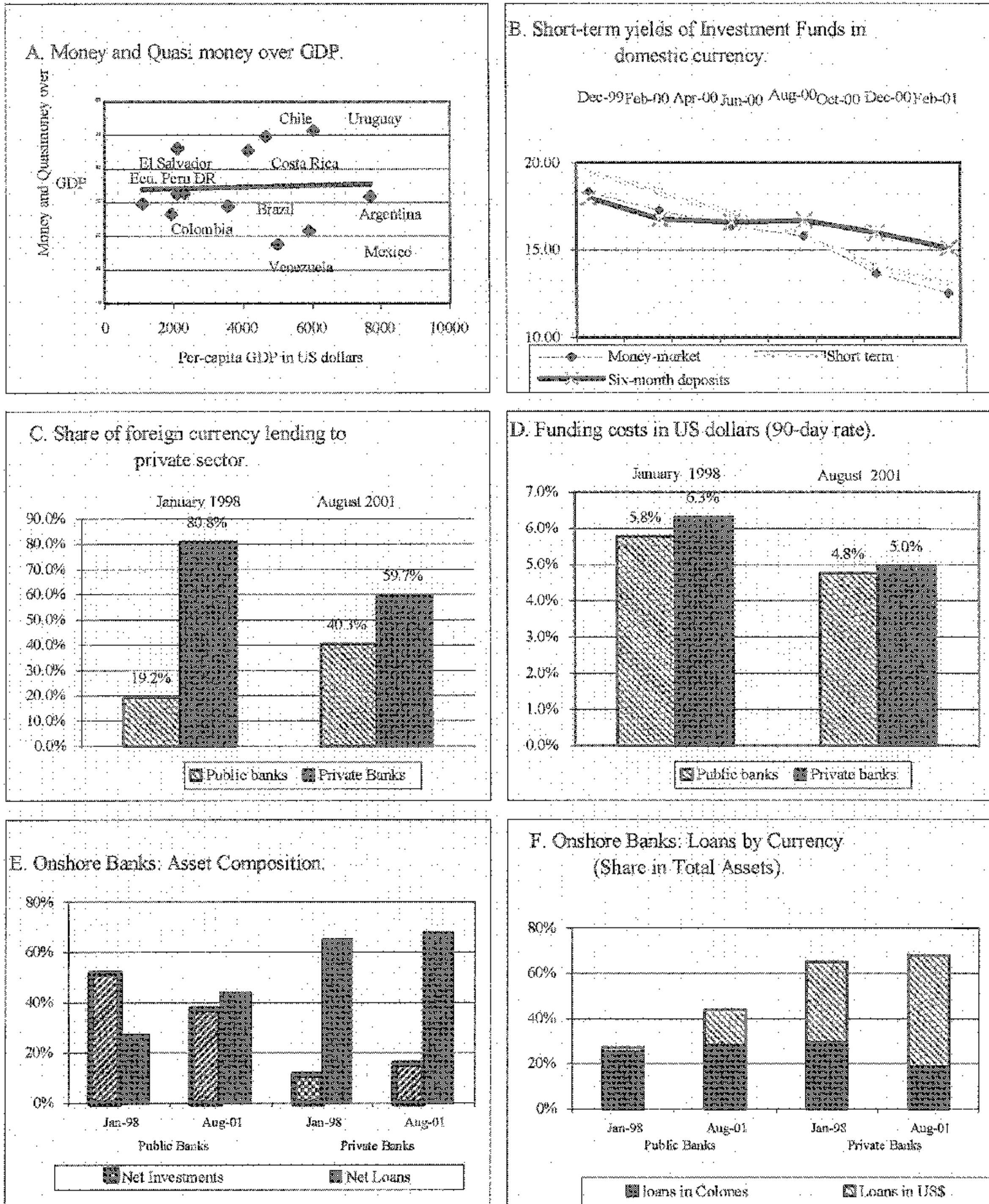
Sources: Central Bank of Costa Rica (unless otherwise specified), and staff calculations.

Figure 3. Costa Rica: External Indicators



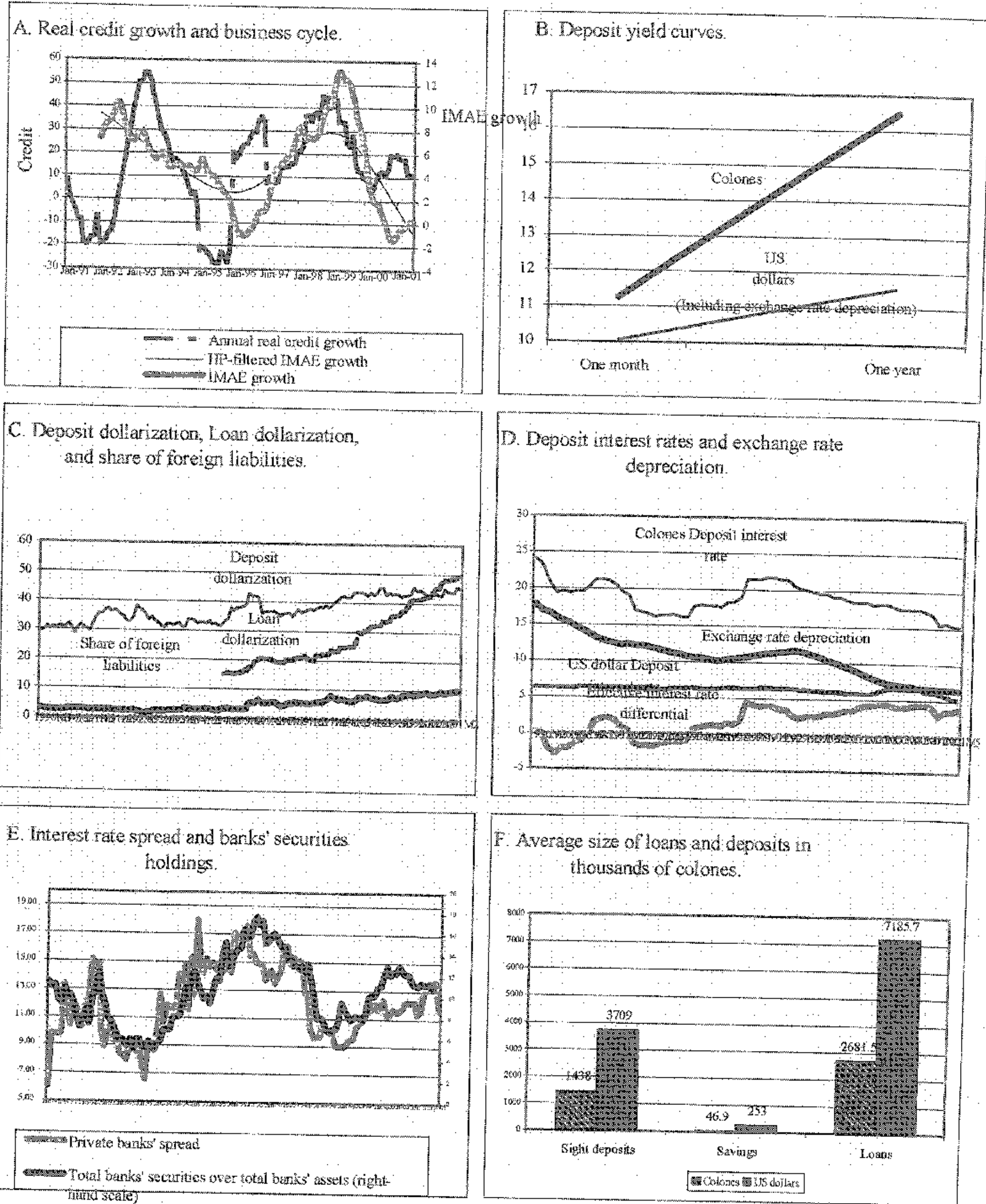
Source: Central Bank of Costa Rica, IFS, JP Morgan and staff calculations.

Figure 4. Costa Rica: Financial Indicators I



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

Figure 5. Costa Rica: Financial Indicators II



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

Figure 6. Costa Rica: Sources of Credit Growth

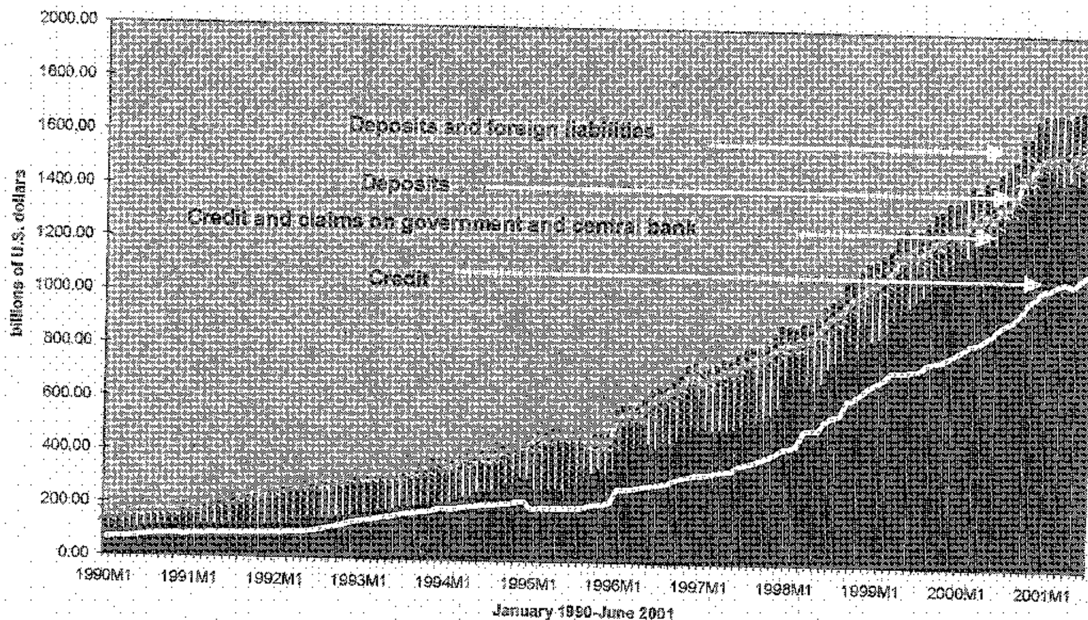
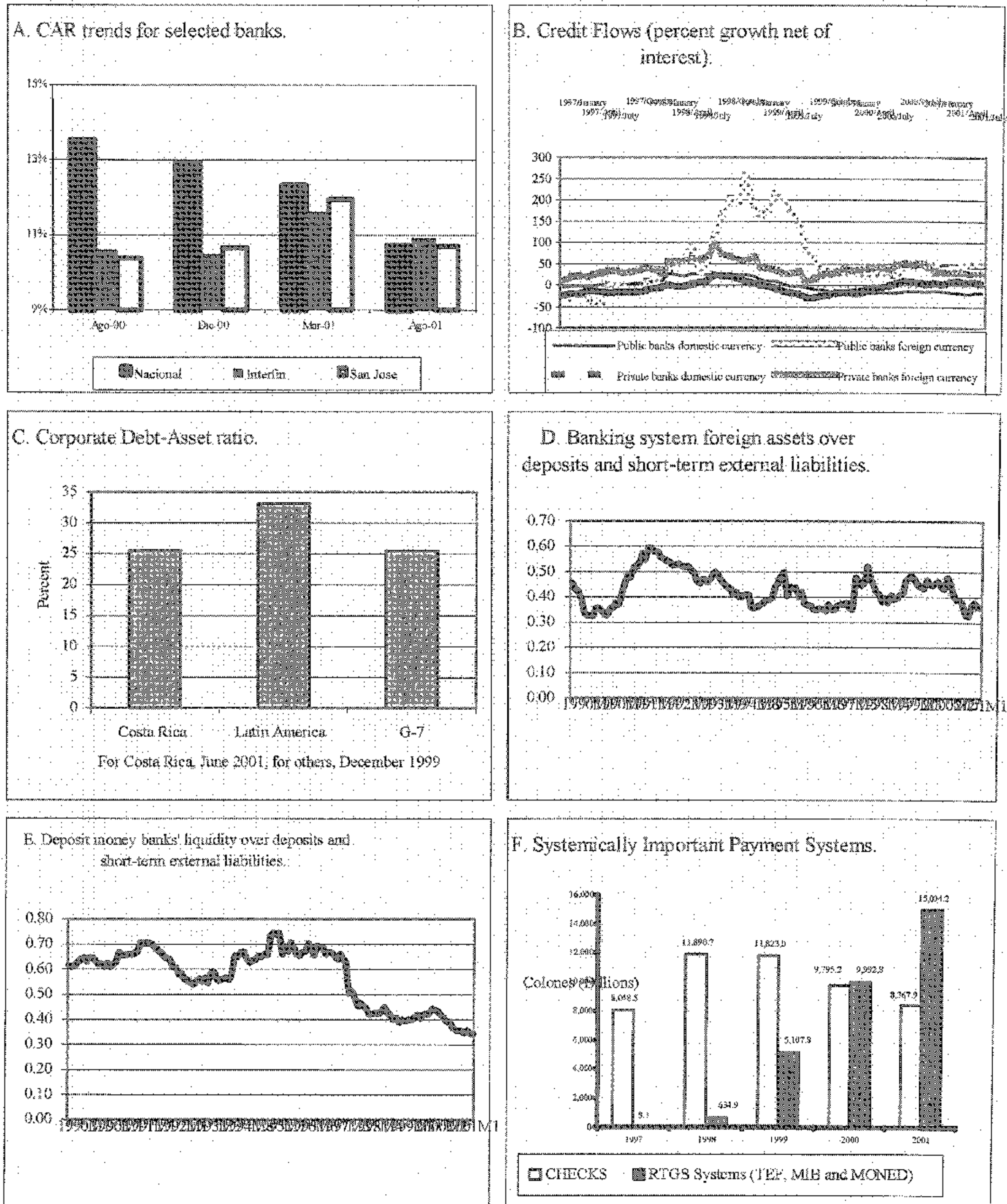


Figure 7. Costa Rica: Financial Indicators III



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

Costa Rica: Summary of FSAP Recommendations

	Short Term	Medium Term
A. Improving liquidity management and deepening the money market		
Enhance communications between the central bank and the market	X	
Eliminate rationing clauses in day-to-day liquidity injections by the central bank	X	
Develop a more active open market intervention capacity		X
Increase reserve funds set aside to ensure settlement finality for cleared checks	X	
Introduce repo-based mechanism of intra-day liquidity for the payment system		X
Introduce book entry system and associated securities clearance/settlement reforms	X	
B. Strengthening prudential management		
Establish joint supervision over financial groups	X	
Set capital requirements for financial groups	X	
Establish full consolidated supervision of financial groups		X
Introduce prudential measures to limit exposure to systemic risk	X	
Modify the functions and/or structure of CONASSIF		X
Fully eliminate asymmetries in the regulatory treatment of public and private banks		X
Modify the current SUGEF system to rate banks	X	
Increase supervisory focus on banks' own risk management systems, in part through incentives for banks to classify and provision correctly their loans	X	X
Establish know-your-customer guidelines to address AML concerns	X	
Enhance the complementarity of the work of bank supervisors and external auditors		X
Improve the coverage and reliability of information of, and facilitate access to, the debtor information system maintained by SUGEF		X
Establish a graduated system of penalties, and disclose enforcement actions		X
Address certain voids in banking system prudential and accounting norms, including adoption of chart of accounts consistent with International Accounting Standards	X	
Strengthen institutional support for mid-level supervisory decisions	X	
Clarify roles of SUGEVAL and Stock Exchange	X	
Enhance broker-dealer disclosure	X	
Introduce mark-to-market valuation of investment funds	X	
Bring *asociaciones solidaristas* under the oversight of SUPEN		X
C. Strengthening crisis management		
Eliminate the *préstamo de emergencia* LOLR window and improve design and operational arrangements of the *redescuento ordinario* LOLR window	X	X
Introduce a simple and effective system of triggers for prompt correction and manage it within regularization (*saneamiento*) plans	X	
Introduce an efficient system of bank closure and resolution and link it to the proposed establishment of a limited deposit insurance scheme		X
Modify certain features of the proposed deposit insurance scheme	X	
Create specialized courts for corporate reorganization/insolvency process or move substantial parts of the process out of the judiciary		X
Limit period of "stay on payments", presume validity of balance sheets in verifying claims, give salient role to creditors, remove presumption of fraudulent bankruptcy		X

	Short Term	Medium Term
Enable voluntary, extra-judicial corporate restructuring agreements		X
D. Fostering sustainable financial sector development		
Intensify efforts to standardize public sector debt securities and develop a market for CPI-indexed, colon-denominated public sector debt securities	X	X
Eliminate the monopoly of broker/dealers on securities transactions and custody, and consider the de-mutualization of the Stock Exchange		X
Raise disclosure, accounting, and corporate governance standards		X
Intensify efforts to assess the feasibility of regionalization of securities and other financial markets across Central America		X
Change the parameters of the defined-benefit, first pillar of the pension system so as to ensure its financial viability	X	X
Liberalize the insurance sector, beginning with allowing the entry of private insurance companies in the life and annuities businesses		X
Create a supervisory agency (or a function within an existing agency) for insurance		X
Create specialized courts that charge reasonable fees for the collateral repossession process, or move substantial parts of the process out of the judiciary		X
Give creditor greater leeway to peacefully repossess or sell the collateral		X
Issue regulations for "guarantee (or collateral) trusts"	X	