PD-ABI-209

Best available copy -- attachment has missing pages

PART I

(BEFORE FILLING OUT THIS FORM, READ THE ATTACHED INSTRUCTIONS) PD-ABI-209

ISN 87314

XD

IDENTIFICATION DATA

A. REPORTING A.I.D. UNIT: USAID/COSTA RICA (Mission or AID/W Office)

(ES# 94-2)

B. WAS EVALUATION SCHEDULED IN CURRENT FY ANNUAL EVALUATION PLAN? yes ☐ slipped ☒ ad hoc ☐

Eval. Plan Submission Date: FY 92 Q 3

C. EVALUATION TIMING interim ☐ final ☐ ex post ☐ other ☒

D. ACTIVITY OR ACTIVITIES EVALUATED (List the following information for project(s) or program(s) evaluated; if not applicable, list title and date of the evaluation report)

Project #	Project/Program Title (or title & date of evaluation report)	First PROAG or equivalent (FY)	Most recent PACD (mo/yr)	Planned LOP Cost ('000)	Amount Obligated to Date ('000)
	"An Assessment of the Costa Rican Financial Sector" Covers the entire financial sector, including the following AID investors: - ESF conditionality in 9 ESF agreements. - Local currency credit lines in the Central Bank totalling $169.5 million. - Dollar-funded credit projects (3) totalling $48.5 million.				

ACTION(S)

E. ACTION DECISIONS APPROVED BY MISSION OR AID/W OFFICE DIRECTOR Action(s) Required	Name of officer responsible for Action	Date Action to be Completed
Mission will assure distribution of this report to major counterpart institutions and IFI and other major donors.	Vinzenz Schmack	12/31/93

(Attach extra sheet if necessary)

APPROVAL

F. DATE OF MISSION OR AID/W OFFICE REVIEW OF EVALUATION: mo 8 day – yr 93

G. APPROVALS OF EVALUATION SUMMARY AND ACTION DECISIONS:

	Project/Program Officer	Representative of Borrower/Grantee	Evaluation Officer	Mission or AID/W Office Director
Signature				
Typed Name	Richard Wheiden		Ginger Waddell	Ronald F. Venezia
Date:	Nov 12/93	N/A	11/12/93	11/13/93

ABSTRACT

H. EVALUATION ABSTRACT (do not exceed the space provided)

The main purpose of the Assessment of the Costa Rican Financial Sector was: a) to review the progress made during the last decade in the development of the Costa Rican financial sector; b) the role of the USAID in this process; and, c) what further progress can and should be made in the coming years. The study should also serve as a possible guide for policy-makers, USAID and other international agencies.

The report analyzes the emergence of the private banks and financieras, the impact they had on state-owned banks, the changes in the legal and regulatory framework and the AID intervention in terms of money and conditions.

It also analyzes the supervisory entities, and the institutions which affect the financial market, like the local stock exchange, the social security system (Caja Costarricense de Seguro Social), the pension system, the nationalized insurance company (Instituto Nacional de Seguros), and the role of the Central Bank (BCCR), its changing role and degree of independence.

This evaluation documents in detail the changes that have taken place in the Costa Rican financial sector that may be attributable to USAID conditionalities and direct intervention. The report recognizes the important role the USAID assistance played in achieving substantial reforms, but is of the opinion that policy dialogue would have been a better way than conditionalities imposed on the GOCR through our ESF programs.

The report also points out that the AID direct assistance to selected financial institutions, does not give evidence that these banks have done better than the other private banks which have not received direct assistance from AID. The assistance given to all private banks through ESF local currency lines of credit have contributed to the strengthening of the private banks, but the dependence on these special lines of credit have led to a relative weak performance in the area of deposit mobilization. However, this statement is not supported by statistical evidence. Also, it does not take into account that at least initially the BCCR set a limit for each bank for the issuance of certificates of deposits (deposit mobilization).

COSTS

I. EVALUATION COSTS

1. Evaluation Team

Name	Affiliation	Contract Number OR TDY Person Days	Contract Cost OR TDY Cost (US$)	Source of Funds
Ronald A. Cartín	ACADEMIA	515-0000-C-00-7016-00	$104,110.00	515-0000,PD&S
Félix Delgado	ACADEMIA			515-0247,
Alvaro Feller	IMCC			Financial
Eduardo Lizano	ACADEMIA			Services Project
John J. McGuire	IMCC			
Robert C. Vogel	IMCC			

2. Mission/Office Professional Staff Person-Days (estimate) 30

3. Borrower/Grantee Professional Staff Person-Days (estimate) 15

A.I.D. EVALUATION SUMMARY PART II

J. SUMMARY OF EVALUATION FINDINGS, CONCLUSIONS AND RECOMMENDATIONS (Try not to exceed the 3 pages provided)
Address the following items:

- Purpose of activity(ies) evaluated
- Purpose of evaluation and Methodology used
- Findings and conclusions (relate to questions)
- Principal recommendations
- Lessons learned

Mission or Office: USAID/Costa Rica

Date this summary prepared: October 1993

Title and Date of Full Evaluation Report: An Assessment of the Costa Rican Financial Sector June 1993

PURPOSE OF EVALUATION

To review the progress made during the last ten years in the development of the Costa Rican fianancial sector, the role USAID has played in this process, and further progress to be made in the coming years in order to create an efficient financial market necessary for a modern, open economy.

FINDINGS

The report shows the important progress which has been made in modernizing the financial market. The progress can be seen in the emergence and strengthening of the private financial sector (banks, financieras, stock exchange), its positive effect on the State-owned banks, which were forced by the competition of the private banks to modernize. The BCCR has changed greatly in the areas of liberalization, decreasing intervention and the strengthening of the supervisory authorities.

Less progress has been made in regulating the other State-owned institutions, like INS, CCSS, and the State-owned pension funds, which are still tightly regulated and restricted in their investment policy.

SUMMARY

RECOMMENDATIONS

The Superintendency of Banks, AGEF (Auditoría General de Entidades Financieras), needs to be strengthened and professionalized and to take under its supervision also other non-banking financial intermediaries, especially savings and loan cooperatives. The Report recommends more independence for the BCCR, further modernization of the State-owned banks, liberalization of the investment policy of CCSS and INS, and privatization of INS. The report makes numerous recommendations to develop an more active stock exchange.

LESSONS LEARNED

1. The conditionalities imposed by the numerous ESF Agreements have been less efficient than a stronger policy dialogue would have been.
2. Targeted assistance to specific financial institutions has not shown the desired result, since these institutions have not shown any better performance than the institutions which have not received any direct financial assistance.
3. ESF produced local currency lines of credit have strengthened private banks in general, but in the area of deposit and resource mobilization, they were less successfull in the opinion of the evaluators. It is, however, clear that they contributed to the impressive growth of the private banking sector.

C

ATTACHMENTS

K. ATTACHMENTS (List attachments submitted with this Evaluation Summary; always attach copy of full evaluation report, even if one was submitted earlier)

Evaluation Report

MISSION COMMENTS ON FULL REPORT

L. COMMENTS BY MISSION, AID/W OFFICE AND BORROWER/GRANTEE

The report brings a good historical resumee of the changes which were made in the financial sector during the 1980 and makes detailed recommendations of the changes still to be made in order to create an efficient financial market necessary for an open, modern economy.

The report is complete and comprehensive; however, some of the statements lack statistical evidence, especially the statements that the special lines of credit, although necessary to strengthen private banks, led to a neglect of deposit mobilization. The special lines of credit could be regarded as seed capital. Once the banks were strong and demonstrated success, the importance of the special lines of credit declined and deposit and resource mobilization increased. Today, special lines of credit have lost their importance.

XD-ABI-209-A

ISN 87315

IMCC

A REPORT TO
THE UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT
COSTA RICA

AN ASSESSMENT OF THE COSTA RICAN FINANCIAL SECTOR

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June, 1993

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Executive Summary

The present assessment of the Costa Rican financial sector has two main purposes:

- to review the progress made during the past decade in the development of the Costa Rican financial sector and, in particular, the role played by the interventions of USAID in that development; and

- to indicate the key areas in which further progress can and should be made in the coming years as a possible guide to Costa Rican policy makers and to USAID and other international agencies.

A decade ago, in 1982, Costa Rica was in the midst of a major economic crisis that was severely affecting its financial sector. It was clear, as least to some, that factors both inside and outside the financial sector were contributing to a weak and declining financial sector that was in turn inhibiting the recovery and growth of the Costa Rican economy. On one hand, fiscal mismanagement had been a major element leading to exchange rate instability and inflation without parallel in Costa Rica's history, thereby creating an environment that was extremely inhospitable to the health of the financial sector. On the other hand, the financial sector itself had severe internal problems including, in particular, excessive and inappropriate government regulation, a Central Bank devoted primarily to the tasks implied by these regulations rather than the tasks of a modern Central Bank, and a government-owned banking system that appeared relatively very large and was certainly very inefficient.

There is no question of the importance that the modernization of the financial system can have within a process of structural adjustment geared toward promoting economic growth and a more active participation in world markets. It is also desirable that such modernization keep pace with policy reforms and liberalization in other sectors of the economy. The Costa Rican financial system has undergone numerous key reforms during the past ten years, and especially since 1984, with probably the most important being the general recognition that the efficiency of financial intermediaries matters. Most changes have benefitted the banking system, which has traditionally been the most visible and important part of the financial system, while less improvement can be found in other segments, that is, in non-bank financial intermediation.

The most significant reforms for the banking system have been related to the reduction in the Central Bank's historically excessive regulation of commercial banks, both government-owned and private, as well as improvements in the supervision of private banks. Interest rates were freed from Central Bank regulation in

order to respond to market forces. Monetary policy also shifted from instruments acting through the asset side of bank balance sheet to the more traditional and typical ones that work on the liabilities side. An important example is the elimination of credit ceilings determined by the Central Bank -- an instrument that was used widely in Costa Rica until the 1980s.

Measures to improve competition in the banking system have also been implemented during the past ten years. Simplification of procedures related to Central Bank regulations, access by private banks to more diverse sources of funds (including not only deposit-like instruments but also credit from the Central Bank itself) and improvements in information available to the public are among the areas that have been addressed. At the same time, supervision has been improved, especially for private banks, through legal reforms and administrative measures to protect depositors and reduce the risk of bank failures.

Although modernization of the Costa Rican financial system is clearly underway, there is still ample room for further improvements in the process. This is true not only for the system as a whole but even for the banking system where certain reforms are still badly needed. At least four key areas should be emphasized as the focus for continuing financial sector reform in the near future:

- improvements in prudential regulation and supervision of financial intermediaries;
- improvements in the functioning of government-owned financial institutions;
- reduction of fragmentation in the financial sector; and
- increased competition among various entities in the financial system, both domestic and foreign.

Supervision

The process that began in the mid-1980s to modernize the supervision of financial intermediaries is still at a critical stage due a variety of problems that continue to affect the performance of the Auditoria General de Entidades Financieras (AGEF) that must still be strengthened in several respects. The danger of reversion in the process of supervision of government-owned and private banks, as well as financieras, must be guarded against. The replacement of obsolete supervision techniques that stressed traditional auditing procedures by modern concepts that include loan and asset assessment, financial analysis, insider lending, etc., is an urgent reform that is still incomplete.

The range of the supervision of financial intermediaries is another area of ongoing concern. The possible extension of AGEF responsibilities to BANHVI and the mutuales, as well as to credit unions, should be studied, and the supervision of these entities should be assigned to some institution or other, with the decision implemented by an appropriate legal reform. Possible overlapping between the AGEF and the Comision Nacional de Valores in the regulation of securities issues and exchanges must also be avoided. Moreover, to the extent that financial liberalization is extended to other areas such as pension and insurance systems, prudential regulation and supervision by the AGEF, the Comision Nacional de Valores or some other specialized entity is crucial to take advantage of the stimulus that such changes could give to the development of capital markets in Costa Rica.

Government-owned Financial Institutions

Reduction in the non-competitive aspects of the banking system is a highly important issue. So long as no political decision is made to eliminate the monopoly of government-owned banks on demand deposits, improvements in the functioning of those banks is essential. Moreover, although interest rates have been freed from Central Bank regulation, problems of dispersion around a market rate and excessive spreads between rates on loans and deposits remain. The crucial importance not only of banks but also of other government-owned financial intermediaries -- BANHVI, the Banco Popular, the Instituto Nacional de Seguros, the various pension systems, etc. -- tends to be an obstacle to the development of the Costa Rica financial system, especially as far as their resource mobilization is strongly oriented toward financing fiscal deficits, so that funds are not necessarily allocated in accordance with private sector development needs.

Integration of the Financial System

The integration of a highly fragmented financial system is also an important area to be addressed in the near future. Regulation and supervision for macroeconomic and prudential purposes cover only a part of the system, thereby leading to other elements of the system that do not have to compete on the same basis, such as the very short-term instruments offered through the securities exchange and the credit union system. Measures to reduce segmentation in the Costa Rican financial system are also required in connection with the dual system represented by domestic and off-shore operations.

The lack of an effective capital market to provide longer term financing in Costa Rica and the need to make decisive improvements in this area are issues that are widely recognized. The integration of insurance and pension funds with the financial system instead of limiting their scope to investment in government debt instruments constitutes a very important objective for the near future. It is also important to introduce appropriate

supervision of private pension systems in order to foster their operations and thereby not only to reduce the destabilizing burden on the government-operated regimes but also to increase long term savings. It should be noted that analyses of the Costa Rican financial system have usually lacked of a comprehensive treatment that would disclose the importance of several kind of financial institutions other than banks. This point is emphasized in this report because of the importance of these institutions in the financial sector, as well as their potential role in promoting a long term capital market in Costa Rica.

Increasing Competition in the Financial System

Ways to increase competition in the financial system also deserve special consideration. Competition with foreign financial intermediaries is related to the decision to set up business directly in domestic markets or to operate from abroad. In either case, legal aspects have to be addressed to facilitate contracts in foreign currencies, and this is currently under discussion in the Costa Rican Congress as part of the reform of the Currency Law, along with other legal limitations on operations of international banks. On the other hand, domestic competition also requires further analysis on certain key issues such as the equal treatment of different intermediaries in terms of regulations, as well as the problem of fragmentation of the market, including the existence of an informal financial market noted above.

Liberalization of regulations with respect to the entry of new participants in the market is another important issue. Increased flexibility to enter the market, by eliminating or reducing barriers to entry, is a prerequisite to reducing whatever oligopolistic elements may still exist in the system. Opening competition instead of privatization could also be a viable solution for the insurance market. Moreover, as noted above, reform of legislation on pension systems is needed to foster the operation of private pension funds with appropriate regulation and supervision.

Macroeconomic Issues and Financial Intermediation

During the past ten years, continuing efforts have been made by the Costa Rican Government to deal with the fundamental macroeconomic imbalances that constitute a serious obstacle to economic growth. Short term policies, both fiscal and monetary, have continually been used to reduce the size of the public sector deficit, to seek out less harmful ways to finance it and to compensate, at least partially, for the monetary expansion caused by the Central Bank's deficit. As a result, the combined public sector deficit (which includes the non-financial public sector deficit and the Central Bank's quasi-fiscal deficit) has been kept under relative control,

and the Central Government and other governmental agencies have ceased to be financed through monetary expansion.

Structural reforms have also been introduced in the macro-financial environment. Some important sources of rigidity in government expenditures have recently been targeted, while legal reforms already approved by the Costa Rican Congress have reduced the impact of some perverse factors such as the pension regimes and tax exemptions. At the same time, the external public debt renegotiations concluded in 1990 have had a major favorable impact not only on the balance of payments position of the country but also on the Central Bank's deficit.

In the foreign exchange area, as well as in pricing policies, actions have also been taken as part of the slow but continuing process of policy reform geared toward the liberalization of the economy. The policy of exchange rate adjustment through a crawling peg system was recently replaced by a "dirty float" regime, where the rate is determined by the participating financial intermediaries taking into account market forces. Moreover, there is now less reliance on government regulation and determination of prices as compared with ten years ago.

There is nonetheless still room for further improvements in the macro-financial situation and related policies. The volatility in the fiscal deficit not only introduces a destabilizing element each year but also creates unfavorable expectations. More actions are required to reduce the fragility of the fiscal situation through structural reforms in both expenditures and taxes and to reduce the overall size of the public sector that is still so large that it leads to a "crowding-out" effect. Returning the required flexibility to monetary policy is also crucial, especially since the public sector deficit situation is fragile. A permanent solution to the problem of the Central Bank's losses, by transferring them to the government budget and using sound financing methods for the resulting increase in the deficit, not only enables monetary policy to be carried out properly but also appropriately returns the Central Bank's losses to their source. Finally, further efforts are required in the area of pricing policies, but mainly with respect to eliminating the legal rigidities for foreign exchange translations. This becomes an increasingly important issue as the process of economic globalization continues and the openness of the Costa Rican economy increases in both the current and capital accounts of the balance of payments.

Banks and Financieras

The Costa Rican banking system has come a long way during the past ten years. This is true for both the government-owned and the private banks. USAID interventions have played an important role

in this process by promoting the development of private banks through encouraging policy reforms and also providing direct assistance to private financial institutions. Nonetheless, it is not clear that more emphasis on the former (policy reforms) and less on the latter (specific assistance) might not have produced a more substantial and sustainable development.

A large group of small but generally financially sound private banks exist. They have developed a wide range of credit and other services aimed at a commercial ('wholesale') clientele. The controlling ownership groups of most of the private banks have established offshore affiliate banks, which provide an assortment of mostly U.S. dollar based deposit and credit services. Some are looking toward the day when they can establish a banking presence in Miami.

Competition from the private banks has forced the government-owned banks to modernize, become more efficient and, above all, become more responsive to their customers. Unfortunately, it can also be said that they have done too little too late. The private banks have 'skimmed the cream' of the private sector corporate business. It is doubtful that the government-owned banks will ever be able to recover much of the business they have lost. Although the government-owned banks show various signs of improvement, they are still inefficient and unprofitable institutions, beset by deeply entrenched labor unions and the implicit excess personnel, overlapping branch systems and, probably worst of all, enormous amounts of bad loans. On a more positive note, the Banco Nacional de Costa Rica has recently established what appears to be a quality credit administration and credit review function. Its allowance for loan losses as a percentage of its loan portfolio is considerable lower than that of the Banco de Costa Rica.

Costa Rican private sector bankers continue to complain about the legal prohibition against their offering checking accounts and the lack of access to the Central Bank rediscount window for liquidity needs. They have been very creative at finding an assortment of ways to make customers' funds effectively available on a demand basis. Also, most of the private banks have off-shore affiliates that can at least offer checking accounts in dollars. However, none of this is particularly efficient with respect to the customers' needs for normal checking accounts. The rediscount issue has largely been solved by the new rediscount facility partially funded by USAID and recently made available by the Central Bank. This facility should be adequate to protect individual financially sound private sector banks and the private bank system, as a whole, from sporadic liquidity crises. However, it is unlikely that it will be of any value to an insolvent bank, such as most, if not all, of those that have failed in recent years.

The principal recommendations with respect to the banking system are as follows:

1. Legislation should be passed enabling private sector banks to offer checking accounts. It will only simplify what they are already doing and enable the Costa Rican public to be more efficiently and economically served. It is reasonable to assume, however, that this would have another negative impact on the government-owned banks since they would most likely loose substantial checking account balances from large, corporate and commercial customers.

2. The AGEF needs considerable further strengthening in order to enable it to monitor the banking system adequately, take preventative measures to avoid or, at least minimize, the impact of bank failures, and to enable it to generate quality financial information for the system as a whole.

3. Legislation or at least Central Bank policy should be developed to force the off-shore banks doing business in Costa Rica, <u>including non-Costa Rican banks</u>, to provide quality financial data on at least a quarterly basis and financial statements independently audited by internationally recognized accounting firms. They should also be required to submit to AGEF examination if they want to do business in Costa Rica. This is the direction of banking law and regulation in the United States and Europe, as evidenced by recent legislation. There is no obvious reason why the Costa Rican public would not be better off if the banks wanting to serve that public were better supervised.

4. Inasmuch as the government-owned banks are inefficient and generally unprofitable, a concerted effort should be made to study alternatives toward the end of privatizing or merging at least three of the four banks, excluding the Banco Nacional de Costa Rica. The Banco Nacional is showing some significant signs of progress. It is also the largest commercial bank in Central America and should be able to focus the financial and human resources necessary to make itself into a reasonably efficient and competitive institution. If one government-owned bank can become efficient and competitive and make commercial banking services available throughout Costa Rica, as all four are currently attempting, there is no apparent reason to have four such entities essentially competing with each other at the expense of the Costa Rican public.

Legal and Regulatory Framework

Considerable progress has been made in a multitude of aspects of the legal and regulatory framework for the financial system, much of it promoted by various USAID policy reform initiatives. Rather

than attempting to summarize each of these, the present summary is focused on the legal reforms that are still required.

Access to Central Bank Credit and Other Powers of the Central Bank

1. Restrict the Government's access to Central Bank credit exclusively to Treasury Bills (Letras del Tesoro) and reduce the present limit from 1/12 to 1/24 of the National Budget. As part of a system of checks and balances, a system of public information (i.e., quarterly reports from the Central Bank to the Congress) should be created that would include the amount of each transaction in Treasury Bills.

2. Restrain clearly all possibilities for the Central Bank and the government owned banks to finance the Government in indirect ways such as using reserve requirements for this purpose.

3. Eliminate access of CODESA and INFOCOOP to Central Bank credit.

4. Restrict the power of the Central Bank to engage in foreign borrowing, so that it needs the approval of Congress except for borrowing for temporary balance of payments support from organizations such as the International Monetary Fund or other central banks.

5. Make clear that the nature of rediscount facilities from the Central Bank to the government owned banks is solely as a lender of last resort, so that the rediscount rate should always be above market interest rates and never lower than the six-month deposit rate (the basic rate).

6. Extend to private banks, but not to financieras, access to the Central Bank rediscount window, but only at rates higher than the six-month deposit rate. This facility should be subject to qualified voting by the Central Bank's Board (i.e., a two-thirds majority) and would only be used when required to avoid an increasing lack of confidence that could affect the whole financial system.

7. To enforce the legal provisions for the former public sector external debtors to the Central Bank, derived from debt rescheduling and renegotiation, a legal reform should impose penalties not only on the delinquent institutions but also on the Central Bank if it fails to use promptly the mechanisms contained in the law to deal with these overdue obligations.

8. Eliminate the Central Bank's legal power to determine interest rates on loans to small farmers and other groups, and thereby

eliminate the need for the Central Bank to have the power to impose commissions on these loans to increase their rates administratively.

9. Initiate a study of the appropriateness of maintaining the general power of the Central Bank to fix interest rates and commissions. Even if such powers remain, the problem of fixing prices and quantities simultaneously should be addressed, along with the dubious gains from fixing either of them.

10. Limit, by law, the power of the Central Bank to impose detailed credit ceilings in order to avoid the negative effects of possible highly interventionist Central Bank policies in the future.

11. The practice of using reserve requirements as a way to finance the Government has largely been abandoned. Although this practice has no clear basis in Costa Rican legislation, a legal reform to eliminate this possibility could be important for the future since this mechanism has been used in the past.

Central Bank Independence

1. Initiate legal reforms to increase the independence of the Central Bank. Since financing public sector deficits and projects to promote economic development have undermined its main responsibility to maintain a stable value for the currency, it is necessary to reduce as much as possible the influence of electoral considerations in the process of making monetary policy.

2. While it is worthwhile to maintain the position of Executive President and the presence of the Minister of Finance on the Central Bank's Board, legal reforms should be initiated to promote the general interests of Costa Rican public in the process of naming the Executive President and the other five Board members. For that purpose, participation of the Congress and lengthening of the period of appointment for Board members, except the Minister of Finance, are alternatives that could be explored.

Issues Related to Banking Policy

1. Provide technical assistance to the Central Bank to improve its system for the analysis and ranking of banks, in order to enhance the protection of investors as long as the Central Bank continues to have the responsibility of authorizing the issuance of certificates of investment by private banks.

2. Analyze in depth the disparities in leverage limits for different financial institutions, as well as the legal

measures required for a uniform and widespread protection for all savers, taking into account the differences among the various types of financial intermediaries.

3. Provide informed advise to the Central Bank with respect to problems of credit concentration and credit to related economic groups, taking into account experiences in other countries as well as domestic legislation.

4. Initiate a study of the appropriateness of creating a deposit insurance system, taking into account not only the legal provision included in the Banking Reform Act of 1988 to create such insurance, but also the possible shortcomings of such a system, especially in terms of moral hazard (laxity on the part of both depositors and financial intermediaries in making financial decisions without an adequate assessment of risk).

5. Carry out additional legal studies with respect to the reforms required to make completely effective the Central Bank's power to increase minimum capital requirements for existing private banks within reasonable limits.

6. Clarify Article 298 of the Banking Reform Act of 1988 (Ley 7107, Ley de Modernizacion del Sistema Financiero) to express clearly that the minimum capital requirement for a "banco solidarista" should be 50 percent of that for private commercial banks ari not 50 million colones.

7. Eliminate the possibility for government owned banks to grant subsidized credits to any group. Interest rates on loans below the market rate for deposits should not be permitted, or at least should be covered by an equivalent transfer from the national budget to the bank.

8. Initiate further analysis with respect to the reforms required in the Banking System Act to provide government owned banks with effective surveillance mechanisms over their efficiency and financial results. This would include eliminating electoral considerations when appointing members of their boards.

9. Eliminate all legal dispositions that force government owned banks to lend to specific economic sectors, thereby recognizing that creditworthiness and feasible productive projects cannot be created by law.

10. Present a legal reform to eliminate the existing 8 percent tax on interest from colon-denominated deposits, bonds and similar instruments.

Regulations Differentiating Financieras from Banks

1. Initiate an in-depth analysis of the justification for having both banks and financieras and of the differences in regulations and requisites pertaining to each of them. Claims by financieras for a regime similar to that of private banks could lead to the conclusion that they should in fact be converted into banks.

2. Reform Central Bank regulations for financieras wanting to convert to banks by recognizing that they have a record in the market and a history of regulation by the Central Bank and supervision by the AGEF, so that requisites should not be as severe as for the creation of a new bank (but with no reduction in minimum capital requirements).

3. Provide financieras with the same regime as applied to private banks in areas not related to the key elements that makes them different from each other, such as the possibility to participate in the foreign exchange market. This reform is in fact included in a bill under consideration by Congress to modify several aspects of the foreign exchange system.

4. In the case that the conclusion is reached that there should be no differences between banks and financieras, a legal reform should be developed to facilitate the merging of financieras to expedite their conversion into banks.

Foreign Exchange Operations

1. Initiate a legal reform to the Currency Act (Ley de la Moneda) to establish clearly that loans stipulated and disbursed in foreign currencies by private and government owned banks and financieras must be repaid in the same foreign currency.

2. Eliminate the powers of the Central Bank to impose quantitative and qualitative restrictions on foreign transactions, as is proposed in a bill currently under consideration by Congress.

3. In the case that the power of the Central Bank to impose prior deposits on imports and other foreign payments continues in effect, as contemplated in the bill mentioned above, some limits should be included, such a similar treatment for all activities, that would prevent discriminatory percentages being applied by the Central Bank's Board.

4. Since a liberalized foreign exchange market requires removing distortions that affect the determination of the price in that market (i.e., the exchange rate), a legal reform should be initiated to eliminate taxes and other charges that raise the spread between the buying and selling rates (e.g., the charges

mandated by law to finance CODESA and the institute for cooperative promotion, INFOCOOP). The law should also prevent similar charges by the Central Bank such as those that were imposed in March 1992 to increase the fund to cover the foreign exchange losses of the government owned banks (Fondo de Perdidas Cambiarias) and to compensate partially for Central Bank losses.

Supervision of Financial Institutions

As a result of various modernization efforts, the AGEF's supervisory capacity improved significantly during the decade of the 1980s. The modernization project initiated in 1988 with financing from the World Bank should be noted in particular. The process of modernization made sustained advances until the end of 1990 when progress stopped as a result of the Auditor General leaving his position and the failure to name a permanent replacement until September of 1991. With the arrival of the new Auditor General it is hoped that advances will again be achieved, although there are certain doubts concerning the possible orientation, mainly because of the lack of experience of the new Auditor General in the area of supervision and the difficulties of coordination with the Central Bank.

The fundamental recommendation is clearly to proceed with the modernization project. With an adequate reorganization and a good use of its human resources, the AGEF can quickly recover a level, if not of excellence, at least acceptable and with good possibilities for continuing improvement. Even with this, however, there are needed improvements in the regulation and supervision of the Costa Rican financial system that go much further. Specifically, the following actions are proposed:

1. An overall review of the legal and regulatory framework for the financial sector, emphasizing in particular the deregulation of permitted operations and a stronger enforcement of prudential regulations;

2. A review of the institutional framework for financial sector supervision, eliminating the conflict of powers and responsibilities between the Central Bank and the AGEF, that is, define in an unambiguous way which institution is in charge of supervision and give that institution the tools and powers necessary to carry out the task. It is recommended that these powers be assigned to the AGEF once the AGEF has reached an adequate professional level, but in the meantime seek out workable coordination with the Central Bank;

3. A major strengthening of the AGEF, in which the modernization project initiated in 1988 is extended as the first stage, and then proceeding to a major restructuring of the AGEF based on

an analysis of its functions and organization, including an evaluation of personnel, a likely reduction in the number of employees and a strong training program in the key areas of bank inspection, possibly complemented with the contracting of specialized professionals; and

4. The inspection of other financial intermediaries such as credit union and especially pension funds and private insurance companies, which could reasonably remain within the AGEF because of economies of scale in supervision, although it is not recommended to assign the AGEF new tasks until the conflict between the AGEF and the Central Bank is resolved and the AGEF demonstrates a significant advance in strengthening its capabilities.

Securities Markets and Instruments

It would be advisable to modify the law so that the CNV becomes responsible for regulating and supervising commodities exchanges as well as securities exchanges, thereby avoiding possible conflicts between the Central Bank and the CNV in the regulation and supervision of the BNV and/or BOLPRO. In order to overcome market imperfections caused by the lack of standardized medium and long term securities issues, and recognizing the particular importance of promoting the standardization of issues for the medium and long term debt of non-financial private companies:

1. The government could play an important role in generating a "demonstration effect" by issuing standardized bonds for maturities longer than one year with a correction for inflation that would induce investment over a longer term.

2. The government could, following the Central Bank, also introduce an auction system for government securities that would permit financial intermediaries and brokers to acquire the primary issues and, subsequently, to sell them with a premium in the secondary market.

3. Since auctions or other more open and competitive systems for primary issues could eliminate several market imperfections, the CNV and the BNV should promote such changes in the primary issues market, with the government taking the lead in using such systems for the sales of its securities.

Given the limited size of the market, establishing more than one securities exchange could organize securities markets in Costa Rica in a way that would not take advantage of economies of scale in the clearing process. In addition, such fragmentation would scatter, instead of centralize, information about transactions and issuers, thereby raising the minimum transaction costs for those who deal in these securities markets. However, to deal with the need to

rationalize the costs of carrying out transactions on the BNV, some actions are required:

1. It should be insisted with the BNV that the best policy would be for the BNV to set the BNV's charges for its services to brokers at a level that would permit the BNV a normal return on capital, taking into account the risky nature of the business, given that commissions that brokers can charge for their services have already been completely liberalized.

2. A legal reform should give the CNV the powers necessary to compel the exchange to reduce its commissions when it is reaping profits greater than what could be considered a normal competitive return (including the risks of the business).

3. The CNV should not have power to set different commissions for the exchange, but rather it should have the power to insist on proportionate overall price reductions because regulators cannot be expected to know how to fix commissions.

4. Moreover, the CNV should have a pre-announced system to authorize the operation of another exchange through public auction that could offer cheaper commissions than those of the existing exchange. The mere threat of this power to authorize a new exchange would induce the existing exchange to reduce its prices.

5. For additional protection of all concerned, the exchange by-laws should also contain limitations on the number of member firms, brokers and issuers (or their owners and managers) that are represented on the board of directors of the exchange, in order to avoid decision-making that is biased in favor of one group over the others. There should also be a balance on the board among the different types of member firms (those affiliated with banking groups and those not affiliated).

The Government of Costa Rica, in the process of privatizing CODESA's subsidiaries, should take definite steps to sell a major part of CODESA's equity in the BNV. However, the government should promote the changes mentioned above while CODESA still has a major share of the BNV's equity, before selling a significant portion of the government's stake. Moreover, within this system with only one exchange, the government should maintain a percentage of its ownership of the exchange to serve as a counterweight to anti-competitive tendencies such as limiting the number of member brokerage firms to those already existing. The government could hold a 15 or 20 percent equity stake in the exchange that could be administrated through a trust arrangement with an impartial trustee acting with a precise mandate on how to represent the government at shareholder meetings.

To overcome the limitations inhibiting the development of long term financing in Costa Rican securities markets, the following measures are suggested:

1. The issuance of standardized medium and long term bonds with adjustable interest rates or monetary correction should be explored. In general, standardization of medium and long term instruments is crucial for reliable indicators of market rates.

2. With respect to the development of equities markets, it is necessary to reform tax laws to eliminate stamp taxes on increases in capital and to leave open to competition the fees that notaries charge for their certifications. It is also necessary to modify the income tax to eliminate those elements that subsidize corporations to incur debt rather than increase equity and to improve the quality of information about issuers.

3. Long-term funds from private insurance companies and pension funds could introduce a greater demand for instruments with adjustable interest rates or monetary correction, but the development of long-term securities markets would also require further legal reforms to permit the official use of such instruments with adequate regulation.

As the CNV grows in experience, it should place its main emphasis in the following areas:

1. With respect to the development of new instruments, it is fundamental that the CNV coordinate its activities closely with the intermediaries who know the market much better than the majority of the CNV's staff.

2. In reviewing actual products, the CNV should avoid the pitfall of assuming that it knows what the market needs better than the brokers and other participants in the market. The CNV should carefully evaluate whatever changes it introduces or promotes in the market, always based on a careful analysis of the realities of the market and the demands of the participants. If instruments that are in demand are prohibited or restricted, these would probably be offered by non-regulated entities, and with higher risks for those who acquire them, contrary to the objectives of the CNV.

3. The CNV should play a major role in introducing the necessary regulations for securities markets so that there is equal treatment for all parties. Some specific cases are: (1) the discrimination that some issuers practice by differentiating between interest rates paid on funds captured through the securities exchange compared to funds captured through direct placements; (2) the use of inside information about issuers'

financial situations and the reliability of the information provided by issuers and brokers; and (3) the role of the CNV in reducing the conflicts of interest that can exist among various clients of brokerage firms (e.g., when a brokerage firm represents an issuer and attempts to sell the issuer's bonds to a client when there exist other options that the client might prefer if the client knew about them, or the conflict of interest that arises when a brokerage firm gives preference to its CAV or OPAB to the detriment of other clients, etc.).

The role of brokers as dealers in certain kinds of operations such as OPAB and CAV contracts should be carefully explored. In the meantime, and as a possible permanent solution, OPAB and CAV contracts could continue operating as they have been, through either brokers or investment funds, with a guaranteed yield, but with a more solid base of solvency than either brokers or investment funds currently offer, by capitalization and by better portfolio and risk valuation systems and more information about risks and portfolio management.

Although more ample powers could be deemed necessary for the CNV, it is important that the CNV continue to operate for some time within the current legal framework in order to check the attitudes that regulatory entities typically adopt with respect to authorizing public offerings, the creation of new instruments, and self-regulation by brokerage firms and securities exchanges.
It would be advisable to modify the law so that the CNV becomes responsible for regulating and supervising commodities exchanges as well as securities exchanges, thereby avoiding possible conflicts between the Central Bank and the CNV in the regulation and supervision of the BNV and/or BOLPRO.

Caja Costarricense de Seguro Social (CCSS)

The Caja was created to implement obligatory social insurance and to increase voluntary insurance, but little effort has been applied to the second objective. The Caja has divided its services into two separate systems (IVM and SEM) that have both been implemented gradually and progressively, but independently and with a different timetable for each system. The coverage actually achieved differs significantly between the two systems and reflects the Caja's greater emphasis on the SEM. About 68 percent of the labor force contributes to the SEM program, and the insured population is estimated at 84 percent of Costa Rica's population. These percentages, which are referred as "contributory coverage" are considered acceptable, especially since 100 percent of the population has the right to receive medical attention when required. On the other hand, the IVM system covers only about 46 percent of the labor force, which is a relatively low coverage considering that universalization is also an important objective of

the IVM program. Moreover, a high percentage of Costa Rican workers are not covered by any pension system.

In compliance with the Caja's basic law, two separate funds have been formed: one for the SEM and one for the IVM. However, a complete separation between the two systems does not exist, since the Board of Directors can alter the allocation of the contributions from employers, employees and the government between the two funds. In the past, mainly before 1982, there were several automatic transfers of funds from the IVM to the SEM, as well as formal loans between the two, even though this is not permitted by law. The main reason that this has not occurred in more recent years is the SEM's operational surpluses since 1982. History has shown, in other Latin American countries as well as in Costa Rica, that if a complete separation does not exist between health programs and pension programs, the former will be financed (even if only temporarily) by the latter if there are operational deficits or cash flow problems.

The Caja is an autonomous institution, under a Board of Directors that is independent of the Central Government. This Board has the conflicting dual functions of directing and supervising the entity's activities, which is an important limitation to guaranteeing effectiveness in both functions. In the last decade, employer contribution rates for social insurance have increased about 51 percent, while worker contribution rates have increased about 23 percent, but the government's contribution rate has declined to one ninth of the rate in force at the beginning of the 1980s. It is a matter of concern that the Caja's Board of Directors has the power to raise contribution rates, which are in essence taxes on payrolls, or change their allocation, without adequate supervision.

The Caja's basic law does not appear to limit, in any seriously detrimental way, the actions of the Board of Directors with respect to investments. In recent years, however, outside influences have affected investment strategy in major ways, mainly the Government's Budget Authority and the National Housing Fund Law.

There seems to exist a serious separation between technical actuarial planning on one hand and practical policy actions on the other. Moreover, there is no actuarial supervision -- obviously very important for pension planning -- and major policy decisions are being made by technical staff, without adequate transparency for these actions. While the SEM has theoretically adhered to an amended version of the Current Disbursement Approach to funding, so that the period's income should approximately equal its expenditures (with no or little accumulation of reserves), in practice the SEM has experienced significant operating surpluses since 1983, and Caja technicians are predicting reserves larger than recommended for this approach to funding. In the IVM, meanwhile, the actuarial funding method has not been officially

specified in a conclusive way. This fact introduces subjectivity and political considerations into the actuarial valuations. It seems reasonable (and some of the Caja's technical staff seem to agree) that Thullen's Scaled Premium Method should be the funding method regulating the IVM. However, conclusions and recommendations of recent studies do not appear to apply Thullen's approach and do not give adequate explanations for the desired level of reserves, the magnitudes of rate increases and the length of the new period of equilibrium.

The accumulation of the assets by the Caja's two social insurance programs is, by any standard, highly significant for Costa Rica since, of all financial institutions in the country, only the Banco Nacional reports more assets that the Caja. While the SEM's assets are mainly fixed assets (e.g., buildings, construction and land) and Government debt (which is usually remunerated at below market rate of interest), almost all of the IVM's assets are financial instruments. The amount of reserves on the IVM's Balance Sheet as of December 31, 1991, represents about 98.1 percent of that system's total assets (approximately 45,200 million colones), thereby suggesting the importance of the Caja as a financial intermediary. IVM reserves are invested mainly in securities issued by the Central Government and the government owned banks and in mortgage loans. In terms of investment performance, the Caja's biggest problem has been achieving a positive real rate of return on its investment portfolio.

It is evident that there is a lack of consensus as to the appropriate political approach to an overall solution for pension problems in Costa Rica. For this reason, the main recommendations to improve pensions are:

- press for a series of in-depth technical studies that can lead to the development of options for the design of a new approach to pension systems in Costa Rica, including especially their relevance to financial intermediation; and

- press Government policymakers to agree formally to a new overall pension system and to formulate an action plan to implement the system.

The design of a new overall pension system for Costa Rica must have, among others, the following objectives:

- provide broader basic coverage;

- coordinate existing pension systems;

- provide adequate benefits; and

- assure adequate financing for all existing systems to guarantee financial solvency; this entails consideration of:

- the definition of an appropriate actuarial method;
- a technical (not political) approach to establishing contribution rates;
- a restatement of the philosophy for the participation of the Government, employers and workers in the financing of the Caja;
- a complete separation of the SEM and IVM programs; and
- the establishment of appropriate actuarial supervision.

Pension Systems

The main pension programs in Costa Rica can be classified into four groups: the Disability, Old Age and Death Insurance (IVM) of the Caja; the Special Programs for the Public Sector; the Non-Contributory System with Basic Benefits; and the Supplementary or Complementary Pension Programs. Of these four, only two -- the IVM and the Complementary Programs -- have the potential of playing important roles as financial intermediaries. As of July 1989, approximately 46 percent of the Costa Rican labor force was left out of the main pension systems.

The Supplementary or Complementary Pension Programs can be classified into two types: those administered by the companies or institutions themselves; and those administered by independent private companies dedicated solely to this business. Both categories have the potential of accumulating significant amounts of funds to be invested and therefore of being important players in Costa Rican financial markets.

Savings Plans for Retirement have only recently been offered by companies or institutions. In less than four years these types of complementary programs have grown to cover about 17,000 participants and have accumulated about 1,600 million colones in investments. This growth could be even faster if proper regulation existed. To this point the funds accumulated by the Savings Plans for Retirement, specifically by the trusteeship arrangements administered by Banex and Pro-Vida, have been invested in securities issued, guaranteed or secured by the Government and are maintained in the custody of government owned commercial banks. Investing solely in government or government backed securities is a self imposed measure with the purpose of strengthening the perceived security of investments and thereby gaining the trust of the general public for this new kind of financial instrument. There is no reason why these companies should not consider placing some of their investment portfolio in private securities through the securities exchange. Over time, with adequate legislation, Savings Plans for Retirement have the potential of becoming

important suppliers of long-term funds to the private sector through the securities exchange.

Legislative developments over the years have shown a lack of consensus as to appropriate policies in the area of pensions, so that numerous laws with conflicting objectives have been decreed in this area. In recent years there has been an increasing awareness in Costa Rica of the major fiscal problem caused by the existing pension systems -- and even of the danger of a possible collapse of major proportions because the promises implicit in these systems are beyond the economic possibilities of the country. Numerous committees, associations, round table discussions and newspaper articles have analyzed various problems in this area, leading to a wide variety of proposals to modify the existing laws. Nonetheless, most have limited themselves to analyzing each system in an isolated manner and without proposing any integral national policy for pension systems that could be implemented in a consistent way in years to come.

Recent examples of such efforts are the new law for the teacher's pension system that was approved at the end of 1991, the new general law for Special Public Programs approved June 24, 1992, and the proposal for a law to regulate Complementary Pension Systems that is being studied by the responsible commission of the Costa Rican Congress. All of them represent isolated well-intentioned efforts, but nearsighted in the sense that they lack the consistency and clarity of objectives that a national pension program should have.

Considering the foregoing comments, together with the conclusions and recommendations in the chapter covering the Caja Costarricense de Seguro Social, the main recommendations for improving Costa Rican pension systems include:

- Promote a series of in-depth technical studies that can lead to the development of options for the design of a new approach to pension systems in Costa Rica. It is crucial to consider as part of this the need to promote, but also to regulate appropriately, the different types of supplementary and complementary pension systems, taking into account not only their potential relevance for financial intermediation but also their objectives within the context of programs to promote economic security. Furthermore, these studies should analyze the impact of pension programs on financial markets and especially the potential of their becoming important suppliers of long-term funds to the private sector in general and the Securities Exchange in particular.

- Strongly encourage government policymakers to agree formally to a new overall pension system and to formulate an action plan to implement it. Immediate action should be taken to improve the legislation proposed for complementary pension

systems so that these can become part of an overall national social security program, as well as an important element in financial markets, with a role more consistent with the economic security and financial liberalization objectives of the Costa Rican Government.

Instituto Nacional de Seguros (INS)

The INS was created with the primary objectives of creating a permanent government monopoly and establishing a significant source of income for the government. These two objectives, which have been the main criteria under which the INS has operated, clearly represented the wishes of the legislature at the time the INS was created in the 1920s. The government's insurance monopoly was implemented in a gradual manner according to the type of insurance: life insurance, fire insurance and work related insurance were all implemented in the 1920s; fidelity insurance in the 1930s; automobile insurance in the 1940s; and integral crop insurance, obligatory automobile insurance and reinsurance in the 1970s.

The INS is an autonomous institution governed by a Board of Directors named by the President. It enjoys administrative independence and is not subject to actuarial or technical supervision -- not even in such crucial matters as rate making, reserve valuation and marketing practices. The INS is nonetheless subject to various external laws and decrees (e.g., the General Public Administration Law, the National Planning Law, the Law for the Financial Equilibrium of the Public Sector, and the Law for Creation of the Budget Authority) that have important implications for the operations of the INS.

The Basic Law creating the INS does not put any detrimental restrictions on the actions of the Board of Directors with respect to investments. However, important restrictions have been added, mostly by external sources not controlled by the Board, and these have affected investment performance, either indirectly by limiting the resources available for investment or directly by imposing certain types of investment options.

The amount of assets accumulated by the INS is significant and, as of the end of 1991, represented about 50 percent of the assets of the Banco Anglo Costarricense and about 58 percent of the total assets of the IVM pension system administered by the CCSS. As of December 1991, about 55 percent of INS assets (i.e., 14,600 million colones) were financial investments. Financial Investments can be categorized in two groups:

- Investments in securities (about 28 percent of financial investments); and

- Investments in mortgage loans (about 72 percent of financial investments).

The performance of these two broad categories of financial investments has been very different. Investments in securities have been quite satisfactory, providing positive real rates of return throughout the period 1983-1991 except in 1988. On the other hand, investments in mortgage loans have consistently yielded negative real rates of return throughout the years from 1983 to 1988. In addition, the INS does not generally consider investment income in its rate making. This is true for all lines of insurance offered, except life and work related insurance. Investment income could have been used to lower the premiums that policyholders pay.

It is evident that circumstances, as well as political views of the government's role in insurance, have changed significantly since the creation of the government's insurance monopoly. For this reason, the main recommendation to improve the provision of insurance in Costa Rica, and especially the role of insurance in financial markets, is to press for a series of in-depth technical studies to analyze the conditions under which a more competitive insurance market might be beneficial to the country, including its role in financial intermediation. These studies should analyze and make formal proposals in each of the following areas:

- creation and implementation of adequate technical supervision;
- deregulation of the INS to allow it to compete with private companies;
- new regulations needed in a competitive market, including consideration of:
    - organization and licensing of insurance and reinsurance companies;
    - types of operations and insurance lines that will be permitted;
    - rate making regulations;
    - product authorization, including requirements to introduce new products;
    - marketing practices, including the authorization of insurance agents and the regulation of publicity;
    - solvency of insurance companies, including standards for reserve and liability valuation, standards for asset valuation, investment regulations, and regulation of expenses, capital and accumulated surplus; and

- special legislation for fidelity insurance, collective insurance and obligatory insurance.

The Impact of USAID Interventions

During the decade from 1982 to 1992, USAID was involved in two distinct types of interventions that impacted the Costa Rican financial sector. On one hand, USAID responded to the crisis that afflicted Costa Rica at the end of the 1970s and the beginning of the 1980s through a series of stabilization and adjustment programs that included dollar funds for balance of payments support (the ESF programs). The disbursement of these dollar funds was conditioned on a changing array of policy adjustments, many of which dealt directly with the financial sector. As part of this process, moreover, the disbursement of dollar funds for imports generated local-currency counterpart funds, a significant portion of which were devoted to financial sector activities, often local-currency credit lines (of the total of approximately $1 billion, more than $150 million, that is, more than 15 percent, was devoted to credit lines). On the other hand, USAID also developed a series of projects that dealt specifically with Costa Rican financial institutions. These projects largely shared a common motivation: to enhance the participation of private institutions in the Costa Rican financial sector in response to the perceived weakness of the government owned commercial banks.

With respect to the success of USAID projects involving ESF conditionality, policy dialogue is widely recognized to be a better path to improved policies than attempts to impose conditionality that is unwanted by the host country. The design of specific elements of conditionality can provide useful discipline to insure that both the funding source and the host country are looking at the same indicators and have the same view of what is supposed to happen. Nonetheless, experience with attempts to enforce conditionality that is not in fact accepted by the host country indicates clearly the greater gains to be had from a more diligent pursuit of policy dialogue wherein the funding source and the host country come to share the same views of policy objectives and techniques of implementation. However, when policy dialogue has been successful, so that essential agreement has in fact been reached, it become unclear whether conditionality still implies additionality (or would the changes have occurred even without the ESF funds?).

This assessment documents in detail the changes that have taken place in the Costa Rican financial sector that may be attributable to USAID conditionality. As is clear, the changes over the period from 1982 to 1992 have been major. What is less clear is whether these changes can unequivocally be attributed to the conditionality contained in USAID's ESF programs or whether they might have taken place in any event. For the future, however, the anticipation of

much lower funding levels suggests that continuation of a major role for USAID in policy reforms to enhance the performance of the financial sector will depend more on emphasis on the technical assistance and policy dialogue aspects of conditionality and on close coordination with other international agencies.

The use of local-currency counterpart funds generated by ESF programs raises two major issues -- both of which are now much better understood by USAID than they were at the beginning of the 1980s when Costa Rica's ESF programs were initiated. The first issue is a general one of the inflationary impact of spending the local-currency counterpart funds generated by ESF dollar sales. As can be seen from recent discussions of ESF programs in Costa Rica with respect to the need to use local-currency counterpart funds for non-inflationary purposes (and even including questions of the payment of interest on these funds), this issue is now well understood by USAID officials in Costa Rica.

The second issue involves the use of ESF generated counterpart funds for local-currency credit lines. In Costa Rica, as in most other countries having ESF programs, a major use of counterpart funds has been for local-currency directed credit lines, and this involves not only ESF programs but also USAID's financial sector projects in Costa Rica. For many years, USAID has been concerned about the subsidy element in directed credit lines stemming from below market rates of interest, and this is clearly reflected in the setting of interest rates for its own financial sector projects and in the conditionality imposed in its ESF programs against Costa Rica's policies of subsidized interest rates. However, directed credit lines still contain an implicit interest rate subsidy -- the "market" interest rates established in "non-subsidized" directed credit lines are usually rates for prime borrowers, but the basic reason for the establishment of directed credit lines is that the intended borrowers (or the activities to be financed) are not prime. Moreover, to control the allocation of credit effectively along the lines supposed in directed credit programs would require control over a country's entire credit program along with extremely detailed and costly programs of monitoring and supervision (the well-known fungibility problem).

In addition to directed credit, USAID's earlier financial sector projects in Costa Rica provided subsidies to specific private financial institutions. This was justified as necessary to provide a private-sector alternative to the heavily predominant and extremely problematic government owned banking system. Attention was also given to this issue in the conditionality of several ESF programs that attempted to provide equal opportunities -- a level playing field -- for private banks (e.g., permission to issue short-term deposit instruments, access to Central Bank rediscounts, permission to create a system of deposit insurance, etc.) along with the provision of local-currency funded credit lines that were open (often exclusively) to private banks. Perhaps more attention

should have been given to such conditionality, since building private financial institutions through direct support for such institutions is an expensive process -- in terms not only of the funds provided for the subsidies and the impact on income distribution but also of the inefficiency (or excess profitability) with which private banks can operate under the umbrella provided by the very high spreads of the government owned banks. In any case, both recent USAID financial sector projects -- the Agricultural and Industrial Reactivation Project and the Financial Services Project -- have largely moved away from subsidies for specific private financial institutions.

The impact of USAID's financial sector projects on the targeted institutions and on Costa Rican financial intermediaries in general is thoroughly documented in this assessment. In this summary, only a few points are emphasized. First, the private banks that have been specifically targeted by USAID (BANEX and COFISA, as well as Banco Cooperativo if PL-480 counterpart funds are taken into account) have not performed notably better than other private banks. Although BANEX is large and profitable, COFISA (excluding its international affiliates) is one of the smallest private banks, and Banco Cooperative became insolvent and had to undergo a major rehabilitation in order to survive. Nonetheless, one significant positive aspect is that the financial institutions targeted by USAID (including the PIC which is difficult to compare directly to the private banks and might be worthy of a special evaluation) tend to have much more widely dispersed ownership than other private financial institutions. This is important not only for the spread of benefits but also for the extremely difficult issue of keeping loans to related parties under reasonable control.

The other main aspect of USAID's impact on the financial sector are its directed credit lines. Central Bank rediscount facilities for private banks have undoubtedly helped to make the playing field more level between the government owned banks and the private banks and are in some part responsible for the relatively rapid growth of lending by private banks during the period from 1982 to 1992. However, one cost of this has been the private banks' heavy dependence on such rediscount lines and relatively weak performance in the area of deposit mobilization in particular and resource mobilization in general. Greater attention to conditionality that might have given the private banks relatively more opportunities and incentives to capture deposits might thus have been more effective, especially in conjunction with better bank supervision to assure to depositors (without the necessity of deposit insurance) the safety of their deposits.

To summarize, it is clear that the decade from 1982 to 1992 has seen major improvements in policies affecting the Costa Rican financial sector and that USAID has been substantially involved in promoting these improvements. Nonetheless, it is not possible to attribute these positive developments exclusively, or even primarily, to USAID conditionality; and, in any event, successful policy dialogue of the type apparently witnessed in Costa Rica is more likely to bring about thorough and lasting changes in the financial sector than is conditionality that is imposed and not basically accepted by the government. The elements of directed and subsidized credit that can be found in the use of local-currency counterpart funds and in USAID's projects to strengthen specific Costa Rican financial institutions would undoubtedly not be approved by USAID today but were nonetheless the norm at the time these project were implemented.

Chapter I

Introduction

The present assessment of the Costa Rican financial sector has two main purposes:

- to review the progress made during the past decade in the development of the Costa Rican financial sector and, in particular, the role played by the interventions of USAID in that development; and

- to indicate the key areas in which further progress can and should be made in the coming years as a possible guide to Costa Rican policy makers and to USAID and other international agencies.

A decade ago, in 1982, Costa Rica was in the midst of a major economic crisis that was severely affecting its financial sector. It was clear, as least to some, that factors both inside and outside the financial sector were contributing to a weak and declining financial sector that was in turn inhibiting the recovery and growth of the Costa Rican economy. On one hand, fiscal mismanagement had been a major element leading to exchange rate instability and inflation without parallel in Costa Rica's history, thereby creating an environment that was extremely inhospitable to the health of the financial sector. On the other hand, the financial sector itself had severe internal problems including, in particular, excessive and inappropriate government regulation, a Central Bank devoted primarily to the tasks implied by these regulations rather than the tasks of a modern Central Bank, and a government-owned banking system that appeared relatively very large and was certainly very inefficient.

Many of the deficiencies relating to the Costa Rican financial sector have been dealt with during the past decade -- at least in terms of various analytical studies if not in effective actions. The basic approach of the present report is thus to review as briefly as possible the more well known of these areas in terms of the progress that has been made, the contributions of USAID's interventions and the issues that remain to be addressed. Nonetheless, even with this attempt at brevity, substantial chapters (more than twenty pages each) were required to deal with such well known areas as the banking system, the legal and regulatory framework, and the supervision of financial institutions. In addition, new areas of the financial sector were to be explored. Because of the need to explore these new areas in depth to make any meaningful contribution -- precisely because these areas had not been dealt with before, at least not from the perspective of their roles in the financial system -- several of these chapters are also quite long.

Table I-1 provides an overview of the Costa Rican financial system as of the end of 1991. As might be expected, the government-owned banks account for more than half of assets of the financial system. However, this is a substantial overstatement of their importance in two major respects: (1) informal financial arrangement are nowhere included in the table, neither domestic informal markets nor off-shore operations; and (2) the total credit of the government-owned banks is only a small -- surprisingly small -- proportion of their total assets. Private banks have grown to represent almost 10 percent of the total assets of the financial system with a substantial proportion of their assets in the form of credit, while financieras have faded into insignificance with the conversion of the larger ones into banks following the liberalization of the rules governing the existence of private banks.

Perhaps the most noteworthy element in Table I-1 is the importance of other financial entities -- taken together, these actually surpass the banks and financieras in terms of total credit. Nonetheless, if the Banco Popular is reclassified to the banking system (and in this report it is discussed in the chapter on banks and financieras), the banks return to the position of the primary providers of credit. Furthermore, most of the credit provided by other financial entities is in the form of credit to the public sector -- a fact that is viewed as unfortunate in the chapters that analyze some of these entities in detail.

Among the other financial entities, the social security system, the national insurance institute, the housing finance system and the securities exchange investment funds appear to be the most important. However, in the case of the housing finance system, there is significant "double counting" (i.e., of credit from BANHVI to the mutuales), so that credit to home buyers and other entities external to the system is much smaller than what is shown in the table. As a consequence, only the social security system, the national insurance institute, and the securities exchange investment funds receive detailed treatment in individual chapters in the report (and credit unions are also not considered separately because of their lesser importance and the fact that they have been amply treated in numerous other reports).

Table I-1

Costa Rican Financial System
Total Assets by Type of Institution as of December 1991
(million of colones and percents)

Type of Institution	Total Assets	Percent of Total
Government-owned Banks	356,855.93	60.08
Commercial Departments	350,928.23	59.08
Total Credit	81,389.91	13.70
Foreign Exchange Assets	16,196.94	2.73
US$ Deposits (100 percent req. res.)	87,855.65	14.79
Other Reserves	36,876.32	6.21
Other Assets	128,609.42	21.65
Fixed Assets (incl. real estate)	21,340.05	3.59
Other Assets	107,269.37	18.06
Rural Credit and Mortgage	5,927.70	1.00
Total Credit	4,961.09	0.84
Private Banks	48,755.45	8.21
Total Credit	30,586.92	5.15
Financieras	5,707.48	0.96
Total Credit	5,096.65	0.86
Other Financial Entities	182,667.90	30.75
Total credit	126,708.67	21.33
Social Security	46,097.09	7.76
Total Credit	37,158.23	6.26
National Insurance Institute	23,248.26	3.91
Total Credit	14,041.89	2.36
Popular Bank	30,974.75	5.21
Total Credit	25,051.08	4.22
Housing System (BANHVI, Mutuales)	22,224.35	3.74
Total Credit	15,378.92	2.59
Credit Unions	7,719.80	1.30
Total credit	5,117.30	0.86
Securities Exchange Investment Funds	14,372.79	2.42
Total	593,986.75	
Total credit	248,743.24	

Source: Central Bank for figures on banks and financieras, and the respective balance sheets for other financial institutions.

Macroeconomic issues and their relevance to financial intermediation are dealt with in the next chapter, which can be relatively brief since the significance of the public sector fiscal deficit and the effort to combat it are already so well known. The following chapters deal with various aspects of the banking system, beginning with an analysis of that part of the financial system and following with chapters on the legal and regulatory framework and the supervision of financial institutions. Although these chapters deal with important and complex issues, part of this material is already so well known in Costa Rica that it has been possible to limit the length of these chapters somewhat. The chapter on the impact of USAID's interventions on the financial sector is placed next because these interventions have focused primarily on the foregoing elements of the financial system.

The remaining chapters of the report focus on the segments of the Costa Rican financial sector that have received less attention in the past. Among these, securities markets and instruments are treated first not only because they are already relatively better known but also because they serve as a background for the other chapters with respect to the key issue of how to create longer term capital markets in Costa Rica. Major attention is devoted to the social security system because of its actual and potential importance for the financial sector and because it is necessary to understand the system in all its major aspects in order to understand its importance for the financial sector. Other pension systems are then considered very briefly. Although their present size may not warrant any treatment in this report, they are potentially quite important -- the public ones because of their potential adverse fiscal implications and the private ones because of their recent very rapid growth. The national insurance institution is then treated at some length, and the report ends with a final chapter of conclusions and recommendations.

Before ending this introductory chapter it is also important to indicate the valuable collaboration that was received in undertaking the analysis for the report. Numerous Costa Ricans in both the public and private sectors provided voluminous amounts of information and significant insights with respect to all aspects of the financial system. In addition, various officials of USAID also provided important support, including not only information and their view on the financial sector but also helpful comments on earlier versions of this report.

Chapter II

Macroeconomic Issues and Financial Intermediation

Introduction

As is well known, the macroeconomic environment plays a highly significant role in the adequate functioning of financial markets. Moreover, a reciprocal relationship between economic growth and financial deepening is now widely recognized. On one hand, the lack of growth in overall economic activity hinders the expansion of financial services. On the other hand, financial repression and related distortions in the economy restrain economic growth, as is now widely accepted after the works of Shaw (1973), McKinnon (1973) and others. To recognize the existence of rigidities and the need to implement policy reforms in order to foster financial intermediation is not enough, however. Economic instability, usually driven by large fiscal deficits, is probably the main element working against financial intermediation in the economic environment of most countries.

Instability in the form of high rates of inflation and exchange rate depreciation has a variety of adverse effects on financial markets. First, inflation reduces the ability of money to serve its main purposes, as a medium of exchange and a store of value. Since money is a main factor in financial and other markets, a direct consequence of this is a decrease in the relative importance of money compared to other less efficient ways to perform its tasks. This problem, known in the economic literature as "currency substitution," appears in the form of physical asset accumulation, as well as the use of foreign currencies in place of the domestic currency.

Second, as a result of excessive fiscal deficits, the government comes to compete with the private sector in the money market, thereby introducing volatility and an upward trend in interest rates. This, in turn, stimulates a short run outlook on the part of economic agents, thereby increasing the risks for financial intermediaries and consequently raising costs in financial markets. Moreover, the financing of the public sector deficit inevitably competes with the allocation of funds by the financial system to productive activities in the private sector.

Third, instability, especially when it stems from excessive fiscal deficits, forces the central bank to adopt restrictive monetary policies, which in more extreme cases can lead to further increases in the costs of intermediation and thereby reduce the efficiency of the financial system. Such is the case in the excessive use of reserve requirements, not only as a classical instrument of monetary policy but also to finance the fiscal deficit more cheaply. There are also other even less desirable instruments such

as direct controls by the central bank on commercial bank lending which are widely used in developing countries. Nonetheless, these are sometimes the only alternatives open to a central banker when open market operations are ruled out in order to make room for the treasury's demand for funds in the market.

The foregoing enumeration is not intended to be exhaustive, but rather to reflect the crucial importance of a stable macroeconomic environment as a prerequisite for successful structural reform of the financial system.

The Case of Costa Rica

Since the financial crisis of 1980-1982, there have been many achievements of the Costa Rican economic authorities in combating disequilibria in the key macroeconomic areas, notably inflation and exchange rate instability. The fiscal deficit, which has probably been the major cause of such disequilibria, has been kept under relatively better control. Due to the emphasis on a development strategy based on increased public spending for many years before 1982, the public sector deficit had reached a very high level by 1981 of about 14 percent of gross domestic product (GDP). The inflationary shock of the crisis years, which was largely the consequence of the profound fiscal disequilibrium of the Costa Rican economy, caused a severe contraction in banking activity and a reversal of financial deepening, as indicated by the fall in total liquidity in real terms to only two thirds of its 1978 level by 1982 (González Vega, 1985).

In the years following the 1980-82 crisis, a sustained decrease in the public sector deficit was achieved. Greater discipline in fiscal administration was achieved in large measure with the help of stabilization programs supported by the International Monetary Fund and other international agencies. As a result, liquidity creation due to the financing of the public sector by the Central Bank moderated significantly. Wage policy was also largely consistent with the stabilization efforts.

The resulting improvements are indicated by the behavior of the main macroeconomic indicators shown in Table II-1. Inflation has been kept under better control, fluctuating between 15 and 25 percent since 1983, which are high rates compared to international standards but not compared to Latin American levels. On the external side, although there have been ups and downs, a sustained improvement has been attained as measured by the reduction in the ratio of the current account deficit to GDP, by the increase in net international reserves, and by a relative normalization of Costa Rica's relationship with international creditor banks and multilateral and bilateral creditors. The foreign exchange market moved to a flexible exchange rate system which took the form of a crawling peg from the end of 1984 until March 1992, when the market was liberalized so that the exchange rate is now determined by the interaction of supply and demand in the banking system.

Table II-1

COSTA RICA: SELECTED ECONOMIC INDICATORS
1981-1991

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
	(Annual percentage change, unless otherwise specified)										
NATIONAL INCOME AND PRICES											
GDP at constant prices	-4.6	-7.3	2.9	8.0	0.7	5.5	4.8	3.4	5.6	3.7	1.0
Nominal GDP	37.9	70.8	32.6	26.1	21.4	24.6	15.3	21.8	21.7	23.5	30.7
Consumer prices (end of period)	65.1	81.7	10.7	17.3	10.9	15.4	16.4	25.3	10.0	27.3	25.3
(average)	37.1	90.1	32.6	12.0	15.0	11.8	16.8	20.8	16.5	19.0	28.7
EXTERNAL SECTOR											
Total exports, f.o.b.	0.2	-13.3	-1.0	-10.9	-5.9	15.6	2.0	6.7	12.8	2.2	9.3
Total imports, c.i.f	-20.6	-26.2	11.1	11.0	0.8	4.7	19.6	2.3	23.0	16.0	-8.5
Non-oil imports, c.i.f.	-22.2	-29.6	13.7	14.6	0.6	12.3	19.6	3.0	22.5	14.7	-9.0
Export volume	9.5	-11.3	0.9	13.7	-7.3	-6.3	13.9	1.6	16.6	2.6	3.2
Import Volume	-25.3	-26.2	19.2	12.2	7.4	7.7	14.2	-1.9	20.3	10.8	-10.3
CENTRAL GOVERNMENT											
Revenue and grants	46.4	80.5	52.7	26.1	18.5	18.8	17.4	21.4	20.1	16.9	34.3
Total expenditure	25.1	60.5	50.7	22.8	12.4	28.7	8.8	25.4	30.6	20.3	26.3
BANKING SYSTEM											
Net domestic assets	62.9	37.5	31.6	8.4	10.4	16.2	15.1	25.8	7.6	33.9	10.6
Of which: public sector	9.1	8.7	0.9	-1.7	0.8	-1.6	-9.3	2.4	2.0	7.8	-3.8
private sector	9.3	37.5	51.7	17.9	16.1	17.4	13.1	6.9	5.7	7.7	2.9
Liabilities to private sector	27.3	50.5	30.3	10.5	12.9	22.2	27.3	29.8	23.5	16.9	24.9
Interest rate (annual rate for six-month deposits, end of period)	21.5	25.0	22.0	20.0	22.5	21.5	20.5	22.7	21.7	32.8	27.5
	(In percent of GDP)										
Combined public sector deficit	19.1	14.6	8.1	6.6	7.0	5.4	3.8	3.6	5.5	4.9	2.0
Nonfinancial public sector deficit	14.1	9.0	3.1	1.9	1.8	1.7	0.3	0.3	2.8	2.9	0.1
Domestic financing	2.6	-1.5	-0.3	-0.2	-0.3	-0.8	-0.4	0.7	1.9	2.6	-0.1
External financing	3.0	2.8	11.7	0.1	3.4	1.4	0.7	-0.4	0.9	0.3	0.2
Central Bank deficit (accrual basis)	5.0	5.6	4.9	4.3	5.2	3.7	3.5	3.3	2.7	2.0	1.9
Central administration deficit	5.3	3.3	3.7	3.0	1.9	3.3	2.0	2.5	4.1	4.4	3.1
Gross domestic investment	24.1	14.1	18.0	20.0	19.3	18.7	27.1	23.8	25.8	27.7	22.5
Gross national savings	9.1	8.4	13.5	15.4	18.4	21.4	16.1	15.5	14.3	15.7	17.6
Trade balance deficit	7.8	1.0	4.3	4.3	5.0	-2.1	6.2	5.1	7.8	11.6	6.5
Current account deficit (excl. official transf. for bal. of payments support)	15.8	9.9	8.3	5.1	8.4	4.1	9.0	6.6	8.4	9.0	2.5
External debt (incl.uses of Fund credit)	91.8	113.6	107.1	98.1	99.8	95.8	89.8	87.6	75.8	61.0	59.6
	(In percent of exports of goods and non factor services)										
Debt service ratio	51.6	54.4	51.2	53.2	53.8	49.2	49.9	46.9	40.9	35.3	16.5
Interest payments	25.4	29.4	27.7	24.6	22.9	19.9	19.6	18.7	16.2	12.5	9.1

Source: Ministry of Finance, Central Bank of Costa Rica and IMF reports. April 30, 1992

Notes to Table I-I:

1. Banking system net domestic assets exclude the counterpart of external payment arrears that are included in net international reserves of the Central Bank, and they also exclude increases in credit arising from the assumption by the Central Bank of part of the external debt of the public sector.

2. The nonfinancial public sector deficit refers to the Central Government plus the eight decentralized agencies and the ten public enterprises, which together account for about 90 percent of total revenues and expenditures of the nonfinancial public sector.

3. The Central Bank deficit for 1989 and 1990 excludes profits from debt conversion and debt repurchases.

4. External public debt includes interest arrears.

5. The debt service ratios and interest payments as a percent of exports of goods and nonfactor services include debt with the International Monetary Fund and interest on short-term debt, but they exclude amortization payments in 1990 related to the commercial bank debt reduction package.

In spite of this relative success, many things remain to be done, especially since financial stability has been demonstrated to be a very fragile condition in a large number of countries. The main purpose of remainder of this chapter is thus to address the major areas that require further policy actions, rather than going deeper into Costa Rica's recent economic history, for which there are numerous reports and an extensive bibliography.

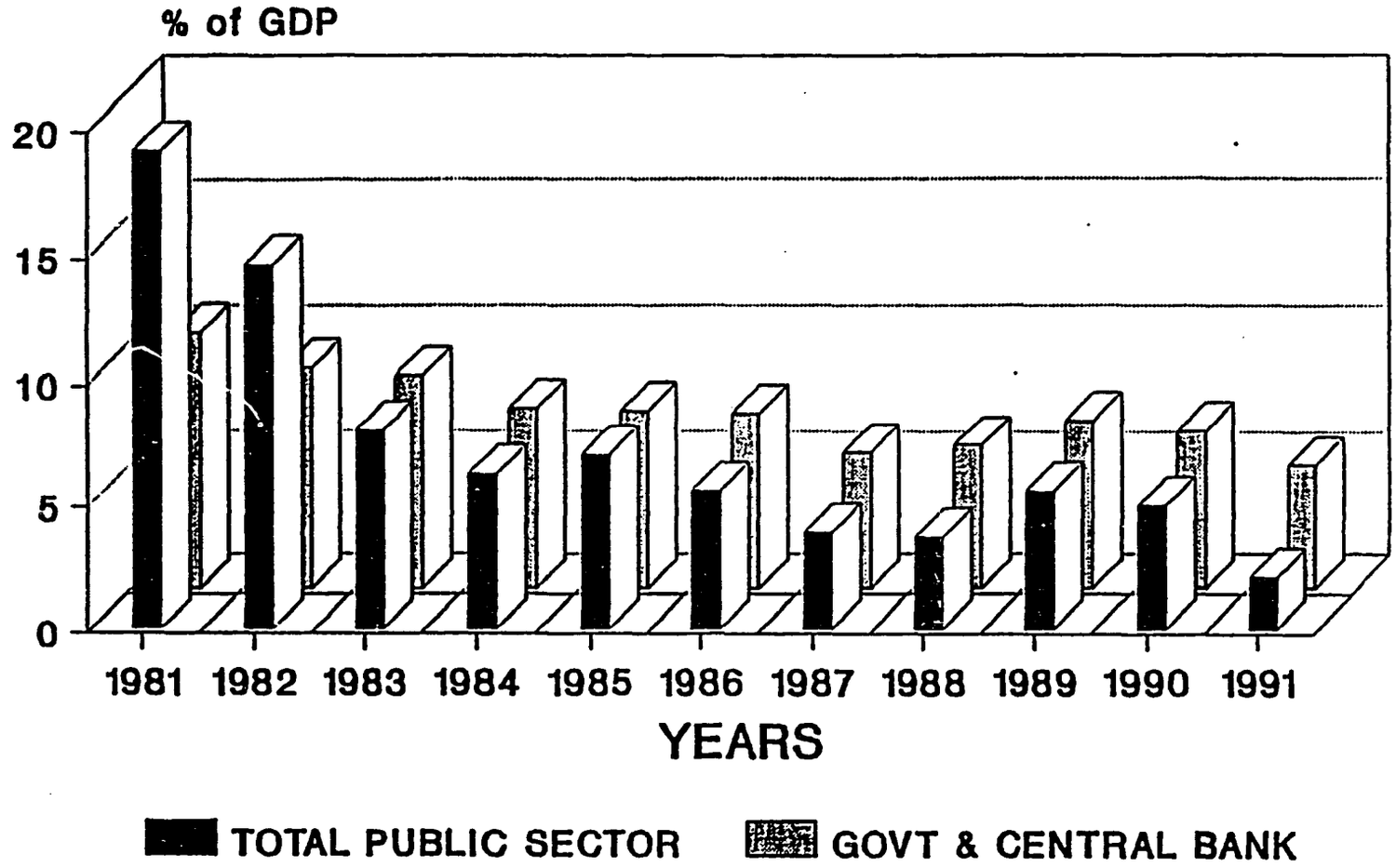
The Public Sector Deficit

Fiscal adjustment since 1982 has relied mainly on yearly stabilization efforts to close the gap between government income and expenditures rather than correcting the long run rigidities that have been causing the continuous imbalances. (See Figure II-1.) It is also important to note that the main contributor to the reduction of the public sector deficit has been the non-financial public sector, excluding the Central Government. As is well known, such a succession of short term adjustment programs over a period of several years can lead to what is known in the economic literature as "adjustment fatigue," which can increasingly frustrate the attainment of stabilization.

Figure II-1

COSTA RICA: PUBLIC SECTOR DEFICIT

As percentage of GDP



Source: Ministry of Finance, Central Bank and IMF estimates

Most of the widely recognized problems that create fiscal imbalances continue to be present. On one hand, the lack of flexibility for the authorities to reduce expenditures comes from the high proportion devoted to the government payroll. The actions of unions and similar groups make it difficult to deal with special privileges, such as those coming from unsustainable pension regimes. Another aspect is the existence of "laudos," a judicial way for public employees to increase their salaries by transferring the determination of wage policy from the employer (i.e., the government and other public institutions) to the court system.

On the other hand, several kinds of incentives and tax exemptions introduce rigidities in fiscal receipts. Protectionism in the form of tax exemptions for exporters under the export contract ("contrato de exportación") and similar regimes, as well as for the development of tourist accommodations, needs to be rationalized for both fiscal and trade reform reasons. Current protection should not be maintained permanently, but should gradually decrease to force enterprises to become more competitive through increased efficiency. Governmental transfers to entities such as universities, as well as the earmarking of certain taxes (e.g., the land tax for regional governments, the "municipalidades"), add to inflexibility in the management of government finances. Moreover, as past deficits had to be financed, the burden of the public debt has grown -- more rapidly in recent years with high nominal interest rates resulting from inflation and financial liberalization -- so that interest payments have become an additional source of rigidity.

Another negative effect of the fiscal deficit has been the reduction in public investment for infrastructure (e.g., roads, ports, etc.) and human capital (e.g., education, health, etc.). As short-run decisions to reduce the fiscal gap have prevailed, reductions in expenditures have sacrificed public investment instead of current expenditures since this is an easier course of action from the political standpoint. These circumstances result in increased costs of production for private enterprises and reduce their ability to compete in international markets.

The combination of delays in structural reforms for the public sector and the problem of "adjustment fatigue" has made fiscal balance, and hence the attainment of stabilization objectives, highly fragile. Nonetheless, the structural adjustment process undertaken by Costa Rica since 1983-84 has had some beneficial results for the macroeconomic context. More recently, initial efforts have been made to reform the pension and tax exemption regimes. However, the achievements so far have been modest and not sufficient to prevent the fiscal deficit from continuing to be the main potential source of financial instability. Moreover, when the problem of Central Bank's deficit (to be addressed below) is taken into account, the danger becomes more clear.

Continuing efforts to avoid even short-run deviations from the declining trend in the fiscal deficit require not just permanent vigilance and definite actions each year to reduce the gap in the budget and reinforce its execution but ultimately a decisive attack on the fiscal rigidities and distortions mentioned above. This is an urgent task since the short-run efforts may be leading to "adjustment fatigue," and it is essential to recognize that the only way to assure stabilization in the longer run is through combating the perverse effects of public deficits by introducing the needed structural reforms as soon as possible.

Monetary Policy and the Central Bank Deficit

As can be seen from the figures in Table II-1, fiscal dependence on the banking system for finance has been reduced during the past ten years, so that there is no longer a direct impact of the fiscal deficit on monetary expansion through additional credit. In most cases, the Treasury has gone directly to the market or has made special arrangements with public institutions that are in surplus to invest their surpluses in Government debt. The important remaining source of Central Bank credit to the Government comes from unpaid interest on credits related to external debt rescheduling in 1983 and 1985 as well as the debt renegotiation of 1990. Under these arrangements, the Central Bank assumed the foreign debt to international creditors, and the original debtors ended up with a liability to the Central Bank. However, the Government has not always honored its obligations to the Central Bank, and this has become a significant means of indirect financing by the Central Bank.

Other sources of monetary expansion through credit to public sector institutions have also continued during most of the 1980s, except for access to Central Bank credit by the price stabilization institution (the Consejo Nacional de Producción, CNP) which was ruled out by the legal reform of 1988 (Ley de Modernización Financiera). In the case of other non-financial public sector institutions (those other than the Central Government), foreign debt renegotiations, and especially the debt of the government development corporation (the Corporación Costarricense de Desarrollo, CODESA) with the Central Bank, have continued to add to undesired increases in Central Bank credit through interest arrearages. Nonetheless, some improvements have been made in that the Central Bank is now to be paid on time with respect to the foreign debt restructuring for the government electricity institution (Instituto Costarricense de Electricidad, ICE) and the government oil refining enterprise (Refinadora Costarricense de Petróleo, RECOPE). However, with respect to CODESA's debt to the Central Bank, the annual accumulation of unpaid interest has only been interrupted by scattered payments with funds coming from the sale of CODESA's enterprises, primarily through the USAID supported program of CODESA divestiture.

It is clear that Central Bank credit to the Government, to CODESA and to commercial banks, as well as the ability of the Central Bank to contract foreign debt without legislative approval, played a significant role as one of the main roots of the financial crisis of 1980-82. The limitation of credit to the Government and CODESA has been implemented as a policy decision of the Board of Directors of the Central Bank.[1] Rediscounts to the commercial banks have not been necessary during the last ten years, as excess liquidity in the system has been the rule. With respect to foreign borrowing, the debt rescheduling and renegotiation required during the 1980s have been enough to prevent increased indebtedness with international banks, although not with multilateral organizations. Nonetheless, as there are no explicit legislative limitations, other than the ban on Central Bank financing of the CNP already approved, such factors could potentially jeopardize stability again in the future.

The most important source of instability through money creation has been Central Bank losses, as explained in detail in Lizano (1987) and Delgado and Vargas (1990). (See Figure II-2.) In spite of the latest external debt renegotiations which reduced these losses from 2.7 percent of GDP in 1989 to 1.9 percent of GDP in 1990, their level remains high enough to continue to be a destabilizing element, especially considering that these losses are equivalent to a fiscal deficit fully financed through money creation.

These Central Bank losses were the result of the same mistaken policies that erupted into the 1980-82 financial crisis. The main perverse element was the accumulation of foreign debt by the Central Bank, which also reflects the involvement of the Central Bank in long-run operations when it is in fact suited for short-run activities. After the explosion of the crisis, the need for highly active monetary policy required an almost total reliance on the sole instrument available: open market operations. The burden of interest payments on the liabilities created by Central Bank open market sales adds to its deficit since there is no interest income as a counterpart.

A second source of the Central Bank's post-crisis deficit was the practice of charging interest on USAID local currency counterpart funds, which were generated by grants and deposited in the Central Bank, during most of the second half of the past decade. USAID support to Costa Rica during the 1980s was a key element of assistance with economic and financial reconstruction after the 1980-82 crisis. Nonetheless, many of the programs called "economic stabilization and recovery" on the basis of grants for balance of payments support in fact spent the colones generated by these

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[1]Since the crisis episode of 1980-82, Central Bank credit to the Central Government has moderated substantially. The suspension of new credit to CODESA is even older, dating from the late 1970s, and has been strictly maintained.

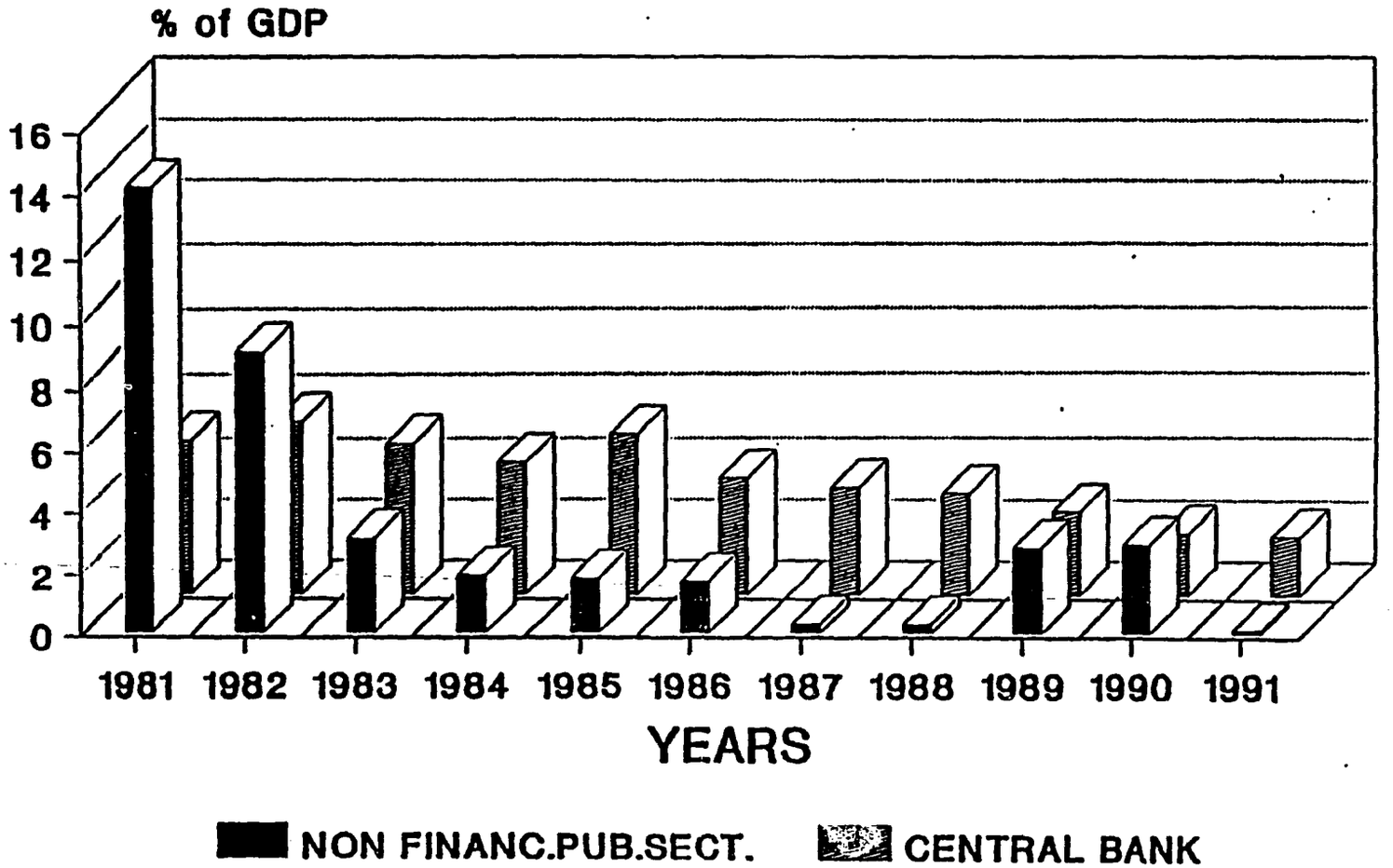
grants, which consequently undermined the purpose of balance of payments support. Moreover, the practice of charging interest on the resulting deposits in the Central Bank increased its expenditures and thereby its deficit.

Recent USAID support to deal with the problem of Central Bank losses has led to an innovative mechanism for the use of funds remaining from former USAID grants. Instead of using such funds (about US$29 million or 4,000 million colones) for expenditures on public programs, which would imply monetary expansion, they will be used to pay interest on a government bond issue to fund the debts accumulated at the Central Bank from the losses of the CNP. This bond issue, approved by an executive decree dated August 27, 1992 (No. 21540-H of the Ministry of Finance), includes not only accumulated debts to the Central Bank of 4,745.3 million colones but also 1,490 million colones of interest from May 1990 through May 1992. These new bonds have a nine year term and an interest rate of 18 percent, in contrast to the original debt that had no interest and for which no term was established by Costa Rican law. This measure not only eliminates a potential source of monetary expansion but also provides the Central Bank with earning assets, thereby reducing its annual deficit by about 0.2 percent of GDP. While this is not a large number, the measure is in the right direction and is the first one taken by the Government to deal with the problem of the Central Bank deficit.

Figure II-2

COSTA RICA: PUBLIC SECTOR DEFICIT

As percentage of GDP



Source: Ministry of Finance, Central Bank and IMF estimates

A third source of Central Bank losses that began in the 1980s are the interest payments on foreign currency deposits. As mentioned elsewhere, dollar deposits in the banking system, which amounted to about $525 million as of the end of 1991, became a liability of the Central Bank as they were used as balance of payments support funds through a 100 percent reserve requirement. As liabilities, they also imply interest expenditures that further increase the Central Bank's losses.

Central Bank losses have caused a high degree of rigidity in monetary policy. In a country such as Costa Rica, where monetary policy has traditionally played a compensatory role in view of the historic lack of discipline on the fiscal side, this is a serious limitation. Given the situation emerging from the 1980s, the Central Bank is not able to play its normal role because it is faced with a most atypical situation: even the income from seigniorage is insufficient to cover its expenses, so that the Central Bank incurs losses. Consequently, there is no room to offset fiscal deviations in the short-run -- nor even in the medium and long run.

The effects on financial markets from Central Bank losses come about not only from constraints on the wider use of open market operations as the main instrument of monetary policy but also because the Central Bank then tries to carry out sterilization operations as much as possible by costless means (to it), such as raising bank reserve requirements. At present levels of 28 percent on demand deposits and 10 percent on time deposits, reserve requirements have become an important factor that increases the cost of financial intermediation -- about 2 percentage points at the present level of interest rates (about 19-20 percent for six-month deposits).

The Overall Public Sector Deficit and Financial Markets

Since both the Central Government and the Central Bank need large amounts of funds in the short run to cover their respective deficits, they increase the demand in the financial market, thereby creating upward pressure on interest rates. This financing is carried out by selling public-debt bonds in the case of the Government and stabilization bonds (bonos de estabilización monetaria - BEMs) in the case of the Central Bank, in both cases either directly or through the securities exchange.

Although the amount of public debt is not yet an overwhelming problem in Costa Rica (total bonded debt was about 180,000 million colones as of April 1992, including government owned banks and other public institutions) as it represents about 27 percent of 1991 GDP, the increasing trend in Central Government debt over a period of several years, as can be seen in Table II-2, is cause for concern. In fact, domestic debt has increased markedly in real

terms in recent years, which not only raises the proportion of government expenditures devoted to interest payments but may also distort the market by increasing interest rates to levels higher than required in a competitive market, since the Government is not governed by the same rationality as private economic agents and hence may be willing to pay any rate to obtain funds.

Table II-2

Government and Central Bank Bonded Debt -- 1985-1991

(millions of colones and percents)

Year	Government Property Certificates	Percent Change	Central Bank Bonds	Percent Change
1985	16.775	30.7	5.710	-15.9
1986	20.892	24.5	6.291	10.2
1987	25.236	20.8	11.765	87.0
1988	33.338	32.1	24.363	107.1
1989	46.027	38.1	30.827	26.5
1990	64.021	39.1	27.726	-10.1
1991	95.277	48.8	32.164	16.0
1992	112.752	18.3	55.902	73.8

Source: Central Bank of Costa Rica.

On the other hand, except for some deviations, the overall public sector deficit (including Central Government, non-financial public institutions and the Central Bank) has shown a decreasing trend since 1982 to levels as low as 2 percent of GDP. However, the combined Central Government and Central Bank deficit has usually been higher than 5 percent of GDP, and this is probably a better figure to measure the impact of the public sector deficit on the financial system, especially since there is no institutionalized way to transfer the surpluses of public institutions directly to finance the Central Government and the Central Bank without distorting financial markets.

An additional point is relevant. It could be argued that Central Bank actions are represented by two opposing forces that offset each other and thus have no effect on the level of interest rates. It is true that there is both monetary expansion due to the Central Bank deficit at the same time as contraction due to placing stabilization bonds in the market. Although simple offsetting forces could be probably expected in a well developed and efficient financial market, this is not the case in Costa Rica, so that this element also adds to the fragility of economic stability.

The External Sector

As indicated in Lizano and Vogel (1991), the foreign exchange regime is also important to understand financial market development. As economies become more integrated into the world economy, not only through the current account of the balance of payments but also through the capital account, mismanagement of exchange rates and the existence of exchange controls, as are common in developing countries, can create expectations and interest rate differentials leading to capital flight and a process of domestic financial disintermediation.

There is, moreover, growing recognition that exchange controls not only have a limited effect in trying to correct balance of payments disequilibria but also induce a perversity in the demand for financial assets due to the fear of future difficulties in converting domestic assets to foreign currency. At the same time, there is a wider acceptance of the view that individuals have the right to protect their net worth through different kinds of currency substitution when domestic policy mismanagement jeopardizes the value of the local currency.

The Costa Rican economy has had a long record of recurrent periods of external instability, most of them related to imbalances caused by the volatility of international prices for primary exports and to fiscal deficits. In fact, during the first thirty years of Breton Woods international monetary system, while the other Central American countries and Mexico had stable currencies, the Costa Rican colon was devaluated from 5.67 to 6.60 colones per dollar in 1961 and to 8.60 in 1974. Moreover, surcharges on imports, dual markets, multiple exchange rates and similar kinds of exchange controls were frequent during this period.

Costa Rica began the 1980s with the financial crisis of 1980-82 that led to a very disorganized foreign exchange market. The official exchange rate (set by the Currency Law) was increased from 8.60 to 20.00 colones per dollar in 1981. At that time, however, the banking rate (a kind of market rate as opposed to the legal rate) was about 36 colones per dollar and the free market rate was almost 2 colones higher (Céspedes et. al., 1983a). By July 1982, the banking rate, controlled by the Central Bank, had risen to 38 colones per dollar and the free market rate was about 60 colones per dollar (Céspedes et. al., 1983b).

After August 1982, a new legal framework banned foreign exchange operations outside the banking system. At the same time, a more flexible exchange rate policy was put in place, with a crawling peg system. Since the second half of 1984, this has been geared to compensating for the difference between the domestic inflation rate and a weighted average of the inflation rates of Costa Rica's major trading partners, as well as other factors changing the relative parities of the currencies. Agreements with the International

Monetary Fund and with USAID have reinforced the Government's decision to adjust the exchange rate in a way that avoids its appreciation in real terms.

It is important to note that, since the external sector of an economy is -- in a sense -- a residual, it is affected by the types of domestic imbalances in public finances described above. The fiscal origin of balance of payments problems in Costa Rica is clear throughout the economic history of the country. However, the flow disequilibrium became a stock disequilibrium during the 1980s because of the large public sector external debt that resulted from the accumulation of public sector deficits throughout the preceding years.

Financial intermediaries are affected by external instability for reasons in addition to those mentioned above. Provision of the kinds of services related to foreign trade is dampened as country risk status increases. Credit transactions involving external savings are also deterred by the substantial foreign exchange risk involved. In addition, there are legal restrictions derived from the fact that the official exchange rate fixed by law has nothing to do with reality. Although no transactions are carried out at the legal exchange rate of 20 colones per dollar, there is still the possibility of being paid at this rate when contracts denominated in foreign currencies are rejected and settlement reaches the courts.

For several years, the government owned banks have offered dollar denominated time deposits. However, these funds could not be used to finance credits in either colones or dollars because a 100 percent reserve requirement had been established by the Central Bank, so that the dollars captured were used to finance the balance of payments deficit. Moreover, the interest rates were fixed by the Central Bank which also paid commissions to the government owned banks for such deposits.

Lizano and Vogel (1991) offer some indicators of the path of nominal exchange rates in recent years, as well as calculations of real exchange rates. They argue that the basic criteria for a crawling peg system have not always been followed strictly and that overvaluation in the last years of the 1980s ensued and could be used to explain the deterioration in the balance of payment. Nonetheless, it has to be remembered that such calculations are greatly influenced by the methodology used, including the choice of the base year, the number of trade partners considered and the weighting criteria used.

The process of liberalization of the foreign exchange market has advanced greatly in recent months. Moreover, a proposal to modify the Currency Law as well as the Central Bank Law has been presented to the Costa Rican Congress to take exchange rate determination away from the Congress and to adjust legislation to conform to the

system actually operating since the early 1980s. Elimination of the ban on foreign exchange transactions outside the banking system and allowing contacts denominated in foreign exchange are other important reforms under way.

Since March 1992, the Central Bank has also stopped fixing the foreign exchange rate through mini-devaluations and has instead transferred the responsibility for exchange rate determination to market forces operating through the commercial banks. Central Bank interventions have occurred in the first stages in order to smooth the transition to a freer regime. The capital account has also been liberalized by allowing banks to sell foreign exchange for any purpose, without requiring justification of any kind as had been true in the past.

Reserve requirements on dollar-denominated time deposits were reduced from 100 percent to 10 percent in March 1992 as a further step toward foreign exchange market liberalization. Now all banks, both public and private, are permitted to receive deposits in dollars (in the case of private banks these are called "certificates of investment") and to use the funds to make loans in the same currency. However, since certain legal reforms have not yet been approved, banks are unwilling to take the risk of being paid in colones at the legal exchange rate of 20 colones per dollar, so that this mechanism is still not working properly.

The liberalization of the foreign exchange market has brought an excess supply of foreign exchange and a declining trend in exchange rate during the first four months after the Central Bank's measures. As Lizano and Vogel (1991) suggest, this is a predictable result when controls are removed and people understand that they can freely take their financial assets into or out of a country without the dictates of any government authority. Nonetheless, other factors also help to explain the present occurrence in Costa Rica. Low interest rates in the United States and other international financial markets, together with worldwide political changes and the process of policy reform in developing countries, have also increased confidence and promoted capital repatriation.

Domestic interest rate misalignment has also played a key role in the downward trend in the nominal exchange rate, at least until such rates were substantially reduced. The representative rates for six-month Central Bank and Government bonds fell from about 31 percent in February to 13 percent in mid-June, thereby becoming negative in real terms against an officially expected rate of inflation of 16 to 18 percent for 1992. Apparently as a result of these interest rate changes, a reversal of the exchange rate trend is occurring, which is as rapid as the previous fall. The exchange rate was 138.50 colones per dollar in February, declined rapidly during the last part of May and the first half of June, reaching

about 122 colones per dollar, but then rose again by the end of June to about 135 colones per dollar.

Reforms in the legislation concerning foreign currency transactions, such as those in the proposal currently under consideration by the Congress, are urgent. In addition, these reforms should be complemented by some additional changes to promote the active participation of financial intermediaries in such operations. It should be clearly stated that any transactions in foreign currencies by banks and financieras have to be settled in the same currency, even though in other contracts among private parties the debtor maintains the right to pay in colones calculated at the prevailing market exchange rate. Furthermore, in a liberalized foreign exchange system the Central Bank should not have the power to impose charges on foreign exchange transactions for specific purposes as it is currently doing. In fact, there are now charges in colones up to the equivalent of US$.89 to help cover the Central Bank's losses, to finance part of a fund to cover the foreign exchange losses incurred by the government owned banks and to finance two public autonomous institutions.

Conclusions and Recommendations

During the past ten years, continuing efforts have been made by the Costa Rican Government to deal with the fundamental macroeconomic imbalances that constitute a serious obstacle to economic growth.

Short term policies, both fiscal and monetary, have continually been used to reduce the size of the public sector deficit, to seek out less harmful ways to finance it and to compensate, at least partially, for the monetary expansion caused by the Central Bank's deficit. As a result, the combined public sector deficit (which includes the non-financial public sector deficit and the Central Bank's quasi-fiscal deficit) has been kept under relative control, and the Central Government and other governmental agencies have ceased to be financed through monetary expansion.

Structural reforms have also been introduced in the macro-financial environment. Some important sources of rigidity in government expenditures have recently been targeted, while legal reforms already approved by the Costa Rican Congress have reduced the impact of some perverse factors such as the pension regimes and tax exemptions. At the same time, the external public debt renegotiations concluded in 1990 have had a major favorable impact not only on the balance of payments position of the country but also on the Central Bank's deficit.

In the foreign exchange area, as well as in pricing policies, actions have also been taken as part of the slow but continuing process of policy reform geared toward the liberalization of the economy. The policy of exchange rate adjustment through a crawling

peg system was recently replaced by a "dirty float" regime, where the rate is determined by the participating financial intermediaries taking into account market forces. Moreover, there is now less reliance on government regulation and determination of prices as compared with ten years ago.

There is nonetheless still room for further improvements in the macro-financial situation and related policies. The volatility in the fiscal deficit not only introduces a destabilizing element each year but also creates unfavorable expectations. More actions are required to reduce the fragility of the fiscal situation through structural reforms in both expenditures and taxes and to reduce the overall size of the public sector that is still so large that it leads to a "crowding-out" effect.

Returning the required flexibility to monetary policy is also crucial, especially since the public sector deficit situation is fragile. A permanent solution to the problem of the Central Bank's losses, by transferring them to the government budget and using sound financing methods for the resulting increase in the deficit, not only enables monetary policy to be carried out properly but also appropriately returns the Central Bank's losses to their source.

Finally, further efforts are required in the area of pricing policies, but mainly with respect to eliminating the legal rigidities for foreign exchange translations. This becomes an increasingly important issue as the process of economic globalization continues and the openness of the Costa Rican economy increases in both the current and capital accounts of the balance of payments.

Chapter III

Banks and Financieras

Introduction and Summary

Banks and Financieras

In order to carry-out the analysis of banks and financieras, including the Banco Popular, approximately forty Costa Rican Government officials, bankers, and others who are involved with or otherwise knowledgeable regarding the financial sector were interviewed. (See Exhibit A.) Summary financial information for all Costa Rican banks was obtained from the Auditoría General de Entidades Financieras (AGEF) for the years 1982, 1985, 1988, and 1991. (See Exhibit B.) Also, detailed financial statements for the year December 31, 1991, including some independently audited financial statements, were obtained for selected private sector banks.

Detailed financial information ("balances analíticas") for Costa Rican banks was requested but was not made available by AGEF. This was not considered to be a major problem for carrying out the terms of reference. Financial information for offshore affiliates of Costa Rican private sector banks is not generally available, except as voluntarily provided by a few banks. This reduced the detail and accuracy of information evidencing the size and growth of Costa Rican private banks. A summary of financial information requested of various institutions and that which they provided is shown in Table III-1.

Nevertheless, an analysis of available financial data indicates that private sector banks have grown from less than 3 percent in 1982 to approximately 10 to 12 percent of total banking assets as of the end of 1991. (See Table III-2.) More importantly, the earning assets, especially loans, of private banks have increased from less than 3 percent in 1982 to 23 percent at the end of 1991. These figures do not tell the entire story since most private sector banks have affiliated banks outside of Costa Rica that focus primarily on serving Costa Ricans living in Costa Rica. Consistent data for the so-called "off-shore banks" are not available. However, an analysis of the independently audited financial statements for two such banks and anecdotal information obtained during interviews indicate that the financial assets managed by the off-shore affiliates is at least as great as the amount managed by the Costa Rican private sector banks themselves. Therefore, private banks now account for close to half of all lending by Costa Rican banks.

Although the private sector banks in Costa Rica (not including off-shore affiliates) only account for 10 percent of assets and 23

percent of loans, they account for 72 percent of profits. If quality financial information concerning the off-shore banks were readily available, then the private sector share of profits for 1991 would most likely exceed 90 percent. This is due to their relative efficiency and lack of the enormous, inefficient infrastructure present in the four public sector banks. Also, private sector banks are mostly focused on commercial or wholesale business with a large share of international trade financing, which generates not only interest income but also fee income from letters of credit and foreign exchange.

All bankers interviewed agreed that USAID intervention, through both the various large credits and the various types of pressure applied to the Costa Rican Government, has been key to the emergence of private sector banks and their growing powers.

Notwithstanding the emergence of the private sector banks, there are still some serious distortions with respect to what a private sector bank can and cannot do in Costa Rica. Most bankers reported two significant problems: (1) lack of authority to offer checking accounts (cuentas corrientes); and (2) lack of a true discount facility at the Central Bank. Upon entering into more detailed conversation and closer analysis, neither of these problems appears to be of as great significance as bankers claim.

Private sector banks have found an assortment of ways to effectively offer customers immediate use of their funds (through payment orders, money market accounts on the securities exchange, etc.). They also offer checking accounts in U.S. dollars through their offshore affiliates. These accounts are mostly provided by means of 'payable through' accounts managed by Barclays Bank, PLC -- Miami Agency. They are free of any reserve requirements since the various jurisdictions (mostly the Cayman Islands and the Bahamas) where the offshore affiliates are chartered have no reserve requirements for bank deposits owned by persons not resident of the charter-granting country. This is explained in detail further on in this report.

The discount facility problem was essentially resolved in late March while research for this study was being conducted. The Central Bank issued a circular informing the private sector banks of the availability of a new discount facility ("Fondo de préstamos a los bancos del Sistema Bancario Nacional ante problemas temporales de liquidez") which was to be funded with a line of credit from an international donor agency source. However, it is worth noting that this facility will be costly to users and unlikely to be needed by the private sector banks, since their cash flow requirements are relatively easily forecast. They are not particularly vulnerable to liquidity crises, especially a run on deposits, since they cannot offer checking accounts. Furthermore, such a facility will not be available to the off-shore affiliates where most demand obligations (checking accounts) exist.

Nevertheless, the "Fondo" is a good beginning toward providing a meaningful rediscount line for liquidity purposes. Subsequent information indicates that the source of funding for the "Fondo" is USAID and that the amount available is C5.6 billion. Based on the total deposits of the private sector banks as of December 31, 1991 (C32,782 million) this fund equals 17 percent of the entire deposit base. This would seem to represent a very substantial 'second line of liquidity' by any standards.

All-in-all, the Costa Rican private banks, as a group, appear to be healthy, growing rapidly, and, when off-shore activities are taken into consideration, "have their cake and eat it too".

The emergence of the private sector banks has had a profound impact on the public sector banks. This is manifest in their financial losses. The public sector banks must now compete with the private sector banks that are much more efficient. This has reduced their interest spread on financial intermediation and their fee income from provision of other services. In other words, the private sector banks have "skimmed the cream" of Costa Rican banking business. The public sector banks continue to carry a huge infrastructure and, though they have a monopoly on checking accounts, must deal with very high reserve requirements and the need to carry working balances of currency at their numerous branches.

The pressure on income, combined with their large and inefficient infrastructure and Byzantine operational practices, has forced the public sector banks, as a group, to incur losses. On the other hand, competition has forced the public sector banks to modernize, reduce personnel, and offer new and more efficient services. All four public sector banks have developed comprehensive strategic plans and are heavily engaged in attempts to compete and survive.

The two most significant problems with respect to the Costa Rican commercial banking sector appear to be the inability of the private sector banks to offer checking accounts and the deficiencies in the supervision of banks, including the lack of control over the offshore affiliates. These problems are interrelated. The offshore affiliates of the private sector banks benefit by being able to operate in a minimally regulated environment, offering U.S. dollar checking accounts without having to maintain reserves and effectively avoiding taxation of their income. However, a rapidly growing portion of the Costa Rican public's deposits and the banking sector in general is operating completely out of control of the Central Bank and Costa Rican regulatory authorities.

Now that private sector banks are thriving in Costa Rica, it is time to upgrade the safety of the system. This means an elimination of remaining competitive barriers, mainly the ability of the private banks to offer checking accounts. It also means that supervisory powers and capabilities must be enhanced.

Information about offshore banking activities should be available to the regulatory authorities and comprehensive examination of offshore banks by Costa Rican authorities (AGEF) should be practiced.

Although regulation of the off-shore banks is technically outside of the control of Costa Rican banking authorities, many means exist by which significant effective control can be exercised. Former President of the Central Bank, Eduardo Lizano, proved that when he put an end to the offshore banks offering colon deposits a few years ago. Other means would include prohibiting such banks from making loans and/or soliciting deposits within Costa Rica. Although they might do as they please anyway, banking authorities could make it very costly by such actions as refusing to allow (not giving legal status to) access to the courts for loan foreclosure actions, 'pressure' on ownership which also owns the private local banks which depend on the Central Bank and AGEF in many ways, etc.

It is worth noting that at least six private banks have explored establishing a banking presence in Miami. However, their small size, the inadequacy of Costa Rican supervisory practices, the much stricter new foreign bank supervisory legislation in the United States, and the location of their offshore affiliates in jurisdictions of questionable credibility will all operate against Costa Rican banks being able to enter the United States. This will be discussed in further detail.

Qualitative Comments and Analysis

Public Sector Banks

The experience of an international banker working for a major California bank and calling on the four public sector commercial banks in Costa Rica between 1975 and 1982 is worth noting.[2] The impression was that they were over-staffed and inefficient institutions characterized by highly formalized and bureaucratic approaches to everything. Impressions ten years later were somewhat similar. However, it is also apparent that much has changed. The public sector banks are "playing a catch-up game". What they are trying to "catch-up with" is the burgeoning private sector competition and modern banking as conducted, even in many smaller Latin American countries, in the 1990s.

As a group, the public sector banks experienced serious operating losses in 1991. (See Tables III-4 and III-7.) This is due to several factors, most notably the following:

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[2]The banker in this case is John McGuire, the primary author of this chapter of the report.

1. The private sector banks have taken much of the more profitable commercial banking business. For example, they have been able to attract as customers many of the best corporate and commercial enterprises in Costa Rica. This means they have also taken the lucrative commission generating foreign exchange and letter of credit business that many of the larger local and multi-national businesses offer and, by soliciting the best private sector companies, they are able to make loans with much lower aggregate portfolio risk than the public sector banks have.

2. The liberalization of interest rates has squeezed the net interest income margins of the public sector banks.

3. Stricter regulations controlling: (1) the classification of problem loans; and (2) when non-performing loans must be taken out of interest accrual status have reduced "paper profits", although leading to more accurate financial reporting.

4. As a result of the 1988 financial sector law, banks must now calculate their contribution to the Employee Pension Fund ("Fondo de garantías y jubilaciones de los empleados") as a charge to earnings of 10 percent of payroll expense, in contrast to the previous practice of applying a percentage of the banks' earnings. This previous practice provided an incentive to 'manage' profits to the benefit of employees. The new law 'assures' all banks of an additional employee expense of a certain amount.

These pressures have forced the public sector banks to do what they never would have done had it not been for the structural changes imposed on the Costa Rican financial sector and for the emergence of the private sector banks. Much improvement can be seen, although most of this can only be described by anecdote.

During the visit to Costa Rica, representatives of three of the four public sector banks were interviewed. Those included the Banco Nacional de Costa Rica, the Banco Anglo Costarricense, and the Banco Crédito Agrícola de Cartago. A planned visit to the Banco de Costa Rica did not occur. In the case of the Banco Nacional de Costa Rica, two members of the consulting team were invited to breakfast at the bank. The breakfast was hosted by the general manager, and virtually the entire executive management team was present. It was clearly intended to impress the consulting team with all that has taken place and is currently being done to make this, the largest commercial bank in Central America, a truly modern and efficient financial institution.

During the brief tour of Banco Nacional de Costa Rica's Head Office, much of what was seen and heard was truly impressive -- more by comparison to what everyone knows about the history of the public sector banks than by comparison to modern banks in the

United States and certain other Latin American countries. However, certain critical problems were glossed-over and/or down-played, e.g., labor unions, excessive personnel, high reserve requirements, etc. Nevertheless, progress is encouraging.

Two specific examples of improvements in the public sector banks are the following:

1. Strategic Planning: During the course of interviews, it was learned that virtually all four of the public sector banks have gone through the strategic planning process and have such operating documents in place. This is considered significant in that strategic planning is a widely accepted process by which an enterprise determines its mission and what must be done to fulfill it.

2. Customer Service: Several, if not all, of the public sector banks have taken specific steps to become more customer oriented and to provide better service. Most have adopted the concept of assigning major accounts/customers to specific account officers who serve as the customer's primary contact person in the bank. In the case of Banco Nacional de Costa Rica, this has taken a well-defined form where different levels of customers, by importance and nature of banking relationship, are assigned to specialized departments, notably a corporate banking department and a private banking department. It was quite obvious that much has been adopted from the best of current practice in the United States and Latin America.

Notwithstanding these encouraging improvements, the public sector banks are in varying degrees in poor condition. Their greatest (and saving) strength is their stature as government-owned banks. This, plus their size, leaves them in a "too big to fail status". However, AGEF has taken intervention steps at both the Banco Anglo Costarricense and the Banco de Crédito Agrícola de Cartago in recent times. Were either of these banks private and/or as small as a typical private bank, they probably would have been intervened and closed. Certainly, their capital positions and the alleged problems in their loan portfolios would have justified such action.

In the specific case of capital, Table III-3 indicates the gravity of the problem. At the end of 1991, the average capital to assets ratios for the public and private sector banks were 5.7 percent and 19.6 percent respectively. However, certain differences must be noted. First, the public sector banks carry a much higher relative proportion of cash and near cash assets, much of which serves as reserve requirements on deposits and appropriate liquidity for demand deposits. This type of asset does not require significant capital support. Second, the public sector banks are widely reputed to have severe problems in their loan portfolios. This

type of asset requires substantial capital which is definitely not there.

Some public sector bankers claim that, although they have the exclusive power to offer demand deposit accounts ('cuentas corrientes'), this does not offer particularly significant profit opportunities. This is due, for example, to:

- high reserve requirements;
- the amount of liquidity that must be maintained to respond to reasonable fluctuations in deposit balances, to support reasonable and normal working cash balances at the branches in the public sector branch networks, and to allow for the fact that efficient emergency transfer of cash from branch to branch is not as developed as it is, say, in the United States where large bank retail branch systems, the Federal Reserve, and armored car companies all facilitate such cash movement; and,
- the high cost in human resources and other expenses involved in supporting this labor intensive service.

There are two areas where improvements could be made with respect to demand deposit accounts, whether or not private sector banks are ever allowed to offer this service. First, reserve requirements could be reduced. Second, more efficient clearing processes could be implemented.

Several bankers reported that checks drawn on one bank and deposited in another take an excessive amount of time to clear, i.e., for the depository bank to determine that the funds are good and to make them available to the depositor/customer. It was reported that even checks deposited in the same bank on which they were drawn can take several days for the funds to be made available. This latter instance occurs if the maker of the check maintains his account in a rural branch and the payee deposits it in his (payee's) account in San José or another rural branch.

It would require some in depth investigation to determine the extent of this problem. Suffice it to say that it is a common complaint and is quite resolvable in today's banking world. An efficient clearing house in San José, on-line communications networks within the public sector banks, and efficient transport of checks between San José and the rural branches could solve this problem, and probably will with time.

It was suggested by at least one Costa Rican banker that USAID could, if desired, provide funding to support a technical study and recommended improvements in the clearing process. The cost of such assistance should be relatively modest.

It was reported by a representative of USAID that, subsequent to the consulting team's visit to Costa Rica, the Asociación Bancaria Costarricense (ABC) has entered into a contract with the Federal Reserve to provide expert assistance in developing a project plan for an electronic funds transfer system. This project is being funded by a USAID grant.

The Banco Popular

The Banco Popular is somewhat of a hybrid. It was founded 23 years ago and is a combination of public sector and private sector and operates more like a savings and loan association than like a bank.

Its capitalization grows through a mandatory apportionment of 1 percent of all salaries paid in Costa Rica and an additional apportionment from employers of 1/2 percent of salaries. The 1 percent from employees takes the form of a forced savings plan at an interest rate of 4 percent p.a. and for a term of 18 months. The employee can withdraw funds that have been on deposit for 18 months or more unless such funds are securing a loan. This has led to the Banco Popular having the second largest net worth of any financial institution in Costa Rica, other than the Banco Nacional de Costa Rica. Notwithstanding the mandatory savings, the Banco Popular has a large deposit base that accounts for about 95 percent of its funding. Considering that 95 percent of funding consists of deposits from the general public, it does not appear that the forced savings plan is now critical to the Banco Popular's financial viability, although it might have been in the past.

Governance of the Banco Popular is in the form of a "Workers' Assembly" consisting of 290 representatives of all sectors. They meet once per year to:

1. determine the mission of the bank;

2. elect four directors (Junta Nacional), with three others being appointed by the Government; and

3. elect the President, the Vice President, and the auditors.

The Banco Popular is audited by AGEF but is not subject to Central Bank regulation. It has a legal reserve requirement of 10 percent which must be held in certain types of short-term instruments. It has no offshore bank nor a seat on the securities exchange.

The most interesting item learned about the Banco Popular is that there is a project to privatize it. This would result in the mandatory apportionments being converted to stock. The project has been approved by the bank's General Assembly and is also advancing well with the Central Bank and the Costa Rican Congress. The only problem of significance is how to value the Bank for purposes of determining share value.

Private Sector Banks

The private sector banks have emerged in the last ten years as a major force in the Costa Rican financial sector. They have increased from essentially none at the beginning of the 1980s to six by the end of 1982 and to 17 at the time of the consulting team's visit to Costa Rica. The number has been as high as perhaps 20 one or two years ago, but three banks have been or are being liquidated. At least two others were experiencing severe problems but were re-capitalized and/or re-organized.

The offshore affiliates mainly deal in U.S. dollars and provide trade financing for Costa Rican enterprises. Their customer bases overlap with but are not entirely the same as that of their Costa Rican affiliate banks. They are reported to be highly liquid with considerably more in deposits than in loans. Much of this liquidity is invested in money market type instruments with large international banks. Much of it is also pledged to secure the trade financing transactions of the offshore banks, especially the confirmation of their letters of credit.

The private sector banks are all quite small as compared to the public sector banks. However, there is a great difference in size among the private banks. Banco Internacional de Costa Rica Limited (BIC Limited) is larger than the rest of the private banks together. However, that is not evidenced by total assets in Costa Rica. BIC Limited's offshore affiliate is much larger than all the other private banks, with or without their offshore affiliates. Aside from BIC Limited, there are five 'large' private sector banks in Costa Rica. The remainder are considerably smaller. (See Table III-5.)

The relatively small size of the private banks, specifically those that have failed, has prevented the failures from having profound effects on the Costa Rican banking system. However, more failures could occur and there is little, if anything, that is likely to be done by AGEF to anticipate, let alone prevent, such failures. It should be noted that none of the individuals interviewed gave any indication that other private sector banks are in imminent danger of failure, nor was there any obvious financial evidence of any weak banks, other than Banco Capital which is now under control of shareholders believed able to capitalize it adequately.

A potential problem derives from the essentially uncontrolled offshore affiliates of the private banks. The only effective control over these banks is the quality of ownership, which appears to be good to excellent in most cases. This will be discussed further in the next section.

Offshore Banks

The offshore affiliates of the Costa Rican private sector banks represent, in many ways, the most interesting aspect of the Costa Rican banking sector. Most of the private sector banks have an offshore affiliate, chartered somewhere in the Caribbean. This has led to their being commonly known as "Caribeña's". The chartering jurisdictions include the Cayman Islands, the Bahamas, Panama, Montserrat, and one or two other locations. The offshore affiliates, including Banco Internacional de Costa Rica Limited (BIC Limited), are owned by the controlling shareholders of the private sector banks, not by the banks themselves.

BIC Limited is a unique entity. It is owned by the four public sector banks. The Banco Nacional de Costa Rica is the majority shareholder and effectively controls BIC Limited. Notwithstanding the public sector ownership, BIC Limited is generally thought of as a private sector bank. Although this view may be difficult to accept, it is nonetheless the perception of the Central Bank, the AGEF and Costa Rican bankers generally.[3]

BIC Limited was originally chartered and initiated operations in Panama in 1976. It established a State of Florida licensed foreign bank agency in Miami in September 1983. The charter was moved from Panama to the Bahamas in 1989 as a result of the political and economic unrest in Panama during the Noriega regime. BIC Limited originally focussed on the Costa Rican market. However, that has changed substantially in the last three years. BIC Limited now has considerable deposits and credit activities with other public and private sector Central American customers. This is largely the result of the extensive contacts of the General Manager of the Miami Agency, a Costa Rican who was previously with the Citizens and Southern (C&S) International Bank in Miami and before that with the C&S subsidiary in Costa Rica. C&S has long had a very strong market position in Central America and the Caribbean.

With the exception of BIC Limited, none of the Costa Rican private sector banks nor their offshore affiliates are believed to have significant non-Costa Rican business.

None of the offshore affiliates, again with the exception of BIC Limited, has an actual presence in the chartering jurisdiction. BIC Limited is somewhat of an exception as it has been present and active in Panama since 1976. However, it is not believed to have

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[3]The reason for this view may be that both BICSA (the Costa Rican 'private bank') and BIC Limited (the offshore bank) largely act and operate as if they were private banks. For example, they do not operate branch networks in Costa Rica, they do not extend credit to the same sectors as do their shareholders, and they generally conduct their business in the best interests of their shareholders.

any significant amount of Panamanian business. The activities of the offshore banks are essentially all controlled from the affiliate private sector bank in San José.[4] This has several implications:

1. The efficiency of the private sector banks is considerably greater than the figures in Table III-7 indicate. This is due to the fact that more assets, loans, deposits, etc., are being managed on a 'per employee' basis than appears to be the case.

2. Since the offshore banks are not under the supervision of AGEF, the quality of their financial statements depends on the quality of ownership, the quality of supervision, if any, in the jurisdictions where they are chartered, and the quality of independent audits performed. The quality of all of these factors varies widely.

3. The offshore banks are managing a considerable base of deposits from the Costa Rican public. Their activities are, with minimal exception, completely out of the jurisdiction of AGEF and the Central Bank. The exception is for those banks (most) which want to be recognized as a 'first class bank' ('banco de primér orden') by the Banco Central. This status has several benefits with respect to withholding taxes and other matters. In order to have this status, the offshore bank must provide independently audited financial statements to the Banco Central. However, there was no evidence that either AGEF or the Banco Central makes any effort to analyze these financial statements in order to determine the financial health of the offshore banks or anticipate problems and weaknesses. Needless to say, there is no evidence that either AGEF or the Banco Central could or would take any action to prevent or limit such a bank's activities in Costa Rica.[5]

4. The offshore banks are essentially unsupervised. Notwithstanding various requirements to submit independently audited financial statements, none are examined by banking regulatory authorities. One large, noteworthy exception is BIC Limited -- Miami Agency. It is examined both by the Federal Reserve and by the State of Florida, Division of Banking, Bureau of International Banking. BIC Limited -- Miami Agency is believed to be in very sound financial condition.

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[4]Again, BICSA is somewhat of an exception as it has a major facility with management structure at its Miami Agency.

[5]Nonetheless, the Central Bank's actions in the case of colon deposit operations of offshore banks should be recalled.

The offshore banks have essentially provided a means by which private sector banking interests can offer checking accounts (in foreign currencies, mostly U.S. dollars, only), avoid reserve requirements, not be subject to certain taxes, and avoid Costa Rican Government control generally. However, these banks are severely restricted in their activities due to their lack of international credibility due to their small size, lack of home country supervision (Costa Rica or chartering country), and lack of credible chartering jurisdiction/country.

These issues are becoming more relevant to the offshore banks. The main impact of these factors is that any of their activities which require credit from foreign banks (lines of credit, confirmations of letters of credit, etc.) require that the offshore bank pledge cash collateral at whatever foreign correspondent bank facilitates the transaction. Additionally, several groups that control private sector and offshore banks have aspirations of establishing a banking presence in Miami. Recently passed banking legislation in the United States has made it impossible for banks chartered in locations such as where the Costa Rican offshore banks are chartered and for banks in countries that do not practice a 'global supervision' over their banking systems to receive any kind of charter or license to engage in banking in the United States.

This new legislation even represents a threat to the long-established and very large BIC Limited which operates a State of Florida licensed foreign bank agency in Miami. BIC Limited's Miami Agency is an agency of the Panama Branch of BIC Limited's Bahamas subsidiary, previously Panamanian subsidiary. If any of the Costa Rican banking groups are serious about entering the U.S. banking industry through either a Costa Rican or offshore chartered entity, they may find themselves in the near future wanting some things (supervision, charters, etc.) from the Costa Rican Government that they currently do not want.

Interestingly, the Costa Rican private bankers are becoming more conscious of the need for international credibility if their institutions are to obtain credit without cash collateral and otherwise be able to operate internationally. Credibility derives from various factors, such as size, location of charter, quality of ownership, quality of supervision, quality of independent audits, etc.

The chartering jurisdiction is critical. Costa Rican bankers have learned that none of the popular Caribbean countries where banking charters are readily obtainable has much international credibility. However, they have also learned that, among those countries, some are much less credible than others. One banker mentioned having inquired of international bankers in Miami as to which jurisdiction offers the best credibility and was told that only the Cayman Islands and the Bahamas have any credibility at all. Montserrat and certain other countries have no credibility whatsoever.

Several of the Costa Rican offshore banks have moved their charters to the Cayman Islands or the Bahamas in recent times in order to mitigate this problem as much as possible.

Another critical issue is the quality of independent financial audit. There are essentially four major multi-national accounting firms that audit Costa Rican banks. Two of them, KPMG Peat Marwick and Price Waterhouse & Company, operate under their own names in Costa Rica. Coopers & Lybrand operates through a long-associated partner, Carlos Ceciliano & Cia. The fourth, Deloitte, operates through a local licensee. It is reported that only the first three (KPMG Peat Marwick, Price, and Coopers) enjoy excellent local reputations. Deloitte's local licensee does not enjoy the same level of local esteem, as supported by several anecdotal comments by Costa Rican bankers and certified public accountants.

The licensing jurisdiction and the independent auditing firms come together in one instance, the Cayman Islands. If a bank is chartered by the Cayman Island Banking Commission, it must submit financial statements, independently audited by an internationally recognized public accounting firm with an office in the Cayman Islands. This means that, for example, KPMG Peat Marwick will audit a Costa Rican bank and its offshore affiliate in San José. It then submits its report and work papers to its Grand Cayman office which then reviews the work papers and generates the audited financial statements with opinion. These financial statements are then presented to the Cayman Islands Banking Commission.

It is further worth noting that the more reputable institutions chartered in the Cayman Islands send senior management representatives to the Cayman Islands to personally make themselves available to the Banking Commissioner and to present their financial statements, discuss their banks and answer any questions. This is 'as good as it gets'. It is said that procedures in the Bahamas are somewhat similar but not as rigorous. Other jurisdictions are far less serious about these matters.

It is illustrative to see which Costa Rican private sector banks are chartered where and audited by whom. (See Table III-6.) Several of the banks listed (as well as one or two of those that have failed) had their charters in Montserrat or similar jurisdictions but have moved them to the Bahamas or the Cayman Islands.

Financieras

Financieras are less important today than was the case prior to 1982. Earlier, financieras represented one of the few ways for the private sector to engage in any sort of financial intermediation. However, many financieras converted to banks once this became an alternative. Several of the banking groups also own financieras and there are also numerous independents.

Many financieras still exist, and new ones have been formed in the last ten years. Some of the reasons include:

- The minimum capital required to establish a new bank is C300 million, whereas only C60 million is required to establish a financiera.

- To establish a bank requires a minimum of 20 shareholders of which none can hold more than 5 percent of the shares. No such limitations exist for a financiera.

- It is much more costly to establish a new bank as compared to the cost to establish a financiera.

One financiera, Financiera ELCA, was visited. It is rather typical in that it is closely held by one family. On the other hand, it is unique in that it is providing very small loans to many customers and apparently with good collection and profit experience. Although individual loans may be small, ELCA imposes numerous fees, charges, and commissions that effectively boost the yield on most individual loans to a level that justifies their small size and offsets the otherwise high administrative cost per loan.

Financial Analysis

Introduction

The financial analysis performed on all of the Costa Rican banks was limited to aggregate figures because detailed financial information, as reported to AGEF and the Central Bank, was not made available. Also, independently audited financial statements were only provided by a few banks and only for the year 1991 (and, in a few cases, 1990). Generally, Costa Rican bankers, both public and private sector, take a very secretive position regarding financial information. A few are quite open, but for most part obtaining quality and detailed financial information was very difficult. Detailed information for the years 1982, 1985, 1988, and 1991 was requested from AGEF at the beginning of the visit to Costa Rica. Highly summarized information of a public nature was provided for those years two days prior to the consulting team's departure.[6]

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[6]In preparing similar analyses of banking systems in other Latin American countries it has usually been possible to obtain copies of the "balances analíticos" for all of the banks in the country's banking system. These have been provided, in a sense of cooperation with various international donor agencies, by the Superintendency of Banks. This type of information was similarly requested in Costa Rica from the AGEF, but the request was declined based on bank secrecy considerations. Summary information, which under any circumstances is essentially public information, was instead provided by the AGEF and was relied on for purposes of this analysis.

The highly summarized financial information did not enable any analysis of loan delinquencies at public or private sector banks.

Subsequent to the consulting team's visit to Costa Rica, the USAID Mission provided independently audited financial statements for the year ended December 31, 1991, (and which also included in most cases financial statements for the year ended December 31, 1990) for two of the four government-owned banks and 15 of the private sector banks. Two observations of significance can be made.

The audited financial statements of just two of the government-owned banks (Banco Nacional de Costa Rica and Banco de Costa Rica) showed approximately U.S.$33 million equivalent in the allowance for loan losses as of December 31, 1991. This amounts to 6.6 percent of the total combined loan portfolios of those two banks. This compares to a combined total of only approximately U.S.$2.5 million equivalent for 14 of the private sector banks or 1.5 percent of their combined portfolios. There are various reasons to suspect that the loan problems in the government-owned banks are even worse. For example, anecdotal information casts doubt on the quality of the audited financial statements of the two government-owned banks mentioned.

The second observation is that the presentation of financial statements varies greatly among the AGEF and the four public accounting firms that audited the 17 banks referred to above, and, surprisingly, from bank to bank as prepared by the same public accounting firm. This is to say, for example, that financial statements audited by KPMG Peat Marwick are not presented in the same format as those audited by Ceciliano & Cia. (Coopers & Lybrand). Furthermore, information provided by the AGEF is a highly summarized version of what is reported by the banks to the AGEF on the "balances analiticos." This makes difficult the reading and comparative analysis of such statements. It is not clear why public accounting firms doing business in Costa Rica are not more consistent in their presentation of financial statements for banks.

Public Sector Banks

The financial condition of the public sector banks is individually and collectively much worse. Some of this can be seen in the general lack of profitability. (See Table III-4.) However, the most serious problem (and cause of the lack of profitability) is the loan portfolio problems. This has been the subject of previous studies and was the subject of much anecdotal comment.

Problem loans are not, however, the only cause of lack of profitability at the public sector banks. They are also required to hold large portfolios of low-yielding Government securities which involves a significant 'opportunity cost'. Additionally, the public sector banks manifest several aspects of large branch

systems. They have a monopoly on demand deposits. However, they also have a monopoly on the tremendous overhead that goes with the large branch systems and the demand deposit monopoly.

Demand deposits clearly represent "free money" in the sense that interest is not paid on these funds. However, the "free money" is only that portion remaining after maintenance of legal reserves and a reasonable amount for normal liquidity needs at each office. Since demand deposits are high transaction volume accounts, as compared to savings and time deposits, there is considerable overhead in terms of employees, check processing equipment, and computer equipment involved in the administration of demand deposits. Banks in the United States and elsewhere recover some of those costs by applying various charges to such accounts, notably a monthly service fee for accounts that do not have a certain minimum monthly balance. The Costa Rican banks do not do this. Taking all of this into consideration, the monopoly on demand deposits is not as valuable as it might seem at first glance.

It is also worth noting that the public sector banks' balance sheets reflect not only the deposit liabilities of their monopoly on demand deposits, but also the assets (legal reserves at the Banco Central and working cash balances associated with normal liquidity requirements). This, together with the considerably greater investment in fixed assets (premises, furniture and equipment) associated with their extensive branch systems, partly explains why the loan portfolios of the public sector banks are smaller relative to their total assets than those of the private sector banks. (See Table III-8.)

The various balance sheet figures and ratios shown in Table III-8 clearly show the relatively much greater investment in cash and near cash maintained by the public sector banks and necessary for legal reserves and normal liquidity for demand deposits. They also clearly show the much greater investment in fixed assets necessary to support the large branch systems. If detailed figures for offshore affiliates were included with the private sector banks, these figures and ratios would be even more dramatic.

The private sector banks generally enjoy comfortable situations. They have the benefits of serving a wholesale, relatively low risk market. Although they cannot formally offer demand deposit accounts, they have found various loopholes that allow them to effectively provide immediate availability of deposits to their customers and, through their offshore affiliates, they can offer demand deposit accounts in U.S. dollars. The latter are highly suitable for settling international trade transactions and even for settling certain payments within Costa Rica.

It is worth commenting that there is really no logical reason for the Costa Rican Government to be in the banking business, let alone with four separate banks, all competing with each other and with

the private sector. However, if it is accepted that the Government is going to be involved in commercial banking, then much can be said for merging the four banks. This would make possible tremendous economies of scale, enabling reductions in personnel (assuming labor unions could also be eliminated or effectively negotiated with) and certainly in executive officers, in redundant branches and agencies, and in computer and other operating systems. It would also facilitate placing the entire public sector banking system branch network 'on-line', thus improving funds availability and customer service efficiency. Some idea of the potential efficiencies in the branch and agency networks alone can be gleaned from the information in Table III-9 showing the geographic location of head offices, branches, agencies, and "cajas auxiliares" by province and canton. Data for December 31, 1988, was used as more detail was provided for that year than for December 31, 1991. Little change in the total number occurred between 1988 and 1991.

A cursory review of Table III-9 clearly indicates the redundancy of public sector bank offices. Although drawing firm conclusions as to just how much redundancy and its degree exists would require considerable additional study, it is nevertheless quite clear that opportunities for major savings exist.

Private Sector Banks

The private banks currently in existence appear and are reported to be generally well-capitalized, profitable and in otherwise sound condition. As a group, the private banks are much better capitalized and profitable than the public sector banks. (See Tables III-3, III-4, III-5, and III-7.)

Most of the private bankers interviewed were of the opinion that their banks were generally well-positioned to compete in the Costa Rican financial environment. However, most of them complained of two remaining competitive disadvantages. The first is the monopoly on checking accounts by the public sector banks. The second is the lack of access to a rediscount line at the Central Bank.

It does not appear that either is a major problem, especially with respect to the private banks' ability to operate profitably. With respect to checking accounts, the private banks have developed an assortment of methods, mainly a money market type account on the Costa Rican securities exchange (BOLSA), which effectively allows customers immediate use of their funds. These enable the customers/depositors to request payment orders from the private bank. This process is quite cumbersome as compared to a normal checking account, but it works.

Also, most of the private banks have an offshore affiliate. These entities issue checking accounts in dollars, and their customers can make dollar payments the same as though they were drawing checks in colones. It is worth noting that some of the offshore

banks started offering checking accounts in colones a few years ago. Since there were no applicable reserve requirements, this effectively took a part of M-1 out of the control of the Central Bank. However, the President of the Central Bank at that time, Eduardo Lizano, applied a bit of very quick 'moral suasion' and put an end to the practice. Apparently, the approach was based on the fact that the offshore banks were generally being allowed to operate with impunity in Costa Rica but that offering colon checking accounts through offshore banks was going too far. The private bankers got the message and promptly discontinued offering colon checking accounts.

The rediscount problem appears to be essentially resolved. A bulletin was released by the Central Bank during the time the consulting team was in Costa Rica. The Central Bank will now make available a line for liquidity purposes. This line is known as the "Fondo de préstamos a los bancos del Sistema Bancario Nacional ante problemas temporales de liquidez". There are substantial, but apparently reasonable, restrictions on its use, and it is costly. Some of those are:

- Maximum indebtedness will be limited to 50 percent of collectible assets. This is consistent with existing law that limits banks to indebtedness with the Central Bank in an amount no greater than 50 percent of a bank's net assets.

- Usage of the line will be based on acceptable collateral to be provided by the bank.

- The interest rate will be based on the base liability rate as calculated by the Central Bank plus 12 percent.

- Maximum term of borrowing is six months, with one six month renewal if approved by the Board of Directors of the Central Bank.

- AGEF must certify that the liquidity problem confronted by the bank is of a temporary nature and that the financial condition of the bank guarantees the future repayment of the discount.

- A user bank that is rated "B" or better by AGEF would not have to explain its usage of the rediscount line up to modest limits. A bank rated "C" or worse would have more restrictive limits and be subject to AGEF scrutiny.

The source of funds for this rediscount line is a U.S.$20 million facility negotiated with a multilateral entity of economic cooperation, specifically USAID, which amounts to C5.6 billion. Based on the total deposits of the private sector banks as of December 31, 1991 (C32,782 million), this fund equals 17 percent of the entire deposit base. This would seem to represent a very substantial 'second line of liquidity' by any standards for the

private banking system as a whole. Generally, this line should provide a "last resort" source of emergency liquidity funds.

It is worth commenting about the private banks that have failed or nearly failed in recent times. As is almost always the case in any country, the failures and near failures were mostly due to bad management and bad lending practices. The question arises as to whether the new rediscount line would indeed serve as protection from a 'run' on a bank such as the ones that have failed. Since some of the conditions of use of the rediscount line relate to the "collectible assets", "acceptable collateral", and an AGEF certification that "the liquidity problem is of a temporary nature and that the financial condition of the bank guarantees the future repayment of the discount", it seems clear that a bank in truly bad condition would not qualify to use the rediscount line. Therefore, the real value of the rediscount line would be to alleviate a systemic crisis, not a run on a truly 'sick' bank.

The following is a brief comment on private sector banks that have failed or nearly failed in recent times.

Banco Cooperativo Costarricense, R.L. (BANCOOP)

This is the only problem bank that could have been closed but survived in its pre-intervention form. Its problems were as follows:

1. Problem loans to non-members. BANCOOP has some 40 shareholders which also constitute its customer base. It was reported that the bank also has about 20 other customers. At one point, the bank was lending extensively to non-members. It is reported that about C700 million of those loans soured.

2. Excess investment in its own real property. BANCOOP management decided it should have a large modern building. It embarked on the acquisition of land and the construction of a very large and expensive building which greatly surpassed its needs and resources. The Central Bank took over the project, but BANCOOP still had to absorb substantial losses.

3. Extreme disorder in the International Department of the bank. Record keeping was poor and the bank had considerable contingent obligations for letters of credit that were not properly registered on the bank's books.

All of these problems have been dealt with. Some, but not all, senior management was changed. Activity has been scaled-back to a manageable level. The bank's offshore affiliate was closed. The financial situation is still not entirely clear as AGEF is still trying to reconcile the bank's accounting records. In any event, the bank should survive.

Banco de la Construcción (now Banco Capital)

This Bank reportedly failed primarily due to problem loans. It was to be liquidated by AGEF. However, its largest creditor was allegedly Capital Bank in Miami. Capital Bank is a closely held institution with total assets on the order of $1 billion. It is well-known for its extremely aggressive practices, especially in the area of lending in various relatively risky markets, both in South Florida and in Latin America. It was reported that Capital Bank owners/management persuaded Costa Rican authorities to allow it (Capital Bank) to take over Banco de la Construcción, rename it, and continue in business.

Capital Bank has a 'less than sterling reputation' and, although it is not believed to be in the league of the infamous Bank of Credit and Commerce (BCCI), it is certainly not the same as having Citibank or Bank of Boston in the country.

Banco Weeden Internacional, S.A.

Banco Internacional de Exportación, S.A. (BIESA)

Banco Germano Centroamericano, S.A.

The above three banks all failed due to varying problems of bad management, bad lending, and fraud. All were liquidated or are in the process of being liquidated. It was reported that a foreign investor group is trying to acquire control of BIESA.[7]

One might ask what is to prevent more such banking problems and institutional failures. At the Costa Rican Government level there is no evidence of anything that might prevent recurrences. Costa Rican banking law has not addressed the issue of offshore banks. AGEF is not yet practicing modern supervision, which would include, among other elements, detailed analysis of monthly financial statements ("balances analíticas") from the banks and rigorous credit review of loan portfolios.

Offshore Banks

Financial information was made available for only a few of the offshore banks. Banco Internacional de Costa Rica Limited (BIC Limited) provided a copy of its financial statements for December 31, 1991, as independently audited by KPMG Peat Marwick. (See Exhibit D.)

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[7]It was reported that people lost money in three cases, although most was lost in the offshore affiliates of Banco Weeden and Banco Germano. People also lost money in the financiera associated with Banco Internacional de Exportación, S.A. (BIESA).

Information provided to and compiled by the State of Florida, Division of Banking, Bureau of International Banking, was available regarding BIC Limited -- Miami Agency. This latter information is made available to the public by the State of Florida every quarter. Data for December 31, 1991, are shown in Exhibit E.

It is worth commenting on the figures for BIC Limited and its Miami Agency. The overwhelming significance of BIC Limited can be seen by comparing its total assets at December 31, 1991, with the total assets for all private sector banks in Costa Rica (as converted to U.S. dollars at the exchange rate C134.10 = U.S.$1). It can be seen that the total assets of all those banks (including the Costa Rican private bank subsidiary of BIC Limited) was equivalent to U.S.$321,961,000 as compared to BIC Limited's total assets of U.S.$560,147,326 and/or to the portion of those assets pertaining to the Miami Agency of U.S.$335,721,000 as of the same date.

Perhaps it can be said that BIC Limited proves that even the Costa Rican Government can run a good bank, if it can do so outside of the traditional restrictions. Although BIC Limited is considered by Costa Rican bankers to be a private bank, it is nevertheless owned by the four public sector banks and controlled by Banco Nacional de Costa Rica, the largest of those banks. However, unlike those banks, BIC Limited does not have to contend with labor unions, high deposit reserve requirements, antiquated operational systems and methodologies, and large networks of branches. Nevertheless, BIC Limited was founded and exists at the will of the Costa Rican Government (public sector banks and Central Bank) and the will of foreign jurisdictions (Panama, Bahamas, and State of Florida).

It is worth noting, however, that BIC Limited's success is relative and not totally clear in financial terms. (See Exhibit D.) It has traditionally had an unusually high net worth as compared to its total assets, total deposits, total liabilities, total loans, or any other ratio that one would care to analyze. Although those ratios declined considerably in 1991, they remain above levels normally found in commercial banks in most countries.

If the allowance for loan losses is added into the net worth, the total capital base of BIC Limited is nearly U.S.$65 million as of December 31, 1991, or 12 percent of assets.

It is worth noting that BIC Limited's assets are heavily concentrated in time deposits with other banks (58 percent as of December 31, 1991, and 42 percent as of December 31, 1990). When all riskless and low risk assets, i.e., cash and due from banks (including time deposits) and investments are summed, they accounted for a whopping 72 percent of total assets as of December 31, 1991, and 56 percent as of December 31, 1990. This is not an institution taking risks that require a capital/asset ratio of 10 percent. Neither do these types of assets represent the kind of

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It is also worth noting that deposits from related parties (presumably Banco Nacional de Costa Rica, the majority shareholder, and the other three Costa Rican public sector banks) accounted for 16 percent of BIC Limited's total deposits as of December 31, 1991, and for 25 percent as of December 31, 1990. If BIC Limited's shareholders are willing to keep such large balances with it and those deposits must logically earn somewhat below market rates, then the only motivation would appear to be the transference of some of their (the shareholders) profits to BIC Limited by means of the implicitly accepted opportunity cost of not placing their funds in higher yielding investments, including higher yielding deposits at other international banks.

It is also known that the private banking (individual depositors) of the Miami Agency are for most part middle class Costa Ricans, who for reasons of smaller balances and less sophistication, most probably receive lower rates on their savings accounts and time deposits than is the case for high net worth individuals at other international banks located in Miami.

Obstacles to Continued Development in the Banking Sector

Much progress has taken place in the Costa Rican financial sector during the past ten years. The emergence of the private banking sector has been very significant. However, the remaining restrictions, notably their inability to offer demand deposits (checking accounts), result in less than a totally competitive environment.

Everyone attributes the changes that have taken place to the various USAID interventions. It is important to note that the real impact of USAID has been in the area of policy changes. Although private sector bankers all applaud this intervention, traditionalists resent USAID and claim that it subrogated the national sovereignty.

Further progress in breaking the public sector banks' monopoly on demand deposit accounts is doubtful in the near term.

There are four important issues that need to be dealt with:

1. There is need for continued improvements in organization, staffing, training and procedures at the AGEF. It is still not particularly effective at monitoring deteriorating conditions at banks. (See chapter on supervision of financial institutions.) Closely related to this is the need to bring the offshore banks within the supervisory environment. This is important if Costa Rican depositors in these offshore institutions are to have any meaningful protection if a deteriorating situation were to occur in one or more of those banks. In the slightly longer run, this will be important if Costa Rican banks are to have any chance of being able to enter the U.S. banking market.[8]

2. Private sector banks should have the authority to offer demand deposit (checking) accounts. This will put them more completely on a "level playing field" with the public sector banks. In can be said that the public sector banks are not really on a "level playing field" themselves since they are burdened by labor unions, arcane practices, and high levels of problem loans. These factors have allowed the private sector banks to outperform the public sector banks for years, despite not having the non-interest bearing demand deposit resources.

3. Whether or not private sector banks receive authorization to offer demand deposit accounts, reserve requirements need to be lower and interest should be paid on reserves by the Central

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[8]The Federal Deposit Insurance Corporation Improvement Act of 1991, commonly known as "FDICIA," was signed into law on December 17, 1991. The Federal Reserve is still in the process of writing appropriate regulations to implement FDICIA. This law is generally considered to be the most sweeping new banking legislation passed in years. FDICIA deals with many areas of banking law, but its international banking provisions are of specific relevance. Among other things, FDICIA specifies that the Federal Reserve shall be the "primary regulator" for foreign banks operating in the United States, even if they are chartered or licensed under state laws, and that only banks from countries whose banking regulatory authorities practice a "comprehensive, consolidated supervision" will be allowed to operated a banking facility in the United States. Generally, banks chartered in so-called "class B" licensing environments (Cayman Islands, Bahamas, etc.) will not be allowed in. In the case of Costa Rican banks, as they now exist, none would qualify to enter the United States -- not even Banco Internacional de Costa Rica. The reasons are simple. The AGEF does not practice "comprehensive, consolidated supervision" of the domestic Costa Rican banks, let alone the off-shore banks. Moreover, the off-shore banks are all chartered in "class B" countries. The implications for the future are that, if Costa Rican banks and bankers decide that they have to be in Miami (or elsewhere in the United States), they will have to lobby the AGEF and/or the Central Bank for what they are currently happy not to have, i.e., "comprehensive, consolidated supervision".

Bank in order to provide the public sector banks with at least a "fighting chance" to curtail their operating losses.

4. The public sector banks, individually and as a group, need to continue modernizing and streamlining their operations. None is profitable and there are reportedly large unrecognized losses in their loan portfolios and in foreign exchange obligations carried on their books at much below market exchange rates. If the Government is even to be in the commercial banking business, there is little if any justification for more than two banks. Any merger that would result in fewer than the current four public sector commercial banks would be conceptually desirable. The economies of scale would result in considerable reduction in operating expenses, especially if such mergers could be accompanied by elimination of labor unions (which would facilitate personnel reductions) and closing of redundant offices. Two alternatives are suggested. Both would leave the Banco Nacional de Costa Rica intact. One alternative would be to sell-off (privatize) the other three. The other alternative would be to merge them or, perhaps, privatize one or two of them.

Conclusions and Recommendations

Conclusions

The Costa Rican banking system has come a long way during the past ten years. This is true for both the government-owned and the private banks.

A large group of small but generally financially sound private banks exist. They have developed a wide range of credit and other services aimed at a commercial ('wholesale') clientele. The controlling ownership groups of most of the private banks have established offshore affiliate banks, which provide an assortment of mostly U.S. dollar based deposit and credit services. Some are looking toward the day when they can establish a banking presence in Miami.

Competition from the private banks has forced the government-owned banks to modernize, become more efficient and, above all, become more responsive to their customers. Unfortunately, it can also be said that they have done too little too late. The private banks have 'skimmed the cream' of the private sector corporate business. It is doubtful that the government-owned banks will ever be able to recover much of the business they have lost.

Although the government-owned banks show various signs of improvement, they are still inefficient and unprofitable institutions, beset by deeply entrenched labor unions and the implicit excess personnel, over-lapping branch systems and,

probably worst of all, enormous amounts of bad loans. On a more positive note, the Banco Nacional de Costa Rica has recently established what appears to be a quality credit administration and credit review function. Its allowance for loan losses as a percentage of its loan portfolio is considerable lower than that of the Banco de Costa Rica.

Costa Rican private sector bankers continue to complain about the legal prohibition against their offering checking accounts and the lack of access to the Central Bank rediscount window for liquidity needs. They have been very creative at finding an assortment of ways to make customers' funds effectively available on a demand basis. Also, most of the private banks have off-shore affiliates that can at least offer checking accounts in dollars. However, none of this is particularly efficient with respect to the customers' needs for normal checking accounts.

The rediscount issue has largely been solved by the new rediscount facility partially funded by USAID and recently made available by the Central Bank. This facility should be adequate to protect individual financially sound private sector banks and the private bank system, as a whole, from sporadic liquidity crises. However, it is unlikely that it will be of any value to an insolvent bank, such as most, if not all, of those that have failed in recent years.

Recommendations

The principal recommendations that are indicated by the investigation for this report are the following:

1. Legislation should be passed enabling private sector banks to offer checking accounts. It will only simplify what they are already doing and enable the Costa Rican public to be more efficiently and economically served. It is reasonable to assume, however, that this would have another negative impact on the government-owned banks since they would most likely loose substantial checking account balances from large, corporate and commercial customers.

2. The AGEF needs considerable further strengthening in order to enable it to monitor the banking system adequately, take preventative measures to avoid or, at least minimize, the impact of bank failures, and to enable it to generate quality financial information for the system as a whole. (For more detail, see the chapter on the supervision of financial institutions.)

3. Legislation or at least Central Bank policy should be developed to force the off-shore banks doing business in Costa Rica, including non-Costa Rican banks, to provide quality financial data on at least a quarterly basis and financial

statements independently audited by internationally recognized accounting firms. They should also be required to submit to AGEF examination if they want to do business in Costa Rica. This is the direction of banking law and regulation in the United States and Europe, as evidenced by recent legislation. There is no obvious reason why the Costa Rican public would not be better off if the banks wanting to serve that public were better supervised.

4. Inasmuch as the government-owned banks are inefficient and generally unprofitable, a concerted effort should be made to study alternatives toward the end of privatizing or merging at least three of the four banks, excluding Banco Nacional de Costa Rica. (Banco Nacional de Costa Rica and Banco de Costa Rica, combined, only earned approximately U.S.$200,000 in 1991, and this figure is highly suspect.) The Banco Nacional is showing some significant signs of progress. It is also the largest commercial bank in Central America and should be able to focus the financial and human resources necessary to make itself into a reasonably efficient and competitive institution. If one government-owned bank can become efficient and competitive and make commercial banking services available throughout Costa Rica, as all four are currently attempting, there is no apparent reason to have four such entities essentially competing with each other at the expense of the Costa Rican public.

TABLE III-1

FINANCIAL INFORMATION REQUESTED OF COSTA RICAN GOVERNMENT OFFICIALS AND PRIVATE SECTOR BANKS AND THAT WHICH WAS PROVIDED

Institution from Which Information was Requested	Type of Information Requested	Type of Information Provided
Banco Central de Costa Rica	Audited Financial Statements for Offshore Banks Designated as 'Bancos de Primer Orden'	None
Auditoria General de Instituciones Financieras	1) Summary Financial Information for Banks for Years Ended 1982, 1985, 1988, and 1991	1) Provided
	2) Detailed Financial Information (Balances Analíticos) for Year Ended 1991	2) None
	3) Total Number of Employees and Total Number and Location of Branches by Bank for Years 1982, 1985, 1988, and 1991	3) Provided
Banco Nacional de Costa Rica	1) Summary Financial Information for Years Ended 1982, 1985, 1988, and 1991	1) None
	2) Total Number of Employees and Total Number and Location of Branches by Bank for Years 1982, 1985, 1988, and 1991	2) None
Banco Internacional de Costa Rica Limited	Audited Financial Statements for Year Ended 1991	Provided
Various Private Sector Banks	Audited Financial Statements for Bank and Its Offshore Affiliate (if any) for Year Ended 1991	Provided by Two Banks and Summary Data Provided by One Additional Bank

TABLE III-2
COSTA RICAN PRIVATE SECTOR BANKS
GROWTH IN MARKET SHARE
1982 - 1991
(millions of Costa Rican colones)

	1982	1985	1988	1991
Number of Private Banks at Year End	10	16	19	17
Total Assets - All Banks at Year End	56,004	107,962	208,987	430,958
Total Assets - Private Banks at Year End	1,591	7,809	25,163	43,175
Private Banks' Share of Total Assets of All Banks	2.8%	7.2%	12.0%	10.0%
Total Loans - All Banks at Year End	19,079	41,494	69,692	100,453
Total Loans - Private Banks at Year End	435	4,558	15,041	24,694
Private Banks' Share of Total Loans of All Banks	2.3%	11.0%	21.6%	24.6%
Total Deposits - All Banks at Year End	31,845	61,557	167,210	329,283
Total Deposits - Private Banks at Year End	0	0	19,413	32,782
Private Banks' Share of Total Deposits of All Banks	0.0%	0.0%	11.6%	10.0%
Total Net Income - All Banks for Year	181	758	1,317	2,228
Total Net Income - Private Banks for Year	72	277	705	1,606
Private Banks' Share of Total Net Income for Year	40.9%	36.5%	53.5%	72.1%
Total Employees - All Banks	6,503	7,575	8,744	9,745
Total Employees - Private Banks	134	446	1,014	1,354
Assets/Employees Public Sector Banks	8	13	21	43
Assets/Employees Private Sector Banks	12	18	25	32

TABLE III-3
COSTA RICAN BANK CAPITALIZATION
(as of December 31, 1991)

Capitalization * (millions of colones)	Public Sector Banks	Private Sector Banks	Banco Popular	All Banks
Total Capital *	20,293	8,479	8,411	37,183
Capital/Assets (%)	5.7	19.6	27.2	8.6
Capital/Earning Assets (%)	24.1	26.3	33.5	26.3
Capital/Loans (%)	36.1	34.3	43.0	37.0

TABLE III-4
COSTA RICAN PUBLIC SECTOR BANKS
(including Mortgage Departments)

SELECTED FINANCIAL INFORMATION
(1991)
(millions of Costa Rican colones)

BANK	TOTAL ASSETS	TOTAL LOANS	CAPITAL (NET WORTH)	NET OPERAT. INCOME	NET INCOME
Banco Anglo Costarricense	53,683	7,008	2,175	(206)	54
Banco Crédito Agrícola	47,191	3,829	2,240	4	11
Banco Nacional de Costa Rica	171,035	37,379	9,545	(1,901)	6
Banco de Costa Rica	78,566	17,663	6,333	(421)	21
TOTAL	356,808	56,206	20,293	(2,254)	92
Average	89,202	14,052	5,073	(631)	23

TABLE III-5
COSTA RICAN PRIVATE SECTOR BANKS

SELECTED FINANCIAL INFORMATION
(arranged by total assets)
(1991)
(millions of Costa Rican colones)

BANK	TOTAL ASSETS	TOTAL LOANS	CAPITAL (NET WORTH)	NET INCOME
INTERFIN	7,062	4,679	813	263
BANEX	5,752	3,769	873	184
Banco San José	4,357	2,100	764	152
Fomento Agrícola	3,742	2,383	489	82
Banco Federado	3,509	2,190	629	136
BANCOMER	3,164	1,926	641	105
BANMETRO	3,124	1,504	549	84
BAMMER	2,494	1,282	517	46
BCT	2,075	708	460	88
BIC Limited	2,005	1,189	687	184
Continental	1,836	1,268	371	81
FINCOMER	1,453	530	541	103
Banco COFISA	1,396	797	429	104
Banco Capital	453	107	245	(28)
Banco Lyon	261	108	163	4
Banco Solidarista	255	102	99	12
Banco Industria	237	56	209	6
TOTAL	43,175	24,694	8,479	1,606
Average	2,540	1,453	499	94

TABLE III-6
OFFSHORE BANKING AFFILIATES OF
COSTA RICAN PRIVATE SECTOR BANKS
COUNTRY OF CHARTER AND INDEPENDENT AUDITORS

COSTA RICAN BANK AFFILIATE	NAME OF OFFSHORE AFFILIATE	CHARTERING JURISDICTION	INDEPENDENT AUDITORS
Banco Internacional de Costa Rica, S.A. (BICSA) *	Banco Internacional de Costa Rica Limited (BIC Limited)	Bahamas (formerly Panama)	Ceciliano y Cia. (Coopers & Lybrand)
INTERFIN	Trans America Bank	Bahamas	Ceciliano y Cia. (Coopers & Lybrand)
BANEX **	Caribbean Export Bank	Cayman Islands	Ceciliano y Cia. (Coopers & Lybrand)
Banco de Fomento Agrícola ***	Commercial International Bank	Bahamas	Ceciliano y Cia. (Coopers & Lybrand)
Banco de San José **	BSJ International	Bahamas	Ceciliano y Cia. (Coopers & Lybrand)
Banco Federado (has former offshore affiliate of BANCOOP)	Federate International Bank	Cayman Islands	KPMG Peat Marwick
Banco de Comercio **	unknown	Panama	KPMG Peat Marwick
Banco Mercantil	Caribbean Mercantil Bank	Cayman Islands	Ceciliano y Cia. (Coopers & Lybrand)
Banco Metropolitano	West Carribean Bank	Cayman Islands	KPMG Peat Marwick
Banco BCT **	BCT Bank International	Cayman Islands	KPMJ Murillo Marchini
Banco Continental	none - yet	n/a	n/a
Banco COFISA **	COFISA International, S.A.	Panama	KPMG Peat Marwick

* BIC Limited has its offshore affiliate charter in the Bahamas. That affiliate operates a branch in Panama, which in turn, operates a State of Florida licensed foreign bank agency in Miami. The BIC Limited offshore operation is, by far, the largest private sector Costa Rican banking operation.

** These five banks are exploring a joint venture which would attempt to enter the U.S. banking market in Miami.

*** This Bank operates an "unofficial" representative office in the heart of the international financial district in Miami.

TABLE III-7
COSTA RICAN BANK PROFITABILITY
(1991)

Capitalization * (millions of colones)	Public Sector Banks	Private Sector Banks	Banco Popular	All Banks
Net Interest Income *	6,076	2,242	1,635	9,953
Net Operating Profits/(Losses) *	(2,254)	1,471	530	(523)
Net Income *	92	1,606	530	2,228
Net Interest Income/Assets (%)	1.70	5.19	5.28	2.31
Net Interest Income/Earning Assets (%)	7.21	6.95	6.52	7.03
Return on Assets (%)	0.03	3.72	1.71	0.52
Return on Equity (%)	0.45	18.94	6.30	5.99

TABLE III-8
COMPARISON OF KEY BALANCE SHEET FIGURES

COSTA RICAN PUBLIC SECTOR BANKS WITH PRIVATE SECTOR BANKS
(December 31, 1991)
(millions of Costa Rican colones)

Balance Sheet Item	Public Sector	Private Sector
Cash and Due from Banks	151,958	4,913
Investments	27,616	7,565
Cash and Due from Banks + Investments	179,574	12,478
Total Loans	54,305	24,694
Total Fixed Assets	28,918	1,931
Total Assets	353,541	43,176
Total Deposits	273,589	32,782
Cash and Due from Banks/Total Assets (%)	43.0	11.4
(Cash and Due from Banks + Investments) / Total Assets	50.8	28.9
Cash and Due from Banks/Total Deposits	55.5	15.0
Loans/Total Assets	15.4	57.2
Fixed Assets/Total Assets	8.2	4.5
Loans/Deposits	19.8	75.3

TABLE III-9
GEOGRAPHIC LOCATION OF COSTA RICAN PUBLIC SECTOR BANK OFFICES BY PROVINCE AND CANTON
(December 31, 1988)

PROVINCE	CANTON	BANCO NACIONAL DE COSTA RICA	BANCO DE COSTA RICA	BANCO ANGLO COSTARRICENSE	BANCO CREDITO AGRICOLA DE CARTAGO	TOTAL
San José	San José	HO, 5A, 6C	HO, 17A, 2C	HO, 8A	HO	42
	Escazu	1A	1A	1A	-	3
	Desamparados	1A, 1C	2A	1A	-	5
	Puriscal	1S, 1C	1S	-	-	3
	Tarrazú	1S	-	1A	-	2
	Aserrí	1A	1A	-	-	2
	Mora	1C	-	-	-	1
	Goicoechea	1A, 2C	2A	1A	-	6
	Santa Ana	1A	1A	-	-	2
	Alajuelita	1A	-	-	-	1
	Coronado	1A	1A	-	-	2
	Acosta	1A	-	-	-	1
	Tibas	1A	1A	-	-	2
	Moravia	1A	1A	-	-	2
	Montes de Oca	1S	1A	1A	-	3
	Turrubares	-	1C	-	-	1
	Dota	1C	-	-	-	1
	Curridabat	1C	-	1A	-	2
	Pérez Zeledón	1S, 2C	1S	1S	-	5
	León Cortéz	1C	-	-	-	1
Sub-Total		HO,4S,15A,16C (36)	HO,2S,28A,3C (34)	HO,1S,14A (16)	1S (1)	87
Alajuela	Alajuela	1S, 2C	1S, 1A	1S, 1C	1S	8
	San Ramón	1S, 1C	1S	-	-	3
	Grecia	1S	1S	1A	-	3
	San Mateo	1C	1A	-	-	2
	Atenas	1A	-	-	-	1
	Naranjo	1A	1A	-	-	2
	Palmares	1A	1A	-	-	2
	Póas	1A	-	-	-	1
	Orotina	1A	-	-	-	1
	San Carlos	1S, 4A, 2C	1S, 2A	1S	-	11
	Alfaro Ruiz	1A	1A	-	-	2
	Valverde Vega	1A	-	1A	-	2
	Upala	2A	-	-	-	2
	Los Chiles	1A	-	-	-	1
	Guatuso	1S	1A	1A	-	3
Sub-Total		5S, 14A, 6C (25)	4S, 8A (12)	2S, 3A, 1C (6)	1S (1)	44
Cartago	Cartago	1S, 1C	1S	1S	HO, 2A, 2C	9
	Paraíso	1A	-	-	-	1
	La Unión	-	-	-	1S	1
	Jiménez	-	-	-	1C	1
	Turrialba	1S, 2C	1S	-	1S	5
	Alvarado	1C	-	-	1A	2
	Oreamuno	1C	-	-	-	1
	El Guarco	1A, 1C	-	-	-	2
Sub-Total		2S, 2A, 6C (10)	2S (2)	1S (1)	HO, 2S, 3A, 3C (9)	22

TABLE III-9
(continued)
GEOGRAPHIC LOCATION OF COSTA RICAN PUBLIC SECTOR BANK OFFICES
BY PROVINCE AND CANTON
(December 31, 1988)

PROVINCE	CANTON	BANCO NACIONAL DE COSTA RICA	BANCO DE COSTA RICA	BANCO ANGLO COSTARRICENSE	BANCO CREDITO AGRICOLA DE CARTAGO	TOTAL
Heredia	Heredia	1S, 1C	1S, 2A	1S	-	6
	Barva	1C	-	-	-	1
	Santo Domingo	1A	1A	-	-	2
	Santa Bárbara	1C	1A	-	-	2
	San Rafael	1C	-	-	-	1
	San Isidro	1C	-	-	-	1
	Belen	1A	1A	-	-	2
	San Joaquín	1C	-	-	-	1
	San Pablo	-	-	-	-	0
	Sarapiquí	2A	-	-	-	2
Sub-Total		1S, 4A, 6C (11)	1S, 5A (6)	1S (1)	- (0)	18
Guanacaste	Liberia	1S	1S	1S	-	3
	Nicoya	1S	1S	1A	-	3
	Santa Cruz	1S	-	1S	-	2
	Bagaces	1A	-	-	-	1
	Carrillo	1S	-	-	-	1
	Cañas	1S	1S	-	-	2
	Abangares	1A, 1C	-	-	-	2
	Tilarán	1S, 1A	1C	1A	-	4
	Nandayure	1A	-	-	-	1
	La Cruz	1A	-	1A, 1C	-	3
	Hojancha	1A	-	-	-	1
Sub-Total		6S, 6A, 1C (13)	3S, 1C (4)	2S, 3A, 1C (6)	- (0)	23
Puntarenas	Puntarenas	1S, 3A, 1C	1S	1S, 1A	-	8
	Esparza	1A	-	1C	-	2
	Buenos Aires	1A	-	-	-	1
	Montes de Oro	1A	-	-	-	1
	Osa	2A	-	-	-	2
	Aguirre	1A	1S	-	-	2
	Golfito	1A, 2C	-	-	-	3
	Coto Brus	2A	1S	1S, 1A	-	5
	Parrita	1A	1A	-	-	2
	Corredores	1S, 1A	1S	2A	-	5
	Garabito	1C	-	-	-	1
Sub-Total		2S, 14A, 4C (20)	4S, 1A (5)	2S, 4A, 1C (7)	- (0)	32
Limón	Limón	1S	1S, 1A, 2C	1S	-	6
	Pococí	1S, 1A	1S	1A	-	4
	Siquirres	1S	-	-	-	1
	Talamanca	2C	-	-	-	2
	Matina	1A	-	-		1
	Guácimo	1A	-	-	-	1
Sub-Total		3S, 3A, 2C (8)	2S, 1A, 2C (5)	1S, 1A (2)	-	15
Totals by Bank and for Country		HO,23S,38A,61C (123)	HO,18S,43A,6C (68)	HO,10S,25A,3C (39)	HO,4S,3A,3C (11)	241

Chapter IV

Legal and Regulatory Framework

Introduction

A key element of financial reform in Costa Rica during the last ten years has been the changes in the laws and regulations governing various aspects of the operation of financial intermediaries. These laws and regulations had constituted a very important source of financial repression during the 1960s and 1970s.

Governmental regulations that had interfered severely with the process of financial intermediation were modified to introduce improvements in several areas:

- the use of monetary policy instruments;
- Central Bank rules related to banking policy and operations;
- the administration and organization of the government owned banks; and
- the supervision of financial intermediaries.

Developments in the first two of these areas are addressed at length in this chapter, and the third is discussed briefly in this chapter and at greater length in the chapter on commercial banks and financieras, while the fourth is addressed entirely in the chapter on the supervision of financial institutions.

Monetary Policy Regulations and Instruments

Several reforms in the conduct of monetary policy were introduced during the past ten years which have had a major impact on the development and behavior of financial institutions. The common feature shared by these reforms has been a diminished reliance on direct monetary instruments of the Central Bank (e.g., credit ceilings and the fixing of interest rates for the operations of financial intermediaries), with a movement toward more active use of orthodox indirect instruments of monetary control such as open market operations and, to some extent, reserve requirements.

The widespread influence of the Central Bank nonetheless clearly persists and has an important effect on nominal market interest rates in particular. This influence includes not only the delayed and diluted effects through the transmission mechanisms of monetary policy but also comes directly from the impact of the Central Bank's determination of the interest rate on the stabilization bonds that it issues and sells in its open market operations.

Interest Rate Determination

For more than thirty years the Central Bank fixed the interest rates on both deposits and loans in accordance with the provisions and powers contained in several articles of its basic law. These rates were applicable to all financial intermediaries subject to Central Bank regulations, that is, government owned and private banks as well as financieras.

In a system where interest rates were completely determined by the Central Bank, financial intermediaries were mere "price-takers" without any possibility of developing active competition for either deposits or loans. Competitive differences among intermediaries were thereby restricted to elements of secondary importance, such as kinds of services and the quality of their provision to customers.

Traditionally, the Central Bank fixed interest rates on various categories of loans for different economic activities. However, such a policy tends to be self-defeating in that it becomes a matter of the statistical classification of loans. In reality, the banker and the client can agree on the interest rate independently of the Central Bank's provisions and then classify the loan in whatever category of the Central Bank's regulations corresponds to that interest rate, whether or not the category actually corresponds to the kind of transaction being carried out. As a result, credit deviation arises, which is very difficult for the Central Bank to control, as will be discussed in greater detail below in the section on credit ceilings. In addition, there are various ways to increase the implicit interest rates paid on deposits in order to attract clients, such as attaching gifts to certain conditions of deposits (e.g., their amount, their minimum permanence in the bank, etc.).

Administrative interest rate determination as described also often leads to lack of flexibility in adjusting interest rates according to inflation, thereby leading to negative real interest rates. This in turn leads to: (1) encouragement of consumption; (2) discouragement of saving in domestic currency and instead either currency substitution (that is, saving in foreign currencies) or disintermediation by using physical assets instead of money as store of value; (3) diversion of scarce financial resources to low yield investments; (4) capital flight, with resulting exchange rate instability; (5) use of capital-intensive instead of labor-intensive techniques, in conflict with the fact that labor is the relatively abundant factor; and (6) regressive income redistribution, as small-scale savers and borrowers suffer relatively more from reduced financial intermediation.

The problem of financial repression was addressed for the first time in Costa Rica in 1978. The important of real interest rates, instead of nominal rates, as well as equilibrium in the funds

market, were the key aspects of the 1978 reform. Rates on deposits at government owned banks were tied to international rates, while those at financieras (including the financieras of the government owned banks) were freed to be determined by supply and demand (see Banco Central de Costa Rica, 1980). However, the financial crisis of 1980-82 undermined this progress toward financial liberalization and led, instead, to more financial repression than before. A more comprehensive and lasting reform was undertaken during the 1980s, especially after 1984, which included a wide range of Central Bank policies that were seen to be the causes of repression in the financial system.

Costa Rica's monetary policy reforms of the 1980s, by emphasizing the use of traditional indirect instruments that operate on the liabilities side of bank balance sheet rather than direct controls affecting the assets side, thereby promoted interest rate liberalization as one of the main objectives. These reforms sought to reduce the cost of intermediation through enhancing competition, while also reducing interest rate dispersion (the difference between the highest and lowest rates), especially on lending rates. Most importantly, as a continuation of the 1978 reform, those in the 1980s pursued the basic objective of giving interest rates their essential economic function as a very important price in the economy -- the price of credit.

The first interest rate reform measures adopted in 1984-85 allowed commercial banks to vary both deposit and lending interest rates within a range of three percentage points, originally only in the upward direction but later in both directions, thereby providing a total range of 6 percentage points. This measure was replaced in 1986 by a complete liberalization of deposit rates and a range for lending rates, with the floor being the six-month deposit rate and the ceiling 10 percentage points higher, which was lowered to 9 percentage points in 1987. Finally, in October 1989, the Central Bank approved a complete interest rate liberalization, so that rates since then have been fixed by the financial intermediaries themselves without the Central Bank's direct intervention.

With respect to commissions and other charges on banking services, the Central Bank decided since 1984-85 not to intervene in their determination but instead to leave these exclusively to the discretion of the financial intermediaries. For some time after that, however, the banks continued with uniform charges, but this oligopolistic practice appears to be disappearing gradually.

Annual Credit Programs of the Central Bank

Credit ceilings applied to the commercial banks were for many years one of the main monetary policy instruments in Costa Rica. It was thought that these annual credit programs, designed and approved by the Central Bank, would be able not only to control total expenditures by setting a global limit on credit but also to

allocate financial resources toward those economic activities deemed to be preferential under certain criteria (e.g., what the authorities considered were key areas to promote growth). This was clearly a strategy based on planning instead of credit allocation by market mechanisms.

Lizano (1987) emphasizes several problems with this instrument, one of the most important being the inducement to credit deviation, both direct and indirect. The former, which takes the form of false declarations of the purpose of loans, could be controlled by the Central Bank with a thorough monitoring system, but only at a very high cost (and with a dubious cost-benefit result). Indirect credit deviation, on the other hand, cannot be detected by regulators since the borrower's own funds are used to finance some profitable activity not authorized for bank financing, while the bank's loan funds are devoted to the activity declared in the loan document (but which would have been financed with the borrower's own funds in the absence of the loan). In addition to these problems, the Central Bank's credit programs, based on detailed ceilings by groups and sub-groups of economic activities, came to replace some of the most important functions of a financial intermediary -- the analysis of potential borrowers and the allocation of funds to those activities and specific projects with high rates of return and high probabilities of success.

Even granting the relative impotence of the instrument because of the various means of avoidance, Central Bank policymakers thought that a gradual process was required to dismantle it in order to enable the commercial banks to recover more fully their identity as financial intermediaries and their full responsibility for lending decisions. Consequently, the Central Bank began a gradual process of reform in 1985 by reducing the number of credit ceilings to only three broad categories: (1) subsidized credits for small farmers in particular; (2) preferential credits for agriculture, livestock, manufacturing, housing and tourism; and (3) credits to remaining activities (commerce, services, personal credit, etc.). With various ups and downs, the process continued during the following years, ending up in 1989 with only two broad categories that divided total credit into preferential credit and other credit and limited the proportion of preferential credit. These categories were in fact broad enough not to present in practice any limit on commercial bank operations. In 1990, all such limits were finally eliminated, except for credit to small farmers at a subsidized rate of interest.

Preferential interest rates for small farmers have been traditional in Costa Rica for many years, as part of a program to support widespread property holding. However, from the point of view of financial sector efficiency, subsidized interest rates, even from government owned banks, should not exist at all, but if they do exist based on political considerations, granting such subsidies should be as limited as possible. The absolute limits imposed on

these subsidized credits since 1985 have led to a substantial reduction in their proportion of total credit from the banking system. Moreover, part of the subsidy has been paid through the Government's budget, as should be the case with subsidies in general. Nonetheless, determination by law of the interest rate for small farmer loans still remains, although the rate has been increased administratively by a general authorization of the Central Bank to charge commissions on these loans.

The Central Bank nonetheless retains the power to impose detailed credit ceilings, requiring only a decision of its Board of Directors. Limits to this inappropriate power should be established by law in order to prevent the negative effects of the return of a highly interventionist policy by the Central Bank in the future.

Rediscounts as an Instrument of Last Resort

In a liberalized financial system, the Central Bank should avoid different treatment for different categories of intermediaries while maintaining a sound monetary policy. In Costa Rica, however, rediscount facilities have been limited to the government owned banks. Moreover, to the extent that the rediscount rate has often been lower than deposit rates in the market, access to these funds not only promotes macroeconomic instability but also creates a privilege for these banks. In fact, the Central Bank has frequently used the rediscount instrument in this way for purposes not consistent with its proper use as a major instrument of monetary policy.

In 1985, the Board of Directors of the Central Bank approved the policy that has been in effect since then, which recognizes the appropriate role of the rediscount window as a facility of last resort for commercial banks to help them when temporary problems of illiquidity appear. To achieve that objective and to discourage inappropriate use of the rediscount mechanism, the rediscount rate has been fixed at a high level, about 8-10 percentage points above the "basic rate".[9]

At about the same time as this decision, in 1985, commercial banks were also authorized to engage in interbank deposits and loans, and these have also been freed by the Central Bank from reserve requirements. The ability to engage in interbank deposits and loans has reduced the dependency of the government owned banks on

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[9]The "basic rate" was originally the six-month deposit rate fixed by the Central Bank for financial intermediaries and then, with interest rates completely liberalized, became a monthly calculation of deposit rates, including not only the banking system but also similar instruments issued by the Central Bank and the Government and weighted by the outstanding amount of each kind of liability.

Central Bank rediscounts. At the same time, these interbank operations have been a first step in the creation of a money market.

Although macroeconomic conditions during the last ten years have generally been characterized by excess liquidity, and have thereby minimized the need for banks to have access to the rediscount window of the Central Bank (except for some scattered exceptions), the new direction of Central Bank rediscount policy has been essentially correct.

One continuing question is whether the Central Bank needs to have complete flexibility to authorize rediscounts at interest rates lower than the market rate, since it is already recognized that the Central Bank must maintain rediscounts as a last resort facility. Limits that do not impede the agility of the monetary authority when this instrument has to be used could help to avoid episodes like those during the three decades before the 1980s, when the rediscount window of the Central Bank was often used as an additional source of funds for the normal operations of the government owned banks.

A second question relates to the access of private banks and financieras to the Central Bank's rediscounting facilities. A reform in this direction has long been considered to be an important step in the process of modernizing the financial system. It has been argued that this reform, among others, is necessary so that the private banks can compete effectively with the government owned banks, since otherwise the risks and therefore the costs of intermediation increase.

These arguments are valid primarily for private banks that are able to fund their operations with very short term instruments, as happened recently in Costa Rica when the term of deposits that could be offered by private banks was lowered to one month. Nonetheless, the need for this reform should not be overstated. When a bank's primary funding sources are time deposits and not demand deposits or other sight deposits, a strong cash flow is the main requirement for adequate liquidity. Under these circumstances, a bank rarely will face the typical banking liquidity problem of having a negative balance in the clearing process, which can arise unexpectedly from the nature of demand deposits, nor is it likely to face an unexpected deposit run. Problems could arise, however, under a situation of widespread and continued distress in the financial system or if there are important differences in term structure between deposits and loans. Moreover, the failure of any large financial intermediary could undermine the public's confidence in the financial system and thus require Central Bank intervention to avoid severe distress. In cases where the problem is not related to the mismanagement of the financial intermediary, limited access to the Central Bank's rediscount window can be highly important.

In any case, representatives of private banks and financieras argue that lack of access to the rediscount window forces them to have higher liquid reserves than would otherwise be required, which has an opportunity cost because of the lower yield compared to options such as more loans. Based on their assumption that one third of earning assets of private banks and financieras could be allocated to loans instead of liquid securities, together with the difference between loan and deposit rates, they estimate that such foregone income is equal to 3 percentage points on earning assets.

Reserve Requirements

Reserve requirements have been widely used by the Central Bank during the last ten years as an instrument of monetary policy (see Table IV-1). Reforms have been introduced to simplify the application of reserve requirements and to add to their transparency, as well as to reduce their negative impact on the costs of intermediation for financial institutions subject to reserve requirements.

The practice of using reserve requirements as a major way to finance the government's fiscal deficit at low cost has been abandoned beginning several years ago. Beginning in 1985, required reserves that previously had to be held as fiscal bonds (7 percent for sight deposits and 10 percent for time deposits) were gradually converted to normal reserve requirements, under the assumption that the Government would redeem these bonds. As fiscal conditions impeded such redemption, arrangements were made in 1986 with both private and government owned banks for gradual repayment and adjustment of interest rates, which finally clarified the monetary purpose of reserve requirements but implied some sacrifice of bank profitability (mainly for the government owned banks for which the redemptions were spread over several years). This practice has no clear support in Costa Rican legislation, so that a legal reform to eliminate any uncertainty would be important for the future.

Early in 1988, the Central Bank reduced reserve requirements on time deposits from 10 percent to 6 percent in order to ease the process of adjustment for private financial intermediaries that began to face financial distress in the second half of 1987 when the failure of some important financieras necessitated the Central Bank's intervention to avoid a major breakdown in confidence.

Some improvements in the structure of reserve requirements were introduced by the Banking Reform Act of 1988. The powers of the Central Bank to increase reserve requirements to more than 50 percent for certain special deposits from the public to cover future payments and to impose marginal reserve requirements in addition to these percentages were eliminated. Specific ceilings on reserve requirements of 10 percent for deposits of six months or more and 30 percent for deposits over 30 days but less than six months were also introduced. In addition, the Banking Reform Act

requires the Central Bank to pay interest on reserve requirements over 10 percent on time deposits.

Table IV-1
Reserve Requirements 1982-1991
(percent)

From:	Local Currency			Foreign Currency	
	Up to 30 days	Between 30 and 180 days	More than 180 days	Up to 30 days	Over 30 days
01/07/83	21	12.5	10	20	100
16/07/83	22	15	10	20	100
01/08/83	22.5	17.5	10	20	100
16/08/83	23	20	10	20	100
01/09/83	23.5	22.5	10	20	100
16/09/83	24	25	10	20	100
01/10/83	24.5	27.5	10	20	100
16/10/83	25	30	10	20	100
01/01/84	25	30	10	20	100
15/09/85	28	20	10	20	100
16/10/85	29	20	10	20	100
22/11/85	31	20	10	20	100
20/12/85	32	20	10	20	100
16/04/87	33	21	10	20	100
16/05/87	34	22	10	20	100
16/06/87	35	23	10	20	100
01/02/88	35	23	10	20	100
01/08/88	35	23	6	20	100
01/01/90	27	23	10	20	100
31/03/90	28	23	10	20	100
30/04/90	29	23	10	20	100
31/05/90	30	23	10	20	100
30/06/90	31	23	10	20	100
09/10/90	15	10	10	20	100
01/11/90	18	10	10	20	100
01/12/90	21	10	10	20	100

From:	Local Currency			Foreign Currency	
	Up to 30 days	Between 30 and 180 days	More than 180 days	Up to 30 days	Over 30 days
01/01/91	24	10	10	20	100
01/02/91	28	10	10	20	100
01/03/91	25	10	10	20	100
01/09/91	26	10	10	20	100
16/09/91	27	10	10	20	100
01/10/91	28	10	10	20	100

Current levels of required reserves nonetheless remain quite high and thus have a significant impact on the intermediation costs of financial institutions subject to such requirements. This situation does not necessitate additional legal reforms but is rather related to the macroeconomic problems stemming from the Central Bank's losses, an issue that is addressed in the chapter covering the macroeconomic environment.

The lack of flexibility in monetary policy due to the effect of the Central Bank's deficit, which precipitates high reserve requirements and active participation by the Central Bank in the funds market, has a negative impact on the development of financial intermediation by increasing the costs of intermediation. At this point, however, there appears to be no way for the Central Bank to reduce the use of these instruments without producing monetary expansion and thereby once again severely affecting the financial system through inflation. Ultimately, the solution requires an attack where the problem begins: with the Central Bank's losses -- also known as the "quasi-fiscal deficit" -- which, like any other fiscal deficit, must be covered through acting on the government budget, either reducing expenditures or, as a second-best solution, increasing taxes.

Money Market Operations

Reliance of the Central Bank on open market operations through the sale of stabilization bonds ("bonos de estabilización monetaria") has increased, but this is not the only mechanism used by the Central Bank for sterilization or for open market operations for general monetary purposes. In 1988, the Central Bank put into effect a new system of very short-term financial instruments ("sistema de inversiones de corto plazo"), essentially an overnight facility that permits the commercial banks, as well as the general public through the banks, to invest excess short-term funds for periods of 24 hours and 7, 15 and 30 days. This is a very important instrument for providing income while also guaranteeing

the liquidity of idle balances for both banks and non-bank enterprises. Moreover, it emphasizes the intention of the Central Bank to act in the short-term money market rather than in the longer-term capital market. At the same time, it represents an indirect way for the Central Bank to pay interest on commercial bank excess reserves.

In March 1992, a slight but important reform was made in this instrument. The short-term instruments of 7, 15 and 30 days were replaced by an auction system for the Central Bank's obligations of 7, 14 and 28 days. Although this is too new to be subject to a detailed evaluation, it appears to be a move in the right direction of relying more on the market to determine interest rates.

The first five months of operation of the new auction system seems to have provided the Central Bank with signals about the magnitude of required adjustments in interest rates for other instruments, specifically stabilization bonds. Adjusting such rates by small percentages allows them to follow more closely the path of short-term rates. Moreover, after the first experiment with the auction system for very short-term instruments, it was extended in October 1992 to stabilization bonds with terms of one month and longer.

As the following table shows, twice-a-week auctions for short-term instruments have replaced the former weekly auctions since August 1992. At the same time, bids for any term between 3 and 30 days have been permitted. Figures on interest rates for 7 and 21 day instruments are given in the table since these have been the preferred terms. They show the downward trend in rates until June 1992 as well as the turn around in the subsequent months.

Central Bank Independence

Because of the close relation often found between successful financial stabilization and the degree of independence of the Central Bank in the process of the carrying out monetary policy, as well as the perverse effect of the lack of stability on the development of financial intermediation, it is worth mentioning what has recently been done to increase Central Bank independence in Costa Rica.

The Banking Reform Act of 1988 (Ley 7107 de Modernización del Sistema Financiero) reduced the direct participation of Government officials in the Board of Directors of the Central Bank and returned to a system very similar to what had existed during the 1950s and 1960s. The seats on the Central Bank's Board for the Minister of Economy and the Minister of Planning were eliminated, with their places taken by two persons named by the Cabinet (el Consejo de Gobierno). In this way, five out of seven of the members of the Board (except for the Executive President and the Minister of Finance) are designated by the Cabinet, taking into account the experience and knowledge of potential Board members in

the areas of economics, finance, banking and management.[10] Moreover, Board members are now designated to assure gradual replacement, so that only during the last year of each Administration will the Board be composed solely of members named by that Administration. While this achievement could be considered modest compared to other recent reforms such as the Chilean one, it represents a major improvement over the prior situation and a point of departure for further steps in this area.

The Banking Reform Act also takes the first steps in limiting access to Central Bank credit. This represents a significant turning point because prior changes in this respect since the creation of the Central Bank in 1951 had moved in a backward direction. In particular, the power of the Central Bank to finance the public sector institution charged with price stabilization functions (Consejo Nacional de Producción) was abrogated. Nonetheless, this is just the beginning of a turning point, and further limits should be set by law to avoid the destabilizing effects of monetary mismanagement stemming from this source. This point is sufficiently important that it is mentioned in various other chapters of this report and is included in the chapter devoted to the main recommendations.

Central Bank Rules Related to Banking Policy and Operations

In addition to the regulation of monetary policy instruments, the Central Bank Act also includes a series of powers for the Central Bank to regulate various aspects of the operations of public and private banks. Moreover, the Banking System Act also contains further provisions that limit the actions of public and private banks. The adequacy of these regulations is important for the development of efficient financial intermediation.

Capital Requirements

Proliferation of private banks, mainly during the 1980s, is undoubtedly related in part to the anachronistic regulations with respect to capital requirements for financial intermediaries, which became seriously misaligned after the high inflation period of 1980-82. The minimum capital requirement, equivalent to somewhat less than $1.0 million when the Banking Act was approved in 1953, could have been considered adequate at that point given that private banks were not permitted to offer anything more than banking services such as those related to foreign trade. After the

[10]In 1974, the position of Executive President was created as both the Chairman of the Board and the full-time head of the Central Bank. At the same time, both the Minister of Economy and the Minister of Planning were included as members ex officio of the Board, while the Minister of Finance has had such status since the creation of the Central Bank.

opening in the legal framework provided by the Commercial Code of 1964, private firms were allowed to enter more widely into financial operations, so that minimum capital requirements acquired more importance in protecting investors and forcing financial intermediaries to be managed under standards of sound business.

In 1982, minimum capital requirements were raised to ¢30 million, equivalent at the end of that year to approximately $700,000 (see Law Number 6813, September 1982). In that same law, the Central Bank was also authorized to increase minimum capital requirements to ¢100 million, a decision that was adopted in 1984. However, minimum capital requirements for financieras continued to be only ¢1.0 million. At the end of 1984, these minimum capital requirements represented $2.1 million and $21,000, respectively.

A further step was taken in 1988 with the Banking Reform Act (Ley de Modernización del Sistema Financiero). Minimum capital requirements for private banks were raised to ¢100 million. For cooperative banks this limit was set at 50 percent of that amount, and for financieras at 20 percent. In 1989, the Board of Directors of the Central Bank approved a gradual increase in this limit, to ¢200 million during the second half of 1989 and to ¢300 million during the first half of 1990. As of the end of 1991, the prevailing limits were equivalent to $2.2 million for private commercial banks, $1.1 million for cooperative banks (also including the Banco Solidarista) and $440,000 for financieras. With some limitations because of a lawsuit by one of the affected bank, this limit remains applicable to all new banks, and most existing banks have also reached this amount.

The power of the Central Bank to modify the minimum capital requirements for new and existing banks is still a pending issue that needs to be clarified. Although it has been argued that banks should be able to have whatever size they want, individuals who invest in the instruments issued by banks and other financial intermediaries need the assurance of a reasonable amount of capital, in addition to general trust and sound business practices.[11] The clarification of the legal ambiguity in this respect should also include a reform to give "bancos solidaristas"

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[11]The purpose of capital requirements, as well as other requirements pertaining to the character and experience of bank owners and managers, is not to limit the number of banks but rather to help to insure that depositors and other holders of bank liabilities are adequately protected. Limitations on the number of banks, if such limits were effective, would provide monopoly profits to the holders of bank charters. The number of banks should be the outcome of competition, given capital requirements and possible economies of scale in banking, among other factors. Fairly exhaustive studies in numerous other countries have not provided many clear cut findings about the existence or range for possible economies of scale in banking, but such studies might nonetheless be usefully carried out in Costa Rica, if only to indicate the complexity of the issue. In any case, this is beyond the scope of the current report.

the same treatment as cooperative banks. In fact, the Banking Reform Act of 1988 included a provision to set their minimum capital at 50 million colones (see Article 28 of the Act), but this should instead be set at 50 percent of the minimum capital for private banks, the same as given for cooperative banks (to which they most closely correspond) in Article 151 of the Banking System Act.

Leverage Limits

The Non-Banking Financial Institutions Act (Ley de Financieras, Number 5044) of 1972 established a leverage limit of 7 to 1, but in 1986 the Central Bank established a leverage limit of 11 to 1 for private banks, with leverage measured as the ratio of total liabilities to capital and reserves. Although these measure go in the right direction, no provisions have been established for government owned commercial banks, so that there are three different regimes for the financial institutions subject to Central Bank regulation. Moreover, since there are many other participants in Costa Rican financial markets that are not subject to leverage limits (some of them competing with banks and financieras), these differences represent a high degree of fragmentation of Costa Rican financial markets and add to competitive disparities.

Since the purpose of leverage limits is to protect savers and not to harm financial intermediaries, it is important to study further the legal measures required for a uniform and overall regulation of leverage as a way to increase protection for all savers, taking into account the differences among the various types of financial intermediaries. Among the entities currently without leverage limits are credit unions and the Banco Popular, as well as the investment funds offered by stock brokers, which together amount to almost 40 percent of total banking system credit. While it may not be practical or appropriate to apply identical leverage limits to all types of financial intermediaries, uniformity should be sought, and the greater risks that tend to be associated with higher leverage limits -- including especially unregulated entities with no limits -- should be brought clearly to the attention of savers to encourage self protection.

During the 1980s the problem of the over-indebtedness of borrowers, especially from government owned banks, and the resulting need to promote savings and internal financing by non-financial firms as well as by financial intermediaries, was addressed. In 1985, the Board of Directors of the Central Bank set leverage limits for borrowers in the form of a maximum ratio of total liabilities to total assets. These limits have evolved over time, from 95 percent in 1985 to 80 percent and 75 percent for working capital and fixed assets, respectively, in 1989. In 1990, this regulation was changed further to a ratio of total liabilities to capital and reserves of not more than 3 to 1.

Funding Regulations for Private Banks and Financieras

The main source of funding for private financial intermediaries in the domestic market has been the issuance of investment certificates (certificados de inversión), rather than time deposits that are restricted by law to the government owned banks. The financial nature of both instruments is nonetheless the same.

To facilitate the access of private banks to this source of funding, the Central Bank issued a set of regulations in 1986 to establish clear and uniform rules for authorizing the issuance of investment certificates. Before these rules were issued, each individual issue of investment certificates by a private bank had to be authorized by the Central Bank's Board for the specific amount and terms of the issue, and this restriction of course created severe inflexibility for their use in domestic financial markets. In the case of financieras, on the other hand, the 1972 law that regulated them set a specific limit on indebtedness at a ratio of 7 to 1 (the relationship of total liabilities to capital and reserves).

Measures taken by the Central Bank in 1985 established four categories of banks based on several indicators of the strength of each bank (e.g., financial ratios, profits, and the degree of compliance with Central Bank regulations). Since that time, a class A bank has been allowed to issue investment certificates up to 11 times its capital and reserves, a class B bank up to 7.5 times, a class C bank up to 5.5 times, and a class D bank up to one time. There is, moreover, an overall restriction on the debt to equity ratio of 11 to 1. Although this regulation improves on the prior situation with respect to the access of private banks to funds in the domestic market, it still is inadequate. Being classified as a class A or a class B bank does not necessarily mean that a private bank is strong enough to honor its obligations to depositors, as recent experiences with bank failures have shown. Moreover, Central Bank officials have always claimed that these classifications are just for internal purposes and not for public use, and for this reason the specific classification for each bank is communicated only to that bank. Because the Central Bank and the AGEF have no clear legal power to disclose bank ratings, a provision was introduced in the new law for the securities market to fill this gap by creating a credit classification system as an obligation for issuers of securities through the exchange. Although other issuers are not legally compelled to participate in the classification system, they will probably be forced to do so in order to market their securities.

With respect to funding from foreign sources, a 1985 reform to the Currency Act (Ley Number 6965, Reforma a Ley de la Moneda) opened up the option for private banks to be financed by the Central Bank with funds coming from multilateral and bilateral development

organizations. USAID lines of credit to be channeled through private banks were thereby facilitated.[12]

The efforts of USAID to encourage private banking in Costa Rica have produced significant results. In fact, during the past ten years a substantial portion of private bank portfolios has been based on lines of credit funded by USAID through loans and grants. To illustrate this conclusion, it is worth pointing out that, as of the end of 1990, Central Bank funding for private banks (mostly through USAID lines of credit), amounted to almost 90 percent of private bank funding through certificates of investment and 47 percent of total funding (Weigel and Solera, 1991).

Another option for funding private banks comes from the issuance of certificates of investment in foreign currencies. Traditionally the Central Bank had imposed a 100 percent reserve requirement on government bank time deposits in dollars, so that these resources have been attracted to the Central Bank for balance of payments and exchange rate support. In February 1992, however, the Central Bank decided to reduce this percentage from 100 percent to 10 percent in the form of a marginal reserve requirement (i.e., applied to the increase in the amount outstanding over the amount at the end of 1991). At the same time, the Central Bank also authorized private banks to carry out financial intermediation operations in U. S. dollars.[13]

Although measures that allow wider use of foreign currencies generally go in the proper direction of increasing liberalization in financial markets, doubts about certain legal aspects have prevented private banks from enjoying this new business opportunity. A reform of the Currency Act (Ley de la Moneda) is currently under discussion in Costa Rican Congress that would improve the environment for transactions in foreign currencies. At present, some contracts derived from lending operations in foreign currencies (those specifically included under the provisions of Article 7 of the Currency Act) can still be settled in colones at the prevailing market exchange rate. Although this can solve the problem of exchange risk, the reform does not deal with the

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[12]Before the reform of 1985 (Ley Number 6965), CODESA was used as an indirect channel for this kind of support to private banks since CODESA had access to Central Bank credit lines and was subject to fewer restrictions and regulations compared to banks. The 1985 reform changed Article 62 (5) of Central Bank Act as it relates to credit operations permitted for the Central Bank.

[13]To this point, private banks have made little or no use of these more advantageous conditions for issuing certificates of investment in dollars. This may be due to the continuing legal uncertainties indicated in the following paragraph or to the fact that it is still more profitable to use offshore arrangements for dollar operations and thereby avoid all reserve requirements and taxes.

obligation of commercial banks to reimburse deposits (or certificates of investment) in the same currency in which they were constituted, so that further steps in this direction need to be taken.

Minimum Terms for Certificates of Investment

As mentioned elsewhere, the deposit monopoly of the government owned banks has now been restricted just to demand deposits and other sight deposits. Private banks and financieras have been allowed for many years to receive time deposits in the form of certificates of investment. In the case of private banks, the Central Bank fixes the minimum term for the issuance of certificates of investment, and this has been progressively lowered, from six to three months in 1987 and to one month in January 1992 (and again later in 1992 as explained below). For the financieras, the minimum term was originally set by law at one year, and this was lowered to six months by the Banking Reform Act of 1988 (Ley de Modernización del Sistema Financiero).

The issue of allowing private financial intermediaries to enter the areas of funding previously limited to government owned banks has long been a highly sensitive one in the Costa Rican political arena. Nonetheless, several ways to by-pass the legal restrictions have been implemented by private intermediaries, reflecting the dynamism and innovations brought about by the increased competition in the financial system. Moreover, while this report was being written, important events occurred with respect to the issue. In particular, in August 1992, the Central Bank's Board of Directors approved a change in existing regulations, to become effective in October 1992, to permit private banks to issue certificates of investment of any term, from one day and longer.

This decision provoked a serious political conflict between the two major parties in Costa Rica and led to suits and countersuits by private and government owned banks before the Sala IV of the Supreme Court, as well as an interpretation by the Attorney General against allowing more flexibility to private banks in receiving funds from the public. The Sala IV has ruled to maintain the effectiveness of the Central Bank's decision while an in-depth study of the issue is carried out, but a more important and lasting effect has been the creation of a possibility for a comprehensive political discussion of the issue, including even the access of private banks to checking accounts and the advisability of selling some of the government owned banks.

On the other hand, an important aspect that persists are the efforts to offset the advantage of the government owned banks stemming from their monopoly over sight deposits through higher reserve requirements on such deposits -- which mainly promotes the creation of substitutes that avoid these reserve requirements while also further reducing the efficiency of the government owned banks.

Although legal restrictions have not been able to prevent an increasing role for private financial intermediaries in deposit mobilization, and a consequent erosion of the importance of the government owned banks, this process has nonetheless weakened the protection of savers. The operation of off-shore non-regulated entities with connections to Costa Rican private banks[14] is perhaps the clearest example of this process. However, recognition of this distortion in the financial system does not necessarily mean that new legal restrictions should be created and enforced more aggressively.

Excessive regulation of the financial system seems to have driven innovations by financial intermediaries in Costa Rica as in other countries. Going back to the 1960s, a policy of restrictive credit ceilings, coupled with an important reform of the Commercial Code in 1964, gave rise to deposit-like operations by private companies and ultimately to their legalization in 1972 with the "Financieras Law." During the 1970s, trust fund operations for housing finance were created by a government owned bank to circumvent credit ceilings and reserve requirements, and these have since become normal operations in almost every Costa Rican bank. Other similar episodes call further into question the effectiveness of excessive regulation, an issue that has been extensively discussed in the technical economics literature. Besides the expected effects on innovation, a negative consequence of such policies is the loss of information for the regulatory agency about the actual functioning of the regulated market.

Deposit Insurance

The lack of a formal system of deposit insurance, and the particular concern that this would place private banks at a competitive disadvantage compared to government owned banks, motivated USAID to support the creation of a fund, managed by the Costa Rican Bankers' Association (ABC -- Asociación Bancaria Costarricense), to guarantee the certificates of investment issued by private and cooperative banks. Contributions to the fund come from interest spreads on two USAID credit lines to private banks through the Central Bank.

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[14]Such financial entities are usually known as "panameñas" or "caribeñas" since they were originally established in Panamá and later in Grand Cayman and other Caribbean Islands as well as in the Bahamas. In many cases, these are just legal entities that have no offices or operations in the places where they are legally established, while all operations are fully carried out at the Costa Rican offices of these banks. Since investors (i.e., depositors) in these off-shore entities are dealing with intermediaries that are not constituted under Costa Rican laws, when failures arise there are no legal entities to sue in Costa Rica. Moreover, supervision by the Costa Rican superintendency (Auditoría General de Entidades Financieras) cannot reach these entities.

Although this fund has been useful to settle part of the unpaid obligations arising from the failure of three private banks (Weeden, Internacional de Exportación and Germano Centroamericano), a more formal, institutionalized mechanism is being sought to give a comprehensive treatment to the problem of deposit insurance. The Banking Reform Act of 1988 charged the National Insurance Institution (INS -- Instituto Nacional de Seguros) with the creation of deposit insurance to protect holders of obligations issued by private financial intermediaries up to ¢1.0 million (with this amount to be adjusted according to inflation). However, no such system has been implemented because the INS argues that the plan is not feasible without a substantial contingency fund, which in any case would only cover holders of private bank liabilities up to the point of total liquidation of the contingency fund.

The importance of a deposit insurance system to improve the competitiveness of private financial intermediates compared to government owned banks, which have the implicit support of the Costa Rican Government, should not be taken for granted. In fact, there can be serious doubts about the benefits of such a system relative to the distortions it could bring, especially the possibility of increased laxity in behavior toward risk and in the responsibility of financial intermediaries and their customers when making decisions. For that reason, a more detailed study of the costs and benefits of deposit insurance should be carried out in order to arrive at a well founded conclusion about the advisability of deposit insurance compared to other alternatives for dealing with depositor risk.

One alternative to deposit insurance (which might become a supplement if deposit insurance were to be instituted) is under discussion between USAID and the Central Bank of Costa Rica as this report is being written. This alternative consists in the creation of a fund to be administered by the Central Bank, with the resources coming from the lines of credit that were originally funded by USAID loans and grants but will not be relent to the private sector. This issue is, moreover, related to the issue of a rediscount facility for private banks, which can also be thought of as a preventive mechanism and hence a substitute for deposit insurance, so that the two questions should be dealt with simultaneously. There is, of course, also the alternative of relying primarily on strengthened bank supervision, as discussed in greater detail in the chapter on the supervision of financial institutions.

Credit Concentration and Related Groups

As experiences in other countries (e.g., Chile) have shown, credit concentration and linkages among borrowers from a financial intermediary, or between borrowers and the owners and managers of a financial intermediary, represent potential hazards that can

jeopardize the success of a reform to liberalize the financial system.

The 1988 Banking Reform Act (Ley de Modernización del Sistema Financiero, Number 7107) included a provision to enable the Central Bank to regulate credit concentration and lending to related groups. The specific regulations were released by the Central Bank in 1989, after long discussions with the affected entities in order to achieve a delicate equilibrium with useful prudential rules that would not excessively obstruct the lending operations of commercial banks. These regulations define the kind of relationships that can be considered for credit concentration, such as common shareholders with not less than 25 percent of the capital of two or more companies or the same connection between a company and a bank. In such cases, the limit of financing which are indicated in the next section apply to the different borrowers as if they were a single borrower.

This problem is, in any event, a difficult one to deal with. There is a valid concern that, for such regulations to be truly effective, they would introduce unacceptable rigidities in the process of bank lending and thereby increase the costs of intermediation. For this reason, further advise to the Central Bank is likely to be necessary, taking into account not only experiences in other countries but also Costa Rican legislation, so that a good solution to this problem can be found.

Credit Limits

The Central Bank Act (Ley Orgánica del Banco Central, Article 85, b) provides a limit to the amount of credit (direct and indirect) for any individual borrower, with the purpose of avoiding credit concentration. Such limits have been an obstacle, especially for government owned banks in their financing of certain large projects, because the limits, being set by law, become out of date with inflation. The Banking Reform Act of 1988 made these limits more flexible by empowering the Central Bank to increase them according to the behavior of inflation. The limit has now been set at 20 percent of capital and reserves or 250 million colones, whichever is smaller, with the latter figure being adjusted from time to time by the Central Bank according to inflation. The actual figure, which represented less than $3.2 million at the end of 1988, has been increased to about 450 million colones, which was equivalent to about $3.3 million at the end of 1991.

While a limit to total borrowing by any individual enterprise from each bank is a useful measure to control risk, it can also become a significant obstacle if the figure is too small. The current limit in fact falls short of the amounts required for many productive projects (e.g., many tourism developments, small infrastructure projects and some agro-industrial projects). In some cases, moreover, the limit could be deemed as unnecessary

because the risk of an individual borrower is not only related to the amount of bank financing but also to the amount of the borrower's assets or capital and reserves, the feasibility of the project, and the proportion of it financed by the bank, among other things. With an absolute limit of only about 0.4 percent of total banking system credit to the private sector as of the end of 1991, there should be room to increase the amount.

A complementary approach could be to explore the obstacles for loan syndication among government owned and private banks. This mechanism could be a good option for financing larger-size productive projects without forcing enterprises to look for foreign financing.

Other Credit Regulations

The reduction of the Central Bank's role in regulating various other aspects of commercial bank operations that should in fact be the responsibilities of the banks themselves (e.g., the amounts of bank commissions, the amounts of credit per unit of area in agricultural loans, seasons for lending in certain activities, rules governing guarantees and the evaluation of guarantees) has been a lengthy process that began during the late 1970s but gained speed after 1984. Credit regulations have now been restricted to general conditions, instead of the practice in the 1960s and 1970s when the Central Bank issued detailed regulations with respect to credit directed to different activities.[15] In those cases where specific rules remain, they are related to programs financed with foreign resources, and they are typically issued to comply with conditions set by these creditors.

Funds from credit programs financed with foreign resources should be lent under the general conditions set by the commercial banks for their operations, except for the destination of the loans. Percentages of projects to be financed, interest rates, terms, etc. should be general, and for this reason some of the regulations for credit programs financed by USAID resources should be revised to eliminate rules that are specific rather than general.

The so-called General Regulations on Credit and Interest Rates issued by the Central Bank ("Regulaciones Generales de Crédito, Tasas de Interés y Comisiones dictadas por el Banco Central de Costa Rica") should also be revised and simplified, under the criterion that what is not included there is not subject to Central Bank regulation. Some areas should be reformed as, for example,

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[15]The proliferation of specific regulations for many commercial bank operations during the 1960s led to some efforts toward simplification in the 1970s. However, distinct set of regulations still remained for the financing of different crops and activities, such as coffee, bananas, cotton, dairy farming, tourism, cattle raising, fishing, etc.

Central Bank regulations with respect to the periodic adjustment of interest rates on both loans and deposits, the regime for deposit redemption before maturity, the capacity to sell deposits through the securities exchange, etc., since these are properly issues for the commercial banks themselves. Some other aspects require legal reform, such as the elimination of interest rate determination by law for certain categories of credit.

As mentioned above, from the 1950s to the 1970s there was a proliferation of Central Bank regulations for bank credit to certain activities and other related topics. In the annex to this chapter, a list of such regulations is provided for illustrative purposes. During the 1970s, as also mentioned above, an effort was made to simplify some of these regulations. In spite of the interest in simplification, it was nonetheless thought that the Central Bank should closely regulate many aspects of commercial bank operations which, at that time, were confined mainly to the four government owned banks. Thus, most of these regulations continued in force for more years, including regulations on the financing of: the coffee crop, banana production, cotton production and marketing, small industry and handicrafts, beef and dairy cattle, fishing, tourism, etc. Regulations included several aspects of credit such as maximum amounts per acre during different stages of the production process, terms, dates for beginning to grant seasonal credits to producers, the kind of guarantee to be required by the commercial bank, etc.

After the Central Bank's decision to end these kinds of specific regulations, those that still remain are mainly required by law and are not confined to credit regulations but instead cover a wide range of topics (e.g, foreign exchange transactions, approval of new private banks, qualification of banks for tax and other purposes, fines for banks that do not comply with Central Bank rules, etc.). Some of these regulations are still inconsistent with the new view of the role of the Central Bank, especially those related to the operation of financial intermediaries and foreign exchange markets. However, it should be recognized that important improvements have been made in this respect. (The annex to this chapter also lists some of the more important regulations of the Central Bank that are still in effect.)

Organization and Administration of Government Owned Banks

The predominance of the government owned banks in Costa Rican banking system is clear. Although private banking has grown very rapidly during the last ten years, the public banks still account for a substantial majority of banking system credit (70 percent of the total as of the end of 1991) and an even higher percentage of total deposits (about 88 percent as of the end of 1991). For this reason, the legal and regulatory framework governing the administrative aspects of the government owned banks is

particularly important, since it influences the costs of intermediation and the efficiency not only of these banks but of the entire system.

The government owned banks are highly regulated, as is the case for other Costa Rican public sector institutions, irrespective of their role as economic enterprises and their financial independence in that their operations are not financed through the Government budget (although their losses ultimately maybe). Nonetheless, in order to compete effectively with their counterparts in the private sector, more flexibility is required for them than for other public institutions.

Reforms in the administration of government owned banks during the past ten years have come mainly through the Banking Reform Act of 1988:

- Higher qualifications for members of the boards of directors of government owned banks are now required.

- Government owned banks have been authorized to create enterprises with their joint participation in order to provide some common services such as vigilance.

- Government owned banks have been exempted from general public sector regulations with respect to wage and employment policies as well as investment decisions. Prior regulations had required prior approval of such decisions by the Budget Authority (Autoridad Presupuestaria) and the Ministry of Planning, respectively, and represented a major rigidity for an activity for which is labor the main factor.

- More flexible regulations were introduced for procurement procedures to provide government owned banks with the capacity to face competition from private banks and other financial intermediaries.

- Contributions to retirement funds for bank employees are now charged as expenditures instead of coming from profits available for distribution. This reform has helped to ease the traditional resistance of government owned banks to declare losses because of union pressures. This reform also made possible a major reform in the traditional practice of government owned banks of continuing to compute as income earned interest on loans long past due.

The Main Accomplishments

The systematic process of financial reform that began in 1984 has been important in the transformation of the Costa Rican financial system. By recognizing the existence of formal (regulated) and

informal (non-regulated) sub-sectors in the financial system, a shift from the use of direct monetary instruments to indirect ones was implemented. The awareness that increased controls over the formal sector will cause funds to flow to the informal sector, thereby reducing the effectiveness of Central Bank control, has resulted in a parallel recognition that the shift in emphasis of monetary policy instruments not only improves the effectiveness of such policies but also discourages the growth of the non-regulated financial sector.

Competition has helped to improve the quality of services provided by the financial system. Far from destroying the government owned banks, this competition has presented them with new challenges, beginning in the mid-1980s, that have been especially important when it is recognized that a complete privatization of banking in Costa Rica is not yet politically feasible. In fact, the government owned banks have begun to adopt modern banking technology, offering new financial instruments and taking a closer look at past due loans and loan recovery administration. While there is still considerable room for improvement, the importance of the advances made cannot be denied.

Throughout the Costa Rican financial system, new services and new investment opportunities are being offered to customers, such as bankers' acceptances, trust arrangements, investments equivalent to short term deposit facilities, overnight deposits, corporate banking services for businesses and large-volume individual clients, transactions in foreign exchange markets, automatic teller machines, computerized systems for financial transactions and to provide information to customers about their deposit accounts, etc.

The creation of a money market operated by the Central Bank for overnight and other very short term deposits has been highly important for the commercial banks, providing them with a riskless liquidity mechanism for their excess reserves. Although a similar system has been operating for some time as part of Costa Rica's private securities exchange, this is not a totally appropriate market for banks because of the risks involved.

Although still a serious problem by international standards, as indicated in Chapter III, the severe problem of past-due loans in the government owned banks has been significantly reduced. In part, this resulted from the use of the equivalent of $60 million from the second structural adjustment loan provided by the World Bank (in collaboration with Japan) to cover the losses of the government owned banks resulting from uncollectible loans and then to recapitalize these banks. In addition, the attitudes of the managers of government owned banks toward non-performing loans have changed. They are now more aware of the consequences of such problems and have implemented new systems to improve loan collection procedures.

The government owned banks also appear to have begun to recognize their role as economic enterprises, rather than simply being social service institutions, and are becoming more concerned with financial results. In particular, they have improved their traditionally bad loan recovery records. On the other hand, greater attention needs to be paid to the quality of the loan portfolios of private banks since some deterioration can be seen in this area. In any case, however, the private banks in general continue to have healthy loan portfolios, so that this is still far from becoming a severe problem.

Nonetheless, not all the problems have been solved. Considerable inefficiency remains in the government owned banks, both the large and small ones. Significant distortions still exist that affect intermediation costs, and these costs continue to be very high in general. The dispersion in interest rates (measured by the range from the lowest to the highest bank lending rates) has been reduced, but there are still differences in the rates charged to different customers that are not related to their probabilities of success or other risks but rather to the activity in which they happen to operate.

Private bankers argue that charges imposed on them by various legal and regulatory provisions increase their intermediation costs by about 9 percentage points. The lack of access to Central Bank rediscounts accounts for 3 percentage points, as explained earlier in this chapter. The 8 percent tax on interest on deposits and certificates of investment adds about 2 percentage points, given current nominal deposit rates of about 25 percent. The reserve requirement of 10 percent of total deposits, on which no interest paid by the Central Bank, adds another 2.5 percentage points at the current level of nominal interest rates. Finally, the local government license fee for financial establishments of 0.5 percent of total revenue increases the spread by another 1.5 percentage points.

Private banks are not yet totally dynamic competitors, and they could take greater advantage of the very high spreads provided by the government owned banks to improve yields for depositors and reduce interest costs for borrowers which, in turn, would cause the private banks to capture a larger share of the market and force the government owned banks to improve their efficiency more rapidly. The problem is that, with the laxity from the spreads permitted by the government owned banks, leakages appear in the discipline of the private banks that would otherwise be forced to greater efficiency.

Areas for Continuing Reform of Laws and Regulations

Access to Central Bank Credit and other Powers of the Central Bank

Legal reforms required:

1. Restrict the Government's access to Central Bank credit exclusively to Treasury Bills (Letras del Tesoro) and reduce the present limit from 1/12 to 1/24 of the National Budget. As part of a system of checks and balances, a system of public information (i.e., quarterly reports from the Central Bank to the Congress) should be created that would include the amount of each transaction in Treasury Bills.

2. Restrain clearly all possibilities for the Central Bank and the government owned banks to finance the Government in indirect ways such as using reserve requirements for this purpose.

3. Eliminate access of CODESA and INFOCOOP to Central Bank credit.

4. Restrict the power of the Central Bank to engage in foreign borrowing, so that it needs the approval of Congress except for borrowing for temporary balance of payments support from organizations such the International Monetary Fund or other central banks.

5. Make clear that the nature of rediscount facilities from the Central Bank to the government owned banks is solely as a lender of last resort, so that the rediscount rate should always be above market interest rates and never lower than the six-month deposit rate (the basic rate).

6. Extend to private banks, but not to financieras, access to the Central Bank rediscount window, but only at rates higher than the six-month deposit rate. This facility should be subject to qualified voting by the Central Bank's Board (i.e., a two-thirds majority) and would only be used when required to avoid an increasing lack of confidence that could affect the whole financial system.[16]

7. To enforce the legal provisions for the former public sector external debtors to the Central Bank, derived from debt

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[16]The denial of access to financieras is based on the present limit of no less than six months for their certificates of investment. If this were changed to be equal to the private banks' regime, further study would be needed to analyze the advantages of having both banks and financieras eligible instead of only banks.

rescheduling and renegotiation, a legal reform should impose penalties not only on the delinquent institutions but also on the Central Bank if it fails to use promptly the mechanisms contained in the law to deal with these overdue obligations.

8. Eliminate the Central Bank's legal power to determine interest rates on loans to small farmers and other groups, and thereby eliminate the need for the Central Bank to have the power to impose commissions on these loans to increase their rates administratively.

9. Initiate a study of the appropriateness of maintaining the general power of the Central Bank to fix interest rates and commissions. Even if such powers remain, the problem of fixing prices and quantities simultaneously should be addressed, along with the dubious gains from fixing either of them.

10. Limit, by law, the power of the Central Bank to impose detailed credit ceilings in order to avoid the negative effects of possible highly interventionist Central Bank policies in the future.

11. The practice of using reserve requirements as a way to finance the Government has largely been abandoned. Although this practice has no clear basis in Costa Rican legislation, a legal reform to eliminate this possibility could be important for the future since this mechanism has been used in the past.

Central Bank Independence

Legal reforms required:

1. Initiate legal reforms to increase the independence of the Central Bank. Since financing public sector deficits and projects to promote economic development have undermined its main responsibility to maintain a stable value for the currency, it is necessary to reduce as much as possible the influence of electoral considerations in the process of making monetary policy.

2. While it is worthwhile to maintain the position of Executive President and the presence of the Minister of Finance on the Central Bank's Board, legal reforms should be initiated to promote the general interests of Costa Rican public in the process of naming the Executive President and the other five Board members. For that purpose, participation of the Congress and lengthening of the period of appointment for Board members, except the Minister of Finance, are

alternatives that could be explored, as proposed by Lizano (1991).[17]

Issues Related to Banking Policy

Legal reforms required:

1. Provide technical assistance to the Central Bank to improve its system for the analysis and ranking of banks, in order to enhance the protection of investors as long as the Central Bank continues to have the responsibility of authorizing the issuance of certificates of investment by private banks.

2. Analyze in depth the disparities in leverage limits for different financial institutions, as well as the legal measures required for a uniform and widespread protection for all savers, taking into account the differences among the various types of financial intermediaries.

3. Provide informed advise to the Central Bank with respect to problems of credit concentration and credit to related economic groups, taking into account experiences in other countries as well as domestic legislation.

4. Initiate a study of the appropriateness of creating a deposit insurance system, taking into account not only the legal provision included in the Banking Reform Act of 1988 to create such insurance, but also the possible shortcomings of such a system, especially in terms of moral hazard (laxity on the part of both depositors and financial intermediaries in making financial decisions without an adequate assessment of risk).

5. Carry out additional legal studies with respect to the reforms required to make completely effective the Central Bank's power to increase minimum capital requirements for existing private banks within reasonable limits.

6. Clarify Article 298 of the Banking Reform Act of 1988 (Ley 7107, Ley de Modernizacion del Sistema Financiero) to express clearly that the minimum capital requirement for a "banco

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[17]This topic, as well as the whole section, draws heavily on Lizano (1991). His proposal is based on: (1) maintaining a Board of seven members, including the Executive President and the Minister of Finance; (2) the Executive President would be appointed by a two-thirds majority of the Congress for a period of ten years; (3) similar procedures would established for the other five Board members, who would be replaced one at a time each two years; and (4) conflicts between the Executive Branch of the Government and the Central Bank Board would be settled by the Congress, and if its decision is against the Board, the Board members have to resign. In this way, some political control over the competence of the Board would be maintained.

solidarista" should be 50 percent of that for private commercial banks and not 50 million colones.

7. Eliminate the possibility for government owned banks to grant subsidized credits to any group. Interest rates on loans below the market rate for deposits should not to permitted, or at least should be covered by an equivalent transfer from the national budget to the bank.

8. Initiate further analysis with respect to the reforms required in the Banking System Act to provide government owned banks with effective surveillance mechanisms over their efficiency and financial results. This would include eliminating electoral considerations when appointing members of their boards.

9. Eliminate all legal dispositions that force government owned banks to lend to specific economic sectors, thereby recognizing that creditworthiness and feasible productive projects cannot be created by law.

10. Present a legal reform to eliminate the existing 8 percent tax on interest from colon-denominated deposits, bonds and similar instruments.

Regulations Differentiating Financieras from Banks

Legal reforms required:

1. Initiate an in-depth analysis of the justification for having both banks and financieras, and of the differences in regulations and requisites pertaining to each of them. Claims by financieras for a regime similar to that of private banks could lead to the conclusion that they should in fact be converted into banks.

2. Reform Central Bank regulations for financieras wanting to convert to banks by recognizing that they have a record in the market and a history of regulation by the Central Bank and supervision by the AGEF, so that requisites should not be as severe as for the creation of a new bank (but with no reduction in minimum capital requirements).

3. Provide financieras with the same regime as applied to private banks in areas not related to the key elements that makes them different from each other, such as the possibility to participate in the foreign exchange market. This reform is in fact included in a bill under consideration by Congress to modify several aspects of the foreign exchange system.

4. In the case that the conclusion is reached in the study mentioned above, that there should be no differences between

banks and financieras, a legal reform should be developed to facilitate the merging of financieras to expedite their conversion into banks.

Foreign Exchange Operations

Legal reforms required:

1. Initiate a legal reform to the Currency Act (Ley de la Moneda) to establish clearly that loans stipulated and disbursed in foreign currencies by private and government owned banks and financieras must be repaid in the same foreign currency.

2. Eliminate the powers of the Central Bank to impose quantitative and qualitative restrictions on foreign transactions, as is proposed in a bill currently under consideration by Congress.

3. In the case that the power of the Central Bank to impose prior deposits on imports and other foreign payments continues in effect, as contemplated in the bill mentioned above, some limits should be included, such a similar treatment for all activities, that would prevent discriminatory percentages being applied by the Central Bank's Board.

4. Since a liberalized foreign exchange market requires removing distortions that affect the determination of the price in that market (i.e., the exchange rate), a legal reform should be initiated to eliminate taxes and other charges that raise the spread between the buying and selling rates (e.g., the charges mandated by law to finance CODESA and the institute for cooperative promotion, INFOCOOP). The law should also prevent similar charges by the Central Bank such as those that were imposed in March 1992 to increase the fund to cover the foreign exchange losses of the government owned banks (Fondo de Perdidas Cambiarias) and to compensate partially for Central Bank losses.

Annex to Chapter IV

Central Bank of Costa Rica: Regulations and Norms

Year	Regulations:
1953	Regulations for the importation of capital goods.
1954	Special regulations for the financing of fertilizer imports.
1956/61	Regulations for the importation of capital goods (World Bank loan).
1960/62	Regulations for operations originating from the Chase Manhattan Bank loan.
1961	Regulations for the granting of guarantees by commercial banks for payments in foreign currency.
1961	Regulations for the extension of loan repayment periods for coffee producers.
1964	Regulations for the extension of loan repayment periods for bank borrowers.
1964/72	Credit regulations for the maintenance of coffee plantations damaged by volcanic ash.
1965/66	Regulations for loans for the repopulation of coffee plantations.
1965	Regulations over goods acquired by banks through auctions.
1965	Regulations for loans to alleviate the damage to crops and cattle caused by volcanic activity.

1967	Regulations for national banking system financing of university studies by teachers at the secondary school level.
1967	Uniform credit regulations for beef cattle.
1968	Regulations for loans to small farmers and small rural entrepreneurs.
1969	Uniform credit regulations for employees of the national banking system.
1970	Regulations for loans for mechanized and technified rice production.
1970	Regulations for loans to provide complementary financing for technified rice production.
1970	Regulations for financing coffee harvests.
1970	Regulations for financing banana production in the Atlantic Region.
1970	Regulations for financing agricultural and industrial sales.
1971	Regulations for financing cattle raising, including both males and females, for meat, dairy or both purposes.
1972	Regulations for the law regulating financieras, investment companies and non-bank special credit institutions.
1973	Regulations for the extension of repayment on loans for banana producers in the Atlantic Region.
1976	Regulations for the credit program to improve small coffee plantations in Santos, Pérez Zeldón and other areas of the country.

1978 Regulations for the norms and operating criteria for FODEIN.

1978 Regulations for financing farmers in Nuevo Arenal, Nuevo Tronadora and Quebrada Azul.

Norms:[18]

1970 Special norms for financing coffee harvests.

1970 Special norms for financing banana production.

1970 Special norms for loans to finance the production and marketing of cotton.

1972 Norms related to industrial credits with funds from Wells Fargo Bank.

1974 Norms for loans to family scale industry and handicrafts.

1974 Norms to facilitate the control of foreign credit operations and the issuance of payment guarantees for the importation of machinery and equipment.

1976 Norms for financing dairy farming.

1976 Norms for the $2 million credit line from Citicorp International.

1977 Norms for the use of the fund to promote exports and tourism.

1977 Norms for the extension of credit to penetrate selected foreign markets.

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[18] These are mainly name changes in existing regulations.

1977 Norms for the extension of repayment of loans for fishing on the Pacific Coast.

1978 Norms for the program to finance the retention of offspring in meat producing cattle farms.

Regulations in force as of December 1991:

1. Regulations pertaining to inserts b, ch, h, and j of Article 7 of the Currency Law.

2. Regulations for the selective registration of capital.

3. Regulations for foreign currency operations in the interbank market.

4. Regulations for the sale of gold by the Central Bank of Costa Rica.

5. Regulations for authorizing the formation, opening and operation of private banks.

6. Norms for recognizing foreign financial entities:

   a. Pertaining to Article 54 of the income tax law.

   b. Pertaining to granting credit, acceptances and guarantees.

   c. For the acquisition of foreign credit and the issuance of guarantees.

7. Regulations for minimum legal reserves.

8. General regulations for credit, interest rates and commissions dictated by the Central Bank of Costa Rica.

9. Norms authorizing access to foreign credit for commercial banks and financieras.

10. Norms for guarantees of foreign payments.

11. Regulations for the export promotion fund.

12. Regulations for the use of funds from the agreements AID-515-0185, 0186, 0192 and 0194.

13. Regulations for the use of the $3 million from AID loan 515-W-040 for credit to small scale industry and handicrafts.

14. Norms for financing agricultural projects undertaken by professionals in agricultural sciences.

15. Regulations for agricultural trust funds.

Chapter V

Supervision of Financial Institutions

Introduction

This chapter covers issues related to the supervision of financial institutions, including an analysis not only of the judicial and regulatory framework but also of the capabilities of the Auditoria General de Entidades Financieras (AGEF).

From the following discussion it is clear that a major change took place in 1988 in the institutional framework for the supervision of financial institutions as a result of the approval of the "Ley de Modernizacion del Sistema Financiero de la Republica" which extended the AGEF's powers in many respects. The AGEF's capabilities have also been significantly affected by the development of a major modernization plan that was initiated at the end of 1988 and which, in spite of various changes and interruptions, is still in the process of implementation.

As a result of these major changes, the AGEF's approach to supervision has begun to be transformed from a primary emphasis on the formal aspects to giving priority to the timely detection of problems, particularly related to the solvency of the supervised institutions. As a consequence, the AGEF's work has begun to embrace increasingly the financial situation analysis of the supervised entities, including both on site and off site evaluations. More modern concepts of financial supervision, such as loan and asset assessment, loans to related parties and insider lending, financial analysis, CAMEL, capital adequacy, reserves for doubtful loans and non-performing assets, have now begun to be used regularly by a large number of Costa Rican supervisors.

Along with the development of a more modern approach to supervision, the modernization program for the AGEF involved the implementation of a management information system that included not only the conceptual aspects of the information system but also the computing hardware and software. As of the preparation of this report, the systems were not yet completely operational, but there have been significant advances in many areas, including the acquisition of a large number of microcomputers, the hiring of qualified personnel and the automatization of many tasks. The modernization project has not, however, included the AGEF's most traditional area -- auditing -- which has continued to use approaches and processes that are much more formalistic than desirable. This fact has caused coordination problems among certain sections of the AGEF, and even some conflicts, particularly with the units responsible for loan and asset assessment and financial analysis.

At the end of 1990, the modernization project faced a major dilemma when the Auditor General, Rafael Diaz, who had strongly supported the project since its beginning, retired from the AGEF. The Sub-Auditor General was then placed in charged of the AGEF and continued in that role until September 1991 when the current Auditor General was appointed. During this period, the project not only stagnated but even went backwards in many aspects (e.g., asset and loan assessment, financial analysis, the accounting program and information disclosure), thereby putting the modernization project not only in danger of collapsing but possibly causing the AGEF to revert to a worse situation than what prevailed two years earlier.

A sample of the problems that the AGEF encountered during the period when there was only an acting chief was the experience with the Banco Germano. Various internal reports of the AGEF showed the weak financial condition of that bank, but the Sub-Auditor General (the acting chief) took no corrective actions. Moreover, it was only recently that the new Auditor General intervened the bank, several month after the problems were originally discovered.

With the recent appointment of a new Auditor General, the modernization project could be given a new impulse. This, however, is still to be seen. There are various positive signs, such as the AGEF's greater speed and capacity in decision making, but there are certain other factors that could cause concern over the coming months about developments at the AGEF. Among these are the lack of experience of the new Auditor General in bank supervision, the reorganization of the AGEF that he initiated without any fundamental analysis immediately after taking office, and the lack of coordination and even conflicts between the AGEF and the Central Bank. Furthermore, the problems of the AGEF are not just at the higher levels. The AGEF also has an excess of personnel, especially in its administrative units, and lacks sufficiently qualified personnel in key areas of supervision such as portfolio evaluation, financial analysis and auditing.

Strengthening the AGEF's capacity for analysis and decisive action is generally seen as a high priority among the issues facing the Costa Rican financial sector. This strengthening could be based on the program developed for the modernization project, but it should also cover other aspects. In particular, the AGEF should be given technical assistance to strengthen the following areas:

- definition of the AGEF's organizational structure and implementation of a reorganization plan including the retraining of personnel;
- techniques of auditing financial institutions; and
- training in:
    - a financial focus for bank regulation and supervision;

- portfolio evaluation;
- financial analysis; and
- auditing.

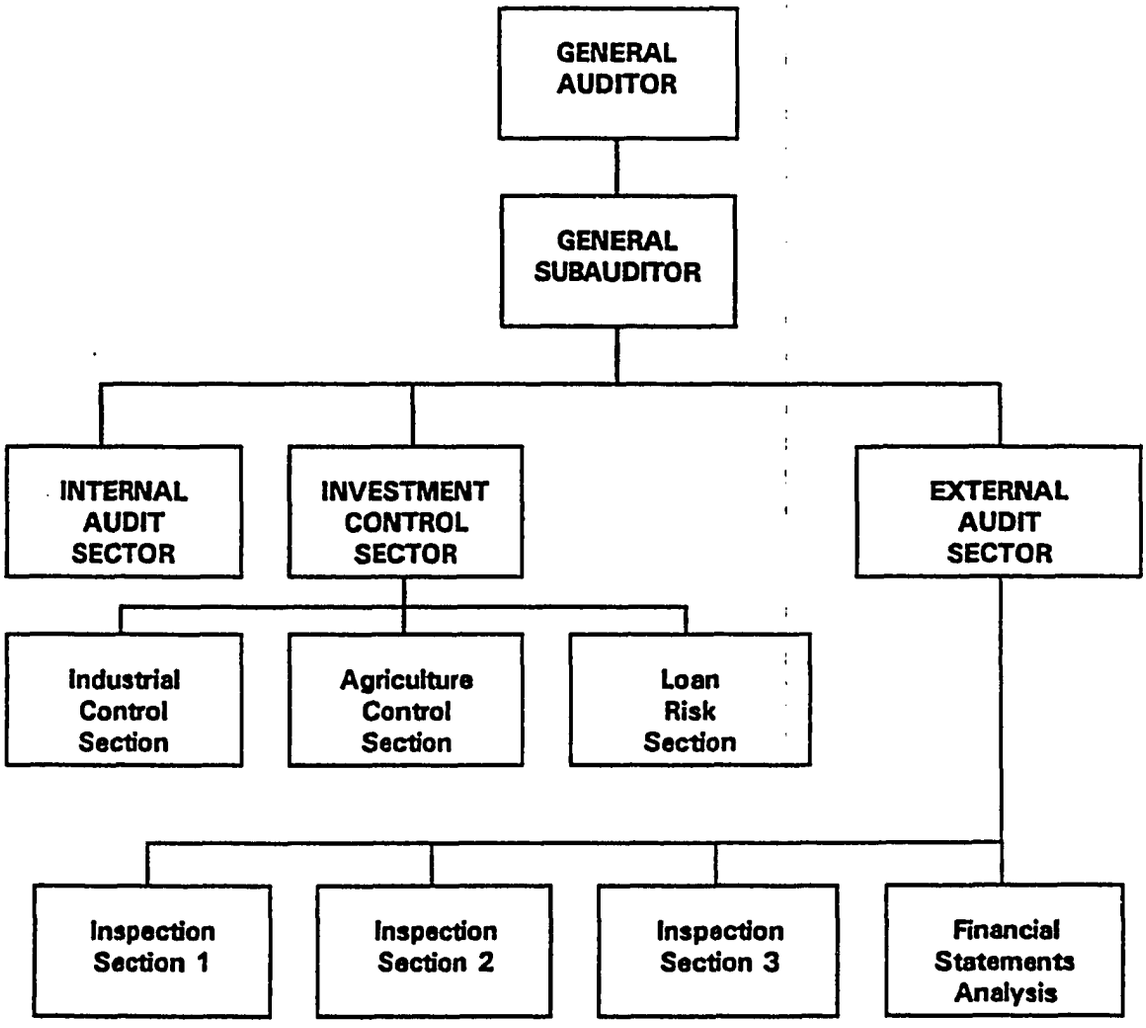
This strengthening of the capacity of the AGEF should include not only the granting of greater autonomy but also the assignment of new responsibilities.

The Situation of the AGEF before 1988

Before the issuance of the Ley de Modernizacion del Sistema Financiero and the almost simultaneous initiation of the technical assistance project, the AGEF's approach had focused on the verification of formal compliance with norms, primarily the Central Bank's credit control rules. This situation largely reflected the Costa Rican Government's ownership of the banking system, in effect since its nationalization in 1948. However, some preliminary progress had been achieved before 1988 in the areas of financial analysis and loan evaluation, and this led the authorities of the Central Bank and the AGEF to consider the importance of implementing a more financially oriented supervision of financial institutions.

The AGEF's approach and situation before 1988 can be appreciated most clearly by analyzing its organizational structure together with the tasks of some of its main units. The AGEF'S organization as of the beginning of 1988 is shown in the following chart:

AGEF ORGANIZATIONAL CHART – 1988



The activities of the **Internal Audit Division** had nothing to do with the usual duties of bank supervisory agencies. Its only function was to carry out the internal audits of the Central Bank.

The activities of the **Investment Control Division**, except for the relatively new Loan Risk Section, also had very little relation to bank supervision. Through the Industrial Control and Agriculture Control Sections, the Investment Control Division monitored the compliance of borrowers with the investment plans presented to banks in their credit applications. This monitoring was carried out through on-site inspections of banks and visits to the farms and businesses of the banks' borrowers. Many of the examiners in the Investment Control Division were agriculture engineers, and their main objectives were:

- to verify the compliance of actual investments with the programs presented by borrowers;
- to issue reports on the implementation of programs financed with foreign resources;
- to supervise the use of funds provided by the Central Bank for the price stabilization program; and
- to appraise the applications for Central Bank foreign exchange subsidies.

The relatively new **Loan Risk Section,**[19] together with the Financial Analysis Unit to be described below, were the only components of the AGEF that dealt with the main issues of bank supervision and then only in a very preliminary way. They supervised the asset assessment and classification mechanisms used by the banks as to their compliance with the AGEF's instructions.

The main achievement of the Loan Risk Section was to introduce in the Costa Rican financial system for the first time the concepts of loan assessment and credit review. Previously, these concepts were meaningless, not only to the banks but also to the AGEF and the Central Bank. Nonetheless, there were a number of critical points that needed to be changed in order to have reliable judgments about the loan portfolios and other assets of Costs Rican banks:

1. The review was aimed to assess individual loan operations and not the overall situations of borrowers. Although this approach can have some advantages, it limits and entangles the analysis in most cases.
2. The information compiled was not fully utilized. Specifically, the information about individual loan operations was not used to assess the borrower's overall financial situation.
3. There was no methodology or standardized procedure to select the cases for loan assessments in a bank.
4. The proportion of a bank's loan portfolio subjected to the assessment routine was too small.
5. Apart from loans, the rest of a bank's assets were not subjected to any serious assessment. This was the case even for important items such as financial investments, real estate and repossessed goods. There was also a lack of monitoring of loans based on funds given in trust (fideicomisos).

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[19]Only in 1985 did the AGEF establish a loan assessment procedure and create a specialized unit to carry out bank examinations.

6. According to rough estimates of the banking system's financial condition, especially the condition of government owned banks, the reserves required for bad loans were inadequate and far below the principle that such reserves must be at least equal to estimated assets losses. This was especially clear when a comparison was made between the mandatory provisions and the estimated loan losses for each category defined in the classification system.[20]

7. There was a very liberal policy with respect to accruing interest that had no relation to common banking practices in other countries. In particular, loans stopped accruing interest only long after they had fallen into arrears. Not until 1988 was a regulation issued to stop accruing interest 180 days after a loan was overdue -- a major but still insufficient advance.

The **External Audit Division** was divided into four sections: three Inspection Sections and one Financial Statement Analysis Section.

The **Inspection Sections** carried out very traditional on-site bank supervision audits, mainly the verification of formal compliance with laws and regulations.

The **Financial Statements Analysis Section** was aimed mainly at off-site monitoring for compliance and some administrative duties related to the supervision process. In addition, it had the new Financial Analysis Unit.

The creation of the **Financial Analysis Unit** was a major step toward the initiation of a modern banking supervision agency. By 1988, this unit had achieved important goals within the AGEF with respect to introducing the concept of financial analysis as well as in using financial ratios as part of a methodological scheme. Nonetheless, several problems existed in these procedures:

1. There was confusion concerning the use and meaning of several ratios, as well as how to use them to describe a bank's condition.

2. The methodology did not include projections of financial statements and ratios and the overall condition of a bank. A lack of understanding of a bank's future capabilities and problems resulted from this.

3. The analysis was too quantitative, lacking the incorporation of qualitative elements necessary to understand fully the condition of a bank. This was reflected in an almost complete absence of

[20]The main impediment to applying a more conservative procedure was the very poor condition of the government owned banks which could only constitute a small portion of the reserves that were needed to cover loan losses fully.

communication with the bank being examined, together with the fact that no appraisal of bank management, policies and control mechanisms was carried out.

4. The unit carried out its functions without adequate coordination with other units within the AGEF, and this was especially detrimental to the ultimate objective of a financial analysis unit. On one hand, their own job was too theoretical in lacking a real knowledge of the actual situation of a bank; on the other hand, the rest of the AGEF did not have a key element to guide their examination activities.

5. The hierarchical position of the unit in the organizational chart of the AGEF was very low. In banking supervision agencies in other countries, these kinds of units are typically the main advisers to top officers.

The strengths and problems of the AGEF discussed above reveal the main elements of the agency and its organizational structure. Nonetheless, there are some other important issues that are also worth mentioning:

1. The AGEF's coordination mechanisms were very weak. In fact, the Auditor General was the only one in charge of coordination. This unstructured arrangement was the basis for a variety of conflicts and low productivity.

2. The information provided to the AGEF's top level officers was too abundant, often immaterial and poorly organized. Moreover, there was a widespread tendency to write long reports, which made it very difficult to distinguish the relevant issues, as well as to submit every report to the Auditor General.

3. There was a lack of basic financial and accounting regulations and no official definition of important concepts. This was reflected in very heterogeneous accounting systems among banks, some of which were very liberal.

4. There was no requirement of external audits for bank financial statements.

5. There was almost no supervision of trust funds (fideicomisos) which are supposed to be trust funds, but in practice are a way of having a parallel bank within a bank for the primary purpose of avoiding regulation.

6. It is not possible to give an opinion about the personnel of an organization unless a serious assessment is made. Nonetheless, it is clear that the number of personnel in the AGEF was more than adequate to carry out modern and thorough banking supervision, but the qualifications of these personnel would have to be modified to have a strong supervisory agency. In

particular, more qualified professionals in financial analysis, credit review and computing systems were needed.

The AGEF'S Modernization and Technical Assistance Project

In November 1988, a technical assistance project began that was aimed at modernizing the AGEF in several aspects, including information systems, loan assessment, financial analysis and training. This project was financed by a technical assistance loan from the World Bank and carried out by a Chilean firm that was contracted by the UNDP after a competitive bidding process. The technical assistance, which involved approximately 210 consultant weeks, was provided between November 1988 and June 1989.

The approach taken by the consulting team considered that the main goal of banking supervision is to know on a timely basis the actual overall condition of the supervised institutions and to be able to react appropriately and promptly when there is a problem. Under such an approach, financial and management issues, and especially the appraisal of solvency, are emphasized. The establishment of good information systems is considered a key tool to help with the supervision activities. The role of more traditional supervision areas, such as accounting audits, is not neglected but is rather oriented mainly toward verifying the reliability of information coming from the supervised entities.

The technical assistance program included the following five areas:

1. **Asset Assessment, Required Provisions for Doubtful Loans and Accrual of Interest Income.** After a diagnosis of these issues in both the AGEF and the banks, recommendations were made regarding the short run as well as the long run. Procedures were provided for the following aspects:
   i. Provisions for doubtful loans;
   ii. Write-offs;
   iii. Non-performing loans and interest accrual;
   iv. Sampling of loans for audit purposes;
   v. Collateral assessment;
   vi. Assessment and accounting for financial investments;
   vii. Repossessed goods;
   viii. Assessment of loans to economic groups;
   ix. Executive reports and working papers; and
   x. Credit review methodology.

2. **Financial Analysis.** The technical assistance program included a critical review of the financial analysis procedures followed by the AGEF along with recommendations for accomplishing both an integrated financial analysis and the writing of executive reports. Recommendations with respect to methodology included the following:

   i. Analysis of financial statements;

   ii. Projections of financial statements;

   iii. Assessment of management and ownership; and

   iv. Use of financial ratios, involving:

      Capital adequacy;

      Earnings;

      Assets;

      Liabilities; and

      Financial gaps (matching of assets with liabilities).

   Recommendations for executive reports included those related to specific banks and to the banking system as a whole.

3. **Statistical Information and Disclosure Policy.** This part of the technical assistance program included analysis and recommendations concerning the statistical information that banks must submit to the AGEF, the Central Bank and the securities exchange for their use and for disclosure to others. Recommendations covered the following:

   i. Balance sheet form;

   ii. Income statement form;

   iii. Accounting for foreign exchange operations;

   iv. Indexation of financial statements;

   v. Information disclosure to the public;

   vi. Accrual of interest;

   vii. Complementary statistics, including:

      Maturities of assets and liabilities;

      Interest rates on loans and deposits;

Geographical statistics;

Loans classified by economic activity of borrower;

Number of deposit and loan operations;

Employees and branches; and

Shareholders, executives and board members.

4. **Information Systems.** As one of its areas of prime concern, the technical assistance program included a proposal for the creation of an integral information system to carry out the AGEF's regulation and supervision activities. The objectives of the proposed system were aimed at the modernization project as a whole, the requirements of the Central Bank and the public, and the technological condition of both the AGEF and the banks. The proposed system contained four main modules:

   i. **Accounting module**, with information concerning the financial statements of the supervised institutions;

   ii. **Borrowers' module**, with data concerning credit operations and borrowers' collateral. This module included, as an important part, a consolidated data base about borrowers. This part was to be used by both the AGEF in its examinations and the banks in their credit decision making process;

   iii. **Statistical module**, with complementary statistical information about the supervised entities; and

   iv. **Financial Institutions module**, with data about the structure of financial institutions.

The system also included three supporting modules that use the information in the basic modules to generate reports.

5. **Training in Asset Assessment and Financial Analysis.** As a consequence of the limited budget for the project, training was included only for the most basic elements and covered only two areas: Asset Assessment and Financial Analysis.

Further Developments

At the beginning of 1990, a few months after the technical assistance project was finished, the AGEF hired two experts from the consulting team as long term resident consultants to help the staff of the AGEF implement the recommendations from the project. One of these consultants was an expert in general banking supervision, with experience in financial analysis and asset assessment. The other was

an industrial engineering expert in information systems. The first consultant worked with the AGEF for one year and the second consultant for two years.

During this period a major restructuring of the AGEF took place. The Investment Control and Internal Audit Divisions were eliminated from the AGEF's organizational chart. The role of the former division simply disappeared, while the role of the latter division was redistributed within the Central Bank according to the new Law. Nonetheless, most of the personnel from these two divisions remained in the AGEF and were reallocated within the organization. The AGEF's new organizational structure had two main areas or Divisions: (1) External Audit; and (2) Asset Assessment and Financial Analysis. The first division was almost the same as its predecessor that had carried the same name, while the second division merged the pre-existing Financial Analysis and Loan Risk Sections. The idea was to integrate these two units that were more directly responsible for monitoring the financial aspects of banks.

Considerable progress was made during 1990 in the implementation of the modernization project, including the addition of some areas that went beyond the terms of reference of the original technical assistance project.

The following are the main areas where significant progress was achieved:

1. Regulations regarding loan classification according to risk;

2. Monitoring procedures for the loan classification process;

3. Use of new financial analysis techniques and ratios;

4. Definition of a new accounting plan for the banks;

5. Definition of information systems, including hardware and software needs, and negotiations with suppliers;

6. Procedures to monitoring insider lending and other operations with related parties; and

7. Statistical and financial information to be disclosed to the public, including a project for an AGEF Journal.

One of the most significant accomplishments was to work along with the banks, explaining each aspect of the project to them, selling the advantages of the new approach, and helping them to define and implement the newly required organizational structures and procedures.

Because of these efforts, the financial institutions allocated both human and material resources to modify and adapt their organizations to the new requirements. This included critical aspects such as the

creation or strengthening of credit departments, the implementation of procedures to assess and classify their loan portfolios, and the design and implementation of new information systems.

The AGEF's Current Situation

Organization

In December 1990, the Auditor General who had led the AGEF during the 1980s and promoted its modernization, including not only the technical assistance project of 1988 but even the first attempts in 1985, retired. Unfortunately, no one was appointed permanently to this position until September 1991. The acting head, the Sub-Auditor General, did not agree with much of the modernization project, so that he not only stopped its progress but also took some steps backward. This was particularly significant in some key areas such as credit review, financial analysis, the accounting plan and the disclosure of information to the public.

In September 1991, a new Auditor General was appointed by the Board of the Central Bank. The new Auditor General had no previous experience in banking supervision but had been a member of the board of one of the government owned banks.

One of the critical aspects that the new Auditor General discovered was a lack of coordination among the different units responsible for monitoring a bank. There was no mechanism through which the information collected and analyzed for each entity could be brought together. Thus, the results of auditing, financial analysis and portfolio evaluation reflected isolated aspects of the condition of each supervised entity.

As a way to achieve such coordination, the new Auditor General changed the organizational structure of the AGEF, eliminating the functional divisions and creating divisions based on the entities supervised. Accordingly, two main divisions were created: (1) Government Owned Banks and Financieras; and (2) Private Banks and Specialized Banks. Each of these divisions was further separated into two departments: (1) Government Owned Banks and (2) Financieras; and (1) Private Banks and (2) Specialized Banks.[21] In turn, each department was divided into three sections: (1) Auditing; (2) Financial Analysis; and (3) Asset Evaluation. This can be seen in the following diagram that gives the new organizational structure for the AGEF.

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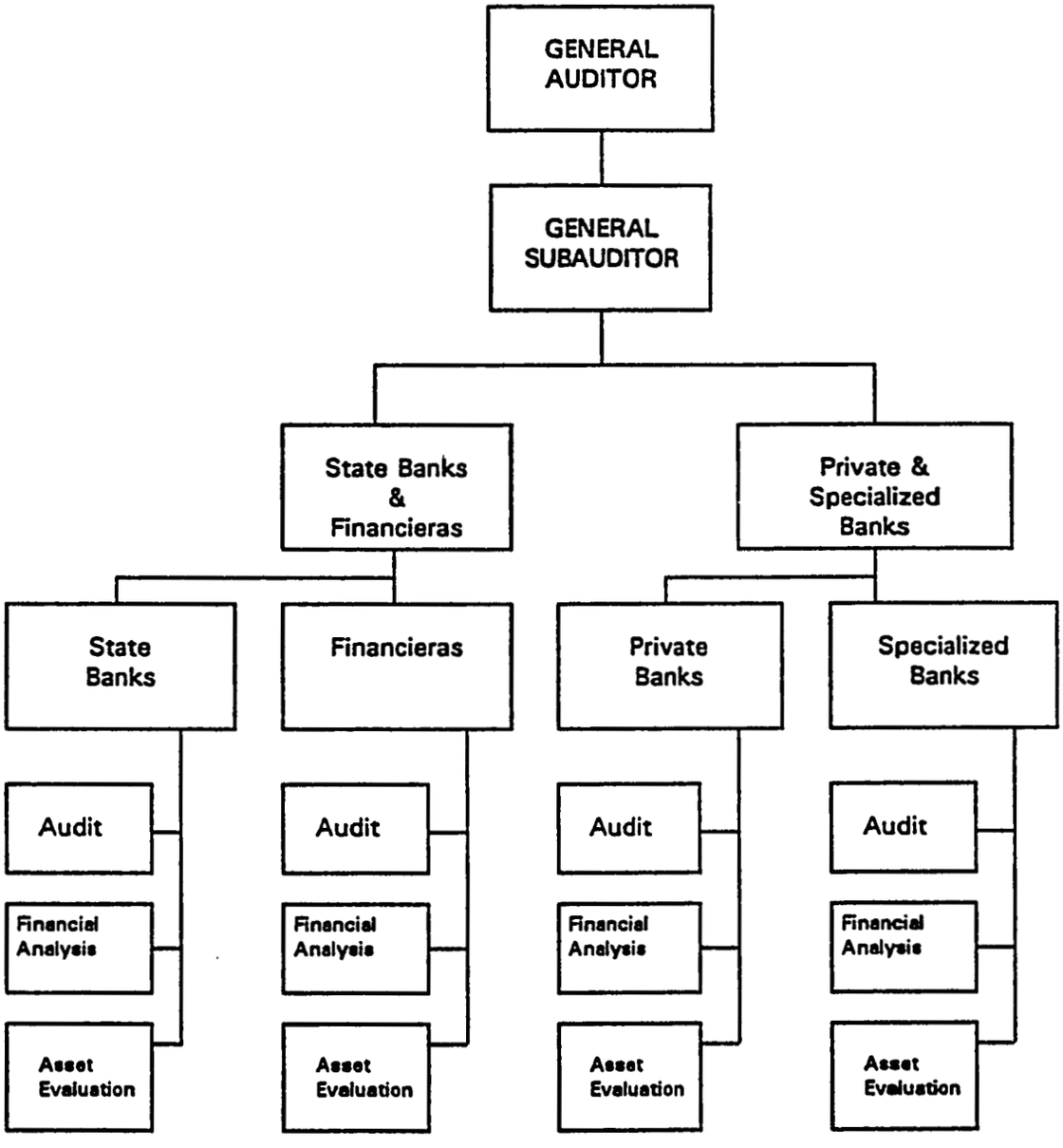
[21]This group includes entities such as the Banco de la Vivienda (BANHVI), the Banco Popular and the cooperative banks. In principle the supervision of these banks should not differ from that carried out for the private and government owned commercial banks, but in practice the inspections of BANHVI and the Banco Popular have been much less rigorous.

AGEF ORGANIZATIONAL CHART -- 1992



This new structure should show greater effectiveness in achieving better coordination and, in particular, in permitting the AGEF to detect problems in a timely manner and to act quickly to resolve them. Nonetheless, certain comments should be made about the new organizational structure.

First, it is well known that there have been serious problems of coordination among the different units. For various reasons, the AGEF

has not been able to implement a system that would allow there to be a responsible person who would know the overall condition of a particular bank. Only recently has such information been brought together at the level of the Auditor General. As a result of this, the AGEF has not been able to react to problems on a timely basis.

Second, the new organizational structure of the AGEF seeks coordination by avoiding specialization in supervision, that is, by having all the key functions of supervision carried out directly by units in charge of a group of banks. Although this approach could permit better coordination, the new structure neglects two key elements of bank supervision: (1) economies of scale in specialized functions such as auditing, financial analysis and portfolio evaluation; and (2) the impossibility of a single individual knowing all the techniques associated with these specialized functions.

Third, improved coordination has been at least partly offset by a loss of consistency in the procedures and focus that each unit gives to the different aspects of supervision. Moreover, there is no unit that is concerned with keeping the different procedures of supervision up to date, nor is any unit in charge of issuing the relevant regulations and instructions.

Because of the foregoing, a potentially better approach to achieving the objectives of better coordination and more adequate supervision is to have specialized units that are centralized but work with each other in teams. In particular, the financial analysts should be responsible for bringing together and analyzing all the information that the different specialized units collect on each bank and also to inform the higher authorities in the AGEF about the most significant aspects. Moreover, with the objective of achieving this coordination, the financial analysts should participate in the teams that carry out on site inspections and work together with the other inspectors on a basis that emphasizes an ongoing interchange of information and ideas.

The position of the new Auditor General is not yet clear with respect to the modernization project and, in particular, the roles of the financial analysis and asset assessment units. In any case, he has given strong support to the activities of the information systems department, where more steady progress along the lines of the original modernization project can now be seen.

Personnel

As of March 1992 the organizational chart of AGEF showed 255 positions. The distribution of these personnel was the following:

The Distribution of AGEF Personnel by Unit

Administrative Unit	Staff
General Auditor Bureau	9
Legal Department	5
Technical Services Department	13
Information Systems Department	22
Subtotal	49
Private and Specialized Banks Division	2
Private Banks Department	37
Specialized Banks Department	42
Subtotal	81
State Banks and Financieras Division	2
State Banks Department	27
Financieras Department	36
Subtotal	65
General Administrative Division	2
Administrative Department	49
Subtotal	51
Internal Audit	9
TOTAL	255

As is typical in Costa Rica, AGEF personnel show a high percentage of higher education and formal training. In the following table it can be seen that an impressive total of 187 AGEF staff members have higher education.

AGEF Personnel with Higher Education

Area of Study	Staff
Business Administration	133
Agriculture	11
Computer Science	15
Public Accounting	19
Law	4
Economics	2
Statistics	1
Industrial Engineering	1
Linguistics	1
TOTAL	187

Since no in-depth appraisal of the AGEF's staff has been done, only a few points can be noted. Apart from the high degree of formal staff training, two aspects should be highlighted. First, the total number of staff seems quite high for a supervisory agency that has to monitor only a small banking system, with just four government owned banks mobilizing most of the deposits. This apparent surplus may reflect a lack of adequate computing support or simply the widespread acceptance of excess personnel. Second, a high proportion of personnel is allocated to administrative positions. It should further be noted that most of the administrative support is provided by the Central Bank.

In spite of the AGEF's highly trained and abundant staff, there is nonetheless a clear lack of specialized staff in certain core areas: financial analysis, asset assessment and bank auditing. The challenge for the AGEF is therefore to reduce the total number of employees and, at the same time, to increase the availability of professionals who are knowledgeable in these key areas. This can be a complicated process given the political, legal and institutional restrictions that exist in Costa Rica. Solutions that might be recommended in other countries cannot be applied in Costa Rica. In particular, even with clear evidence of an excess of personnel, it can be extremely difficult to achieve a significant reduction. Considering these restrictions, and also assuming that no additional functions will be given to the AGEF, an approach is proposed that would involve the following stages:

1. Evaluation of the current organizational structure of the AGEF, including its personnel;

2. Development of a new organizational structure, including the required personnel;

3. Development of a training program to prepare more fully the AGEF personnel who are currently the best qualified, together with the definition of priorities for the hiring of new personnel with skills that are not currently available within the AGEF; and

4. Development of a program to reduce excess personnel (e.g., through reassignment to other government entities, incentives for voluntary resignations, early retirement, etc.).

The main requirements for the training of AGEF personnel can be summarized in the following points without contradicting what will subsequently need to be elaborated in more detail in the development of a training program.

1. **Objectives and fundamentals of systems of financial regulation and supervision:** functions and roles of financial systems; principles governing financial regulation and supervision; and general aspects of the techniques and procedures of bank supervision.

2. **Treatment of financial institutions with problems:** procedures to be followed when dealing with a financial institution with problems, including methods of restructuring and strengthening, intervention and liquidation. This course should focus on specific experiences in Costa Rica and other countries, together with an evaluation of practical options under different circumstances.

3. **Asset evaluation:** theoretical and practical aspects of evaluating the assets of financial institutions; evaluation and classification according to risk of loans, investments, fixed assets and repossessed collateral; and techniques for evaluating different types of assets and borrowers.

4. **Auditing of compliance and accounting:** principle aspects and techniques of bank auditing focusing on compliance and accounting aspects; treatment of the objectives of audits; systems of internal controls; methods of sampling and analysis; the role of internal and external auditors; compliance with regulations; evaluation of computer system security; information systems; and administrative, operational, credit and investment policies.

5. **Financial Analysis:** solvency and capital adequacy; analysis of the structure of balance sheets and income statements; analysis of income and expenses, including concepts of profitability, margins, spreads and efficiency; analysis of the risks from interest rates, liquidity and exchange rates; evaluation of financial and overall administration; projections of financial statements; and overall evaluation of financial institutions, including the CAMEL system.

The Interventions of the Banco Germano and BANCOOP

The recent interventions of the Banco Germano and BANCOOP indicate both the potential and the weakness of the AGEF. According to the information that could be obtained, the intervention of the Banco Germano was undertaken by the AGEF only after a long delay, principally because of slowness in acting by the Sub-Auditor General who was then the head of the AGEF. According to what could be discovered unofficially, the technical staff of the AGEF was clear with respect to the weak condition of the bank, which was principally due to loan portfolio and administrative problems. This information had been promptly relayed to the Sub-Auditor General, but he took no corrective action.

An interesting aspect of this case is the indication that within the AGEF the potential exists in certain working groups to produce relatively timely and accurate diagnostic studies of the condition of banks, as not only the financial indicators but also the portfolio evaluations had indicated the weak condition of the two banks. At the same time, it is clear that this capability is not enough without the

willingness at higher levels to act and apply the appropriate corrective measures.

The Banco Germano was intervened recently when the current Auditor General took control, after the situation had very probably become much worse than when the original analysis was carried out. A somewhat different case was the more recent intervention of BANCOOP. This bank, according to what could be discovered, had some portfolio problems, but the main weaknesses were in its administration and in the construction of its new office building.

BANCOOP's condition was known by the AGEF to be weak at least since 1991, but apparently was not considered to be extremely critical. In any case, at the time of its intervention, BANCOOP's condition was much less weak than that of the Banco Germano. It was the owners of BANCOOP themselves, the cooperatives, that provided the capital that resolved the bank's insolvency, along with the sale of its office building to the Central Bank.

This apparently easy private solution to the situation of BANCOOP has raised the question of the rationale for its intervention. Without the pertinent information, it is difficult to make a judgement on this point. Nonetheless, it is clear that there were problems and that the owners had not made BANCOOP solvent promptly in spite of receiving warnings. This clearly illustrates the lack of power of the AGEF to require certain corrective actions by banks before having to apply the extreme act of intervention.

Legal Framework for Banking Supervision

The AGEF's legal framework was initially delineated in 1953 with a modification of the Central Bank's Law. The AGEF was created as a department of the Central Bank responsible for monitoring and supervising all departments and units of that institution, as well as the rest of the banking entities in the country.

The AGEF's institutional status and enforcement powers were consistent with a banking environment where most banks had been nationalized and were being used as instruments of the government's general economic policies.[22] Issues such as bank solvency, credit assessment and stability or their underlying concepts were not frequently raised by anyone.

Many of the enforcement powers that are typical of bank supervisory agencies were not granted to the AGEF. This was true in particular for actions such as the intervention of supervised entities and the application of economic fines and administrative sanctions.

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[22]Government owned banks have also been broadly used as a way to achieve political goals and to subsidize certain groups.

Table VI-1

USAID-ESF Conditionality

Condition	Status
ESR-II -- 1982	
the government was to submit a law giving private banks equal access (compared to state owned banks) to Central Bank rediscounts	pending
to unify the exchange rate during 1983	done (September 1983)
ESR-III -- 1984	
the basic deposit rate (on six month certificates) was to be positive in real terms	done
rates on loans were to be unified to only two major categories	reduced the number of categories, but not to two
no more than 16 percent of loans outstanding to be charged less than the basic rate (and with at least 50 percent of these loans to be financed with non-deposit resources)	done
interest rates were to be adjusted regularly taking into account inflation, international rates and supply and demand for credit	done
a program was to be developed to reduce costs and spreads of government owned banks and transaction costs for their clients	individual measures taken, but not an overall program
the exchange rate was to continue to be unified and to be adjusted as necessary	continued to be done

Condition	Status
mandated the creation of a central mortgage banks to refinance housing loans	done later (November 1986)
access to credit for two major money-losing state enterprises (CODESA and its subsidiaries and the CNP) to be sharply limited	done later by law for CNP (November 1988); done in fact (but not by law) for CODESA
ESR-IV -- 1985	
the basic deposit rate was to continue to be positive in real terms	continued to be done
loans with interest rates below the basic rate were to be limited to specific activities, with amounts outstanding not to increase (and with at least 50 percent of these loans to be financed with non-deposit resources)	continued to be done
interest rates were to be adjusted regularly taking into account inflation, international rates and supply and demand for credit	continued to be done
the exchange rate was to continue to be unified and to be adjusted as necessary	continued to be done
access to credit for CODESA and its subsidiaries and for the CNP were to continue to be limited	see above
the Central Bank was required to announce and maintain a credit program and to report and explain any deviations between programmed and realized magnitudes	done

Condition	Status
ESR-V -- 1986	
credit to the non-financial public sector was to be limited to the levels agreed on with the IMF for 1985	done
the basic deposit rate to be positive in real terms	continued to be done
the amount of loans outstanding with rates below the basic rate to be limited to 1984 levels	continued to be done
the exchange rate was to continue to be unified	continued to be done
the Central Bank to continue to maintain its announced credit program	done
access to credit for CODESA and its subsidiaries was to be further limited, with the objective of eliminating CODESA and privatizing its subsidiaries	see above
ESR-VI -- 1987	
compliance with various financial conditions and macro-economic targets (e.g., credit to the public sector, net domestic assets of the Central Bank, fiscal deficit, balance of payments, etc.)	done
limit subsidized credit	continued to be done
continue a unified, market determined exchange rate	continued to be done
positive, market determined interest rates	done later (October 1989)
study the impact of FODEA (the law to reschedule agricultural loans) and the related program with the World Bank	not determined

Condition	Status
adopt measures to help private and cooperative banks increase their access to financial markets	done
ESR-VII -- 1988	
approve and implement an economic program with agreed upon limits for credit to the public sector and net domestic assets of the Central Bank	done
maintain a unified and market determined exchange rate	continued to be done
positive and market determined interest rates	see above
limit subsidized credit (except for external or explicit fiscal sources of funds)	continued to be done
eliminate detailed credit categories	begun in 1985 and continuing
prepare a new rural credit program based on an evaluation of current practices	not done
support the development of a deposit guarantee program for private banks	done (using USAID credit line spreads)
simplify procedures for private sector dealings with the government, including credit access	not determined
support of the Housing Bank (BANHVI) including the government's promised capital contribution, better credit policies for loan recovery, BANHVI's role in discounting mortgages rather than direct lending, and a better definition of the role of different government housing institutions	not done

Condition	Status
ESR-VIII -- 1989	
approve and implement an economic program with agreed upon limits for credit to the public sector and net domestic assets of the Central Bank	done
maintain a unified and market determined exchange rate	continued to be done
positive and market determined interest rates	continued to be done
subsidized credit was now given a numerical limit (7.7 billion colones) including all sources of funds	done
conditionality for BANHVI was reiterated, including the government's promised capital contribution, better credit policies for loan recovery, BANHVI's role in discounting mortgages rather than direct lending, and a better definition of the role of different government housing institutions	done, except for the roles of the different government housing institutions
a study of Costa Rica's pension systems	done
ESR-IX -- 1990	
compliance with stabilization and adjustment programs	done
a limit of 7.7 billion colones on the total amount of subsidized credit	continued to be done
continuing interest in the reform of the pension system	done
permitting private banks to have access to locally-funded rediscounts and to have deposit insurance	not done

Condition	Status
reducing the overall size and improving the efficiency of the public sector	some progress
collaboration with other international agencies, in particular with the World Bank's trade and financial sector conditionality under SAL-II	some progress
TIP-I -- 1991	
collaboration with the World Bank expected to continue under the proposed SAL-III operation, especially in the areas of trade liberalization and public sector efficiency	SAL-III not yet done
losses of the Central Bank (e.g., elimination of subsidizes on foreign exchange operations and the assumption of foreign exchange risk; prohibition of new international clearing system involving credit to other countries and financing of the public sector except through Treasury Bills).	done

Chapter VII

Securities Markets and Instruments in Costa Rica

Introduction

This chapter presents an evaluation of Costa Rican securities markets and instruments as they have developed over the past ten years, with recommendations for increasing efficiency, from the following points of view:

1. the role of the Bolsa Nacional de Valores as a financial intermediary and its presence in the primary and secondary markets for public and privately issued securities, the cost of securities transactions and the competitive structure of the market;

2. the most important restrictions on securities markets and the areas in which the activities of securities markets could be expanded, with special reference to new instruments and long term financing of investment; and

3. the supervision and regulation of securities markets, with special emphasis on promotion, the availability, relevance, timeliness, and quality of information and the elimination of non-competitive practices.

Legal Aspects

There has been a securities exchange operating in Costa Rica for the past 15 years, incorporated as the Bolsa Nacional de Valores, S.A. (BNV -- National Securities Exchange). Additionally, the Comisión Nacional de Valores (CNV -- National Securities Commission) has recently processed an application from a group of private businessmen to establish the Bolsa de Valores de Costa Rica S.A. (BVCR -- Costa Rican Securities Exchange). Furthermore, the Central Bank of Costa Rica recently approved the establishment of an exchange for agricultural products, due to begin operating in a few months, legally incorporated as a commercial exchange with the name of Bolsa de Productos Agropecuarios S.A. (BOLPRO -- Agricultural Products Market).

Costa Rican law now recognizes two types of exchanges: commodities and securities. Before the promulgation of the Ley Reguladora del Mercado de Valores (LRMV -- Regulatory Law of Securities Exchanges) on October 29, 1990, the Costa Rican Commercial Code provided for commercial exchanges, in which it was possible to realize transactions of all types, including commercial paper, equities, commodities, futures, etc. Since the BNV and BOLPRO were legally incorporated before the LRMV came into effect, both the BNV and BOLPRO maintain their ability to engage in all types of transactions because of a

constitutional prohibition against applying laws retroactively. The legal distinction between commodities exchanges and securities exchanges that was established when the LRMV became law means that commodities exchanges established under the LRMV cannot engage in transactions legally reserved for securities exchanges (e.g., equities or debt).

The CNV is the government agency authorized to regulate and supervise the operation of securities markets and their participants (e.g., securities exchanges, brokerage firms, individual brokers, securities dealers, securities issuers, investment companies, mutual funds and securities depositories). The Central Bank is the entity legally responsible for supervising commodities exchanges.

For reasons previously indicated, the commercial exchanges established before the legal reforms of October 1990 are regulated by the CNV for the purpose of securities trading and by the Central Bank for trading in everything else. It is important to note that the CNV is a separate entity and operates independently from the Central Bank. The Central Bank's Board of Directors designates a representative to the CNV's Board of Directors, which permits improved coordination in supervising the BNV and BOLPRO (when the latter issues securities such as options). Nevertheless, it would be advisable to modify the law so that the CNV becomes responsible for regulating and supervising commodities exchanges as well as securities exchanges, thereby avoiding possible conflicts between the Central Bank and the CNV in the regulation and supervision of the BNV and/or BOLPRO.

The Bolsa Nacional de Valores, S.A. (BNV)

Ownership Structure

The BNV is a corporation, with subscribed capital of C300 million ($2.3 million) and total capital (including retained earnings) of close to C530 million ($4 million) as of May 1992.

The Corporación Costarricense de Desarrollo S.A. (CODESA -- Costa Rican Development Corporation), a government entity, holds 40 percent of the equity in the BNV, with the rest dispersed among approximately 500 shareholders. No shareholder, except CODESA, is allowed to hold more than 2 percent of the equity, and the 100 other largest shareholders in fact own about 55 percent of the BNV's equity. The Government of Costa Rica, in the process of privatizing CODESA's subsidiaries, has raised the possibility of selling a major part of CODESA's equity in the BNV and has recently authorized the sale of 30 percent of CODESA's 40 percent share to begin early in 1993. This could bring in the business groups that are behind the BVCR and thereby avoid the fragmentation of the securities market into several different exchanges.

Characteristics of BNV and Needed Reforms

The value of securities transactions in Costa Rica has increased rapidly in recent years. As a percentage of Gross Domestic Product (GDP), the value of the total volume traded rose from 5.2 percent in 1982 to 34.6 percent in 1986 and to 68.6 percent in 1991. In 1991, the primary market (newly issued securities) represented close to 83 percent of the total value traded, and the secondary market represented 17 percent.

The BNV operates with 22 brokerage firms, each of which has received a concession from the BNV. Of the 22, five are government entities (four government owned commercial banks and one subsidiary of CODESA), seven are corporations affiliated to private banks and the remaining ten are independent corporations. There are approximately 150 individual brokers who are authorized to trade, but only as employees of the 22 brokerage firms, with 90 of them on the active list. The member firms carry out securities transactions on the BNV through these individual brokers and also provide other complementary services to their clients (issuers of securities, savers, etc.).

Securities trading on the BNV, as well as in the rest of the Costa Rican financial system, focuses on short-term debt instruments issued mainly by government entities (the Central Government, the Central Bank, the government owned commercial banks and others) and by a group of 80 private businesses from the following sectors: banking (16 companies), finance (21), industrial (18), agricultural (3), agroindustrial (2), commercial (11), and service (9). These businesses must disclose their financial statements to the public on a quarterly basis or with the occurrence of any pertinent event. Additionally, they must issue a prospectus containing relevant financial information for investors, and this is examined by the CNV.

Another group of businesses exists that accesses public savings without complying with the aforementioned regulations by issuing notes that are guaranteed by financial entities approved by the CNV (cf., bankers' acceptances).

The securities that are traded are almost exclusively debt instruments (government bonds, government owned commercial bank certificates of deposit denominated in both dollars and colones, investment certificates of private banks, finance companies and other private businesses, bankers' acceptances, commercial paper, mortgage participation certificates, etc.) with less than a year of maturity. Few equities are traded; in 1991 shares of only 20 businesses were traded on the BNV, and their market capitalization was C42 billion, approximately $325 million, or 6 percent of GDP.

The value of circulating debt instruments issued by private businesses and registered with the BNV was approximately C39.7 billion at the end of April 1992. At that date, the outstanding debt issues of non-bank, non-financial private businesses with debt issues registered with the

BNV represented 12.3 percent of the total credit available to the private sector from the banking and finance sectors.

As a primary market, the BNV has served to finance a significant, although variable, portion of the fiscal deficit by selling government bonds to individual investors and to public and private enterprises. In addition, given the high spreads charged by the government owned and private banks of the national banking system as well as by non-bank finance companies, the better organized and more prestigious private companies that are prepared to disclose financial information to the public have found that the BNV's primary market and direct placements are a lower-cost financing alternative and a partial substitute for credit offered by the banks and finance companies.

The BNV's secondary market offers holders of registered securities the possibility of increased liquidity. As will be mentioned later, the cost of these operations has been substantially reduced during the past two years. However, since the Costa Rican securities market is mainly a money market, with few standardized securities issues, the secondary market is imperfect in establishing effective market prices for all but short-term securities because of its shallowness.

Both the BNV and the CNV recognize the necessity of promoting standardized issues for medium- and long-term debt of non-financial private companies, with bonds standardized by issuer in terms of interest rates, principal, terms and dates of maturity. This would permit more adequate valuation in a more competitive market in which the seller of a bond would have to compete with several other sellers of similarly standardized bonds in facing many potential buyers. What is currently taking place is that the great variety and limited standardization of bonds forces one seller to face a large number of buyers, who can create an oligopsony, as evidenced by the fact that brokers, when they act as buyers, normally demand higher yields in the secondary market than in the primary market for equivalent bonds.

The standardization process cannot be imposed on the market, especially when the market is a money market for short-term securities. As long as the causes persist for concentration in the short term, it will be almost impossible to standardize securities. The government could nonetheless play an important role in generating a "demonstration effect" by issuing standardized bonds for maturities longer than one year with a correction for inflation that would induce investment over a longer term.

As discussed in Chapter IV, the Central Bank introduced an auction system for very short term instruments (less than 30 days) during 1992 which was subsequently extended to stabilization bonds. The Costa Rican Government could also introduce an auction system for government securities. Financial intermediaries and brokers could then acquire the primary issues and subsequently sell them with a premium in the secondary market. This could add greater depth to the secondary market and establish the possibility of developing and widening the

use of these types of systems and techniques, which could eventually be used for primary placements by private sector issuers, with financial intermediaries and brokers playing the roles of specialists in certain types of instruments.

Auction systems would also create the possibility that the primary market in private bonds could become more even-handed and competitive than currently, where certain issuers discriminate in the sale of bonds by closing or limiting sale through the BNV and paying higher interest rates in direct sales to clients. Letting the issuer set the interest rate and the total amount to be sold, as currently happens, could mean that on occasion the issuer might have to pay a higher interest rate for the same amount than in a more open and competitive market. The current mechanism also leads to direct negotiations in which not all of the participants have the same opportunity to obtain the same interest rate from the issuer. Auctions or other more open and competitive systems for primary markets would eliminate these imperfections. The CNV and the BNV should promote these changes in the primary market, with the government taking the lead in using these systems for the sales of its securities.

Just as in any enterprise in which the possibility of obtaining profits permits the development of private initiative, the BNV's system of intermediation has given rise to a series of instruments that have mobilized a significant quantity of resources for the buyers and sellers of private and public bonds in both primary issues and secondary operations. However, the market has imperfections that should be corrected, such the those indicated above and others to be mentioned later. It is important to note that not all of the imperfections are due to factors under the control of the BNV and its members, so that reform also requires action by entities outside the securities exchange itself.

The Bolsa de Productos Agropecuarios (BOLPRO)

Initially, BOLPRO will trade contracts for agricultural commodities and, eventually, futures and options for these products. The BNV is currently the sole owner of BOLPRO, but before it begins operations the BNV must place 60 percent of the shares of BOLPRO in the hands of the Finance Ministry for a public offering.

In April 1992, BOLPRO put on sale the first 22 concessions to carry out brokerage operations, and they were sold at an average price of C4 million ($30,000) each.

In the scheme for only one securities market that will be proposed later, BOLPRO would specialize in the trading of contracts involving prices and quantities of agricultural products.

The Bolsa de Valores de Costa Rica (BVCR)

The BVCR has already been authorized by the CNV and is expected to begin operations sometime in the first half of 1993. The group that promoted the creation of this second securities exchange includes some banks and commercial enterprises that are attracted by the profitability of the BNV and its quasi-monopolistic position and by the high cost and difficulty of obtaining authorization for new member brokerage firms.

It is important to note that the initial members of this new securities exchange all have brokerage operations with the BNV. However, the members of the BVCR would be the only brokers in the new exchange. Experience with this kind of system in other countries has shown that it could be a very closed system, unwilling to welcome new members or the establishment of new brokerage firms. Barriers to entry against new brokerage firms are evident even in the BNV, where the brokerage firms hold shares in the BNV, but they are not the only shareholders, or even a majority, so that they do not necessarily control the securities exchange.

The Cost of Intermediation in the Exchange and the Competitive Structure of the Market

The Cost of Intermediation and Needed Reforms

In general, the BNV and its brokers have been highly profitable businesses. In fact, the BNV has been one of the most profitable enterprises of its type, and the prices of memberships, which are really only licenses to operate brokerage firms, reached the equivalent of about $400,000 in 1988, comparable to what has sometimes been the price of a membership on the New York Stock Exchange. In 1976, the first BNV memberships were sold for the equivalent of about $3,000.

Normally there has been strong opposition from existing members to decisions of the BNV to authorize new memberships, but with the threat of increased competition from the pending operation of the BVCR, the BNV is currently evaluating the authorization of new memberships. Although existing members can try to influence this decision, the BNV's Board of Directors has the power, by law, to decide the number of members, and existing members have no legal power to oppose the decision. Moreover, the entry of new individual brokers is unrestricted and is subject only to an individual's completion of academic prerequisites and an internship with a brokerage firm.

The LRMV modified the limitation that had previously existed to establishing more than three commercial exchanges (the fourth, or more, must be justified by a market analysis) and also left it entirely to the discretion of the CNV to authorize new securities exchanges. Furthermore, the law did not assign any government entity the authority to regulate the commissions that the brokers and the

exchanges can charge for their services, nor give any powers to force the creation of new memberships on exchanges. It is nonetheless evident that the BNV faces competition from informal options such as direct placements by issuers and secondary trading outside the BNV as well as from the pending operation of the BVCR.

Until recently, the BNV set the commissions that brokers and the exchange itself charge for transactions carried out on the BNV, just as in securities exchanges in other developing countries. According to most analysts, commissions were fixed at cartel-like levels to take advantage of the quasi-monopolistic position enjoyed by the system. This has brought high profits and high market values for memberships and is clearly one of the principal motives to establish new securities exchanges and to create more memberships.

Facing competition and possible limits to growth in its trading volume, the BNV has reduced its commissions gradually since February 1991, changing from a system of percentages fixed according to the maturity of the security (which varied between .25 percent flat and 2 percent flat) that discriminated among instruments, markets and terms, to a system of annually fixed commissions for transactions in short-term instruments (less than a year) and flats for longer maturities, in order to avoid the heavy charges that flats represent for short-term instruments in a market concentrated in the short term. Additionally, the BNV liberalized the commissions that brokers can charge on certain transactions with volumes that are presently insignificant, such as equities and foreign debt. For these transactions, the BNV considerably reduced its commissions. In summary, the BNV introduced a system of commissions that was much cheaper and with less discrimination among markets, instruments and maturities.

Before this reform of the overall system (the BNV and the brokers), the ratio of revenues from commissions to the value of transactions was 0.35 percent (0.26 percent in the primary market and 0.89 percent in the secondary market). In April 1992, the ratio was 0.26 percent (0.24 percent in the primary market and 0.38 percent in the secondary market). In other words, the average commission in the secondary market is 43 percent of its level of 18 months ago, while the average commission in the primary market hardly changed.

To continue to rationalize the costs of carrying out transactions in the BNV, the best policy would be for the BNV to liberalize completely the commissions that the brokers can charge for their services and to set the BNV's charges for its services to brokers at a level that would permit the BNV a normal return on capital, taking into account the risky nature of the business. These risks are related to a clearinghouse and services of custody and safekeeping of securities, much as the BNV would incur in the near future with the introduction of a foreign exchange clearing house and with the issue of notes based on personal property guarantees, macro-securities and other products that may be developed in the future.

It has been argued that liberalizing brokers' commissions could place the brokers associated with banking groups in a superior competitive position vis-a-vis other brokers because banks could tie the granting of loans or other banking services to the use of the banks' brokerage services in order to undercut the other brokers. However, this is not necessarily a valid argument. The banks with affiliated brokers can already carry out the same type of discrimination by charging less for traditional banking services and retaining the commission rates fixed by the BNV. If banks really have sufficient power to tie banking services to brokerage services, it is irrelevant whether the fees are charged to the banking services or the brokerage services.

If brokerage firms unrelated to banking groups have been able to grow and profit for many years (and many have done so since the establishment of the BNV or from the beginning of the participation of private banking groups in securities trading in 1983-85) and have successfully faced the increasing competition from brokers associated with banking groups, it seems that fears of unfair competition are unsubstantiated or that banks do not have as much power to discriminate as is believed. Moreover, the argument seems to be mainly a defense of the status quo with commissions fixed by a cartel that permits brokers to discriminate among clients by offering disguised discounts from the commissions fixed by the BNV when it suits them.

With the threat of increased competition from the impending opening of the BVCR, the BNV has more recently liberalized completely the commissions that member brokerage firms can charge their clients, to become effective at the beginning of 1993. At the same time, the BNV is introducing a new system of commissions for what it charges its member brokerage firms. This system includes declining marginal commissions according to the volume traded by each member firm and altogether should result in an average reduction in commission charges of 45 to 50 percent. With these changes, innovations to attract a greater volume of transactions to the BNV can be expected, along with continuing reductions in BNV and brokerage firm operating costs.

The Optimal Structure of the Securities Market

Given the limited size of the market, establishing more than one securities exchange could organize securities markets in Costa Rica in a way that would not take advantage of economies of scale in the clearing process. In addition, such fragmentation would scatter, instead of centralize, information about transactions and issuers, thereby raising the minimum transaction costs for those who deal in these securities markets.

The BNV has in fact, in addition to addressing the issues of fixed commissions and limited memberships, introduced a variety of innovations. It has developed electronic trading systems to the point that all of the primary market and about 70 percent of the secondary market is automated and traded in an electronic auction market, and

further plans include a new version of the system before the middle of 1993 that would allow elimination of the trading floor. The BNV has also installed an automated auction system for use by the Central Bank and the Treasury for their primary issues which could be further extended to private issuers. Rather than participating in these new systems, the BVCR plans to contract such services from a Chilean securities exchange, thereby limiting the realization of further economies of scale and also posing some questions for the effectiveness of supervision by the CNV.

The BNV has also introduced automated systems for the clearing, settlement and custody of securities. As part of that, member brokerage firms now have continuous access to all information on their trading during the day and on securities held in custody at the Central de Valores administered by the BNV. In addition, the BNV has introduced a "macro" security representing several separate securities that is being offered by one of the government owned banks and is being evaluated for use by several private corporations. Another innovation by the BNV worth noting is the creation, through a subsidiary, of a fully automated system for foreign exchange trading in just one month after the Central Bank liberalized the foreign exchange market.

It is nevertheless evident that if only one securities exchange is maintained, it could more easily set prices for its services that might be non-competitive and yield monopolistic profits and a greater than normal return on capital. For this reason, the CNV should have the powers necessary to compel the exchange to reduce its commissions when it is reaping profits greater than what could be considered a normal competitive return (including the risks of the business). As the theory of long-term marginal cost states, this level of profit would make it possible to obtain additional resources to increase capacity, that is, no external resources would be required as members would decide how much to reinvest and how much to pay in dividends.

The CNV should not have power to set different commissions for the exchange, but rather it should have the power to insist on proportionate overall price reductions because regulators cannot be expected to know how to fix commissions. Moreover, the CNV should have a pre-announced system to authorize the operation of another exchange through public auction that could offer cheaper commissions than those of the existing exchange. The mere threat of this power to authorize a new exchange would induce the existing exchange to reduce its prices.[35]

To maintain administrative efficiency and an adequate level of investment for development, the exchange should retain its status as a private corporation. Nonetheless, within this system with only one

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[35]For a discussion of this type of scheme, see Harold Demetz, "Why Regulate Utilities?" The Journal of Law and Economics, vol. 11, April 1968, pp. 55-65.

exchange, the government should maintain a percentage of its ownership of the exchange to serve as a counterweight to anti-competitive tendencies such as limiting the number of member brokerage firms to those already existing. The government could hold a 15 or 20 percent equity stake in the exchange that could be administrated through a trust arrangement with an impartial trustee acting with a precise mandate on how to represent the government at shareholder meetings.

For additional protection of all concerned, the exchange by-laws should also contain limitations on the number of member firms, brokers and issuers (or their owners and managers) that are represented on the board of directors of the exchange, in order to avoid decision-making that is biased in favor of one group over the others. There should also be a balance on the board among the different types of member firms (those affiliated with banking groups and those not affiliated).

These reforms should come about as a result of negotiations that would involve the different aspects mentioned (a single exchange, freedom to set brokerage commissions, commissions for the exchange that will allow normal profitability, the possibility of memberships for new brokerage firms, and a legal reform to authorize the CNV to require reductions in commissions and to give authorization to create other exchanges with lower commissions through public auctions). The government should promote these changes while CODESA still has a significant share of the BNV's equity, before selling any major portion of the government's stake.

The reforms would require an agreement with the group that wants to develop the BVCR. Following Costa Rica's legal and constitutional principles, it would not be feasible, nor advisable, to eliminate the possibility of opening new securities exchanges since private monopolies granted by law are prohibited. However, it would be feasible to come to an agreement such as the one proposed, in which the threat of eventual competition together with the efficient and low cost operation of the exchange would be the way to maintain an effective monopoly, but one that acts under pricing rules and productivity consistent with competition. The alternative of having the BVCR initiate operations and then interconnect, and possibly merge, with the BNV would be a decidedly inferior alternative involving substantial waste in the opening of the new exchange and in developing interconnections.

Restrictions to Long-Term Financing and Securities Trading

Some of the most important limitations to the development of securities markets have already been highlighted in previous sections. This section will deal with the limitations related to long-term financing.

It is undeniable that instability in the purchasing power of a currency leads to the issue of short-term bills or notes in securities

markets, such as those in Costa Rica, in which instruments without monetary correction totally dominate. With securities that lack monetary correction, the investor assumes the risk that the interest rate will fail to cover unexpected decreases in the purchasing power of the currency and will consequently demand a return that will compensate for this risk. This, in turn, becomes a load that the issuer's cash flow has to bear. Issuers generally prefer to float short-term bills and run the risk that these instruments cannot be rolled over when they come due, so that they come to use such financing for short-term investment projects or working capital.

Another cause of the bias toward short-term bills is the lack of institutional investors that normally offer medium and long term funds (e.g., pension funds, insurance companies, and investment trusts). In the first two cases, there are government entities that have followed the policy of investing only in government debt instruments. At the same time, the government has also specialized, except in some recent exceptions, in issuing short-term bills, nor has it used its financing to promote any standardization.

One possible solution to this problem is the issue of bonds with adjustable interest rates or with monetary correction. The government currently offers bonds with adjustable interest rates, but the limited standardization of the medium and long term market, fostered in large part by the government itself as well as by the securities brokers, makes it difficult to count on having a reliable indicator of market rates. Bonds with monetary correction could have the advantage, in principle, of being based on an official price index and thereby increasing the confidence of savers. As experiences in Southern Cone countries have shown in times of high inflation, these types of instruments permit medium and long term funds to be captured.

The existence of funds from private insurance companies and pension funds could introduce a greater demand for instruments with adjustable interest rates or monetary correction, but the development of long-term securities markets would also require further legal reforms to permit the official use of such instruments with adequate regulation.

With respect to the development of equities markets, it is necessary to reform tax laws to eliminate stamp taxes on increases in capital and to leave open to competition the fees that notaries charge for their certifications. These changes are obvious, but even more important is the necessity of modifying income tax laws to eliminate those elements that subsidize corporations to incur debt rather than increase equity. In particular, under circumstances of significant inflation, the deductibility of interest expenses in nominal terms together with the failure to tax the gains from the depreciation of debt instruments in real terms provides a significant incentive to use debt rather than equity finance. Moreover, tax abatement schemes to favor the issue of equity rather than debt have been shown in a large number of countries to be a poor substitute for the correction of basic distortions, while also adding to the government's fiscal

problems. Furthermore, in the specific case of Costa Rica, fiscal incentives for open stock companies have rarely been subscribed to because of the requirement that no shareholder can own more than 10 percent of the equity of the company. Another important element in encouraging equity issues is to improve the quality of information about the issuers.

The Regulation and Supervision of Securities Exchanges

The BNV acted in a self-regulatory manner during its first fourteen years of operation, under regulations approved by the Central Bank in 1976. In 1990, the newly-created CNV assumed some regulatory functions that were previously carried out by the BNV and others that no one had previously carried out.

The CNV initiated its operations with its major emphasis on the development and supervision of securities markets, although the relative youth of the institution and of its personnel suggests that it still has much to learn in both areas. The following are three areas in which the CNV should place its main emphasis:

First, with respect to the development of new instruments, it is fundamental that the CNV coordinate its activities closely with the intermediaries who know the market much better than the majority of the CNV's staff. The failures of regulatory agencies that think they know better than market participants the services and instruments that should exist are well known.

Second, when it comes time to review actual products, the CNV should again avoid the pitfall of assuming that it knows what the market needs better than the brokers and other participants in the market. Examples of this type of situation can be seen currently in the review of OPAB and CAV contracts (Operaciones de Administración Bursátil and Contratos de Administración de Valores) and the interest of the CNV in developing the legal forms for mutual funds and investment funds.

OPABs were initially promoted by brokerage firms in 1983-84 as an instrument through which firms and individuals could obtain a return on very short-term funds in the face of the distortion caused by the lack of interest bearing checking accounts due to the monopoly of the government owned commercial banks. OPABs have operated, regulated by the BNV and growing through the years, with CAVs added in 1990. Presently, the amount administered in these forms is over C25 billion.

The CNV wants to eliminate the common characteristic of both types of contract, through which brokerage firms guarantee a certain yield to their clients and obtain a profit from the margin between the yield that they receive on the funds invested for clients and the yield that they promise to pay to these clients.

Although it is true that OPABs and CAVs mean that brokerage firms assume risks, this does not mean that the elimination of brokers'

guarantees of yields, and replacing this with a system in whic. investment funds would administer clients' portfolios in exchange for commissions, would eliminate the demand for arrangements similar to OPABs and CAVs that would then be offered by other financial intermediaries (e.g., trust funds in banks, etc.). Instead, this would give an advantage to these other systems over those administered by the brokerage firms.

The OPAB and CAV contracts could continue operating as they have been, through either brokers or investment funds, with a guaranteed yield, but with a more solid base of solvency than either brokers or investment funds currently offer, by capitalization and better portfolio and risk valuation systems and more information about risks and portfolio management. The economic incentive that creates the demand for these types of contracts stems from the distortion of the lack of interest bearing checking accounts, and, as long as this distortion is not eliminated, the market will continue to demand OPABs and CAVs or similar instruments.

The development of mutual funds and investment funds, in which portfolio managers do not guarantee yields and investors assume the risks in terms of the variance of the portfolio yield, is not something that the CNV can impose on the market. Several years ago, the BNV had already established regulations for these types of arrangements, but few of them are operating today, representing only 2.5 percent of the total value of OPABs and CAVs. There are no market studies that demonstrate that there is greater repressed demand for these instruments, probably because of the market's bias toward the short term, the lack of an equities market and the lack of institutional investors that would offer long-term funds to support these arrangements.

Because of this, the CNV should carefully evaluate whatever changes it introduces or promotes in the market, always based on a careful analysis of the realities of the market and the demands of the participants. If instruments that are in demand are prohibited or restricted, these would probably be offered by non-regulated entities, and with higher risks for those who acquire them, contrary to the objectives of the CNV.

Third, the CNV should play a major role in introducing the necessary regulations for securities markets so that there is equal treatment for all parties. The discrimination that some issuers practice by differentiating between interest rates paid on funds captured through the securities exchange compared to funds captured through direct placements has already been mentioned. There is also the issue of inside information about issuers' financial situations and the reliability of the information provided by issuers and brokers. Lastly, the CNV should also play an important role reducing the conflicts of interest that can exist among various clients of brokerage firms (e.g., when a brokerage firm represents an issuer and attempts to sell the issuer's bonds to a client when there exist other

options that the client might prefer if the client knew about them, or the conflict of interest that arises when a brokerage firm gives preference to its CAV or OPAB to the detriment of other clients, etc.).

It has been argued that the LRMV gave very limited powers to the CNV in certain areas and that the BNV introduced those limitations during the development of the legislation as a safety valve to possible overregulation by the CNV, based on the experiences in other Latin American countries where securities commissions have emphasized the minimization of market risk, thereby stunting the development of these markets. It has been proposed to reform the LRMV to eliminate these restrictions and to give the CNV all the powers that it might need. However, it is important that the CNV continue to operate for some time within the current legal framework in order to check the attitudes that regulatory entities typically adopt with respect to authorizing public offerings, the creation of new instruments, and self-regulation by brokerage firms and securities exchanges.

Conclusions and Recommendations

It would be advisable to modify the law so that the CNV becomes responsible for regulating and supervising commodities exchanges as well as securities exchanges, thereby avoiding possible conflicts between the Central Bank and the CNV in the regulation and supervision of the BNV and/or BOLPRO.

In order to overcome market imperfections caused by the lack of standardized medium and long term securities issues, and recognizing the particular importance of promoting the standardization of issues for the medium and long term debt of non-financial private companies:

1. The government could play an important role in generating a "demonstration effect" by issuing standardized bonds for maturities longer than one year with a correction for inflation that would induce investment over a longer term.

2. The government could, following the Central Bank, also introduce an auction system for government securities that would permit financial intermediaries and brokers to acquire the primary issues and, subsequently, to sell them with a premium in the secondary market.

3. Since auctions or other more open and competitive systems for primary issues could eliminate several market imperfections, the CNV and the BNV should promote such changes in the primary issues market, with the government taking the leading in using such systems for the sales of its securities.

Given the limited size of the market, establishing more than one securities exchange could organize securities markets in Costa Rica in a way that would not take advantage of economies of scale in the

clearing process. In addition, such fragmentation would scatter, instead of centralize, information about transactions and issuers, thereby raising the minimum transaction costs for those who deal in these securities markets. However, to deal with the need to rationalize the costs of carrying out transactions on the BNV, some actions are required:

1. It should be insisted with the BNV that the best policy would be for the BNV to set the BNV's charges for its services to brokers at a level that would permit the BNV a normal return on capital, taking into account the risky nature of the business, given that commissions that brokers can charge for their services have already been completely liberalized.

2. A legal reform should give the CNV the powers necessary to compel the exchange to reduce its commissions when it is reaping profits greater than what could be considered a normal competitive return (including the risks of the business).

3. The CNV should not have power to set different commissions for the exchange, but rather it should have the power to insist on proportionate overall price reductions because regulators cannot be expected to know how to fix commissions.

4. Moreover, the CNV should have a pre-announced system to authorize the operation of another exchange through public auction that could offer cheaper commissions than those of the existing exchange. The mere threat of this power to authorize a new exchange would induce the existing exchange to reduce its prices.

5. For additional protection of all concerned, the exchange by-laws should also contain limitations on the number of member firms, brokers and issuers (or their owners and managers) that are represented on the board of directors of the exchange, in order to avoid decision-making that is biased in favor of one group over the others. There should also be a balance on the board among the different types of member firms (those affiliated with banking groups and those not affiliated).

The Government of Costa Rica, in the process of privatizing CODESA's subsidiaries, should take definite steps to sell a major part of CODESA's equity in the BNV. However, the government should promote the changes mentioned above while CODESA still has a major share of the BNV's equity, before selling a significant portion of the government's stake. Moreover, within this system with only one exchange, the government should maintain a percentage of its ownership of the exchange to serve as a counterweight to anti-competitive tendencies such as limiting the number of member brokerage firms to those already existing. The government could hold a 15 or 20 percent equity stake in the exchange that could be administrated through a

trust arrangement with an impartial trustee acting with a precise mandate on how to represent the government at shareholder meetings.

To overcome the limitations inhibiting the development of long term financing in Costa Rican securities markets, the following measures are suggested:

1. The issuance of standardized medium and long term bonds with adjustable interest rates or monetary correction should be explored. In general, standardization of medium and long term instruments is crucial for reliable indicators of market rates.

2. With respect to the development of equities markets, it is necessary to reform tax laws to eliminate stamp taxes on increases in capital and to leave open to competition the fees that notaries charge for their certifications. It is also necessary to modify the income tax to eliminate those elements that subsidize corporations to incur debt rather than increase equity and to improve the quality of information about issuers.

3. Long-term funds from private insurance companies and pension funds could introduce a greater demand for instruments with adjustable interest rates or monetary correction, but the development of long-term securities markets would also require further legal reforms to permit the official use of such instruments with adequate regulation.

As the CNV grows in experience, it should place its main emphasis in the following areas:

1. With respect to the development of new instruments, it is fundamental that the CNV coordinate its activities closely with the intermediaries who know the market much better than the majority of the CNV's staff.

2. In reviewing actual products, the CNV should avoid the pitfall of assuming that it knows what the market needs better than the brokers and other participants in the market. The CNV should carefully evaluate whatever changes it introduces or promotes in the market, always based on a careful analysis of the realities of the market and the demands of the participants. If instruments that are in demand are prohibited or restricted, these would probably be offered by non-regulated entities, and with higher risks for those who acquire them, contrary to the objectives of the CNV.

3. The CNV should play a major role in introducing the necessary regulations for securities markets so that there is equal treatment for all parties. Some specific cases are: (1) the discrimination that some issuers practice by differentiating between interest rates paid on funds captured through the securities exchange compared to funds captured through direct

placements; (2) the use of inside information about issuers' financial situations and the reliability of the information provided by issuers and brokers; and (3) the role of the CNV in reducing the conflicts of interest that can exist among various clients of brokerage firms (e.g., when a brokerage firm represents an issuer and attempts to sell the issuer's bonds to a client when there exist other options that the client might prefer if the client knew about them, or the conflict of interest that arises when a brokerage firm gives preference to its CAV or OPAB to the detriment of other clients, etc.).

The role of brokers as dealers in certain kinds of operations such as OPAB and CAV contracts should be carefully explored. In the meantime, and as a possible permanent solution, OPAB and CAV contracts could continue operating as they have been, through either brokers or investment funds, with a guaranteed yield, but with a more solid base of solvency than either brokers or investment funds currently offer, by capitalization and by better portfolio and risk valuation systems and more information about risks and portfolio management.

Although more ample powers could be deemed necessary for the CNV, it is important that the CNV continue to operate for some time within the current legal framework in order to check the attitudes that regulatory entities typically adopt with respect to authorizing public offerings, the creation of new instruments, and self-regulation by brokerage firms and securities exchanges.

Chapter VIII

Caja Costarricense de Seguro Social (CCSS)

Legal Environment and General Characteristics

Creation, Benefits and Coverage

The Caja Costarricense de Seguro Social (Caja or CCSS) was created by law in the year 1941 with the basic mandate to implement obligatory social insurance and to increase voluntary insurance.[36] The Caja's basic law specifically established that obligatory social insurance includes protection against the risks of sickness, disability, old age, death and involuntary unemployment, and that the Caja would also participate in financial assistance for maternity, widowhood, orphanhood and funeral costs.

This basic law made social security obligatory for all workers receiving salaries. Nonetheless, it exempted from this obligation employers' non-salaried family members, workers receiving a pension from the government or any of its agencies, and any other type of worker that the Caja's Board of Directors might consider advisable not to include under obligatory insurance. In essence, the Board has the power to determine the entry requirements for the system and each sub-system, as well as the benefits and their conditions.

The Constitution of Costa Rica, enacted on November 7, 1949, reinforced and strengthened (in its Article 73) the establishment of social insurance programs benefiting all workers, financed by obligatory contributions by the government, the employer and the employee, and administered by an autonomous institution.[37]

In accordance with its mandate, the CCSS has divided its services and benefits into two separate insurance systems:

- Disability, old age and death insurance (Seguro de Invalidez, Vejez y Muerte -- IVM). As its name implies, this system pays benefits (mostly in the form of monthly pensions) in cases of disability, old age or death of participants (which includes financial assistance to surviving widows, orphans and other dependents). It also provides medical and hospital services to all its retired participants.

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[36] Law Number 17 of November 1941, later modified by Law Number 17 of October 1943, and referred to as the Constitutive (basic) Law of the Caja Costarricense de Seguro Social.

[37] Law Number 2737 of May 1961 expressed specifically that this institution is the Caja.

- Sickness and maternity insurance (Seguro de Enfermedad y Maternidad -- SEM). This system provides medical and hospital services to all participants to assist them in times of sickness and maternity, and it also provides basic financial support for funeral expenses.

It is important to note that social insurance has been implemented in a gradual and progressive manner according to the type of activity and the geographical location of different participant groups. The SEM began to operate in 1942, while the IVM did not initiate operations until 1947. Since their initiation, each of the systems has been independently increasing its coverage, but it should be pointed out that the SEM has consistently been able to reach a larger percentage of the nation's labor force than the IVM. Since 1975, the IVM's coverage of the labor force has basically remained constant, oscillating between 43 percent and 51 percent of the economically active population, while the SEM's coverage has stabilized at a higher percentage since 1980, between 65 and 68 percent of the economically active population. (See Table VIII-1.)

Table VIII-1

Coverage of Social Insurance Programs Administered by the CCSS

Year	Labor Force	SEM		IVM	
		Insured	Coverage (percent)	Insured	Coverage (percent)
1950	288,961	63,317	21.9	12,400	4.3
1955	326,623	79,290	24.3	19,663	6.0
1960	374,251	94,304	25.2	22,109	5.9
1965	439,769	131,928	30.0	73,990	16.8
1970	528,700	202,291	38.2	124,755	23.6
1975	639,007	326,923	51.2	290,419	45.4
1980	779,089	526,282	67.6	396,100	50.8
1985	927,836	605,743	65.3	404,643	43.6
1990	1,074,205	725,758	67.6	499,890	46.5

Definitions: Labor Force: Economically Active Population
Insured: Active Contributory Participants
Coverage: Percentage of Labor Force Insured

Source: "Universalización del Seguro Social en Costa Rica," CCSS, DAPE, October 1991.

The differences in coverage between the SEM and the IVM as a percentage of the labor force in recent years can be explained basically by two political decisions: (1) making the participation of independent workers voluntary, with the predictable result that a substantial percentage of workers in the voluntary category have

accepted affiliation with the SEM, but very few with the IVM; and (2) covering a significant percentage of salaried Government workers with their own separate pension systems instead with the IVM, while maintaining SEM coverage for medical services.

As of mid 1989, relatively reliable statistics show that the SEM program covered almost three-fourths of salaried workers, about 60 percent of non-salaried (independent) workers, and only one in eight domestic workers. At this same point in time, the IVM program covered about two-thirds of salaried workers, but a mere 2 percent of non-salaried (independent) workers, and about one in eight domestic workers. (See Tables VIII-2 and VIII-3.)

Table VIII-2

IVM Coverage by Occupational Category

Occupational Category	Total Workers (1)	Protected by IVM (2)	Percentage Protected (2)/(1)
Salaried:			
Public Sector	167,957	119,974	71.4
Private Sector	510,288	351,760	68.9
Domestic Service	48,759	6,033	12.4
Total Salaried	727,004	477,767	65.7
Non-salaried:			
Independent	246,138	5,231	2.1
Family/Others	52,406	1,177	2.2
Total Non-Salaried	298,544	6,408	2.1
Total Labor Force	1,025,548	484,175	47.2

Sources: "Encuesta de Hogares," D.G.E.C., July 1989; and "Anuario Estadístico 1989," CCSS, Dirección Técnica Actuarial y de Planificación Económica.

Table VIII-3
SEM Coverage by Occupational Category

Occupational Category	Total Workers (1)	Protected by SEM (2)	Percentage Protected (2)/(1)
Salaried:			
Public Sector	167,957	168,574	100.0
Private Sector	510,288	356,846	69.9
Domestic Service	48,759	6,054	12.4
Total Salaried	727,004	531,474	73.1
Non-salaried:			
Independent	246,138	126,634	51.4
Family/Others	52,406	47,115	89.9
Total Non-salaried	298,544	173,749	58.2
Total Labor Force	1,025,548	705,223	68.8

Sources: "Encuesta de Hogares", D.G.E.C., July 1989; and "Anuario Estadístico 1989," CCSS, Dirección Técnica Actuarial y de Planificación Económica.

It should also be pointed out that there seems to have been a clear political decision to universalize the SEM program. This decision is evident from several important laws and decrees, agreements of the Board of Directors and special collective insurance bargaining, among which the following should be highlighted:

- Law Number 2738 of May 12, 1961, which modifies Article 117 of the Constitution to institutionalize the obligation to universalize the social security programs and giving the Caja a period of ten years to comply with the mandate of universalization;

- Law Number 5349 of September 1973 which mandates the transfer of all hospital facilities to the Caja from the Public Health Ministry, the Junta de Proteccion Social and the Patronatos Medicos Asistenciales; and

- Executive Decree 15133-S of January 1984 which includes a new system of temporary insurance to cover the population in extreme poverty, to be paid by the Government.

From a more global perspective, the population insured by the SEM, taking in account not only direct economically active participants but also direct participants that are not economically active (e.g., family and dependents) and insured government workers, represents about 84 percent of the national population. This coverage is referred to as the contributory coverage, but in reality, since the

totality of the population has the right to receive medical attention if required, the Caja actually has a 100 percent coverage in terms of attention. (See Table VIII-4.)

Table VIII-4

National Population According to SEM Insurance Coverage

Insured Population: (*)	1970	1975	1980	1985	1990
Direct Active Participants	202,291	320,432	528,033	605,743	725,758
Direct Inactive Participants	3,847	24,433	68,962	91,079	139,089
Family/ Dependents	609,989	827,307	1,131,647	2,149,982	2,537,423
Insured Gov't. Workers	--	--	--	286,995	299,449
Total Insured	816,127	1,172,172	1,728,642	2,149,982	2,537,423
Non-Insured	914,651	796,042	555,853	492,092	494,971
Total Population	1,730,778	1,968,214	2,284,495	2,642,073	3,032,394
Percent Insured by SEM	47.2	59.6	75.7	81.4	83.7

* The insured population refers to contributory coverage; attention coverage is supposedly 100 percent.

Source: "Universalización del Seguro Social en Costa Rica," CCSS, DAPE, October 1991.

Administration and Supervision

The Caja is governed by a Board of Directors which is appointed by the Council of Government. Nonetheless, the Board carries out its functions with absolute independence from the Central Government

and therefore is solely responsible for the Caja's management and direction. It is also important to note that the basic law of the Caja explicitly indicates that the Board of Directors has the dual function of directing and supervising the Caja's activities, which of course evidently creates a conflict of interest.

The function of internal audit (supervision of financial accounts and operations) is under the direction of an Internal Auditor, while the function of external audit lies with the Contraloria General de la Republica. However, it must be emphasized that the Caja is not in fact subject to any external actuarial, financial or technical supervision.

Income as Established by Law

According to the basic law of the Caja, income for the obligatory social insurance programs is obtained from tripartite compulsory contributions: from insured workers; from employers; and from the government. Fees are determined by the Board of Directors in accordance with the cost of services given in each region and in conformity with the respective actuarial calculations.

According to the Caja's basic law, two separate funds were to be formed: one for the benefits and expenses of the "pay-as-you-go" SEM system, to be formed by employers' contributions to meet the expenses of the SEM; and the other for the benefits and expenses of the "funded" IVM system, to be formed by contributions from the government and from the insured workers to meet the expenditures of the IVM.

The Caja's Board of Directors can change the allocation of the different tripartite contributions (employers, employees and government) between the two funds (between "pay-as-you-go" and "funded") if actuarial calculations indicate that it is advisable to do so and if the prior authorization of the Contraloria General de la Republica has been obtained.

In practice, the Caja's Board of Directors has done both during the past decade: it has modified the obligatory contribution rates for the social insurance programs; and it has varied the allocation of the tripartite contribution between the two systems. At the beginning of the 1980s, the total contribution to insure a salaried worker in both programs was 21.5 percent, 14 percent for SEM and 7.5 percent for IVM, and the distribution among the three contributors was as follows:

- Employer's Contribution: 9.25 percent, 6.75 percent to SEM and 2.5 percent to IVM;
- Employee's Contribution: 6.50 percent, 4 percent to SEM and 2.5 percent to IVM; and

•Government Contribution:	5.75 percent, 3.25 percent to SEM and 2.5 percent to IVM.

In 1982 the Board of Directors approved an increase of 2 percentage points in the total contribution, raising it to 23.5 percent, with 16 percent for SEM and 7.5 percent for IVM. The allocation of the contributions was also change as follows:

•Employer's Contribution:	14.00 percent, 9.25 percent to SEM and 4.75 percent to IVM;
•Employee's Contribution:	8.00 percent, 5.50 percent to SEM and 2.5 percent to IVM; and
•Government Contribution:	1.50 percent, 1.25 percent to SEM and 0.25 percent to IVM.

This decision can be viewed as a major increase in payroll taxes. The employer's obligatory contribution rate was increased by about 51 percent, from 9.25 percent of salary to 14 percent, while the worker's contribution rate was increased by about 23 percent, from 6.5 percent to 8 percent. On the other hand, the Government's contribution rate declined to one fourth of its former level, from 5.75 percent to 1.25 percent.

Since this reform, the employer and employee rates have remained the same, but the Government's rate has been decreased even further (to 0.75 percent for 1986-1987 and to 0.25 percent for 1988-1993) through special arrangements between the Ministry of Finance and the Caja. (See Table VIII-5.)

Table VIII-5

Contributions of Salaried Workers
(Percent of Salary)

Year	Employer	Employee	Government	Total
SEM				
1981	6.75	4.00	3.25	14.00
1982	6.75	4.00	3.25	14.00
1983	9.25	5.50	1.25	16.00
1984	9.25	5.50	1.25	16.00
1985	9.25	5.50	1.25	16.00
1986	9.25	5.50	0.75	15.50
1987	9.25	5.50	0.75	15.50
1988	9.25	5.50	0.25	15.00
1989	9.25	5.50	0.25	15.00
1990	9.25	5.50	0.25	15.00
IVM				
1981	2.50	2.50	2.50	7.50
1982	2.50	2.50	2.50	7.50
1983	4.75	2.50	0.25	7.50
1984	4.75	2.50	0.25	7.50
1985	4.75	2.50	0.25	7.50
1986	4.75	2.50	0.25	7.50
1987	4.75	2.50	0.25	7.50
1988	4.75	2.50	0.25	7.50
1989	4.75	2.50	0.25	7.50
1990	4.75	2.50	0.25	7.50

Source: Dirección Actuarial y de Planificación Económica, CCSS.

Legal Constraints on Investments

The basic law of the Caja establishes that the reserves of the social insurance programs must be invested in the most favorable conditions with respect to safety and return. However, other things being equal, preference is to be given to those investments that support institutional services and contribute to housing construction, sickness prevention and the general well being of the insured.

The law prohibits the undertaking of speculative operations of any kind, as well as buying shares or any form of ownership in private companies in which directors, managers or other officials of the Caja (or any of their relatives) have specific interests. There is also a prohibition against loans of less than 75,000 colones, and authorization must be obtained from the Congress to make a loan for more than 5,000,000 colones (an amount which is periodically adjusted).

The basic law, as given, does not seem to limit in any seriously detrimental way the actions of the Board of Directors with respect to investments. It is rather the Board itself that, as a "precautionary" measure, has recently approved some changes in its investment "rulebook," specifically changing some articles that had expressly given the Caja the freedom to invest in private securities. It is interesting to point out two recent changes in particular:

- Internal regulations now explicitly state that IVM reserves cannot be used to buy shares in any private company. The basic law had been less restrictive, only prohibiting buying shares in private companies in which CCSS employees or their relatives have an interest.[38]

- The part of the regulations that explicitly stated that it was permissible to hold securities of private enterprise was eliminated.[39]

Recently, there have also been two significant outside actions that influence the Caja's investment options:

- The instructions given by the Budget Authority ("Autoridad Presupuestaria") for all public sector entities (except banking institutions and the court system) establish that new acquisitions of term financial assets in domestic currency, or the renewal of such instruments, must be in the form of Government Securities (or instruments of the Central Bank, if the financing requirements of the Government have been satisfied).[40]

- Law Number 7052 establishing the National Housing Fund indicates in its Article 44 that the Caja will maintain in term deposits with BANHVI (the Banco Hipotecario de la Vivienda) a minimum of 25 percent of the IVM's temporary investments. These deposits will have terms no longer than three months and will earn interest at the rate determined by BANHVI, according to conditions in financial markets.[41]

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[38]Article 8 of the "Reglamento para la Inversion de las Reservas del Seguro IVM."

[39]Article 13 of the "Reglamento para la Inversion de las Reservas del Seguro IVM."

[40]Resolution Number 1172 of Budget Authority (Session Number 32-90, held on December 7, 1990) ratified by the President.

[41]Law Number 7052 of November 13, 1986, known as the law creating the National Financial System for Housing.

Financing Methods and Investment Potential

The financing method chosen to guide a particular insurance system will by itself determine some of the most important characteristics of the investment of its funds. It is important, therefore, to understand which methods are guiding the IVM and SEM systems in order to grasp their investment potential.

As indicated above, the Caja's basic law contemplated the formation of two separate funds. On one hand, one fund would be formed under the "Current Disbursement Approach" to pay the expenses of the SEM. Under this approach, the income of the period should basically be equal to the expenditures for the same period, so there should be no accumulation of reserves. In practice, however, the SEM is an amended version of the "pay-as-you-go" approach, since it is necessary to include the formation and maintenance of a contingency reserve that would permit the system to meet unfavorable deviations in either income or expenditures. This kind of reserve should consequently be invested in short-term, relatively liquid instruments.

On the other hand, the Caja's basic law stipulates the formation of a "collective capitalization" fund (the "aggregate funding" approach) to cover the benefits to be provided by the IVM. It should be noted that the law does not establish, in a determinant and technically precise way, the specific actuarial funding method to be used. There are, in fact, various actuarial methods that fit in the general category of "aggregate funding".

According to actuarial studies carried out prior to the program's implementation, the IVM insurance system was to adhere to a funding method generally referred to as the "Uniform Level Percentage Premium Method" ("Prima Media Nivelada"). It was intended to finance the benefits and expenses of the system with a uniform contribution rate across the different generations. Consequently, the Uniform Level Premium was to be determined at the required level to make the probable actual value of all expenditures equal to the probable actual value of all future income. It must be pointed out that this does not technically identify in a conclusive way the actuarial funding method. There exist different alternatives for the uniform level premium method that differ according to the use of benefit allocation versus cost allocation, the use of attained age versus initial age, the use of an individual versus an aggregate calculation method, and the consideration or not of a supplemental value.

Actuarial studies carried out in 1980 and 1985[42] recommended the adoption of the "Scaled Premium Method" (as mathematically defined by Peter Thullen in the "Scale Premium System for the Financing of Social Insurance Pension Schemes: Maximum Period of Equilibrium"). Under this system the contribution rate is fixed to maintain an equilibrium during a determined period. Nonetheless, to this date, the IVM regulations do not explicitly define the actuarial funding method to which the system must adhere.

In any case, it seems reasonable to assume that the Scaled Premium Method is the funding method that regulates the IVM insurance system. This means, among other things, that the surpluses from normal operation should be accumulated in a technical reserve and that this reserve should be placed in long-term investments (by its own definition, Thullen's Scale Premium System establishes that only income from contributions or investment interest earned by the reserves during the period can be used to cover the payment of benefits, and not the accumulated reserves themselves). The amount of reserve accumulation is decided beforehand by choosing a period of equilibrium of longer or shorter duration. Under this system, the function of the investment of the reserves is determined by the achievement of the chosen equilibrium period. If reserves are invested in an inadequate manner (e.g., at a negative rate of return) a situation of disequilibrium will be reached. All else equal, a greater rate of return on the reserve funds will mean a longer duration for the period of equilibrium.

Financial Position

The SEM's Financial Position

A simple comparison of the annual operating income of the SEM with its annual operating expenditures for the years 1981 to 1991 shows clearly that prescribed income was greater than expenditures in every one of these ten years. In fact, since contributions were increased for the SEM in 1982, the surplus based on assuming that prescribed contributions will be received seems much larger than would be expected for a "pay-as-you-go" system (or even for an amended version of it). For every year after 1982, there is an annual surplus of more than 2,000 million colones, reaching 4,500 million colones in 1990. However, if only the effectively received income is considered, it can be seen that the SEM had a cash deficit for 1981 and almost no surplus for 1982. Thereafter,

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[42] Ronald Cartin Carranza, "Evaluacion Actuarial del Regimen de Invalidez, Vejez y Muerte," Direccion Tecnica Actuarial y de Planificacion Institucional, CCSS, San Jose, Costa Rica, December 1980; and Jorge Brenes Cedeno, "Evaluacion Actuarial del Seguro Invalidez, Vejez y Muerte al 31 de Diciembre de 1984," Direccion Tecnica Actuarial y de Planificacion Institucional, CCSS, San Jose, Costa Rica, July 1985.

effective income, which is substantially less than prescribed income, mainly because of the government's failure to pay promptly, is consistently greater than expenditures, although for the years 1989 and 1990 the effective surplus is moderate. (See Table VIII-6.)

Table VIII-6
SEM Insurance System
(in million of colones)

Year	Prescribed Income	Effective Income	Expenses	Surplus from Prescribed Income	Surplus from Effective Income
1981	2,832.4	2,166.6	2,782.4	50.0	-615.7
1982	4,662.4	4,034.4	3,934.9	727.6	99.6
1983	7,559.4	6,902.9	5,480.4	2,079.0	1,422.6
1984	9,831.2	8,792.3	7,189.1	2,642.2	1,603.2
1985	11,938.1	11,089.6	9,044.9	2,893.3	2,044.7
1986	14,267.9	12,840.0	10,954.9	3,313.0	1,885.1
1987	17,795.6	15,875.0	12,610.1	5,185.5	3,265.0
1988	21,303.3	19,262.0	16,985.1	4,318.2	2,276.9
1989	27,012.3	24,079.0	23,319.1	3,693.2	759.9
1990	34,654.5	30,854.7	30,058.2	4,596.2	796.5

An actuarial study dated November 1988, and carried out by the Actuarial Office responsible for planning for the SEM system,[43] made the observation that the actual contribution rate for the SEM was greater than necessary for financing the program and that the projections carried out indicate that the accumulation of reserve funds will grow larger than recommended for this kind of program. This is a serious matter since it means that Costa Rican salaried workers have been and will probably continue to be overcharged in the form of obligatory payroll taxes for their insurance protection. (See Table VIII-7.)

[43]Luis Guillermo Fernandez and Manuel Francisco Ugarte, "Valoracion Actuarial Sobre Los Seguros de Enfermedad, Yejez y Muerte," Direccion Tecnica Actuarial y de Planificacion Institucional, CCSS, San Jose, Costa Rica, November 1988.

Table VIII-7

SEM Income, Expenditure, and Reserves
Projections 1990 - 1998
(Millions of colones)

Year	Interest Income	Income from Contributions and others	Total Income	Total Expenditures	Reserves Acum. at End of Year
1990	6.374.4	10,460.3	16,834.7	10,178.2	36,163.8
1991	7,559.3	12,797.0	20,356.3	13,131.2	43,388.9
1992	8,996.1	15,679.4	24,675.5	16,779.7	51,284.8
1993	10,279.8	19,169.8	29,449.6	21,448.9	59,285.4
1994	11,465.7	23,522.9	34,988.6	27,436.9	66,837.1
1995	12,731.6	28,702.2	41,433.8	35,060.1	73,210.7
1996	13,672.1	34,990.2	48,662.3	44,690.8	77,182.1
1997	13,981.6	42,215.9	56,197.5	56,764.6	76,614.9
1998	13,245.6	51,443.1	64,688.7	72,217.1	69,086.5

Source: "Valoración Actuarial sobre los Seguros de Enfermedad y Maternidad, e Invalidez, Vejez y Muerte," DTAPI, CCSS, San José, Costa Rica, November 1988.

The IVM's Financial Position

As expected for a system such as the IVM with a "funding approach" to financing pension benefits, and especially considering that the system has not yet reached population maturity, the IVM had annual prescribed income substantially greater than expenditures for each year in the period 1980-1991. Moreover, annual effective income (i.e., income actually received) was also always much greater than annual expenditures. (See Table VIII-8.)

Table VIII-8

IVM Insurance System
(millions of colones)

Year	Prescribed Income	Effective Income	Expenses	Surplus from Prescribed Income	Surplus from Effective Income
1981	1,216.2	1,117.4	512.8	703.4	604.6
1982	1,770.9	1,769.9	874.0	896.8	895.9
1983	2,843.5	2,842.2	1,477.1	1,366.4	1,365.0
1984	3,893.1	3,786.7	2,006.3	1,886.8	1,780.4
1985	5,280.3	5,131.1	2,777.6	2,502.7	2,353.5
1986	6,674.2	6,423.7	3,598.0	3,076.2	2,825.6
1987	8,174.9	7,921.1	4,615.1	3,559.8	3,306.1
1988	10,220.0	9,907.6	6,038.8	4,181.2	3,868.8
1989	12,861.3	12,328.3	7,730.8	5,130.4	4,597.5
1990	17,130.7	16,546.1	10,084.9	7,045.9	6,461.3

The question is: Does this situation of annual operating surpluses mean that the IVM system is in fact in good financial condition? To answer this question fully, it is necessary to know and understand the actuarial financing method under which the system will assign or allocate -- in a systematic and consistent manner -- the different costs throughout the years.

A recent study carried out by the Actuarial Office responsible for planning for the IVM developed projections of annual income, expenses and accumulated reserves up to the year 2000 under the system of contributions and benefits in force at the end of 1991. (See Table VIII-9.)

Table VIII-9

IVM --Income, Expenditures and Reserves
Projections 1990 - 2000
(Millions of colones)

Year	Interest Income	Income from Contributions and others	Total Income	Total Expenditures	Reserves Acum. at End of Year
1990	5,674.0	10,872.1	16,546.1	10,062.0	35,882.4
1991	7,628.6	13,406.0	21,034.6	12,984.3	44,623.0
1992	9,419.6	16,981.3	26,401.0	16,517.0	54,507.0
1993	11,223.0	21,253.6	32,476.6	20,774.8	66,208.7
1994	13,238.4	26,489.8	39,728.2	26,522.8	79,414.1
1995	15,807.4	32,771.0	48,578.4	33,525.3	94,467.1
1996	18,695.8	40,598.6	59,294.4	42,574.3	111,187.2
1997	21,999.8	49,430.0	71,479.8	51,856.3	130,810.5
1998	25,564.1	58,879.4	84,443.5	64,859.7	150,394.3
1999	29,039.5	70,124.4	99,163.9	80,518.2	169,040.0
2000	32,071.2	83,515.7	115,586.9	100,884.2	183,742.7

Source: "Evaluación Actuarial, Seguros de Invalidez, Vejez y Muerte, Año 1991.", Dirección Actuarial y de Planificación Económica, CCSS, San José, Costa Rica, 1992.

According to these projections, ordinary expenditures due to pension benefits in 1995 will be greater than ordinary income from contributions, so that some interest from investments will have to be used to cover expenditures in that year. If the Scale Premium Method is not well understood, many officials may assume that the Caja will again have to take major action, such as raising further the retirement age or increasing contributions, but this is not true according to Thullen's model.

The study mentioned above concludes that contribution rates must be increased by 1994. However, it should be noted in Table VIII-9 that reserves will continue to increase until the year 2000. According to Thullen's Scale Premium Method, this fact in itself suggests that it will probably not be necessary to raise contribution rates at least until the year 2000. This will depend on three objectives: the level of the reserves, the magnitude of the rate increases and the length of the new period of equilibrium -- none of which is even discussed in the study.

Assets, Reserves and Investment Practices

Asset Accumulation and Composition

The accumulation of assets by the two social insurance programs administered by the Caja are, by any standard, highly significant for Costa Rica. By the end of 1991, total assets reported by the two systems totalled almost 100,000 million colones (about 54 percent of these assets belong to the SEM and the other 46 percent to IVM). Of all the banking institutions in the country, only the Banco Nacional reported more assets as of the same date.

During the last ten years, the assets of SEM have increased in absolute terms about 10.5 times, from 5,100 million colones in 1982 to 53,400 million colones in 1991. Over the same period, the assets of IVM have increased in absolute terms about 8.5 times, from 5,400 million colones in 1982 to 46,100 million colones in 1991. Meanwhile, for these same years, the CPI increased 4.26 times, so that both systems have experienced significant growth in real assets. (See Table VIII-10.)

Table VIII-10

Asset Accumulation
Social Insurance Programs: SEM and IVM
(in millions of colones)

Year	SEM	IVM	Relation SEM/IVM
1982	5,105.5	5,425.3	0.94
1983	9,338.6	7,806.9	1.20
1984	11,573.6	9,802.7	1.18
1985	14,672.7	12,375.3	1.19
1986	18,028.1	15,721.1	1.15
1987	22,595.0	19,389.1	1.17
1988	27,084.1	23,283.7	1.16
1989	36,143.3	30,187.5	1.20
1990	41,883.5	36,955.8	1.13
1991	53,368.1	46,097.1	1.16

Source: Departamento de Contabilidad, CCSS.

Even though asset accumulation is not very different in magnitude between the two systems (the SEM reported about 16 percent more assets than the IVM at the end of 1991), asset composition differs drastically between them and explains why the influence as an intermediary in financial markets is much greater for the IVM.

From the Balance Sheets as of December 1991, shown on the following pages, it can readily be seen that for the SEM the main assets are: Buildings, Land, Equipment, Inventories and Accounts Receivable (more than 50 percent of total assets); and Government Debt and Government Long Term Bonds (about 35 percent of assets). Thus the SEM has relatively little opportunity to be a major player in financial markets. On the other hand, the dominant assets for the IVM are: Temporary Investments (46.56 percent of total assets); Mortgage Loans (21.45 percent); and Long Term Bonds (9.44 percent). The magnitude of temporary investments alone clearly shows the potential importance of the IVM as a financial intermediary. (See Tables VIII-11 and VIII-12.)

If the government continues its practice of not paying its required contributions, the SEM will clearly not be able to participate as much as a financial intermediary. However, if this changes, and the government starts to pay as required, reserves would grow significantly (as projected) and the SEM could also become an important player in financial markets. On the other hand, the IVM is already an important financial intermediary, and will continue to be so, especially if the Government makes its contributions as required.

Table VIII-11

SEM Insurance System Balance Sheet
December 31,1991
(thousands of colones and percents)

Assets		
Current Assets	13,902,382	26.05
Bank Deposits	1,514,267	2.84
Temporary Investments	1,382,685	2.59
Inventories	6,450,018	12.09
Accrued interest	454,404	0.85
Current account due from IVM	174,541	0.33
Accounts receivable and other	3,936,469	7.36
Fixed Assets	39,465,764	73.95
Equipment (including reevaluation)	2,819,817	5.29
Long-term Bonds	6,214,693	11.64
Art (including reevaluation)	115,065	0.22
Construction	2,352,786	4.41
Government debt	13,299,250	24.92
Buildings (including reevaluation)	10,853,548	20.33
Land (including reevaluation)	3,239,174	6.07
Other	571,432	1.07
Total Assets	53,368,147	100.00
Liabilities and Retained Earnings		
Current Liabilities	5,353,163	10.03
Accounts payable (suppliers)	1,325,968	2.48
Accounts payable (institutions)	2,648,795	4.96
Other	1,378,400	2.58
Long-term liabilities	2,092,176	3.92
Accounts payable	2,092,176	3.92
Retained Earnings	45,922,808	86.05
Accumulated R.E.	43,157,380	80.87
Surplus from period	2,765,428	5.18
Total Liabilities and Retained Earnings	53,368,147	100.00

Source: "Presentación Estados Financieros a Diciembre 1991"; Departamento de Contabilidad, CCSS..

Table VIII-12

IVM Insurance System Balance Sheet
December 31,1991
(thousands of colones and percents)

Assets		
Current Assets	25,450,775	55.21
Bank Deposits	1,366,442	2.96
Temporary Investments	21,462,495	46.56
Short-term Bonds	50	0.00
Accrued interest	1,227,364	2.66
Accounts receivable and other	1,394,423	3.02
Fixed Assets	20,646,320	44.79
Long-term Bank Investments	300,000	0.65
Long-term Bonds	4,352,457	9.44
Mortgages and receivables	1,104,242	2.40
Mortgage loans	9,888,936	21.45
Government debt	2,319,581	5.03
Buildings (including reevaluation)	661,101	1.44
Land (including reevaluation)	1,706,822	3.70
Other	313,182	0.57
Total Assets	46,097,095	100.00
Liabilities and Reserves		
Current Liabilities	852,771	1.85
Current Account due from SEM	429,333	0.93
Custody Deposits, guarantees, etc.	226,011	0.49
Accrued expenses	183,146	0.40
Other	14,281	0.03
Long-term liabilities	21,594	0.05
Accounts due to Government	21,594	0.05
Reserves	45,222,731	98.10
Current Pensions	34,022,828	73.81
Future Pensions	2,323,637	5.04
Surplus from period	8,727,021	18.93
Other	149,244	0.32
Total Liabilities and Reserves	46,097,095	100.00

Source: "Presentación Estados Financieros a Diciembre 1991"; Departamento de Contabilidad, CCSS.

The SEM's Reserves and Investment Practices

From the information provided by the Department of Investment, Programming and Control of the CCSS, the SEM's reserves at the end of 1991 had reached the sum of 2,000 million colones, which represents less than 3.9 percent of the SEM's total assets. There are basically three different reserve funds for the SEM system, and, as of December 1991, these reserves amounted to:

	Amount (thousands of colones)	percent of SEM assets
For Attention to Loans	703,598	1.32 percent
Installed Capacity	1,297,570	2.43 percent
Contingencies	60,914	0.11 percent

About 87 percent of these reserves are invested in Government Securities, while the rest (13 percent) are invested in deposit certificates of government owned banks.

The IVM's Reserves and Investment Practices

The IVM's reserves, as reported on the Balance Sheet for December 1991, reached 45,200 million colones, equal to 98.1 percent of the total assets for this system.

Traditionally, the IVM's reserves have been divided in two seemingly technical reserves: Reserve for Current Pensions; and Reserve for Future Pensions. It must be pointed out, however, that these amounts are not mathematical valuations of the respective actuarial liabilities, but are instead a simple allocation of the surpluses from operations in previous periods. Moreover, under Thullen's Scale Premium Method, it is not necessary to maintain the procedure of declaring a reserve for each pension granted.

At first glance, the growth in absolute terms of the IVM's reserve fund throughout the past ten years seems to be considerable. In fact, it grew from 5,200 million colones in 1982 to 45,200 million colones in 1991 or 8.7 times. However, it is worrisome to see the highly negative rate of return experienced by reserves in the years 1981 and 1982, which undoubtedly will eventually become an important source of actuarial imbalance, no matter what funding method was in force. Moreover, the gross rate of return (calculated without consideration of administrative costs for investments) was greater than inflation in only four of the last 12 years, and in the two most recent years, 1990 and 1991, was lower than the inflation rate. In summary, it can be stated that, since 1981, the IVM's reserves have usually had a negative real rate of return. (See Table VIII-13.)

Table VIII-13

IVM Insurance System
Reserves and Rate of Return

Year	Reserve (millions of colones)	Nominal Rate of Return	Rate of Inflation	Real Rate of Return
1981	4,186.8	6.34	65.09	-58.75
1982	5,243.2	5.91	81.75	-75.84
1983	7,573.9	8.93	10.70	-1.77
1984	9,560.1	10.63	17.35	-6.72
1985	12,029.3	15.23	10.93	4.30
1986	14,886.9	16.96	15.43	1.53
1987	18,480.0	16.45	16.43	0.02
1988	22,646.0	17.76	25.34	-7.58
1989	28,822.0	17.36	9.95	7.41
1990	35,882.0	18.53	27.25	-8.72
1991	45,223.0	20.84	25.32	-4.48

Source: Dirección Actuarial y de Planificación Económica, CCSS.

Throughout the past ten years, the IVM's reserves have been invested mainly in the following assets:

- Securities;
- Mortgage Loans;
- Institutional Loans; and
- Government Debt.

In 1981, the IVM's reserves were basically made up of:

- Loans to the SEM, about 30 percent of reserves;
- Securities, about 25 percent of reserves; and
- Mortgage Loans, almost 16 percent of reserves.

(See Table VIII-14.)

Table VIII-14

IVM Insurance System
Summary of the Investment Portfolio
December 31, 1981
(Thousands of Colones)

Type of Instrument	Amount	Percent of Portfolio	Weighted Average Return
Securities	1,122,900	25.2	4.5
Mortgage Loans	708,878	15.9	10.5
Land and Buildings	147,273	3.3	5.6
Loans to SEM	1,333,583	30.0	6.0
Government Debt	377,220	8.5	6.0
Other Loans (*)	48,115	1.1	6.0
Other Assets (**)	711,115	16.0	0.0
Total	4,449,084	100.0	5.4

(*) Loans to Institutions and Mortgages and Notes Receivable.
(**) Accounts Receivable and Bank Deposits.

Source: Departamento de Programación y Control de Inversiones, CCSS.

Ten years later, in 1991, loans to the SEM have disappeared from the IVM's portfolio, and securities now represent 56.2 percent of reserve investments, while mortgage loans represent 21.5 percent. (See Table VIII-15.)

Table VIII-15

IVM Insurance System
Summary of Investment Portfolio
December 31, 1991
(Thousands of Colones)

Type of Instrument	Amount	Percent of Portfolio	Weighted Average Return
Securities(*)	25,925,343	56.2	25.5
Mortgage Loans	9,893,025	21.5	22.4
Land and Buildings	2,367,923	5.1	18.9
Loans to SEM	0	0.0	0.0
Government Debt	2,319,581	5.0	6.0
Other Loans (**)	1,154,242	2.5	18.0
Other Assets (***)	4,436,981	9.6	0.0
Total	46,097,095	100.0	20.9

(*) Of the securities, C5,873 million (22 7 percent) are debt of public sector banks and C20,052 (77.4 percent) are government bonds.
(**) Loans to Institutions and Mortgages and Notes Receivable.
(***) Accounts Receivable and Bank Deposits.

Source: Departamento de Programación y Control de Inversiones, CCSS.

To understand more clearly the IVM's recent investment practices, a few comments with respect its investments in securities, in mortgage loans and in government debt follow.

- Investment in Securities

This item covers investments in securities of short, medium and long term issued by the Central Government or by the government owned banks. From Table VIII-16, it is clear that there has been a preference for short-term securities, thereby providing a high degree of liquidity. As of December 1991, about 81 percent of this type of investment had a term of one year or less. (See Table VIII-16.)

Table VIII-16

IVM Insurance System
Summary of Investments in Securities
December 31, 1991
(Thousands of Colones)

Type of Security	Amount	Percent of Portfolio	Weighted Average Return
Short-Term Deposits	5,313,208	20.49	28.72
Medium-Term Deposits	300,000	1.16	21.50
Short-Term Govt. Sec.	15,699,678	60.56	28.76
Short-Term Govt. Bonds	250	0.00	15.20
Medium-Term Govt. Bonds	105 169	0.41	11.24
Long-Term Govt. Bonds	4,247,038	16.38	9.93
Bankers' Acceptances	260,000	1.00	32.00
Total	25,925,343	100.0	25.55

Source: Departamento de Programación y Control de Inversiones, CCSS.

It should be noted that the short-term securities offered positive real rates of return during 1991. Short-term deposits, as well as short-term Government Securities, had a gross rate of return of about 28.7 percent, while the inflation rate for the year was 25.32 percent. On the other hand, investments in long-term securities experienced a negative real rate of return in 1991.

- Mortgage Loans

Mortgage loans are usually given for housing purposes, for terms that vary between ten and twenty years, and at interest rates 10 or more percentage points below those established by the government owned banks. The reasons given for investing under such unfavorable conditions have usually focused on social desirability. This is probably a misinterpretation of Article 39 of the basic law of the Caja, which states that preference should be given to investments that contribute to general well being, but only under similar circumstances of risk and return.

As expected, investments in mortgage loans have been highly vulnerable to increases in the rate of inflation and have therefore frequently resulted in negative real rates of return. (See Table VIII-17.)

Table VIII-17

IVM Insurance System
Mortgage Loans

Year	Loans (millions of colones)	Percent of Reserves	Nominal Rate of Return	Rate of Inflation	Real Rate of Return
1983	1,002.7	13.2	16.0	10.7	5.3
1984	1,173.0	12.3	17.1	17.4	-0.3
1985	1,505.4	12.5	17.5	10.9	6.6
1986	1,983.6	13.3	18.8	15.4	3.4
1987	2,875.3	15.6	18.0	16.4	1.6
1988	4,297.7	19.0	19.4	25.3	-5.9
1989	6,548.3	22.7	20.5	9.9	10.6
1990	9,471.6	26.4	22.0	27.3	-5.3
1991	9,888.9	21.5	24.3	25.3	-1.0

Source: Dirección Actuarial y de Planificación Económica, CCSS.

Mortgage lending by the Caja has represented an important contribution to housing finance in Costa Rica over the years. Comparing the amounts invested by the Caja in mortgages loans with the amounts invested by the two other institutions that are important in housing finance in Costa Rica, the INS and the mutuales system, it is interesting to observe that, as of the end of 1991, the amount of the Caja's mortgages loans (9.89 billion colones) was only 6 percent less than the amount for the INS (10.55 billion colones) and 28 percent greater than the amount for all the mutuales in Costa Rica (7.7 billion colones).

- Government Debt

This item includes government contributions, both as employer and as government, that have not been paid to the IVM. This type of investment clearly has had a consistently negative real rate of return since the interest rate has been 6 percent.

Conclusions and Recommendations

Conclusions

The Caja was created to implement obligatory social insurance and to increase voluntary insurance, but little effort has been applied to the second objective.

The Caja has divided its services into two separate systems (IVM and SEM) that have both been implemented gradually and progressively, but independently and with a different timetable for

each system. The coverage actually achieved differs significantly between the two systems and reflects the Caja's greater emphasis on the SEM. About 68 percent of the labor force contributes to the SEM program, and the insured population is estimated at 84 percent of Costa Rica's population. These percentages, which are referred as "contributory coverage" are considered acceptable, especially since 100 percent of the population has the right to receive medical attention when required. On the other hand, the IVM system covers only about 46 percent of the labor force, which is a relatively low coverage considering that universalization is also an important objective of the IVM program. As will be seen in the chapter dealing with private pension systems, a high percentage of Costa Rican workers are not covered by any pension system.

The Caja is an autonomous institution, under a Board of Directors that is independent of the Central Government. This Board has the conflicting dual functions of directing and supervising the entity's activities, which is an important limitation to guaranteeing effectiveness in both functions.

In compliance with the Caja's basic law, two separate funds have been formed: one for the SEM and one for the IVM. However, a complete separation between the two systems does not exist, since the Board of Directors can alter the allocation of the contributions from employers, employees and the government between the two funds. In the past, mainly before 1982, there were several automatic transfers of funds from the IVM to the SEM, as well as formal loans between the two, even though this is not permitted by law. The main reason that this has not occurred in more recent years is the SEM's operational surpluses since 1982. History has shown, in other Latin American countries as well as in Costa Rica, that if a complete separation does not exist between health programs and pension programs, the former will be financed (even if only temporarily) by the latter if there are operational deficits or cash flow problems.

In the last decade, employer contribution rates for social insurance have increased about 51 percent, while worker contribution rates have increased about 23 percent, but the government's contribution rate has declined to one ninth of the rate in force at the beginning of the 1980s. It is a matter of concern that the Caja's Board of Directors has the power to raise contribution rates, which are in essence taxes on payrolls, or change their allocation, without adequate supervision.

The Caja's basic law does not appear to limit, in any seriously detrimental way, the actions of the Board of Directors with respect to investments. In recent years, however, outside influences have affected investment strategy in major ways, mainly the Government's Budget Authority and the National Housing Fund Law.

There seems to exist a serious separation between technical actuarial planning on one hand and practical policy actions on the other. Moreover, there is no actuarial supervision -- obviously very important for pension planning -- and major policy decisions are being made by technical staff, without adequate transparency for these actions.

While the SEM has theoretically adhered to an amended version of the Current Disbursement Approach to funding, so that the period's income should approximately equal its expenditures (with no or little accumulation of reserves), in practice the SEM has experienced significant operating surpluses since 1983, and Caja technicians are predicting reserves larger than recommended for this approach to funding. In the IVM, meanwhile, the actuarial funding method has not been officially specified in a conclusive way. This fact introduces subjectivity and political considerations into the actuarial valuations. It seems reasonable (and some of the Caja's technical staff seem to agree) that Thullen's Scaled Premium Method should be the funding method regulating the IVM. However, conclusions and recommendations of recent studies do not appear to apply Thullen's approach and do not give adequate explanations for the desired level of reserves, the magnitudes of rate increases and the length of the new period of equilibrium.

The accumulation of the assets by the Caja's two social insurance programs is, by any standard, highly significant for Costa Rica since, of all financial institutions in the country, only the Banco Nacional reports more assets that the Caja. While the SEM's assets are mainly fixed assets (e.g., buildings, construction and land) and government debt (which is usually remunerated at below market rate of interest), almost all of the IVM's assets are financial instruments. The amount of reserves on the IVM's Balance Sheet as of December 31, 1991, represents about 98.1 percent of that system's total assets (approximately 45,200 million colones), thereby suggesting the importance of the Caja as a financial intermediary.

In fact, IVM reserves are invested mainly in securities issued by the Central Government and the government owned banks and in mortgage loans. In terms of investment performance, the Caja's biggest problem has been achieving a positive real rate of return on its investment portfolio.

Recommendations

It is evident that there is a lack of consensus as to the appropriate political approach to an overall solution for pension problems in Costa Rica. For this reason, the main recommendations for USAID's role to improve pensions are:

- press for a series of in-depth technical studies that can lead to the development of options for the design of a new approach to pension systems in Costa Rica, including especially their relevance to financial intermediation; and

- press Government policymakers to agree formally to a new overall pension system and to formulate an action plan to implement the system.

The design of a new overall pension system for Costa Rica must have, among others, the following objectives:

- provide broader basic coverage;

- coordinate existing pension systems;

- provide adequate benefits; and

- assure adequate financing for all existing systems to guarantee financial solvency; this entails consideration of:

  - the definition of an appropriate actuarial method;

  - a technical (not political) approach to establishing contribution rates;

  - a restatement of the philosophy for the participation of the Government, employers and workers in the financing of the Caja;

  - a complete separation of the SEM and IVM programs; and

  - the establishment of appropriate actuarial supervision.

Chapter IX

Pension Systems

General Overview of Existing Pension Systems

The Main Pension Systems in Costa Rica

At the present time there are numerous different pension programs in Costa Rica, most of them covering only small groups of workers, operating in an independent and uncoordinated manner and without any external supervision. These pension programs can be classified into four different groups or systems:

- Disability, Old Age and Death Insurance (Seguro de Invalidez, Vejez y Muerte -- IVM), created by the basic law of the Caja Costarricense de Seguro Social (CCSS) and administered by that institution.[44]

The IVM program, which is the pension plan of the Costa Rican Social Insurance System, is undoubtedly the most important pension program in the country as it covers almost half a million workers and had accumulated assets of about 46,097 million colones at the end of 1991, thereby establishing it as a highly important financial intermediary. The investment practices and various other aspects of the CCSS have already been discussed in detail in the preceding chapter.

- Special Programs for the Public Sector (Regímenes Especiales del Sector Público) which are largely charged to Costa Rica's Government Budget and were created by a variety of different laws.[45]

These special programs operate completely separately from the IVM program (i.e., participants are not forced to belong to the Caja's system) and are not supplementary to that program. Even though they cover a far smaller number of workers (about 70,000), these programs have a significant impact on Costa Rica's fiscal situation since they are financed mainly by funds from the government budget. These special programs cover about 42 percent of government workers, but less than 7 percent of the country's work force.

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[44]The basic law of the Caja Costarricense de Seguro Social (Law Number 17 of November 1941, later modified by Law Number 17 of October 1943) was decreed in 1941, but the pension program did not initiate operations until 1947.

[45]Some of these laws were decreed before the creation of the Caja in 1941, while others are subsequent to that date.

As of May 1992, there were 13 significant special pension programs operating in Costa Rica.[46] Five of these are non-contributory and offer only basic amounts for survival, while eight are contributory but are nonetheless financed primarily by the government (i.e., the judicial system, the Pacific Railroad, the National Registry, communications workers, municipal workers, the Finance Ministry, the Public Works and Transportation Ministry, and teachers). It should be mentioned that only a short time ago (June 24), the Congress approved a new basic law for these special programs (Ley Marco). However, this new law contributes little to the solution of the serious fiscal problems caused by these special programs since the two most important programs were left out (the teachers and the judicial system which represent about 90 percent of the total participants in all special programs) and basic benefits significantly higher than the IVM's were maintained for all current participants in the main contributory special programs.

Recent actuarial studies have shown that these special pension programs are actuarially insolvent. With the exception of the pension plan for the judicial system, they do not have any reserves, the contributions established by law are insufficient and their investment potential is null.[47]

- Non-Contributory Systems with Basic Benefits (Régimen No Contributivo de Pensiones por Monto Básico) created in 1974 by law and administered by the Caja.[48]

This system is in fact a public assistance program and not a part of the social insurance system. It provides pension benefits according to its financial resources to persons who are in an evident state of need. These benefits are not a legal right of those who qualify, but rather possible assistance that might be received if the system has financial resources. As of the end of 1989, the number of pensions being paid was about 48,000. Except for very small contingency reserves, this program is supposed to pay out most of its resources in benefits, thereby leaving very little potential for investment activity.

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[46]The exact number of special pension programs depends on how programs for veterans and various other small associations are grouped, as some authors mention 17 different programs and others 19.

[47]For more information on these programs, see Ronald A. Cartín, "Sistemas de Pensiones en Costa Rica: Descripción, Opciones de Reforma y una Propuesta Integral," PNUD/CEPAL, January 1991.

[48]Law Number 5662 of December 23, 1974 (Ley de Desarrollo Social y de Asignaciones Familiares).

- Supplementary or Complementary Pension Programs, which have arisen in general through agreements between individual employers and their employees.

These pension programs operate in a highly independent manner and are not subject to government regulation.[49] Programs of this type have begun to operate in several autonomous institutions, in banks and in many professional associations. Furthermore, a new alternative has appeared recently in the private sector. These are Savings Plans for Retirement which are offered by several finance companies and are essentially trusteeship contracts between finance companies and workers. A more detailed description of the growth of the Savings Plans for Retirement and their accumulation of funds is presented below.

Coverage of the Pension Systems

In mid-1989, the economically active population of Costa Rica (Población Económicamente Activa -- PEA) was approximately 1,025,000 persons.[50] About 485,000 (47.3 percent) were covered by the IVM program and about 70,000 (6.8 percent) by the special programs for the public sector. Before 1989, the supplementary and complementary programs were oriented toward providing additional benefits to workers who already belonged to one of these two groups of programs. Consequently, as of July 1989, about 470,000 workers (45.8 percent of the total PEA) were left out of Costa Rica's main pension systems. Some of these unprotected workers may eventually qualify for assistance from the Basic Non-Contributory System, but a great majority of them will have to depend exclusively on their savings and their personal financial planning for their retirement years. For them, the new complementary systems being offered by private financial entities might represent useful options.

Legislative Background

It is evident that Costa Rican policymakers have not reached a consensus with respect to overall policy and philosophy in the area of pensions. This has been manifest by the numbers of different laws with different, and sometimes conflicting, philosophies and objectives that have been decreed throughout the years in this area. It is useful to pinpoint the basic sequence of events and the apparent inconsistencies.

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[49]Recently, there have been several efforts to try to regulate Costa Rica's complementary private pension systems. The two following efforts, which are independent of each other, should be noted in particular: the proposal presently being studied by the Comision de Asuntos Hacendarious of the Congress (of which a revised version will probably be recommended to Congress in the first half of 1993) and the proposal being written by the Ministry of Planning.

[50]According to the "Encuesta de Hogares", D.G.E.C., July 1989.

Before social insurance programs were established in Costa Rica, more than eight special independent pension systems were already in existence, created by different laws. The Government had tried to protect different groups of workers in separate and different ways, creating unequal benefits according to the pressure of the specific group.

In 1941, when social insurance was decreed in Costa Rica and the Caja was created, an alternative solution to the problem of the special systems was defined. It was established then that every new Government worker must belong to the new Social Insurance Program and, in this way, the special systems would be closed, covering only the participants at that time. For new entrants, pension benefits would be under the new IVM program.

Nevertheless, this important step in defining social security arrangements did not represent a strong consensus among Costa Rican policymakers, as the following events clearly demonstrate. The IVM program did not begin operations until 1947. In the interim between the approval and the actual initiation of operations by the IVM, the Congress decreed two new special systems, approving once again a differentiated treatment for certain groups of public workers.

After 1947, and continuing even in recent years, different pressure groups have managed, through modifications or extensions of various laws, to be included in special systems, thereby excluding themselves from the IVM system and enjoying significantly superior benefits than those offered by the IVM program. Even in the very recent approval of the new General Law for Special Systems for the Public Sector, there was a clear inconsistency: while new entrants to the special contributory programs (except for the judicial system and teachers) will be forced to join the IVM system, a new separate system for teachers was created for beginning teachers not participating at this time in the old system to be closed.

Savings Plans for Retirement: The Complementary Pension Program Option

An Introduction to Complementary Pension Programs

The various pension programs that aim to supplement or complement the retirement benefits to be received from the IVM system (usually on a voluntary basis) can be classified, according to the administrator, into two broad categories:

- complementary plans that are administered by the employing companies (or institutions) themselves; and
- plans administered by independent private companies completely dedicated to the business of managing pension programs.

In the first category (i.e., those in which the employing company or organization manages its own pension program), there have been numerous private companies, as well as public institutions and other organizations, that have instituted and maintained these kinds of programs for many years. Important examples in this category include:

- banks (which had been obligated by law to assign 10 percent of their profits to retirement funds);
- autonomous institutions such as the Caja, INS, ICE and others which have created complementary pension programs for their employees;
- professional associations, such as the associations of lawyers and of dentists, which have their own complementary pension programs, sometimes instituted by the law creating them; and
- multinational companies which have adapted to Costa Rica their common practice in other countries of offering additional retirement benefits.

Since available financial information for these programs is practically nonexistent -- they are not subject to any external supervision and are usually reluctant to give any financial information to third parties -- it is extremely difficult to estimate the coverage, funding and growth of these programs. Nonetheless, it can be supposed that they might manage substantial amounts of funds and could be important financial intermediaries.

Programs in the second category (i.e., private finance companies dedicated to managing complementary pension programs for other companies' employees) have appeared only recently. Important examples in this group include:

- Fiduciaria de Ahorro Banex, S.A.;
- Operadora de Fondos de Pensión Pro-Vida, S.A.; and
- the Instituto Nacional de Seguros.

In addition, Bancoop and Inversiones Sama, S.A., have entered the market at a smaller level, and other banks, such as the Banco Popular, the Banco Nacional de Costa Rica, the Banco de Costa Rica and the Banco Solidarista, have also announced their intentions to enter this market in the near future. As this recent activity indicates, the potential growth of this market and of the funds it administers is huge. Many of the companies involved could thus become important financial intermediaries in a very short period of time.

The Growth of Administrators of Savings Plans for Retirement

As indicated above, Savings Plans for Retirement are a product that has been offered to the public only very recently (since late 1988) by several private financial companies. Nonetheless, these plans have grown very rapidly in terms of both the number of participants and the amount of funds accumulated. As of May 1992, there were about 17,000 participants in these kinds of plans, and the funds accumulated exceeded 1,600 million colones -- all in less than four years. This rapid growth is expected by many, especially the operators of these plans, to continue for at least the next ten years; and, with proper regulation, growth might even be more rapid.

The main reasons for the rapid growth of these savings plans include:

- the perception of the public that the IVM's pension benefits are inadequate by themselves to live a decent retirement;
- public awareness of the fact that the Special Public Sector Programs are financially insolvent so that they may tend to disappear in the long run;
- the lack of other options for the great majority of the Costa Rican labor force to complement or supplement the IVM and other public sector programs to provide adequate retirement benefits; and
- the aggressive and efficient manner in which private companies (two in particular) have entered this business.

The two most important Savings Plans for Retirement offered at this time are those of the Fiduciaria de Ahorro Banex, S.A., and the Operadora de Fondos de Pensión Pro-Vida, S.A. A general description of these two major complementary pensions plans and their growth follows.

Fiduciaria de Ahorro Banex, S.A.

Fiduciaria de Ahorro Banex was the first company to sell this type of savings plan specifically designed for retirement, beginning in 1988. Since then, this operation has grown at a very rapid rate in both coverage and the accumulation of funds. In only a little more than three years, coverage (i.e., the number of people affiliated) has increased by a factor of 15.5, from 772 employees participating in the program in December 1988 to 12,000 participating in April 1992. Over the same period, the amount of funds accumulated in the program has increased by more than 200 times, from a mere 5.5 million colones in December 1988 to a substantial 1,150 million colones in April 1992 (see Table IX-1).

Table IX-1

Fiduciaria de Ahorro Banex, S.A.
Coverage and Fund Growth

Date	Coverage (Number of persons)	Accumulated Fund (thousands of colones)
Dec 1988	772	5,545
Dec 1989	3,219	147,895
Dec 1990	6,577	406,738
Dec 1991	9,538	843,821
Apr 1992	12,000	1,150,000

Source: Gerencia General, Fiduciaria de Ahorro Banex.

The Banex Savings Plan for Retirement is basically a trusteeship arrangement that is established between the Fiduciaria de Ahorro Banex, S.A., and an individual worker or group of workers and the company for which they work. Through this trusteeship arrangement, the worker saves a percentage of his salary, and these funds are invested and maintained in an individual account in the worker's name, so that when he retires (possibly with IVM coverage as well) he will begin to receive a pension (complementary to the possible IVM pension) or the total value of the funds that have been accumulated for him. It is important to point out that this system is a defined contribution plan in which the benefits to be received depend on the investment performance of the fund and no guarantee is made as to the amount of benefits to be received by the worker.

All funds accumulated under the plan are invested in securities issued, guaranteed or secured by the Government or its institutions. For safety reasons, the securities in which the plan has invested are maintained in the custody of a government owned commercial bank. Since the creation of the Banex Savings Plan for Retirement, the performance of its investments has been extremely competitive with consistently positive real rates of return (see Table IX-2).

Table IX-2

Fiduciaria de Ahorro Banex, S.A.
Fund Rate of Return
(percent)

Year	Fund Rate of Return	Rate of Inflation	Real Rate of Return
1988	32.23	25.34	6.89
1989	34.40	9.95	24.45
1990	31.24	27.25	3.99
1991	35.36	25.32	10.04

Source: Gerencia General, Fiduciaria de Ahorro Banex.

Operadora de Fondos de Pensión Pro-Vida, S.A.

The Operadora de Fondos de Pensión Pro-Vida, S.A., began to sell the type of savings plans specifically designed for retirement at the end of 1990. Since then, the plan has grown at a very rapid rate in both coverage and the accumulation of funds. In just over one year, coverage (i.e., the number of people affiliated) has increased more than four times, from 850 employees participating in the plan in January 1991 to 3,550 participants in March 1992. Over that same period, the funds accumulated have increased by almost five times, from 36 million colones in January 1991 to 178 million colones in March 1992 (see Table IX-3).

Table IX-3

Fondos de Pensión Pro-Vida, S.A.
Coverage and Fund Growth

Date	Coverage (Number of persons)	Accumulated Fund (million of colones)
Jan 1991	850	36
Mar 1991	1196	49
May 1991	1476	60
Jul 1991	1690	69
Sep 1991	1898	88
Nov 1991	2200	94
Jan 1992	3000	128
Mar 1992	3550	178

Source: Gerencia General, Operadora de Fondos de Pensión Pro-Vida, S.A.

The Pro-Vida Savings Plan for Retirement is basically the same product offered by Banex, a trusteeship arrangement with the funds accumulated invested in securities issued, guaranteed or secured by the Government or its institutions and maintained in the custody of a government owned commercial bank. The performance of its investments has also been very competitive, with a rate of return of approximately 33 percent in December 1991 and around 24 percent in May 1992.

Conclusions and Recommendations

Conclusions

- The main pension programs in Costa Rica can be classified into four groups: the Disability, Old Age and Death Insurance (IVM) of the Caja; the Special Programs for the Public Sector; the Non-Contributory System with Basic Benefits; and the Supplementary or Complementary Pension Programs. Of these four, only two -- the IVM and the Complementary Programs -- have the potential of playing important roles as financial intermediaries.

- As of July 1989, approximately 46 percent of the Costa Rican labor force was left out of the main pension systems.

- Legislative developments over the years have shown a lack of consensus as to appropriate policies in the area of pensions, so that numerous laws with conflicting objectives have been decreed in this area.

- The Supplementary or Complementary Pension Programs can be classified into two types: those administered by the companies or institutions themselves; and those administered by independent private companies dedicated solely to this business. Both categories have the potential of accumulating significant amounts of funds to be invested and therefore of being important players in Costa Rican financial markets.

- Savings Plans for Retirement have only recently been offered by companies or institutions. In less than four years these types of complementary programs have grown to cover about 17,000 participants and have accumulated about 1,600 million colones in investments. This growth could be even faster if proper regulation existed.

- To this point the funds accumulated by the Savings Plans for Retirement, specifically by the trusteeship arrangements administered by Banex and Pro-Vida, have been invested in securities issued, guaranteed or secured by the Government and are maintained in the custody of government owned commercial banks. Investing solely in government or government backed

securities is a self imposed measure with the purpose of strengthening the perceived security of investments and thereby gaining the trust of the general public for this new kind of financial instrument. There is no reason why these companies should not consider placing some of their investment portfolio in private securities through the securities exchange. Over time, with adequate legislation, Savings Plans for Retirement have the potential of becoming important suppliers of long-term funds to the private sector through the securities exchange.

Recommendations

In recent years there has been an increasing awareness in Costa Rica of the major fiscal problem caused by the existing pension systems -- and even of the danger of a possible collapse of major proportions because the promises implicit in these systems are beyond the economic possibilities of the country. Numerous committees, associations, round table discussions and newspaper articles have analyzed various problems in this area, leading to a wide variety of proposals to modify the existing laws. Nonetheless, most have limited themselves to analyzing each system in an isolated manner and without proposing any integral national policy for pension systems that could be implemented in a consistent way in years to come.

Recent examples of such efforts are the new law for the teacher's pension system that was approved at the end of 1991, the new general law for Special Public Programs approved June 24, 1992, and the proposal for a law to regulate Complementary Pension Systems that is being studied by the responsible commission of the Costa Rican Congress. All of them represent isolated well-intentioned efforts, but nearsighted in the sense that they lack the consistency and clarity of objectives that a national pension program should have.

Considering the foregoing comments, together with the conclusions and recommendations in the chapter covering the Caja Costarricense de Seguro Social, the main recommendations for USAID's possible role in improving Costa Rican pension systems include:

- Promote a series of in-depth technical studies that can lead to the development of options for the design of a new approach to pension systems in Costa Rica. It is crucial to consider as part of this the need to promote, but also to regulate appropriately, the different types of supplementary and complementary pension systems, taking into account not only their potential relevance for financial intermediation but also their objectives within the context of programs to promote economic security. Furthermore, these studies should analyze the impact of pension programs on financial markets and especially the potential of their becoming important

suppliers of long-term funds to the private sector in general and the securities exchange in particular. A study of highest priority for the immediate future would be an in-depth technical analysis of the strengths and weaknesses of the proposed law for private pension systems, as noted above.

- Strongly encourage government policymakers to agree formally to a new overall pension system and to formulate an action plan to implement it. Immediate action should be taken to improve the legislation proposed for complementary pension systems so that these can become part of an overall national social security program, as well as an important element in financial markets, with a role more consistent with the economic security and financial liberalization objectives of the Costa Rican Government.

Chapter X

Instituto Nacional de Seguros (INS)

Legal Environment and General Characteristics

Creation, Objectives and Implementation

The Instituto Nacional de Seguros (INS) was created by Law Number 12 of October 30, 1924. This law clearly established that insurance contracts of any type are a monopoly of the government and that an autonomous institution (initially referred to as the Banco Nacional de Seguros) would be responsible for administering all insurance business in Costa Rica.[51] The law applied to all kinds of insurance, including commercial as well as social insurance (which was later assigned to the Caja Costarricense de Seguro Social). However, it exempted from this monopoly life insurance societies, both cooperative and mutual benefit societies, existing at the time of the issuance of the law.

At the time the law was being developed there were two important circumstances that helped to create conditions for its acceptance:

- numerous cases of arson in which unscrupulous businessmen were insuring their buildings for more than their real value and then setting fires to collect insurance benefits from foreign companies; and

- the strong interest of the Costa Rican Government in providing protection from job related risks -- protection that private companies were reluctant to offer.

However, Law Number 12 clearly had as a purpose more than just creating an entity that would offer a wider variety of insurance than private companies were willing to offer at the time. The desire of the Costa Rican Government was stronger: to create a permanent government monopoly.

The main arguments behind this law were based either on strictly nationalistic sentiments, against the "monopolies" created by large private companies and related to Costa Rican desires to be "emancipated from foreign servitude," or on the advantages of a government monopoly over a private monopoly from the reasoning that

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[51]Law Number 12 of October 30, 1924, commonly referred to as the "Ley de Monopolios y del Instituto Nacional de Seguros," initially stated that the institution in charge of administering the monopoly was to be named the "Banco Nacional de Seguros," but later this was changed to read "Instituto Nacional de Seguros" by Law Number 4183 of September 4, 1968.

market forces alone would not appropriately satisfy social objectives and thus implied the intervention of the government.[52]

From the preamble to Law Number 12, it can easily be verified that the law had the following explicit objectives:[53]

- to avoid capital flight, which was said to be taking place through private insurance companies;
- to convert the prevailing "monopoly" of a few powerful entities into a government "monopoly under law;"
- to constitute this "monopoly under law" as a social service and as a source of income for the government;
- to promote an activity that, without government support, was not believed to reach an adequate level of acceptance; and
- to introduce the new concept of social insurance, as the government would use the profitable areas of insurance to subsidize other insurance of social value, whereas private enterprise will choose to offer protection in only profitable areas.

It is worth noting that circumstances and people's views of the functions of government have changed significantly. At present, many would argue that:

- not each of these objectives is necessarily desirable or even acceptable;
- some of these objectives can be better attained by proper government regulation and supervision;
- the basic conditions regarding fire and job-related insurance are now different, as arson is no longer a major problem and an institution (the CCSS) has been created to administer social insurance; and
- in general, most of the objectives could probably better be served nowadays by letting the government compete with private enterprise, under proper regulation and supervision.

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[52]"Evaluación del Instituto Nacional de Seguros, 1983-1989," Comisión Evaluadora, Artículo 37, Ley de Equilibrio Financiero, June, 1991.

[53]From the "Considerandos de la Ley de Monopolios y del Instituto Nacional de Seguros, Numero 12, del Octubre 30, 1924, Politicas y Objetivos Generales del INS," Direccion de Planificacion, INS.

The government's insurance monopoly, although established by Law Number 12 in 1924, was not to be implemented in that year. In fact, the law stated that the Costa Rican Government would establish the effective implementation date for each different kind of insurance. In practice, the implementation of the government monopoly was carried out in a gradual manner, through various Executive Decrees and laws, according to the type of insurance:

- Life insurance was the first type of insurance to be sold under the government monopoly, as ordered by Executive Decree Number 30 of October 22, 1925, and initiated on November 1, 1925. It should be pointed out that Law Number 12 had established in its Article 22 that life insurance would be obligatory for all government workers as soon as life insurance was initiated by the government monopoly, but to the present this has not been enforced.[54]

- Fire insurance was initiated under Executive Decree Number 9 of February 17, 1926. As stated earlier, fire insurance was one of the important reasons for creating a government monopoly, since an important objective for many of the promoters of Law Number 12 was to reduce arson that was so common in those days.

- Work related insurance (riesgos profesionales) was ordered by Executive Decree Number 16 of May 22, 1926, and initiated by the government monopoly on August 10, 1926, but conditioned by the Law on Labor Accident Reparation. This law was amended by the Labor Code of 1943 and later by Law Number 6727 of March 1982 (the Universalization of the Regimen of Labor Risks) which declared this kind of insurance to be obligatory for all types of labor activities. It should be pointed out that an autonomous institution (the CCSS) was created in 1941 by Law Number 17 to implement obligatory social insurance, but to this date protection for job-related accidents is still provided by the INS instead of the CCSS.[55]

- Fidelity insurance was initiated on March 30, 1931. It should be noted that this type of insurance was undertaken without the monopoly condition, thereby leaving other institutions

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[54]Some of these other programs, such as the Seguros de Vida del Magisterio Nacional, are not insignificant, but they are nonetheless quite small relative to the INS. For example, the investments of the Seguros de Vida del Magisterio Nacional are about 5 percent of those of the INS.

[55]There are, however, various proposals currently under consideration that would transfer this type of insurance from the INS to the CCSS. Since this type of insurance accounts for about 25 percent of the premiums received by the INS and also, apparently, for a significant proportion of INS profits, such a transfer could have a major impact on the INS.

with an opportunity to compete in this specific insurance business.

- Automobile insurance was initiated by the government monopoly under Decree Number 2 of January 16, 1943. This type of insurance is for the protection of automobile drivers on a voluntary basis.

- Integral crop insurance was created by Law Number 4461 of November 12, 1969 and regulated by Executive Decree Number 70 of April 16, 1970. This type of insurance is to protect agricultural producers against all adversities of nature (until that time, crop insurance had protected only against specific named risks).

- Automobile insurance was made obligatory by Law Number 5930 of September 19, 1976, which modified Traffic Law Number 5322 of August 1973. Such insurance is now obligatory for all automobiles operating in the country, and the law also establishes civil responsibilities for damages caused by the driver in any accident that he causes willfully, by negligence or by imprudent behavior.

- Reinsurance was established as a government monopoly for all kinds of risks by Law Number 6082 of August 30, 1977. This law also established that the reinsurance monopoly would be administered by the INS.

Government Administration and Supervision

According to Law Number 12 the administration of the government's insurance monopoly would be the responsibility of an autonomous institution (the INS) that will be governed by a Board of Directors appointed by the President. With respect to supervision, the only statement in the law is that National Accounting (Contabilidad Nacional) and the Office of Control (Oficina de Control) will examine the accounts and the condition of the INS annually and will submit a written report that will be published in the Annual Report of the Ministry of Finance (Memoria de Hacienda).

This independence from the Central Government was reaffirmed in the Constitution of 1949, which initially established overall independence, but was modified in 1968 to establish that autonomous government institutions enjoy only administrative independence. In any case, it is clearly stated that the Board of Directors of each autonomous institution is responsible for the management of that institution.

Since then, there have been various examples of government interference in affairs of the autonomous institutions, including the INS, through the indiscriminate application of certain laws to

these institutions. In this respect, it is important to mention the following laws:

- the General Public Administration Law (Ley General de la Administración Pública), Law Number 6227 of May 2, 1978, which establishes that it is the relevant minister's job, in conjunction with the President, to direct and coordinate the administration of all the institutions in his area, autonomous as well as centralized;

- the National Planning Law (Ley de Planificación Nacional), Law Number 5525 of May 2, 1974, which integrates all public sector institutions into a national planning system;

- the Law for the Financial Equilibrium of the Public Sector (Ley para el Equilibrio Financiero del Sector Público), Law Number 6955 of February 24, 1984, which imposes on the INS significant extraordinary contributions to the Central Government; and

- the Law of Creation of the Budget Authority (Ley de Creación de la Autoridad Presupuestaria), Law Number 6821 of October 14, 1982, which creates a special agency to formulate, among other things, guidelines for the budget policy of the public sector, including aspects related to investment, indebtedness and salaries. Among the approved policies has been a restriction of the increase in ordinary expenditures for the INS to 8 percent of the last period's normal expenditures and a requirement for prior approval by the budget agency of the use of any surplus or for any investment in fixed assets. It is also important to highlight that, with respect to salaries in the case of the INS, the special arbitration court has ruled in favor of workers -- with major financial repercussions.

These laws have significant implications in that, for the INS to be able to compete against private insurance companies, it would be necessary to remove many of these restrictions over the INS and give it the same independence as the private sector.

Regarding supervision, the internal audit function is handled by an internal auditor, while the function of external audit lies with the Contraloría General de la República. However, it must be emphasized that the INS is not subject to any external actuarial, financial or technical supervision whatsoever, not even in such important matters as rate making, marketing practices and product characteristics.

Legal Constraints on Investments

Law Number 12 establishes that, in order to guarantee the fulfillment of its insurance obligations, the INS will establish the necessary technical reserves which must be invested under the best conditions with respect to return and liquidity, taking in consideration the nature of its insurance obligations. In addition to this basic regulatory guideline, the law also establishes that guarantees for the INS on mortgage loans must be first mortgages. The basic law clearly does not limit in a detrimental way the actions of the INS Board of Directors with respect to investments. The restrictions that can cause significant difficulties come from other laws or outside sources.

The INS Board, through Agreement 7016-VII of November 12, 1984, has established a written policy with respect to investment that can be summarized as follows:

General Investment Policies

- Investments in financial assets should be adequately diversified. In addition, primary factors should be rate of return, liquidity, risk, administrative cost and taxes on the investment. Secondary factors should be the "social returns" and macroeconomic considerations.

- No investment should be made in "speculative" assets.

- Investments should be made in accordance with the nature of the resources funding them.

- Investments over a certain amount in fixed assets such as buildings, land and equipment require specific studies.

Specific Investment Policies

- Technical reserves for Unearned Premiums, Pending Risks and Expired Policies, Dividends to Insured, and Contingencies and Earthquake must be invested in short term securities of high liquidity and return.

- Mathematical reserves of Life, Accident and Health, and Work Related Risks should be invested in long term securities. Life reserves should be invested in loans to policyholders and in mortgage loans. Accidents and Health reserves should be invested in mortgage loans. Work-related Risk reserves should be used to finance the requirements of that system and for mortgage loans.

- The Capital of the INS should be invested in fixed assets needed for its operations.

- Amortizations received from investments in policy loans and mortgage loans should be reinvested in that portfolio.

- Amortizations received from short term investments should be reinvested in similar instruments, taking in consideration the liquidity requirements of the INS.

- The INS will attempt to finance all its short and long term requirements with its own resources.

Overall, from a technical perspective, the preceding guidelines seem reasonable and appear to follow principles of sound financial management, which dictate that assets be accumulated consistent with the characteristics of the liabilities that the institution has assumed. However, important restrictions interfere with the basic investment objectives set up by the law creating the INS. Such interference has been due primarily to external influences not controlled by the INS Board of Directors. Some affect investment capabilities indirectly by limiting the resources available for investment (i.e., allocating INS funds to other purposes), while others do so directly by imposing certain types of investment options and other restrictions. It is important, in particular, to point out the over-riding restrictions from the following sources:

- the instructions given by the Budget Authority (Autoridad Presupuestaria): specifically, it is important to highlight the instructions issued by this authority to all public sector entities (except banking institutions and the court system) establishing that new acquisitions of term financial assets denominated in local currency or renewals of this type of instrument must be in instruments of the Central Government, or instruments of the Central Bank if the financing requirements of the Central Government have been satisfied;

- the guidelines issued by the Contraloría General de la República allowing the INS to invest only in securities issued by public institutions;

- the special contributions that the INS is forced to make to the Central Government, especially the contributions required by the Law for the Financial Equilibrium of the Public Sector and complementary laws, that otherwise could have increased the amounts available for investment by the INS;

- the legal restrictions on the ability of the INS to act as a financial intermediary, especially the Law for the Financial Equilibrium of the Public Sector and the Law of Financial System Modernization and Reform, that impose the legal requirement that all securities transactions be carried out through the stock exchange seat of CODESA or through the government owned banks, whatever their intermediation costs;

- the multiple objectives assigned to mortgage loans, such as the objective of satisfying the housing needs of the middle class insured, that have resulted in more favorable financial conditions than those offered by the market (e.g., lower interest rates and longer terms) at the expense of raising the costs of insurance; and

- the legal impediments to strengthening the INS's Accumulated Reserves or Capital through annual surpluses, such as Article 2 of the Law of the Universalization of Integral Crop Insurance that determines the way in which annual profits are to be distributed: 75 percent applied to increasing the Contingency Reserve of the Crop Insurance Fund and only 25 percent to increasing INS Capital.

Investment Potential and the INS's Role as a Financial Intermediary

In general, insurance companies are more than just risk bearing institutions. They are major financial institutions investing large sums of money. The magnitude and nature of these investment activities have established their roles as significant factors in capital markets.

Under single premium or level premium plans for life insurance protection, the insurer, in effect, retains portions of the premiums paid during the early years of the policy and accumulates them, together with the earnings on them, toward the payment of benefits in later years. As the rate of return on invested assets increases, other things being equal, the company can lower the premiums it charges for new or existing policies or increase the benefits or both. In a competitive market, since premium rates and net benefits are important considerations in choosing a company or a product, the investment function is a significant factor in a company's competitive position. In a monopoly situation however, such as Costa Rica's insurance market, it is debatable whether lowering premium rates and increasing net benefits for a particular type of insurance constitute important goals for the system. For the INS, it is probably a more important objective to be able to offer loans to policyholders at interest rates below market than to lower premium rates. In any case, accumulated funds for life insurance reserves allow the INS to carry out substantial long term investment, in the form of mortgage loans or possibly other instruments.

In other types of insurance, it is common that the premiums are paid annually at the beginning of the insurance period. This originates important sums that can be deposited or invested by the insurance company. These funds can also be held as cash to be paid out as required under policy contracts. However, because the interest that can be earned on these funds can significantly reduce the amount of premiums that policyholders will have to pay (or, if

the company chooses, it can increase the amount of its profits), these funds are largely invested to yield a return. Traditionally, such investment income has not been explicitly considered by the INS in setting the premiums for any of its insurance lines (except for life and work-related insurance). The INS argument for this position is that the funds invested, including funds derived from unearned premiums and loss reserves, belong to the insurance company and not to the policyholders. Consequently, it is argued that the investment income also belongs to the insurance company, so that it can be used at the discretion of the INS and not necessarily for the direct benefit of policyholders, such as reducing premiums.

Assets, Reserves and Investment Practices

Asset Accumulation and Composition

The accumulation of assets by the INS has been very significant and has made this institution an important player in financial markets. As of the end of 1991, the assets reported by the INS totalled 26,721 million colones. This figure represents about 27 percent of the total assets reported by the CCSS, about 58 percent of the assets reported by the IVM program and about 49 percent of the assets reported by the Banco Anglo Costarricense (many of which are of questionable value).

During the past eleven years, the assets of the INS have increased in absolute terms about 12.7 times, from 2,109 million colones in 1981 to 26,721 million colones in 1991. Meanwhile, the consumer price index increased about 7.7 times, which means that the INS has experienced significant real growth in its assets. Specifically, by 1991 INS assets had increased in real terms by 64 percent with respect to assets in 1981. (See Table X-1.)

Table X-1

Instituto Nacional de Seguros: Asset Accumulation
(thousands of colones)

	Current Colones		Deflated Colones		
Year	Colones	Index	CPI	Colones	Index
1981	2,109,430	1.00	261.29	8,073	1.00
1982	2,800,854	1.33	474.90	5,898	0.73
1983	3,783,172	1.79	525.72	7,196	0.89
1984	4,838,384	2.29	616.93	7,843	0.97
1985	5,770,684	2.74	684.33	8,433	1.04
1986	6,848,683	3.25	789.89	8,670	1.07
1987	9,223,745	4.37	919.65	10,030	1.24
1988	12,186,546	5.78	1,152.65	10,573	1.31
1989	15,484,316	7.34	1,267.39	12,217	1.51
1990	21,330,168	10.10	1,612.81	13,225	1.64
1991	26,721,655	12.67	2,021.11	13,221	1.64

CPI = 100.00 in December 1975.
Source: Financial Statements, INS.

Examining asset composition over the period 1981-1991, it should be noted that the percentage allocated to financial investments has stayed consistently between 55 and 70 percent of total assets. This alone suggests the major financial role that the INS plays as an intermediary, reporting at the end of 1991 a total of 14,600 millions colones in financial instruments. (See Table X-2.)

Table X-2

Instituto Nacional de Seguros: Asset Composition
(thousands of colones and percent of total assets)

Year	Financial Investments	Property and Equipment	Other	Total
1981	1,491,298	66,436	551,696	2,109,430
	70.70	3.15	26.15	100.0
1982	1,572,969	407,254	820,631	2,800,854
	56.16	14.54	29.29	100.0
1983	2,348,633	419,293	1,015,246	3,783,172
	62.08	11.08	26.84	100.0
1984	3,059,030	404,911	1,374,443	4,838,384
	63.22	8.37	28.41	100.0
1985	3,722,792	450,821	1,597,071	5,770,684
	64.51	7.81	27.68	100.0
1986	4,242,696	670,172	1,935,815	6,848,683
	61.95	9.79	28.26	100.0
1987	5,344,087	705,493	3,174,165	9,223,745
	57.94	7.65	34.41	100.0
1988	7,381,798	716,407	4,088,341	12,186,546
	60.57	5.88	33.55	100.0
1989	9,785,607	863,952	4,834,757	15,484,316
	63.20	5.88	31.22	100.0
1990	12,914,417	1,024,834	7,390,917	21,330,168
	60.55	4.80	34.65	100.0
1991	14,600,006	1,303,152	10,818,499	26,721,657
	54.64	4.88	40.49	100.0

Source: Financial Statements, INS.

On the following pages, INS balance sheets for the years 1990 and 1991 are presented. (See Tables X-3 and X-4.)

Table X-3

INS Balance Sheet
December 31, 1990
(thousands of colones and percents)

Assets		
Cash and Bank Deposits	85,761	0.40
Financial Investments	12,914,417	60.55
Short term Investments	3,982,521	18.67
Long term Investments	92,934	0.44
Mortgage Loans	8,838,962	41.44
Property and Equipment	1,024,834	4.80
Equipment (Net)	297,018	1.39
Buildings (Net)	679,961	3.19
Land	47,855	0.22
Other Assets	7,305,156	34.65
Premiums To Be Received	2,847,106	13.35
Other	4,458,050	20.90
Total Assets	21,330,168	100.00
Liabilities, Reserves and Surplus		
Technical Reserves	14,227,931	66.79
Mathematical Reserves	5,268,476	24.70
Unearned Premiums	3,376,163	15.82
Pending Claims & Expired Policies	3,056,529	14.33
Contingency	742,217	3.48
Crop Contingency	444,517	2.08
Dividends to Insured	71,756	0.34
Earthquakes	677,853	3.17
Pending Claims on Reinsurance	590,420	2.77
Other Liabilities	6,662,497	31.24
Accounts Payable	6,662,497	31.24
Capital	439,740	2.07
Capital	240,089	1.13
Surplus from Asset Revaluation	199,651	0.94
Total Liab., Reserves and Surplus	21,330,168	100.00

Source: Financial Statements, INS.

Table X-4

INS Balance Sheet
December 31, 1991
(thousands of colones and percents)

Assets		
Cash and Bank Deposits	82,334	0.31
Financial Investments	14,600,006	54.63
Short term Investments	3,962,484	14.83
Long term Investments	84,959	0.32
Mortgage Loans	10,550,311	39.48
Other	2,252	0.00
Property and Equipment	1,285,838	4.82
Equipment (Net)	552,017	2.07
Buildings (Net)	685,961	2.57
Land	47,860	0.18
Other Assets	10,753,478	40.24
Premiums To Be Received	3,527,531	13.20
Other	7,225,947	27.04
Total Assets	26,721,655	100.00
Liabilities, Reserves and Surplus		
Technical Reserves	18,412,255	68,90
Mathematical Reserves	6,064,031	22.69
Unearned Premiums	4,321,783	16.17
Pending Claims & Expired Policies	4,470,780	16.73
Contingency	1,004,809	3.76
Crop Contingency	528,843	1.98
Dividends to Insured	63,297	0.24
Earthquakes	1,091,998	4.09
Pending Claims on Reinsurance	607,814	2.27
Contingency on Reinsurance	258,899	0.97
Other liabilities	7,637,243	28.58
Other liabilities	7,637,243	28.58
Capital	672,157	2.52
Capital	240,089	0.90
Surplus from Asset Revaluation	199,651	0.74
Current Income (Net)	232,417	0.87
Total Liab., Reserves and Surplus	26,721,655	100.00

Source: Financial Statements, INS.

From these it can be seen that the three main asset categories of the INS are:

- Mortgage Loans (about 40 percent of total assets);
- Short Term Investments (between 15 and 19 percent of total assets); and
- Premiums to be received (about 13 percent of total assets).

Reserves

Although the technical reserves of an insurance institution are often referred to as funds, they are simply bookkeeping entries that are actuarially determined to measure the liability of the institution under policy contracts outstanding. Thus, the reserve is a liability, and it is necessary for the institution to hold assets to offset that liability in order to remain solvent.

From the INS balance sheets presented as Tables 3 and 4 it is clear that the three most important types of technical reserves for the INS are, in terms of amounts accumulated:

- Mathematical Reserves (24 percent of total assets);
- Unearned Premiums (about 16 percent of total assets); and
- Pending Claims (between 14 and 17 percent of total assets);

INS reserves, as reported on the respective balance sheets, reached 14,228 million colones in December 1990 and 18,412 million colones in December 1991. These figures represent between 66 and 69 percent of total assets for these years. This means specifically that, for 1991, of the 26,700 million colones reported by the INS in total assets at the end of the year, 18,412 million colones (68.9 percent) are required as backing against policy reserve liabilities. In other words, over two thirds of the total assets held by the INS represent assets held to support reserve liabilities. Furthermore, it should be noted that in the early 1980s this ratio was even higher: reserves then represented about four fifths of total assets. (See Table X-5.)

It should also be noted that, since 1983, financial investments have represent between 73 and 90 percent of reserve liabilities. This percentage should, in fact, probably be closer to 100 percent.

Table X-5

INS: Comparison of Reserves, Assets and Financial Investments
(millions of colones and percents)

Year	Reserves	Assets	Financial Investments	Reserves / Assets	Fin. Inv. / Reserves
1981	1,737	2,109	1,491	82.36	85.84
1982	2,271	2,801	1,573	81.08	56.16
1983	3,180	3,783	2,349	84.06	73.87
1984	3,798	4,838	3,059	78.50	80.54
1985	4,804	5,771	3,723	83.24	77.50
1986	5,534	6,849	4,243	80.80	76.67
1987	6,813	9,224	5,344	73.86	78.44
1988	8,768	12,187	7,382	71.95	84.19
1989	11,298	15,484	9,786	72.97	86.62
1990	14,228	21,330	12,914	66.70	90.76
1991	18,412	26,722	14,600	68.90	79.30

Source: Financial Statements, INS.

Investment Practices

At first sight, the growth over the last eleven years of INS financial investments in absolute terms seems to be considerable: from 1,491 million colones in 1981 to 14,600 million colones in 1991 (9.8 times). Considering that the CPI grew only 7.7 times over this same period, it can be seen that financial investments grew in real terms.

In general, the financial investments made by the INS can be classified in two broad portfolio groups:

- the Investment Portfolio, consisting of investments, both short and long term, in securities; and
- the Mortgage Portfolio, consisting of loans to policyholders and other mortgage loans.

Of these two categories, the mortgage portfolio has been dominant, representing over the last seven years more than 66 percent of INS financial investments. Furthermore, it should be pointed out that the relative importance of mortgage loans has had a tendency to increase over time. During the first four years of the 1980s the INS mortgage portfolio oscillated between 49 and 65 percent of total financial investments, while in recent years (since 1986) mortgage loans have oscillated between 68 and 80 percent of financial investments. (See Table X-6.)

Table X-6

INS: Financial Investments by Category
(millions of colones and percent of total financial investments)

Year	Investment Portfolio		Mortgage Portfolio		Total Financial Investments
1981	525	35.21	966	64.79	1,491
1982	562	35.73	1,011	64.27	1,573
1983	1,195	50.87	1,154	49.13	2,349
1984	1,452	47.47	1,607	52.53	3,059
1985	1,231	33.06	2,492	66.94	3,723
1986	913	21.52	3,367	79.35	4,243
1987	1,086	20.32	4,258	79.68	5,344
1988	1,749	23.69	5,633	76.31	7,382
1989	2,709	27.68	7,077	72.32	9,786
1990	4,075	31.55	8,839	68.45	12,914
1991	4,050	27.74	10,550	72.26	14,600

Source: Financial Statements, INS.

The performance of these two broad categories of financial investments has yielded very different results. A general description of the structure and rates of return obtained by each portfolio is presented in the two following sections.

The Investment Portfolio (Investments in Securities)

This category includes investment in both short and long term securities, using either the INS's own resources or other resources given to the INS to be administered by it. Looking at the structure and the rates of return for different types of investments in this overall category as of December 1991, several points should be highlighted:

- even though the majority of the assets are the INS's own resources, the resources given to the INS to be administered provided a significant 30 percent of all financial investments;

- the main investments in this category are short term certificate of deposit in dollars (31.34 percent), short term public sector bonds and monetary stabilization bonds (55.35 percent) that include both own and administered resources, and short term certificates of deposits in colones (10.42 percent).

- an overwhelming majority of all investments (97.12 percent) are short term; and

- the short term assets obtained with the INS's own resources had a positive real rate of return, while the short term assets obtained with the INS's administered resources, as well as the long term investments, experienced negative real rates of return. (See Table X-7.)

Table X-7

Structure and Performance of INS Investment Portfolio
December 31, 1991
(millions colones and percents)

Investment Type	Amount	Percent of Total Investment	Average Rate of Return
INS Resources			
Short Term			
Certfs. of Deps. col.	505.0	10.42	27.48
Certfs. of Deps. US$	1,518.3	31.34	37.80
Govt. Bonds	1,318.8	27.22	37.70
Total Short Term	3,342.1	68.99	36.20
Long Term			
Govt. Bonds	35.0	0.72	8.00
Total INS Resources	**3,377.1**	**69.71**	**35.91**
Administered Resources			
Short Term			
Govt. Bonds	1,363.1	28.13	23.47
Long Term			
Govt. Bonds	104.0	2.15	18.00
Total Admin. Resources	**1,467.1**	**30.29**	**23.08**
Total Investments	**4,844.2**	**100.00**	**32.02**

Source: Registro Auxiliar de Inversiones, Departamento de Tesorería, INS.

In tables X-8 and X-9 on the following pages, the structure and rates of return of the INS investment portfolio are presented for each year over the period 1983 through 1991.

Table X-8

Structure of INS Investment Portfolio -- 1983-1991
(percents of total investment portfolio)

Investment Type	1983	1984	1985	1986	1987
INS Resources	97.1	99.9	80.5	87.3	93.4
Short Term	97.1	99.9	78.2	82.6	79.1
Cert. Dep. Col.	75.2	74.1	16.6	28.4	30.2
Cert. Dep. US$	0.8	1.8	2.6	3.5	5.4
Collateral Notes	0.0	10.6	9.6	0.0	13.3
Govt. Bonds	21.1	13.3	49.3	50.6	30.3
Long Term	0.0	0.0	2.3	4.8	14.3
LACSA Bonds	0.0	0.0	1.3	0.0	1.3
Other Bonds	0.0	0.0	1.0	4.8	13.0
Admin. Resources	2.9	0.1	19.5	12.7	6.6
Short T. Govt. Bonds	2.9	0.1	9.7	0.0	0.1
Long T. Govt. Bonds	0.0	0.0	9.8	12.7	6.5

Investment Type	1988	1989	1990(*)	1991(*)
INS Resources	93.0	85.5	77.4	69.7
Short Term	87.8	84.0	76.5	69.0
Cert. of Dep. Col.	22.6	25.4	18.6	10.4
Cert. of Dep. US$	5.6	3.7	4.0	31.3
Collateral Notes	9.7	6.9	0.0	0.0
Govt. Bonds	50.0	48.1	53.8	27.2
Long Term	5.2	1.5	1.0	0.7
LACSA Bonds	0.0	0.0	0.0	0.0
Other Bonds	5.2	1.5	1.0	0.7
Administered Resources	7.0	14.5	22.6	30.3
Short Term Govt. Bonds	3.7	11.2	20.1	28.1
Long Term Govt. Bonds	3.3	3.3	2.5	2.2

Source: Table 29, Anexo Estadístico, Evaluación del Instituto Nacional de Seguros, 1983-1989.
(*) Estimated from Registro Auxiliar de Inversiones.

Table X-9
Rates of Return on INS Investment Portfolio -- 1983-1991
(percents)

Investment Type	1983	1984	1985	1986	1987
INS Resources	21.9	19.3	20.2	21.4	18.5
Short Term	21.9	19.3	20.6	21.9	19.2
Cert. of Dep. Col.	22.1	20.1	21.4	32.4	20.0
Cert. of Dep. US$	9.8	13.4	21.3	8.2	8.6
Collateral Notes	n.c.	18.1	20.0	n.c.	20.3
Govt. Bonds	21.8	18.4	21.5	17.5	21.4
Long Term	n.c.	n.c.	17.2	12.6	13.7
LACSA Bonds	n.c.	n.c.	19.0	n.a.	20.0
Other Bonds	n.c.	n.c.	17.2	12.6	13.7
Admin. Resources					
Short T. Gvt. Bonds	n.a.	18.0	20.0	0.0	19.6
Long T. Gvt. Bonds	n.c.	n.c.	12.3	12.6	17.2
Rate of Inflation	10.7	17.4	10.9	15.4	16.4
Real Ret. INS Res.	11.2	2.0	9.3	6.0	2.1

Investment Type	1988	1989	1990	1991
INS Resources	18.7	20.6	29.6	35.9
Short Term	19.1	20.8	29.9	36.2
Cert. of Dep. Col.	20.1	21.0	27.3	27.5
Cert. of Dep. US$	9.4	9.2	33.0	37.8
Collateral Notes	21.5	21.9	n.a.	n.a.
Govt. Bonds	20.3	22.2	30.6	37.7
Long Term	12.5	8.0	8.0	8.0
LACSA Bonds	----	----	----	----
Other Bonds	12.5	8.0	8.0	8.0
Administered Resources				
Short Term Govt. Bonds	21.4	19.8	21.9	23.5
Long Term Govt. Bonds	17.1	18.0	18.0	18.0
Rate of Inflation	25.3	10.0	27.3	25.3
Real Rate of Return INS Res.	-6.6	10.7	2.4	10.6

Notes: n.c. = not comparable. n.a. = not available.
Source: Treasury

With respect to the structure of the investment portfolio, the following should be highlighted:

- the relative importance of investments derived from the INS' own resources and administered resources has varied significantly, as less than 3 percent of the investments were obtained from administered resources in 1983, while in 1991 30.3 percent of investments were obtained from that source; and

- the importance of certificates of deposits in colones relative to those in dollars has changed markedly, as certificates of deposits in dollars represented less than 1 percent of the investment portfolio in 1983, while in 1991 they represented 31.3 percent of that portfolio. (See Table X-8.)[56]

With respect to the rates of return experienced, it is important to note that for every year except 1988 the investment portfolio has yielded positive real rates of return. (See Table X-9.)

The Mortgage Portfolio (Mortgage Loans)

Mortgage loans are usually granted for housing purposes, for terms that vary between ten and twenty years, and at interest rates 10 or more percentage points below those established by the government owned banks.[57] The reason given for investing under such unfavorable conditions has usually been social desirability. This is done in clear contradiction of Article 21 of the Basic Law of the INS which states that technical reserves should be invested under the best conditions of profitability and liquidity. As might be expected, investments in mortgage loans have been vulnerable to increases in the rate of inflation, thereby often yielding negative real rates of return. (See Table X-10.)

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[56]It should be noted that all INS deposits are in government owned banks.

[57]Individuals with INS life insurance policies are eligible for housing loans.

Table X-10

Rates of Return on the INS Mortgage Portfolio -- 1984-1989
(thousands of colones and percents)

Year	Portfolio on June 30	Gross Rate of Return	Net Rate of Return	Rate of Inflation	Real Rate of Return
1984	1,040,840	10.91	8.56	17.35	-8.79
1985	1,638,017	12.60	9.84	10.93	-1.09
1986	2,614,962	13.84	11.53	15.43	-3.90
1987	3,318,968	14.93	12.66	16.43	-3.77
1988	4,381,086	14.41	12.17	25.34	-13.17
1989	5,487,959	14.55	12.70	9.95	+2.75

Net rate of return deducts administrative costs of investment.

Source: Departamento de Créditos, INS.

Financial Soundness of the INS

Notwithstanding the assets, capital and reserves of the INS, it is not possible to reach any clear conclusions about its financial soundness based on the information that has been made available by the INS. In any case, the following points should be noted:

- The amount of assets accumulated by the INS does not insure its solvency. The quality of these assets must be reviewed as well as the extent to which these assets are in excess of liabilities, including a realistic estimate of the reserves necessary for complying with the terms of policy contracts. The INS appears to have adequate assets to cover its liabilities (i.e., in 1991 reserves were about 69 percent of assets). However, to take a position on this point, it would be necessary to have adequate actuarial studies to determine the prudent level of reserves for each of the insurance lines, but at the present time there is not even any actuarial regulation or supervision of the INS.

- For the five years since 1987, the INS as a whole has produced annual operating surpluses, but it should be noted that in each of these years the re-insurance component has run a deficit. Moreover, there is evidence of cross-subsidies among the different insurance lines. For example, in 1990 and 1991 the lines of personal insurance had operating surpluses, while the lines of fire and earthquake and voluntary automobile insurance had significant deficits. Because of the monopoly position of the INS, and consequently the lack of market discipline where clients can change to another insurance company, certain insured groups can be forced to subsidize other insured groups within broad limits.

Conclusions and Recommendations

Conclusions

- The INS was created with the primary objectives of creating a permanent government monopoly and establishing a significant source of income for the government. These two objectives, which have been the main criteria under which the INS has operated, clearly represented the wishes of the legislature at the time the INS was created in the 1920s.

- The government's insurance monopoly was implemented in a gradual manner according to the type of insurance: life insurance, fire insurance and work related insurance were all implemented in the 1920s; fidelity insurance in the 1930s; automobile insurance in the 1940s; and integral crop insurance, obligatory automobile insurance and reinsurance in the 1970s.

- The INS is an autonomous institution governed by a Board of Directors named by the President. It enjoys administrative independence but is subject to various external laws and decrees. In fact, there are numerous laws (e.g., the General Public Administration Law, the National Planning Law, the Law for the Financial Equilibrium of the Public Sector, and the Law for Creation of the Budget Authority) that have important implications for the operations of the INS.

- The INS is not subject to actuarial or technical supervision -- not even in such crucial matters as rate making, reserve valuation and marketing practices.

- The Basic Law creating the INS does not put any detrimental restrictions on the actions of the Board of Directors with respect to investments. However, important restrictions have been added, mostly by external sources not controlled by the Board, and these have affected investment performance, either indirectly by limiting the resources available for investment or directly by imposing certain types of investment options.

- The INS does not generally consider investment income in its rate making. This is true for all lines of insurance offered, except life and work related insurance. Investment income could have been used to lower the premiums that policyholders pay.

- The amount of assets accumulated by the INS is significant and, as of the end of 1991, represented about 50 percent of the assets of the Banco Anglo Costarricense and about 58 percent of the total assets of the IVM pension system administered by the CCSS.

- As of December 1991, about 55 percent of INS assets (i.e., 14,600 million colones) were financial investments.

- Financial Investments can be categorized in two groups:

  - Investments in securities (about 28 percent of financial investments); and

  - Investments in mortgage loans (about 72 percent of financial investments).

- The performance of these two broad categories of financial investments has been very different. Investments in securities have been quite satisfactory, providing positive real rates of return throughout the period 1983-1991 except in 1988. On the other hand, investments in mortgage loans have consistently yielded negative real rates of return throughout the years from 1983 to 1988.

Recommendations

It is evident that circumstances, as well as political views of the government's role in insurance, have changed significantly since the creation of the government's insurance monopoly. For this reason, the main recommendation to improve the provision of insurance in Costa Rica, and especially the role of insurance in financial markets, is to press for a series of in-depth technical studies to analyze the conditions under which a more competitive insurance market might be beneficial to the country, including its role in financial intermediation.

These studies should analyze and make formal proposals in each of the following areas:

- creation and implementation of adequate technical supervision;

- deregulation of the INS to allow it to compete with private companies;

- new regulations needed in a competitive market, including consideration of:

  - organization and licensing of insurance and reinsurance companies;

  - types of operations and insurance lines that will be permitted;

  - rate making regulations;

  - product authorization, including requirements to introduce new products;

- marketing practices, including the authorization of insurance agents and the regulation of publicity;
- solvency of insurance companies, including standards for reserve and liability valuation, standards for asset valuation, investment regulations, and regulation of expenses, capital and accumulated surplus; and
- special legislation for fidelity insurance, collective insurance and obligatory insurance.

Chapter XI

Conclusions and Recommendations

There is no question of the importance that the modernization of the financial system can have within a process of structural adjustment geared toward promoting economic growth and a more active participation in world markets. It is also desirable that such modernization keep pace with policy reforms and liberalization in other sectors of the economy.

The Costa Rican financial system has undergone numerous key reforms during the past ten years, and especially since 1984, with probably the most important being the general recognition that the efficiency of financial intermediaries matters. Most changes have benefitted the banking system, which has traditionally been the most visible and important part of the financial system, while less improvement can be found in other segments, that is, in non-bank financial intermediation.

The most significant reforms for the banking system have been related to the reduction in the Central Bank's historically excessive regulation of commercial banks, both government-owned and private, as well as improvements in the supervision of private banks. Interest rates were freed from Central Bank regulation in order to respond to market forces. Monetary policy also shifted from instruments acting through the asset side of bank balance sheet to the more traditional and typical ones that work on the liabilities side. An important example is the elimination of credit ceilings determined by the Central Bank -- an instrument that was used widely in Costa Rica until the 1980s.

Measures to improve competition in the banking system have also been implemented during the past ten years. Simplification of procedures related to Central Bank regulations, access by private banks to more diverse sources of funds (including not only deposit-like instruments but also credit from the Central Bank itself) and improvements in information available to the public are among the areas that have been addressed. At the same time, supervision has been improved, especially for private banks, through legal reforms and administrative measures to protect depositors and reduce the risk of bank failures.

Although modernization of the Costa Rican financial system is clearly underway, there is still ample room for further improvements in the process. This is true not only for the system as a whole but even for the banking system where certain reforms are still badly needed. At least four key areas should be emphasized as the focus for continuing financial sector reform in the near future:

- improvements in prudential regulation and supervision of financial intermediaries;
- improvements in the functioning of government-owned financial institutions;
- reduction of fragmentation in the financial sector; and
- increased competition among various entities in the financial system, both domestic and foreign.

Supervision

The process that began in the mid-1980s to modernize the supervision of financial intermediaries is still at a critical stage due a variety of problems that continue to affect the performance of the Auditoria General de Entidades Financieras (AGEF) that must still be strengthened in several respects. The danger of reversion in the process of supervision of government-owned and private banks, as well as financieras, must be guarded against. The replacement of obsolete supervision techniques that stressed traditional auditing procedures by modern concepts that include loan and asset assessment, financial analysis, insider lending, etc., is an urgent reform that is still incomplete.

The range of the supervision of financial intermediaries is another area of ongoing concern. The possible extension of AGEF responsibilities to BANHVI and the mutuales, as well as to credit unions, should be studied, and the supervision of these entities should be assigned to some institution or other, with the decision implemented by an appropriate legal reform. Possible overlapping between the AGEF and the Comision Nacional de Valores in the regulation of securities issues and exchanges must also be avoided. Moreover, to the extent that financial liberalization is extended to other areas such as pension and insurance systems, prudential regulation and supervision by the AGEF, the Comision Nacional de Valores or some other specialized entity is crucial to take advantage of the stimulus that such changes could give to the development of capital markets in Costa Rica.

Government-owned Financial Institutions

Reduction in the non-competitive aspects of the banking system is a highly important issue. So long as no political decision is made to eliminate the monopoly of government-owned banks on demand deposits, improvements in the functioning of those banks is essential. Moreover, although interest rates have been freed from Central Bank regulation, problems of dispersion around a market rate and excessive spreads between rates on loans and deposits remain.

The crucial importance not only of banks but also of other government-owned financial intermediaries -- BANHVI, the Banco Popular, the Instituto Nacional de Seguros, the various pension systems, etc. -- tends to be an obstacle to the development of the Costa Rica financial system, especially as far as their resource mobilization is strongly oriented toward financing fiscal deficits, so that funds are not necessarily allocated in accordance with private sector development needs.

Integration of the Financial System

The integration of a highly fragmented financial system is also an important area to be addressed in the near future. Regulation and supervision for macroeconomic and prudential purposes cover only a part of the system, thereby leading to other elements of the system that do not have to compete on the same basis, such as the very short-term instruments offered through the securities exchange and the credit union system. Measures to reduce segmentation in the Costa Rican financial system are also required in connection with the dual system represented by domestic and off-shore operations.

The lack of an effective capital market to provide longer term financing in Costa Rica and the need to make decisive improvements in this area are issues that are widely recognized. The integration of insurance and pension funds with the financial system instead of limiting their scope to investment in government debt instruments constitutes a very important objective for the near future. It is also important to introduce appropriate supervision of private pension systems in order to foster their operations and thereby not only to reduce the destabilizing burden on the government-operated regimes but also to increase long term savings.

It should be noted that analyses of the Costa Rican financial system have usually lacked of a comprehensive treatment that would disclose the importance of several kind of financial institutions other than banks. This point is emphasized in this report because of the importance of these institutions in the financial sector, as well as their potential role in promoting a long term capital market in Costa Rica.

Increasing Competition in the Financial System

Ways to increase competition in the financial system also deserve special consideration. Competition with foreign financial intermediaries is related to the decision to set up business directly in domestic markets or to operate from abroad. In either case, legal aspects have to be addressed to facilitate contracts in foreign currencies, and this is currently under discussion in the Costa Rican Congress as part of the reform of the Currency Law, along with other legal limitations on operations of international banks. On the other hand, domestic competition also requires

further analysis on certain key issues such as the equal treatment of different intermediaries in terms of regulations, as well as the problem of fragmentation of the market, including the existence of an informal financial market noted above.

Liberalization of regulations with respect to the entry of new participants in the market is another important issue. Increased flexibility to enter the market, by eliminating or reducing barriers to entry, is a prerequisite to reducing whatever oligopolistic elements may still exist in the system. Opening competition instead of privatization could also be a viable solution for the insurance market. Moreover, as noted above, reform of legislation on pension systems is needed to foster the operation of private pension funds with appropriate regulation and supervision.

Specific Recommendations

The remainder of this chapter consists of specific recommendations for high-priority measures to be undertaken for continuing financial reform and liberalization in Costa Rica. Also included are suggestions for further study and the main conclusions on which these recommendations and suggestions are based.

Macroeconomic Issues and Financial Intermediation

During the past ten years, continuing efforts have been made by the Costa Rican Government to deal with the fundamental macroeconomic imbalances that constitute a serious obstacle to economic growth.

Short term policies, both fiscal and monetary, have continually been used to reduce the size of the public sector deficit, to seek out less harmful ways to finance it and to compensate, at least partially, for the monetary expansion caused by the Central Bank's deficit. As a result, the combined public sector deficit (which includes the non-financial public sector deficit and the Central Bank's quasi-fiscal deficit) has been kept under relative control, and the Central Government and other governmental agencies have ceased to be financed through monetary expansion.

Structural reforms have also been introduced in the macro-financial environment. Some important sources of rigidity in government expenditures have recently been targeted, while legal reforms already approved by the Costa Rican Congress have reduced the impact of some perverse factors such as the pension regimes and tax exemptions. At the same time, the external public debt renegotiations concluded in 1990 have had a major favorable impact not only on the balance of payments position of the country but also on the Central Bank's deficit.

In the foreign exchange area, as well as in pricing policies, actions have also been taken as part of the slow but continuing process of policy reform geared toward the liberalization of the economy. The policy of exchange rate adjustment through a crawling peg system was recently replaced by a "dirty float" regime, where the rate is determined by the participating financial intermediaries taking into account market forces. Moreover, there is now less reliance on government regulation and determination of prices as compared with ten years ago.

There is nonetheless still room for further improvements in the macro-financial situation and related policies. The volatility in the fiscal deficit not only introduces a destabilizing element each year but also creates unfavorable expectations. More actions are required to reduce the fragility of the fiscal situation through structural reforms in both expenditures and taxes and to reduce the overall size of the public sector that is still so large that it leads to a "crowding-out" effect.

Returning the required flexibility to monetary policy is also crucial, especially since the public sector deficit situation is fragile. A permanent solution to the problem of the Central Bank's losses, by transferring them to the government budget and using sound financing methods for the resulting increase in the deficit, not only enables monetary policy to be carried out properly but also appropriately returns the Central Bank's losses to their source.

Finally, further efforts are required in the area of pricing policies, but mainly with respect to eliminating the legal rigidities for foreign exchange translations. This becomes an increasingly important issue as the process of economic globalization continues and the openness of the Costa Rican economy increases in both the current and capital accounts of the balance of payments.

Banks and Financieras

The Costa Rican banking system has come a long way during the past ten years. This is true for both the government-owned and the private banks.

A large group of small but generally financially sound private banks exist. They have developed a wide range of credit and other services aimed at a commercial ('wholesale') clientele. The controlling ownership groups of most of the private banks have established offshore affiliate banks, which provide an assortment of mostly U.S. dollar based deposit and credit services. Some are looking toward the day when they can establish a banking presence in Miami.

Competition from the private banks has forced the government-owned banks to modernize, become more efficient and, above all, become more responsive to their customers. Unfortunately, it can also be said that they have done too little too late. The private banks have 'skimmed the cream' of the private sector corporate business. It is doubtful that the government-owned banks will ever be able to recover much of the business they have lost.

Although the government-owned banks show various signs of improvement, they are still inefficient and unprofitable institutions, beset by deeply entrenched labor unions and the implicit excess personnel, over-lapping branch systems and, probably worst of all, enormous amounts of bad loans. On a more positive note, the Banco Nacional de Costa Rica has recently established what appears to be a quality credit administration and credit review function. Its allowance for loan losses as a percentage of its loan portfolio is considerable lower than that of the Banco de Costa Rica.

Costa Rican private sector bankers continue to complain about the legal prohibition against their offering checking accounts and the lack of access to the Central Bank rediscount window for liquidity needs. They have been very creative at finding an assortment of ways to make customers' funds effectively available on a demand basis. Also, most of the private banks have off-shore affiliates that can at least offer checking accounts in dollars. However, none of this is particularly efficient with respect to the customers' needs for normal checking accounts.

The rediscount issue has largely been solved by the new rediscount facility partially funded by USAID and recently made available by the Central Bank. This facility should be adequate to protect individual <u>financially sound</u> private sector banks and the private bank system, as a whole, from sporadic liquidity crises. However, it is unlikely that it will be of any value to an insolvent bank, such as most, if not all, of those that have failed in recent years.

The principal recommendations that are indicated by the investigation for this report are the following:

1. Legislation should be passed enabling private sector banks to offer checking accounts. It will only simplify what they are already doing and enable the Costa Rican public to be more efficiently and economically served. It is reasonable to assume, however, that this would have another negative impact on the government-owned banks since they would most likely loose substantial checking account balances from large, corporate and commercial customers.

2. The AGEF needs considerable further strengthening in order to enable it to monitor the banking system adequately, take

preventative measures to avoid or, at least minimize, the impact of bank failures, and to enable it to generate quality financial information for the system as a whole. (For more detail, see the chapter on the supervision of financial institutions.)

3. Legislation or at least Central Bank policy should be developed to force the off-shore banks doing business in Costa Rica, <u>including non-Costa Rican banks</u>, to provide quality financial data on at least a quarterly basis and financial statements independently audited by internationally recognized accounting firms. They should also be required to submit to AGEF examination if they want to do business in Costa Rica. This is the direction of banking law and regulation in the United States and Europe, as evidenced by recent legislation. There is no obvious reason why the Costa Rican public would not be better off if the banks wanting to serve that public were better supervised.

4. Inasmuch as the government-owned banks are inefficient and generally unprofitable, a concerted effort should be made to study alternatives toward the end of privatizing or merging at least three of the four banks, excluding the Banco Nacional de Costa Rica. (Banco Nacional de Costa Rica and Banco de Costa Rica, combined, only earned approximately U.S.$200,000 in 1991, and this figure is highly suspect.) The Banco Nacional is showing some significant signs of progress. It is also the largest commercial bank in Central America and should be able to focus the financial and human resources necessary to make itself into a reasonably efficient and competitive institution. If one government-owned bank can become efficient and competitive and make commercial banking services available throughout Costa Rica, as all four are currently attempting, there is no apparent reason to have four such entities essentially competing with each other at the expense of the Costa Rican public.

Legal and Regulatory Framework

Access to Central Bank Credit and Other Powers of the Central Bank

Legal reforms required:

1. Restrict the Government's access to Central Bank credit exclusively to Treasury Bills (Letras del Tesoro) and reduce the present limit from 1/12 to 1/24 of the National Budget. As part of a system of checks and balances, a system of public information (i.e., quarterly reports from the Central Bank to the Congress) should be created that would include the amount of each transaction in Treasury Bills.

2. Restrain clearly all possibilities for the Central Bank and the government owned banks to finance the Government in indirect ways such as using reserve requirements for this purpose.

3. Eliminate access of CODESA and INFOCOOP to Central Bank credit.

4. Restrict the power of the Central Bank to engage in foreign borrowing, so that it needs the approval of Congress except for borrowing for temporary balance of payments support from organizations such as the International Monetary Fund or other central banks.

5. Make clear that the nature of rediscount facilities from the Central Bank to the government owned banks is solely as a lender of last resort, so that the rediscount rate should always be above market interest rates and never lower than the six-month deposit rate (the basic rate).

6. Extend to private banks, but not to financieras, access to the Central Bank rediscount window, but only at rates higher than the six-month deposit rate. This facility should be subject to qualified voting by the Central Bank's Board (i.e., a two-thirds majority) and would only be used when required to avoid an increasing lack of confidence that could affect the whole financial system.[58]

7. To enforce the legal provisions for the former public sector external debtors to the Central Bank, derived from debt rescheduling and renegotiation, a legal reform should impose penalties not only on the delinquent institutions but also on the Central Bank if it fails to use promptly the mechanisms contained in the law to deal with these overdue obligations.

8. Eliminate the Central Bank's legal power to determine interest rates on loans to small farmers and other groups, and thereby eliminate the need for the Central Bank to have the power to impose commissions on these loans to increase their rates administratively.

9. Initiate a study of the appropriateness of maintaining the general power of the Central Bank to fix interest rates and commissions. Even if such powers remain, the problem of fixing prices and quantities simultaneously should be

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[58]The denial of access to financieras is based on the present limit of no less than six months for their certificates of investment. If this were changed to be equal to the private banks' regime, further study would be needed to analyze the advantages of having both banks and financieras eligible instead of only banks.

addressed, along with the dubious gains from fixing either of them.

10. Limit, by law, the power of the Central Bank to impose detailed credit ceilings in order to avoid the negative effects of possible highly interventionist Central Bank policies in the future.

11. The practice of using reserve requirements as a way to finance the Government has largely been abandoned. Although this practice has no clear basis in Costa Rican legislation, a legal reform to eliminate this possibility could be important for the future since this mechanism has been used in the past.

Central Bank Independence

Legal reforms required:

1. Initiate legal reforms to increase the independence of the Central Bank. Since financing public sector deficits and projects to promote economic development have undermined its main responsibility to maintain a stable value for the currency, it is necessary to reduce as much as possible the influence of electoral considerations in the process of making monetary policy.

2. While it is worthwhile to maintain the position of Executive President and the presence of the Minister of Finance on the Central Bank's Board, legal reforms should be initiated to promote the general interests of Costa Rican public in the process of naming the Executive President and the other five Board members. For that purpose, participation of the Congress and lengthening of the period of appointment for Board members, except the Minister of Finance, are alternatives that could be explored, as proposed by Lizano (1991).[59]

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[59]This topic, as well as the whole section, draws heavily on Lizano (1991). His proposal is based on: (1) maintaining a Board of seven members, including the Executive President and the Minister of Finance; (2) the Executive President would be appointed by a two-thirds majority of the Congress for a period of ten years; (3) similar procedures would established for the other five Board members, who would be replaced one at a time each two years; and (4) conflicts between the Executive Branch of the Government and the Central Bank Board would be settled by the Congress, and if its decision is against the Board, the Board members have to resign. In this way, some political control over the competence of the Board would be maintained.

Issues Related to Banking Policy

Legal reforms required:

1. Provide technical assistance to the Central Bank to improve its system for the analysis and ranking of banks, in order to enhance the protection of investors as long as the Central Bank continues to have the responsibility of authorizing the issuance of certificates of investment by private banks.

2. Analyze in depth the disparities in leverage limits for different financial institutions, as well as the legal measures required for a uniform and widespread protection for all savers, taking into account the differences among the various types of financial intermediaries.

3. Provide informed advise to the Central Bank with respect to problems of credit concentration and credit to related economic groups, taking into account experiences in other countries as well as domestic legislation.

4. Initiate a study of the appropriateness of creating a deposit insurance system, taking into account not only the legal provision included in the Banking Reform Act of 1988 to create such insurance, but also the possible shortcomings of such a system, especially in terms of moral hazard (laxity on the part of both depositors and financial intermediaries in making financial decisions without an adequate assessment of risk).

5. Carry out additional legal studies with respect to the reforms required to make completely effective the Central Bank's power to increase minimum capital requirements for existing private banks within reasonable limits.

6. Clarify Article 298 of the Banking Reform Act of 1988 (Ley 7107, Ley de Modernizacion del Sistema Financiero) to express clearly that the minimum capital requirement for a "banco solidarista" should be 50 percent of that for private commercial banks and not 50 million colones.

7. Eliminate the possibility for government owned banks to grant subsidized credits to any group. Interest rates on loans below the market rate for deposits should not be permitted, or at least should be covered by an equivalent transfer from the national budget to the bank.

8. Initiate further analysis with respect to the reforms required in the Banking System Act to provide government owned banks with effective surveillance mechanisms over their efficiency and financial results. This would include eliminating electoral considerations when appointing members of their boards.

9. Eliminate all legal dispositions that force government owned banks to lend to specific economic sectors, thereby recognizing that creditworthiness and feasible productive projects cannot be created by law.

10. Present a legal reform to eliminate the existing 8 percent tax on interest from colon-denominated deposits, bonds and similar instruments.

Regulations Differentiating Financieras from Banks

Legal reforms required:

1. Initiate an in-depth analysis of the justification for having both banks and financieras and of the differences in regulations and requisites pertaining to each of them. Claims by financieras for a regime similar to that of private banks could lead to the conclusion that they should in fact be converted into banks.

2. Reform Central Bank regulations for financieras wanting to convert to banks by recognizing that they have a record in the market and a history of regulation by the Central Bank and supervision by the AGEF, so that requisites should not be as severe as for the creation of a new bank (but with no reduction in minimum capital requirements).

3. Provide financieras with the same regime as applied to private banks in areas not related to the key elements that makes them different from each other, such as the possibility to participate in the foreign exchange market. This reform is in fact included in a bill under consideration by Congress to modify several aspects of the foreign exchange system.

4. In the case that the conclusion is reached in the study mentioned above, that there should be no differences between banks and financieras, a legal reform should be developed to facilitate the merging of financieras to expedite their conversion into banks.

Foreign Exchange Operations

Legal reforms required:

1. Initiate a legal reform to the Currency Act (Ley de la Moneda) to establish clearly that loans stipulated and disbursed in foreign currencies by private and government owned banks and financieras must be repaid in the same foreign currency.

2. Eliminate the powers of the Central Bank to impose quantitative and qualitative restrictions on foreign transactions, as is proposed in a bill currently under consideration by Congress.

3. In the case that the power of the Central Bank to impose prior deposits on imports and other foreign payments continues in effect, as contemplated in the bill mentioned above, some limits should be included, such a similar treatment for all activities, that would prevent discriminatory percentages being applied by the Central Bank's Board.

4. Since a liberalized foreign exchange market requires removing distortions that affect the determination of the price in that market (i.e., the exchange rate), a legal reform should be initiated to eliminate taxes and other charges that raise the spread between the buying and selling rates (e.g., the charges mandated by law to finance CODESA and the institute for cooperative promotion, INFOCOOP). The law should also prevent similar charges by the Central Bank such as those that were imposed in March 1992 to increase the fund to cover the foreign exchange losses of the government owned banks (Fondo de Perdidas Cambiarias) and to compensate partially for Central Bank losses.

Supervision of Financial Institutions

As a result of various modernization efforts, the AGEF's supervisory capacity improved significantly during the decade of the 1980s. The modernization project initiated in 1988 with financing from the World Bank should be noted in particular.

The process of modernization made sustained advances until the end of 1990 when progress stopped as a result of the Auditor General leaving his position and the failure to name a permanent replacement until September of 1991. With the arrival of the new Auditor General it is hoped that advances will again be achieved, although there are certain doubts concerning the possible orientation, mainly because of the lack of experience of the new Auditor General in the area of supervision and the difficulties of coordination with the Central Bank.

The fundamental recommendation is clearly to proceed with the modernization project. With an adequate reorganization and a good use of its human resources, the AGEF can quickly recover a level, if not of excellence, at least acceptable and with good possibilities for continuing improvement.

Even with this, however, there are needed improvements in the regulation and supervision of the Costa Rican financial system that go much further. Specifically, the following actions are proposed:

1. An overall review of the legal and regulatory framework for the financial sector, emphasizing in particular the deregulation of permitted operations and a stronger enforcement of prudential regulations;

2. A review of the institutional framework for financial sector supervision, eliminating the conflict of powers and responsibilities between the Central Bank and the AGEF, that is, define in an unambiguous way which institution is in charge of supervision and give that institution the tools and powers necessary to carry out the task. It is recommended that these powers be assigned to the AGEF once the AGEF has reached an adequate professional level, but in the meantime seek out workable coordination with the Central Bank;

3. A major strengthening of the AGEF, in which the modernization project initiated in 1988 is extended as the first stage, and then proceeding to a major restructuring of the AGEF based on an analysis of its functions and organization, including an evaluation of personnel, a likely reduction in the number of employees and a strong training program in the key areas of bank inspection, possibly complemented with the contracting of specialized professionals; and

4. The inspection of other financial intermediaries such as credit union and especially pension funds and private insurance companies, which could reasonably remain within the AGEF because of economies of scale in supervision, although it is not recommended to assign the AGEF new tasks until the conflict between the AGEF and the Central Bank is resolved and the AGEF demonstrates a significant advance in strengthening its capabilities.

Securities Markets and Instruments

It would be advisable to modify the law so that the CNV becomes responsible for regulating and supervising commodities exchanges as well as securities exchanges, thereby avoiding possible conflicts between the Central Bank and the CNV in the regulation and supervision of the BNV and/or BOLPRO. In order to overcome market imperfections caused by the lack of standardized medium and long term securities issues, and recognizing the particular importance of promoting the standardization of issues for the medium and long term debt of non-financial private companies:

1. The government could play an important role in generating a "demonstration effect" by issuing standardized bonds for maturities longer than one year with a correction for inflation that would induce investment over a longer term.

2. The government could, following the Central Bank, also introduce an auction system for government securities that would permit financial intermediaries and brokers to acquire the primary issues and, subsequently, to sell them with a premium in the secondary market.

3. Since auctions or other more open and competitive systems for primary issues could eliminate several market imperfections, the CNV and the BNV should promote such changes in the primary issues market, with the government taking the lead in using such systems for the sales of its securities.

Given the limited size of the market, establishing more than one securities exchange could organize securities markets in Costa Rica in a way that would not take advantage of economies of scale in the clearing process. In addition, such fragmentation would scatter, instead of centralize, information about transactions and issuers, thereby raising the minimum transaction costs for those who deal in these securities markets. However, to deal with the need to rationalize the costs of carrying out transactions on the BNV, some actions are required:

1. It should be insisted with the BNV that the best policy would be for the BNV to set the BNV's charges for its services to brokers at a level that would permit the BNV a normal return on capital, taking into account the risky nature of the business, given that commissions that brokers can charge for their services have already been completely liberalized.

2. A legal reform should give the CNV the powers necessary to compel the exchange to reduce its commissions when it is reaping profits greater than what could be considered a normal competitive return (including the risks of the business).

3. The CNV should not have power to set different commissions for the exchange, but rather it should have the power to insist on proportionate overall price reductions because regulators cannot be expected to know how to fix commissions.

4. Moreover, the CNV should have a pre-announced system to authorize the operation of another exchange through public auction that could offer cheaper commissions than those of the existing exchange. The mere threat of this power to authorize a new exchange would induce the existing exchange to reduce its prices.

5. For additional protection of all concerned, the exchange by-laws should also contain limitations on the number of member firms, brokers and issuers (or their owners and managers) that are represented on the board of directors of the exchange, in order to avoid decision-making that is biased in favor of one group over the others. There should also be a balance on the

board among the different types of member firms (those affiliated with banking groups and those not affiliated).

The Government of Costa Rica, in the process of privatizing CODESA's subsidiaries, should take definite steps to sell a major part of CODESA's equity in the BNV. However, the government should promote the changes mentioned above while CODESA still has a major share of the BNV's equity, before selling a significant portion of the government's stake. Moreover, within this system with only one exchange, the government should maintain a percentage of its ownership of the exchange to serve as a counterweight to anti-competitive tendencies such as limiting the number of member brokerage firms to those already existing. The government could hold a 15 or 20 percent equity stake in the exchange that could be administrated through a trust arrangement with an impartial trustee acting with a precise mandate on how to represent the government at shareholder meetings.

To overcome the limitations inhibiting the development of long term financing in Costa Rican securities markets, the following measures are suggested:

1. The issuance of standardized medium and long term bonds with adjustable interest rates or monetary correction should be explored. In general, standardization of medium and long term instruments is crucial for reliable indicators of market rates.

2. With respect to the development of equities markets, it is necessary to reform tax laws to eliminate stamp taxes on increases in capital and to leave open to competition the fees that notaries charge for their certifications. It is also necessary to modify the income tax to eliminate those elements that subsidize corporations to incur debt rather than increase equity and to improve the quality of information about issuers.

3. Long-term funds from private insurance companies and pension funds could introduce a greater demand for instruments with adjustable interest rates or monetary correction, but the development of long-term securities markets would also require further legal reforms to permit the official use of such instruments with adequate regulation.

As the CNV grows in experience, it should place its main emphasis in the following areas:

1. With respect to the development of new instruments, it is fundamental that the CNV coordinate its activities closely with the intermediaries who know the market much better than the majority of the CNV's staff.

2. In reviewing actual products, the CNV should avoid the pitfall of assuming that it knows what the market needs better than the brokers and other participants in the market. The CNV should carefully evaluate whatever changes it introduces or promotes in the market, always based on a careful analysis of the realities of the market and the demands of the participants. If instruments that are in demand are prohibited or restricted, these would probably be offered by non-regulated entities, and with higher risks for those who acquire them, contrary to the objectives of the CNV.

3. The CNV should play a major role in introducing the necessary regulations for securities markets so that there is equal treatment for all parties. Some specific cases are: (1) the discrimination that some issuers practice by differentiating between interest rates paid on funds captured through the securities exchange compared to funds captured through direct placements; (2) the use of inside information about issuers' financial situations and the reliability of the information provided by issuers and brokers; and (3) the role of the CNV in reducing the conflicts of interest that can exist among various clients of brokerage firms (e.g., when a brokerage firm represents an issuer and attempts to sell the issuer's bonds to a client when there exist other options that the client might prefer if the client knew about them, or the conflict of interest that arises when a brokerage firm gives preference to its CAV or OPAB to the detriment of other clients, etc.).

The role of brokers as dealers in certain kinds of operations such as OPAB and CAV contracts should be carefully explored. In the meantime, and as a possible permanent solution, OPAB and CAV contracts could continue operating as they have been, through either brokers or investment funds, with a guaranteed yield, but with a more solid base of solvency than either brokers or investment funds currently offer, by capitalization and by better portfolio and risk valuation systems and more information about risks and portfolio management.

Although more ample powers could be deemed necessary for the CNV, it is important that the CNV continue to operate for some time within the current legal framework in order to check the attitudes that regulatory entities typically adopt with respect to authorizing public offerings, the creation of new instruments, and self-regulation by brokerage firms and securities exchanges.
It would be advisable to modify the law so that the CNV becomes responsible for regulating and supervising commodities exchanges as well as securities exchanges, thereby avoiding possible conflicts between the Central Bank and the CNV in the regulation and supervision of the BNV and/or BOLPRO.

Caja Costarricense de Seguro Social (CCSS)

The Caja was created to implement obligatory social insurance and to increase voluntary insurance, but little effort has been applied to the second objective.

The Caja has divided its services into two separate systems (IVM and SEM) that have both been implemented gradually and progressively, but independently and with a different timetable for each system. The coverage actually achieved differs significantly between the two systems and reflects the Caja's greater emphasis on the SEM. About 68 percent of the labor force contributes to the SEM program, and the insured population is estimated at 84 percent of Costa Rica's population. These percentages, which are referred as "contributory coverage" are considered acceptable, especially since 100 percent of the population has the right to receive medical attention when required. On the other hand, the IVM system covers only about 46 percent of the labor force, which is a relatively low coverage considering that universalization is also an important objective of the IVM program. Morever, a high percentage of Costa Rican workers are not covered by any pension system.

The Caja is an autonomous institution, under a Board of Directors that is independent of the Central Government. This Board has the conflicting dual functions of directing and supervising the entity's activities, which is an important limitation to guaranteeing effectiveness in both functions.

In compliance with the Caja's basic law, two separate funds have been formed: one for the SEM and one for the IVM. However, a complete separation between the two systems does not exist, since the Board of Directors can alter the allocation of the contributions from employers, employees and the overnment between the two funds. In the past, mainly before 1982, there were several automatic transfers of funds from the IVM to the SEM, as well as formal loans between the two, even though this is not permitted by law. The main reason that this has not occurred in more recent years is the SEM's operational surpluses since 1982. History has shown, in other Latin American countries as well as in Costa Rica, that if a complete separation does not exist between health programs and pension programs, the former will be financed (even if only temporarily) by the latter if there are operational deficits or cash flow problems.

In the last decade, employer contribution rates for social insurance have increased about 51 percent, while worker contribution rates have increased about 23 percent, but the government's contribution rate has declined to one ninth of the rate in force at the beginning of the 1980s. It is a matter of concern that the Caja's Board of Directors has the power to raise

contribution rates, which are in essence taxes on payrolls, or change their allocation, without adequate supervision.

The Caja's basic law does not appear to limit, in any seriously detrimental way, the actions of the Board of Directors with respect to investments. In recent years, however, outside influences have affected investment strategy in major ways, mainly the Government's Budget Authority and the National Housing Fund Law.

There seems to exist a serious separation between technical actuarial planning on one hand and practical policy actions on the other. Moreover, there is no actuarial supervision -- obviously very important for pension planning -- and major policy decisions are being made by technical staff, without adequate transparency for these actions.

While the SEM has theoretically adhered to an amended version of the Current Disbursement Approach to funding, so that the period's income should approximately equal its expenditures (with no or little accumulation of reserves), in practice the SEM has experienced significant operating surpluses since 1983, and Caja technicians are predicting reserves larger than recommended for this approach to funding. In the IVM, meanwhile, the actuarial funding method has not been officially specified in a conclusive way. This fact introduces subjectivity and political considerations into the actuarial valuations. It seems reasonable (and some of the Caja's technical staff seem to agree) that Thullen's Scaled Premium Method should be the funding method regulating the IVM. However, conclusions and recommendations of recent studies do not appear to apply Thullen's approach and do not give adequate explanations for the desired level of reserves, the magnitudes of rate increases and the length of the new period of equilibrium.

The accumulation of the assets by the Caja's two social insurance programs is, by any standard, highly significant for Costa Rica since, of all financial institutions in the country, only the Banco Nacional reports more assets that the Caja. While the SEM's assets are mainly fixed assets (e.g., buildings, construction and land) and Government debt (which is usually remunerated at below market rate of interest), almost all of the IVM's assets are financial instruments. The amount of reserves on the IVM's Balance Sheet as of December 31, 1991, represents about 98.1 percent of that system's total assets (approximately 45,200 million colones), thereby suggesting the importance of the Caja as a financial intermediary.

In fact, IVM reserves are invested mainly in securities issued by the Central Government and the government owned banks and in mortgage loans. In terms of investment performance, the Caja's biggest problem has been achieving a positive real rate of return on its investment portfolio.

It is evident that there is a lack of consensus as to the appropriate political approach to an overall solution for pension problems in Costa Rica. For this reason, the main recommendations to improve pensions are:

- press for a series of in-depth technical studies that can lead to the development of options for the design of a new approach to pension systems in Costa Rica, including especially their relevance to financial intermediation; and
- press Government policymakers to agree formally to a new overall pension system and to formulate an action plan to implement the system.

The design of a new overall pension system for Costa Rica must have, among others, the following objectives:

- provide broader basic coverage;
- coordinate existing pension systems;
- provide adequate benefits; and
- assure adequate financing for all existing systems to guarantee financial solvency; this entails consideration of:
    - the definition of an appropriate actuarial method;
    - a technical (not political) approach to establishing contribution rates;
    - a restatement of the philosophy for the participation of the Government, employers and workers in the financing of the Caja;
    - a complete separation of the SEM and IVM programs; and
    - the establishment of appropriate actuarial supervision.

Pension Systems

- The main pension programs in Costa Rica can be classified into four groups: the Disability, Old Age and Death Insurance (IVM) of the Caja; the Special Programs for the Public Sector; the Non-Contributory System with Basic Benefits; and the Supplementary or Complementary Pension Programs. Of these four, only two -- the IVM and the Complementary Programs -- have the potential of playing important roles as financial intermediaries.

- As of July 1989, approximately 46 percent of the Costa Rican labor force was left out of the main pension systems.

- Legislative developments over the years have shown a lack of consensus as to appropriate policies in the area of pensions, so that numerous laws with conflicting objectives have been decreed in this area.

- The Supplementary or Complementary Pension Programs can be classified into two types: those administered by the companies or institutions themselves; and those administered by independent private companies dedicated solely to this business. Both categories have the potential of accumulating significant amounts of funds to be invested and therefore of being important players in Costa Rican financial markets.

- Savings Plans for Retirement have only recently been offered by companies or institutions. In less than four years these types of complementary programs have grown to cover about 17,000 participants and have accumulated about 1,600 million colones in investments. This growth could be even faster if proper regulation existed.

- To this point the funds accumulated by the Savings Plans for Retirement, specifically by the trusteeship arrangements administered by Banex and Pro-Vida, have been invested in securities issued, guaranteed or secured by the Government and are maintained in the custody of government owned commercial banks. Investing solely in government or government backed securities is a self imposed measure with the purpose of strengthening the perceived security of investments and thereby gaining the trust of the general public for this new kind of financial instrument. There is no reason why these companies should not consider placing some of their investment portfolio in private securities through the securities exchange. Over time, with adequate legislation, Savings Plans for Retirement have the potential of becoming important suppliers of long-term funds to the private sector through the securities exchange.

In recent years there has been an increasing awareness in Costa Rica of the major fiscal problem caused by the existing pension systems -- and even of the danger of a possible collapse of major proportions because the promises implicit in these systems are beyond the economic possibilities of the country. Numerous committees, associations, round table discussions and newspaper articles have analyzed various problems in this area, leading to a wide variety of proposals to modify the existing laws. Nonetheless, most have limited themselves to analyzing each system in an isolated manner and without proposing any integral national policy for pension systems that could be implemented in a consistent way in years to come.

Recent examples of such efforts are the new law for the teacher's pension system that was approved at the end of 1991, the new general law for Special Public Programs approved June 24, 1992, and the proposal for a law to regulate Complementary Pension Systems that is being studied by the responsible commission of the Costa Rican Congress. All of them represent isolated well-intentioned efforts, but nearsighted in the sense that they lack the consistency and clarity of objectives that a national pension program should have.

Considering the foregoing comments, together with the conclusions and recommendations in the chapter covering the Caja Costarricense de Seguro Social, the main recommendations for improving Costa Rican pension systems include:

- Promote a series of in-depth technical studies that can lead to the development of options for the design of a new approach to pension systems in Costa Rica. It is crucial to consider as part of this the need to promote, but also to regulate appropriately, the different types of supplementary and complementary pension systems, taking into account not only their potential relevance for financial intermediation but also their objectives within the context of programs to promote economic security. Furthermore, these studies should analyze the impact of pension programs on financial markets and especially the potential of their becoming important suppliers of long-term funds to the private sector in general and the Securities Exchange in particular.

- Strongly encourage government policymakers to agree formally to a new overall pension system and to formulate an action plan to implement it. Immediate action should be taken to improve the legislation proposed for complementary pension systems so that these can become part of an overall national social security program, as well as an important element in financial markets, with a role more consistent with the economic security and financial liberalization objectives of the Costa Rican Government.

Instituto Nacional de Seguros (INS)

- The INS was created with the primary objectives of creating a permanent government monopoly and establishing a significant source of income for the government. These two objectives, which have been the main criteria under which the INS has operated, clearly represented the wishes of the legislature at the time the INS was created in the 1920s.

- The government's insurance monopoly was implemented in a gradual manner according to the type of insurance: life insurance, fire insurance and work related insurance were all

implemented in the 1920s; fidelity insurance in the 1930s; automobile insurance in the 1940s; and integral crop insurance, obligatory automobile insurance and reinsurance in the 1970s.

- The INS is an autonomous institution governed by a Board of Directors named by the President. It enjoys administrative independence but is subject to various external laws and decrees. In fact, there are numerous laws (e.g., the General Public Administration Law, the National Planning Law, the Law for the Financial Equilibrium of the Public Sector, and the Law for Creation of the Budget Authority) that have important implications for the operations of the INS.

- The INS is not subject to actuarial or technical supervision -- not even in such crucial matters as rate making, reserve valuation and marketing practices.

- The Basic Law creating the INS does not put any detrimental restrictions on the actions of the Board of Directors with respect to investments. However, important restrictions have been added, mostly by external sources not controlled by the Board, and these have affected investment performance, either indirectly by limiting the resources available for investment or directly by imposing certain types of investment options.

- The INS does not generally consider investment income in its rate making. This is true for all lines of insurance offered, except life and work related insurance. Investment income could have been used to lower the premiums that policyholders pay.

- The amount of assets accumulated by the INS is significant and, as of the end of 1991, represented about 50 percent of the assets of the Banco Anglo Costarricense and about 58 percent of the total assets of the IVM pension system administered by the CCSS.

- As of December 1991, about 55 percent of INS assets (i.e., 14,600 million colones) were financial investments.

- Financial Investments can be categorized in two groups:

  - Investments in securities (about 28 percent of financial investments); and

  - Investments in mortgage loans (about 72 percent of financial investments).

- The performance of these two broad categories of financial investments has been very different. Investments in securities have been quite satisfactory, providing positive

real rates of return throughout the period 1983-1991 except in 1988. On the other hand, investments in mortgage loans have consistently yielded negative real rates of return throughout the years from 1983 to 1988.

It is evident that circumstances, as well as political views of the government's role in insurance, have changed significantly since the creation of the government's insurance monopoly. For this reason, the main recommendation to improve the provision of insurance in Costa Rica, and especially the role of insurance in financial markets, is to press for a series of in-depth technical studies to analyze the conditions under which a more competitive insurance market might be beneficial to the country, including its role in financial intermediation.

These studies should analyze and make formal proposals in each of the following areas:

- creation and implementation of adequate technical supervision;
- deregulation of the INS to allow it to compete with private companies;
- new regulations needed in a competitive market, including consideration of:
    - organization and licensing of insurance and reinsurance companies;
    - types of operations and insurance lines that will be permitted;
    - rate making regulations;
    - product authorization, including requirements to introduce new products;
    - marketing practices, including the authorization of insurance agents and the regulation of publicity;
    - solvency of insurance companies, including standards for reserve and liability valuation, standards for asset valuation, investment regulations, and regulation of expenses, capital and accumulated surplus; and
    - special legislation for fidelity insurance, collective insurance and obligatory insurance.

The Impact of USAID Interventions

During the decade from 1982 to 1992, USAID was involved in two distinct types of interventions that impacted the Costa Rican financial sector. On one hand, USAID responded to the crisis that

afflicted Costa Rica at the end of the 1970s and the beginning of the 1980s through a series of stabilization and adjustment programs that included dollar funds for balance of payments support (the ESF programs). The disbursement of these dollar funds was conditioned on a changing array of policy adjustments, many of which dealt directly with the financial sector. As part of this process, moreover, the disbursement of dollar funds for imports generated local-currency counterpart funds, a significant portion of which were devoted to financial sector activities, often local-currency credit lines (of the total of approximately $1 billion, more than $150 million, that is, more than 15 percent, was devoted to credit lines). On the other hand, USAID also developed a series of projects that dealt specifically with Costa Rican financial institutions. These projects largely shared a common motivation: to enhance the participation of private institutions in the Costa Rican financial sector in response to the perceived weakness of the government owned commercial banks.

With respect to the success of USAID projects involving ESF conditionality, policy dialogue is widely recognized to be a better path to improved policies than attempts to impose conditionality that is unwanted by the host country. The design of specific elements of conditionality can provide useful discipline to insure that both the funding source and the host country are looking at the same indicators and have the same view of what is supposed to happen. Nonetheless, experience with attempts to enforce conditionality that is not in fact accepted by the host country indicates clearly the greater gains to be had from a more diligent pursuit of policy dialogue wherein the funding source and the host country come to share the same views of policy objectives and techniques of implementation. However, when policy dialogue has been successful, so that essential agreement has in fact been reached, it become unclear whether conditionality still implies additionality (or would the changes have occurred even without the ESF funds?).

This assessment documents in detail the changes that have taken place in the Costa Rican financial sector that may be attributable to USAID conditionality. As is clear, the changes over the period from 1982 to 1992 have been major. What is less clear is whether these changes can unequivocally be attributed to the conditionality contained in USAID's ESF programs or whether they might have taken place in any event. For the future, however, the anticipation of much lower funding levels suggests that continuation of a major role for USAID in policy reforms to enhance the performance of the financial sector will depend more on emphasis on the technical assistance and policy dialogue aspects of conditionality and on close coordination with other international agencies.

The use of local-currency counterpart funds generated by ESF programs raises two major issues -- both of which are now much better understood by USAID than they were at the beginning of the

1980s when Costa Rica's ESF programs were initiated. The first issue is a general one of the inflationary impact of spending the local-currency counterpart funds generated by ESF dollar sales. As can be seen from recent discussions of ESF programs in Costa Rica with respect to the need to use local-currency counterpart funds for non-inflationary purposes (and even including questions of the payment of interest on these funds), this issue is now well understood by USAID officials in Costa Rica.

The second issue involves the use of ESF generated counterpart funds for local-currency credit lines. In Costa Rica, as in most other countries having ESF programs, a major use of counterpart funds has been for local-currency directed credit lines, and this involves not only ESF programs but also USAID's financial sector projects in Costa Rica. For many years, USAID has been concerned about the subsidy element in directed credit lines stemming from below market rates of interest, and this is clearly reflected in the setting of interest rates for its own financial sector projects and in the conditionality imposed in its ESF programs against Costa Rica's policies of subsidized interest rates. However, directed credit lines still contain an implicit interest rate subsidy -- the "market" interest rates established in "non-subsidized" directed credit lines are usually rates for prime borrowers, but the basic reason for the establishment of directed credit lines is that the intended borrowers (or the activities to be financed) are not prime. Moreover, to control the allocation of credit effectively along the lines supposed in directed credit programs would require control over a country's entire credit program along with extremely detailed and costly programs of monitoring and supervision (the well-known fungibility problem).

In addition to directed credit, USAID's earlier financial sector projects in Costa Rica provided subsidies to specific private financial institutions. This was justified as necessary to provide a private-sector alternative to the heavily predominant and extremely problematic government owned banking system. Attention was also given to this issue in the conditionality of several ESF programs that attempted to provide equal opportunities -- a level playing field -- for private banks (e.g., permission to issue short-term deposit instruments, access to Central Bank rediscounts, permission to create a system of deposit insurance, etc.) along with the provision of local-currency funded credit lines that were open (often exclusively) to private banks. Perhaps more attention should have been given to such conditionality, since building private financial institutions through direct support for such institutions is an expensive process -- in terms not only of the funds provided for the subsidies and the impact on income distribution but also of the inefficiency (or excess profitability) with which private banks can operate under the umbrella provided by the very high spreads of the government owned banks. In any case, both recent USAID financial sector projects -- the Agricultural and Industrial Reactivation Project and the Financial Services Project

-- have largely moved away from subsidies for specific private financial institutions.

The impact of USAID's financial sector projects on the targeted institutions and on Costa Rican financial intermediaries in general is thoroughly documented in this assessment. In this summary, only a few points are emphasized. First, the private banks that have been specifically targeted by USAID (BANEX and COFISA, as well as Banco Cooperativo if PL-480 counterpart funds are taken into account) have not performed notably better than other private banks. Although BANEX is large and profitable, COFISA is one of the smallest private banks, and Banco Cooperative became insolvent and had to undergo a major rehabilitation in order to survive. Nonetheless, one significant positive aspect is that the financial institutions targeted by USAID (including the PIC which is difficult to compare directly to the private banks and might be worthy of a special evaluation) tend to have much more widely dispersed ownership than other private financial institutions. This is important not only for the spread of benefits but also for the extremely difficult issue of keeping loans to related parties under reasonable control.

The other main aspect of USAID's impact on the financial sector are its directed credit lines. Central Bank rediscount facilities for private banks have undoubtedly helped to make the playing field more level between the government owned banks and the private banks and are in some part responsible for the relatively rapid growth of lending by private banks during the period from 1982 to 1992. However, one cost of this has been the private banks' heavy dependence on such rediscount lines and relatively weak performance in the area of deposit mobilization in particular and resource mobilization in general. Greater attention to conditionality that might have given the private banks relatively more opportunities and incentives to capture deposits might thus have been more effective, especially in conjunction with better bank supervision to assure to depositors (without the necessity of deposit insurance) the safety of their deposits.

To summarize, it is clear that the decade from 1982 to 1992 has seen major improvements in policies affecting the Costa Rican financial sector and that USAID has been substantially involved in promoting these improvements. Nonetheless, it is not possible to attribute these positive developments exclusively, or even primarily, to USAID conditionality; and, in any event, successful policy dialogue of the type apparently witnessed in Costa Rica is more likely to bring about thorough and lasting changes in the financial sector than is conditionality that is imposed and not basically accepted by the government. The elements of directed and subsidized credit that can be found in the use of local-currency counterpart funds and in USAID's projects to strengthen specific Costa Rican financial institutions would undoubtedly not be

approved by USAID today but were nonetheless the norm at the time these project were implemented.

EXHIBIT A

INDIVIDUALS INTERVIEWED AND BIBLIOGRAPHY

INDIVIDUALS INTERVIEWED

Individual / Title	Institution
Alan Batchelder Chief Economist	U.S.A.I.D.
Kenneth A. Lanza Chief, Private Sector Office	"
Miguel Lorfa Economist	"
Vinzenz Schmak Consultant, Private Sector Office	"
Luis Solera Deputy Chief, Private Sector Office	"
Public Sector Banks and Entities	
William Calvo Director, Monetary Department	Banco Central de Costa Rica
Gerardo Corrales Deputy Chief, Board of Directors Secretariat	"
Jorge Guardia Presidente Ejecutivo	"
Ana Rodriguez Aguilera Directora, División Económica	"
Fernando Aguilar Jefe, Departamento Informática	Auditoría General de Entidades Financieras (AGEF)
Ana Matilde Bolaños Auditdora Interna	"
José Luis Víquez Fonseca Jefe, Division Bancos Estatales y Financieras	"
Alfonso Guzmán Jefe, Asesoría Jurídica	"
Ricardo Matta Auditor General	"
Rafael E. Quesada A. Director, Dirección General Administrativa	"
Mario Sáez ex-Asesor en el área de informática	"

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Individual / Title	Institution
Rafael Sandoval Jefe, Departamento Bancos Privados	"
Juan Luis Silva ex Asesor en el área de supervisión y regulación	"
Rafael Durán Zamora Jefe, Departamento Bancos Estatales	"
Minor Sagot Subgerente de Finanzas	Banco de Costa Rica
Ricardo Longan Espinoza Vice Presidente, Junta Directiva	Banco Crédito Agrícola de Cartago
Arturo Cuevillas León Gerente General	Banco Nacional de Costa Rica
Bernardo Chaverri Rivera Sub-Gerente General	"
José Dimas Céspedes C. Sub-Gerente General	"
Oscar Ruin Céspedes Sub-Gerente General	"
Marvin Arias Aguilar Auditor General	"
Roger Aguilar Director Actuarial	Caja Costarricense de Seguro Social
Virya Miranda Depto. de Control de Inversiones	"
Juan Elías Peña Unidad Actuarial	"
Gilberto Valeriao Jefe, Contabilidad	"
Damaris Ulate R. Gerente	Comisión Nacional de Valores
William A. Chinchilla S. Director, Departamento Asesoría Bursatil	"
Ana María Moreno Sub-Gerente	"
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William Ramírez Unidad de Nuevos Productos	"
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Individual / Title	Institution
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Private Sector Banks and Financial Institutions	
Walter Kissling Gerente, Fiduciaria de Ahorro	Banco BANEX, S.A.
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Carlos L. Vargas R. Director de Operaciones	Banco Continental
Alvaro Mayorga Nuñez Gerente Internacional	Banco Cooperativo Costarricense, R.L.
Mario Vargas A. Gerente General	Fedecredito R.L.
Mario Fernández Subgerente General	Banco Federado
Carlos Mora V. Gerente General	Banco Federado
Alberto Dent Z. Gerente General	Banco de Fomento Agrícola
Luis Liberman Gerente General	Banco Interfin
Mario Maroto Vicepresidente Ejecutivo	Banco Internacional de Costa Rica, Ltd.
Lemuel Byram Lopez Gerente General	Banco Metropolitano S.A.
Max Alvarado Ramírez Gerente General	Banco Popular y de Desarrollo Comunal
Mario Montealegre Saborio Gerente General	Banco de San José
Carlos A. Alvarado Moya Presidente, and Presidente	Financiera ELCA Cámara Nacional de Finanzas, Inversiones y Crédito

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Individual / Title	Institution
Manuel Rodríguez Vice-Presidente	Financiera del First Pennsylvania S.A.
Renato Morera Gerente, Operadora de Fondos de Pensión	Pro-Vida, S.A.

Others

Rodrigo Bolaños Zamora Gerente General	BOLSA Nacional de Valores, S.A.
Carlos Ceciliano B. Socio	Ceciliano & Compañia Coopers & Lybrand
Jorge Corrales Q. Consultor	Econofin, S.A.
Francisco Gutierrez Profesor and Dean	Instituto Centroamericano de Administración de Empresas (INCAE)
Franklin Matamoros Abogado and Socio	Lara, Lopez, Matamoros, Rodriguez & Tinoco
Mario Gomez Pacheco Director Ejecutivo	Asociación Bancaria Costarricense
William Hayden Quintero Director-Gerente	Corporación Privada de Inversiones
Manuel Peralta Abogado and Socio	Vargas, Jiménez & Peralta
Juan Carlos Quesada Gerente Senior	KPMG Peat Marwick
Ernesto Rohrmoser Gerente General	Coalición Costarricense de Iniciativas de Desarrollo (CINDE)
Thelmo Vargas Madrigal Economista	Academia de Centroamérica

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EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-82)

STATE-OWNED BANKS

(millions of colones)	Banco Anglo Costarricense			Banco Credito Agricola de Cartago		
ACCOUNT \ BANK ->	Commercial	Mortgage	Total	Commercial	Mortgage	Total
ASSETS						
Cash & due from banks	2,823	16	2,839	770	4	774
Earning assets:						
Securities	903	59	962	606	129	735
Loans	2,960	36	2,996	1,132	404	1,536
Sub-total	3,863	95	3,958	1,738	533	2,271
Other operating assets	2,410	1	2,411	812	15	627
Fixed assets	83	0	83	41	0	41
Total Assets	9,179	112	9,291	3,361	552	3,913
LIABILITIES						
Deposits:						
At sight			0			0
Time			0			0
Sub-total	5,747	0	5,747	2,034	0	2,034
Other Liabilities	2,621	60	2,681	1,042	479	1,521
Total Liabilities	8,368	60	8,428	3,076	479	3,555
EQUITY						
Capital	705	40	745	252	68	320
Reserves	80	12	92	15	5	20
Retained earnings	26	0	26	18	0	18
Net Worth	811	52	863	285	73	358
Total	9,179	112	9,291	3,361	552	3,913
Contingent Liabilities	0	0	0	0		0
Interest income	585	7	592	305	73	378
Interest expense	299	5	304	216	72	288
Net Interest Income	286	2	288	89	1	90
Other Income:						
Fee income	10	0	10	3	0	3
Other income	9	0	9	0	0	0
Total Other Income	19	0	19	3	0	3
Total Operating Income	305	2	307	92	1	93
General & Admin. Expense	246	0	246	115	4	119
Miscellaneous expense	0	0	0	0	0	0
Net Operating Income	59	2	61	(23)	(3)	(26)
Extraordinary Income	0	0	0	40	1	41
Extraordinary Expense	2	1	3	1	2	3
Net Income / (Loss)	57	1	58	16	(4)	12
OTHER DATA						
Number of Offices	35		35	6		6
Number of Employees	1,253		1,253	581		581
RATIOS						
Capital/Assets	8.8%	46.4%	9.3%	8.5%	13.2%	9.1%
Capital/Earning Assets	21.0%	54.7%	21.8%	16.4%	13.7%	15.8%
Capital/Loans	27.4%	144.4%	28.8%	25.2%	18.1%	23.3%
Capital/Assets+Contingent	8.8%	46.4%	9.3%	8.5%	13.2%	9.1%
Capital/Loans+Contingents	27.4%	144.4%	28.8%	25.2%	18.1%	23.3%
Assets/Employees	7	ERR	7	6	ERR	7
Assets/Offices	262	ERR	265	560	ERR	652
Net Int. Inc./Assets	3.12%	1.79%	3.10%	2.65%	0.18%	2.30%
Net Int. Inc./Earn. Asset	7.40%	2.11%	7.28%	5.12%	0.19%	3.96%
Return on Assets	0.62%	0.89%	0.62%	0.48%	-0.72%	0.31%
Return on Equity	7.03%	1.92%	6.72%	5.61%	-5.48%	3.35%
Loans/Deposits	51.5%	ERR	52.1%	53.7%	ERR	75.5%
Liquid Assets/Deposits	49.1%	ERR	49.4%	37.9%	ERR	38.1%
Liquid Assets/Sight Depos	ERR	ERR	ERR	ERR	ERR	ERR

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EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-82)

STATE-OWNED BANKS

(millions of colones)	Banco Nacional de Costa Rica			Banco de Costa Rica		
ACCOUNT \ BANK ->	Commercial	Mortgage	Total	Commercial	Mortgage	Total
ASSETS						
Cash & due from banks	5,951	6	5,957	4,163	0	4,163
Earning assets:						
Securities	3,433	74	3,507	1,918	0	1,918
Loans	7,146	226	7,372	4,316	122	4,438
Sub-total	10,579	300	10,879	6,234	122	6,356
Other operating assets	6,026	11	6,037	4,566	9	4,575
Fixed assets	353	0	353	166	0	166
Total Assets	22,909	317	23,226	15,129	131	15,260
LIABILITIES						
Deposits:						
At sight			0			0
Time			0			0
Sub-total	14,591	0	14,591	9,473	0	9,473
Other Liabilities	6,505	252	6,757	4,241	106	4,347
Total Liabilities	21,096	252	21,348	13,714	106	13,820
EQUITY						
Capital	1,650	30	1,680	1,277	10	1,287
Reserves	67	35	102	103	15	118
Retained earnings	96	0	96	35	0	35
Net Worth	1,813	65	1,878	1,415	25	1,440
Total	22,909	317	23,226	15,129	131	15,260
Contingent Liabilities	0	0	0	0	0	0
Interest income	1,561	35	1,596	1,152	14	1,166
Interest expense	1,013	18	1,031	471	11	482
Net Interest Income	548	17	565	681	3	684
Other Income:						
Fee income	36	0	36	29	0	29
Other income	149	0	149	9	0	9
Total Other Income	185	0	185	38	0	38
Total Operating Income	733	17	750	719	3	722
General & Admin. Expense	715	15	730	697	4	701
Miscellaneous expense	0	0	0	2	0	2
Net Operating Income	18	2	20	20	(1)	19
Extraordinary Income	36	1	37	9	0	9
Extraordinary Expense	12	0	12	3	0	3
Net Income / (Loss)	42	3	45	26	(1)	25
OTHER DATA						
Number of Offices	65		65	49		49
Number of Employees	2,735		2,735	1,800		1,800
RATIOS						
Capital/Assets	7.9%	20.5%	8.1%	9.4%	19.1%	9.4%
Capital/Earning Assets	17.1%	21.7%	17.3%	22.7%	20.5%	22.7%
Capital/Loans	25.4%	28.8%	25.5%	32.8%	20.5%	32.4%
Capital/Assets+Contingent	7.9%	20.5%	8.1%	9.4%	19.1%	9.4%
Capital/Loans+Contingents	25.4%	28.8%	25.5%	32.8%	20.5%	32.4%
Assets/Employees	8	ERR	8	8	ERR	8
Assets/Offices	352	ERR	357	309	ERR	311
Net Int. Inc./Assets	2.39%	5.36%	2.43%	4.50%	2.29%	4.48%
Net Int. Inc./Earn. Asset	5.18%	5.67%	5.19%	10.92%	2.46%	10.76%	
Return on Assets	0.18%	0.95%	0.19%	0.17%	-0.76%	0.16%
Return on Equity	2.32%	4.62%	2.40%	1.84%	-4.00%	1.74%
Loans/Deposits	49.0%	ERR	50.5%	45.6%	ERR	46.8%
Liquid Assets/Deposits	40.8%	ERR	40.8%	43.9%	ERR	43.9%
Liquid Assets/Sight Depos	ERR	ERR	ERR	ERR	ERR	ERR

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EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-82)

PRIVATE BANKS

(millions of colones)

ACCOUNT \ BANK ->	BANEX	BANCOMER	(CAPITAL) CONSTRUCCION	INTERFIN	LYON	BANK AMERICA	WEEDEN
ASSETS							
Cash & due from banks	11	48	49	30	6[illegible]	312	[illegible]
Earning assets:							
Securities	17	41	1	21	0	30	[illegible]
Loans	179	137	3	60	3	36	[illegible]
Sub-total	196	178	4	81	3	66	[illegible]
Other operating assets	129	19	60	14	2	29	[illegible]
Fixed assets	2	3	1	1	3	3	
Total Assets	338	248	114	126	73	410	1[illegible]
LIABILITIES							
Deposits:							
At sight							
Time							
Sub-total	0	0	0	0	0	0	
Other Liabilities	306	214	103	94	63	393	
Total Liabilities	306	214	103	94	63	393	
EQUITY							
Capital	30	25	10	30	1	5	
Reserves	1	3	1	0	6	10	
Retained earnings	1	6	0	2	3	2	
Net Worth	32	34	11	32	10	17	
Total	338	248	114	126	73	410	
Contingent Liabilities	0	0	0	0	0	0	
Interest income	27	44	5	7	6	66	
Interest expense	12	23	1	2	0	10	
Net Interest Income	15	21	4	5	6	56	
Other Income:							
Fee income	0	5	2	0	2	4	
Other income	2	0	0	1	0	0	
Total Other Income	2	5	2	1	2	4	
Total Operating Income	17	26	6	6	8	60	
General & Admin. Expense	12	9	5	2	4	29	
Miscellaneous expense	1	3	0	0	0	0	
Net Operating Income	4	14	1	4	4	31	
Extraordinary Income	0	0	0	0	0	0	
Extraordinary Expense	0	0	1	2	0	0	
Net Income / (Loss)	4	14	0	2	4	31	
OTHER DATA							
Number of Offices	1	1	1	1	1	1	
Number of Employees	35	46	15	unknown	30	unknown	[illegible]
RATIOS							
Capital/Assets	9.5%	13.7%	9.6%	25.4%	13.7%	4.1%	[illegible]
Capital/Earning Assets	16.3%	19.1%	275.0%	39.5%	333.3%	25.8%	[illegible]
Capital/Loans	17.9%	24.8%	366.7%	53.3%	333.3%	47.2%	[illegible]
Capital/Assets+Contingent	9.5%	13.7%	9.6%	25.4%	13.7%	4.1%	[illegible]
Capital/Loans+Contingents	17.9%	24.8%	366.7%	53.3%	333.3%	47.2%	[illegible]
Assets/Employees	10	5	8	ERR	2	ERR	
Assets/Offices	338	248	114	126	73	410	
Net Int. Inc./Assets	4.44%	8.47%	3.51%	3.97%	8.22%	13.66%	[illegible]
Net Int. Inc./Earn. Asset	7.65%	11.80%	100.00%	6.17%	200.00%	84.85%	[illegible]
Return on Assets	1.18%	5.65%	0.00%	1.59%	5.48%	7.56%	[illegible]
Return on Equity	12.50%	41.18%	0.00%	6.25%	40.00%	182.35%	[illegible]
Loans/Deposits	ERR	ERR	ERR	ERR	ERR	ERR	
Liquid Assets/Deposits	ERR	ERR	ERR	ERR	ERR	ERR	
Liquid Assets/Sight Depos	ERR	ERR	ERR	ERR	ERR	ERR	

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EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-82)

PRIVATE BANKS

(millions of colones)

ACCOUNT \ BANK ->	SANTANDER	COOPERATIVO COSTARRICEN.	INTERNACIONAL EXPORTACIONES	POPULAR
ASSETS				
Cash & due from banks	28	1	4	77
Earning assets:				
Securities	55	8	6	155
Loans	8	0	40	2,302
Sub-total	63	8	46	2,457
Other operating assets	158	3	7	16
Fixed assets	1	1	4	173
Total Assets	250	13	61	2,723
LIABILITIES				
Deposits:				
At sight				
Time				
Sub-total	0	0	0	2,003
Other Liabilities	210	5	11	413
Total Liabilities	210	5	11	2,416
EQUITY				
Capital	35	7	42	307
Reserves	3	0	8	
Retained earnings	2	1	0	
Net Worth	40	8	50	307
Total	250	13	61	2,723
Contingent Liabilities	0	0	0 0	0
Interest income	28	7	6	364
Interest expense	7	0	1	280
Net Interest Income	21	7	5	84
Other Income:				
Fee income	7	0	0	
Other income	2	0	0	20
Total Other Income	9	0	0	20
Total Operating Income	30	7	5	104
General & Admin. Expense	13	4	5	136
Miscellaneous expense	0	0	0	1
Net Operating Income	17	3	0	(33)
Extraordinary Income	0	0	0	0
Extraordinary Expense	0	0	0	0
Net Income / (Loss)	17	3	0	(33)
OTHER DATA				
Number of Offices	1	1	1	unknown
Number of Employees	unknown	8	unknown	unknown
RATIOS				
Capital/Assets	16.0%	61.5%	82.0%	11.3%
Capital/Earning Assets	63.5%	100.0%	108.7%	12.5%
Capital/Loans	500.0%	ERR	125.0%	13.3%
Capital/Assets+Contingent	16.0%	61.5%	82.0%	11.3%
Capital/Loans+Contingents	500.0%	ERR	125.0%	13.3%
Assets/Employees	ERR	2	ERR	ERR
Assets/Offices	250	13	61	ERR
Net Int. Inc./Assets	8.40%	53.85%	8.20%	3.08%
Net Int. Inc./Earn. Asset	33.33%	87.50%	10.87%	3.42%
Return on Assets	6.80%	23.08%	0.00%	-1.21%
Return on Equity	42.50%	37.50%	0.00%	-10.75%
Loans/Deposits	ERR	ERR	ERR	114.9%
Liquid Assets/Deposits	ERR	ERR	ERR	3.8%
Liquid Assets/Sight Depos	ERR	ERR	ERR	ERR

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EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-82)

(millions of colones)	STATE BANKS		PRIVATE BANKS				
ACCOUNT \ BANK ->	SUB-TOTAL STATE BANKS	AVERAGE STATE BANKS	SUB-TOTAL PRIVATE BANKS	AVERAGE PRIVATE BANKS	TOTAL ALL BANKS	AVERAGE ALL BANKS	PRIVATE BANKS' SHARE OF TOTAL
ASSETS							
Cash & due from banks	13,733	3,433	545	55	14,355	957	3.[illegible]
Earning assets:							
Securities	7,122	1,781	173	17	7,450	497	2.3%
Loans	16,342	4,086	435	44	19,079	1,272	2.3%
Sub-total	23,464	5,866	608	61	26,529	1,769	2.3%
Other operating assets	13,850	3,463	417	42	14,283	952	2.9%
Fixed assets	643	161	21	2	837	56	2.5%
Total Assets	51,690	12,923	1,591	159	56,004	3,734	2.[illegible]
LIABILITIES							
Deposits:							
At sight	0	0	0	0	0	0	ERR
Time	0	0	0	0	0	0	ERR
Sub-total	31,845	7,961	0	0	0	0	ERR
Other Liabilities	15,306	3,827	1,392	139	17,111	1,141	8.1%
Total Liabilities	47,151	11,788	1,392	139	17,111	1,141	8.1%
EQUITY							
Capital	4,032	1,008	159	16	4,498	300	3.5[illegible]
Reserves	332	83	24	2	356	24	6.7[illegible]
Retained earnings	175	44	16	2	191	13	8.4[illegible]
Net Worth	4,539	1,135	199	20	5,045	336	3.9[illegible]
Total	51,690	12,923	1,591	159	22,156	1,477	7.2[illegible]
Contingent Liabilities	0	0	0	0	0	0	ERR
Interest income	3,732	933	192	19	4,288	286	4.5
Interest expense	2,105	526	55	6	2,440	163	2.3
Net Interest Income	1,627	407	137	14	1,848	123	7.4
Other Income:							
Fee income	78	20	20	2	98	7	20.[illegible]
Other income	167	42	5	1	192	13	2.[illegible]
Total Other Income	245	61	25	3	290	19	8.[illegible]
Total Operating Income	1,872	468	162	16	2,138	143	7.[illegible]
General & Admin. Expense	1,796	449	81	8	2,013	134	4.
Miscellaneous expense	2	1	4	0	7	0	57.
Net Operating Income	74	19	77	8	118	8	65.
Extraordinary Income	87	22	0	0	87	6	0.
Extraordinary Expense	21	5	3	0	24	2	12.
Net Income / (Loss)	140	35	74	7	181	12	40.
OTHER DATA							
Number of Offices	155	39	9	1	164	11	5.
Number of Employees	6,369	1,592	134	13	6,503	434	2.
RATIOS							
Capital/Assets	8.8%	8.8%	12.5%	12.5%	9.0%	9.0%	
Capital/Earning Assets	19.3%	19.3%	32.7%	32.7%	19.0%	19.0%	
Capital/Loans	27.8%	27.8%	45.7%	45.7%	26.4%	26.4%	
Capital/Assets+Contingent	8.8%	8.8%	12.5%	12.5%	9.0%	9.0%	
Capital/Loans+Contingents	27.8%	27.8%	45.7%	45.7%	26.4%	26.4%	
Assets/Employees	8	8	12	12	9	9	
Assets/Offices	333	333	177	177	341	341	
Net Int. Inc./Assets	3.15%	3.15%	8.61%	8.61%	3.30%	3.30%	
Net Int. Inc./Earn. Asset	6.93%	6.93%	22.53%	22.53%	6.97%	6.97%	
Return on Assets	0.27%	0.27%	4.65%	4.65%	0.32%	0.32%	
Return on Equity	3.08%	3.08%	37.19%	37.19%	3.59%	3.59%	
Loans/Deposits	51.3%	51.3%	ERR	ERR	ERR	ERR	
Liquid Assets/Deposits	43.1%	43.1%	ERR	ERR	ERR	ERR	
Liquid Assets/Sight Depos	ERR	ERR	ERR	ERR	ERR	ERR	

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EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-85)

STATE-OWNED BANKS

(millions of colones)

	Banco Anglo Costarricense			Banco Credito Agricola de Cartago		
ACCOUNT \ BANK ->	Commercial	Mortgage	Total	Commercial	Mortgage	Total
ASSETS						
Cash & due from banks	5,318	38	5,356	2,611	0	2,611
Earning assets:						
Securities	1,784	37	1,821	1,631	173	1,804
Loans	5,655	21	5,676	1,886	738	2,624
Sub-total	7,439	58	7,497	3,517	911	4,428
Other operating assets	2,578	1	2,579	1,618	39	1,657
Fixed assets	168	0	168	60	0	.60
Total Assets	15,503	97	15,600	7,806	950	8,756
LIABILITIES						
Deposits:						
At sight			0			0
Time			0			0
Sub-total	11,898	0	11,898	4,567	364	4,931
Other Liabilities	2,609	45	2,654	2,784	514	3,298
Total Liabilities	14,507	45	14,552	7,351	878	8,229
EQUITY						
Capital	705	40	745	252	68	320
Reserves	27	12	39	15	4	19
Retained earnings	264	0	264	187	0	187
Net Worth	996	52	1,048	454	72	526
Total	15,503	97	15,600	7,805	950	8,755
Contingent Liabilities	0	0	0	0		0
Interest income	1,415	4	1,419	660	153	813
Interest expense	899	4	903	427	141	568
Net Interest Income	516	0	516	233	12	245
Other Income:						
Fee income	15	0	15	6	0	6
Other income	31	0	31	0	0	0
Total Other Income	46	0	46	6	0	6
Total Operating Income	562	0	562	239	12	251
General & Admin. Expense	541	0	541	268	9	277
Miscellaneous expense	0	1	1	0	0	0
Net Operating Income	21	(1)	20	(29)	3	(26)
Extraordinary Income	13	0	13	47	1	48
Extraordinary Expense	2	0	2	4	2	6
Net Income / (Loss)	32	(1)	31	14	2	16
OTHER DATA						
Number of Offices	38		38	7		7
Number of Employees	1,399		1,399	640		640
RATIOS						
Capital/Assets	6.4%	53.6%	6.7%	5.8%	7.6%	6.0%
Capital/Earning Assets	13.4%	89.7%	14.0%	12.9%	7.9%	11.9%
Capital/Loans	17.6%	247.6%	18.5%	24.1%	9.8%	20.0%
Capital/Assets+Contingent	6.4%	53.6%	6.7%	5.8%	7.6%	6.0%
Capital/Loans+Contingents	17.6%	247.6%	18.5%	24.1%	9.8%	20.0%
Assets/Employees	11	ERR	11	12	ERR	14
Assets/Offices	408	ERR	411	1,115	ERR	1,251
Net Int. Inc./Assets	3.33%	0.00%	3.31%	2.98%	1.26%	2.80%
Net Int. Inc./Earn. Asset	6.94%	0.00%	6.88%	6.62%	1.32%	5.53%
Return on Assets	0.21%	-1.03%	0.20%	0.18%	0.21%	0.18%
Return on Equity	3.21%	-1.92%	2.96%	3.08%	2.78%	3.04%
Loans/Deposits	47.5%	ERR	47.7%	41.3%	202.7%	53.2%
Liquid Assets/Deposits	44.7%	ERR	45.0%	57.2%	0.0%	53.0%
Liquid Assets/Sight Dpsts	ERR	ERR	ERR	ERR	ERR	ERR

EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-85)

STATE-OWNED BANKS

(millions of colones)

ACCOUNT \ BANK ->	Banco Nacional de Costa Rica			Banco de Costa Rica		
	Commercial	Mortgage	Total	Commercial	Mortgage	Total
ASSETS						
Cash & due from banks	11,817	6	11,823	8,406	0	8,406
Earning assets:						
Securities	4,926	87	5,013	3,734	0	3,734
Loans	13,405	292	13,697	8,987	133	9,120
Sub-total	18,331	379	18,710	12,721	133	12,854
Other operating assets	9,612	11	9,623	6,556	11	6,567
Fixed assets	659	0	659	328	0	328
Total Assets	40,419	396	40,815	28,011	144	28,155
LIABILITIES						
Deposits:						
At sight			0			0
Time			0			0
Sub-total	25,581	0	25,581	19,147	0	19,147
Other Liabilities	11,971	331	12,302	7,341	119	7,460
Total Liabilities	37,552	331	37,883	26,488	119	26,607
EQUITY						
Capital	1,650	30	1,680	1,277	10	1,287
Reserves	98	36	134	122	15	137
Retained earnings	1,119	0	1,119	124	0	124
Net Worth	2,867	66	2,933	1,523	25	1,548
Total	40,419	397	40,816	28,011	144	28,155
Contingent Liabilities	0	0	0	0	0	0
Interest income	3,050	60	3,110	2,371	14	2,385
Interest expense	1,940	21	1,961	1,220	8	1,228
Net Interest Income	1,110	39	1,149	1,151	6	1,157
Other Income:						
Fee income	23	0	23	20	0	20
Other income	255	0	255	37	0	37
Total Other Income	278	0	278	57	0	57
Total Operating Income	1,388	39	1,427	1,208	6	1,214
General & Admin. Expense	1,818	39	1,857	1,164	6	1,170
Miscellaneous expense	0	0	0	3	0	3
Net Operating Income	(430)	0	(430)	41	0	41
Extraordinary Income	599	1	600	54	2	56
Extraordinary Expense	81	0	81	17	1	18
Net Income / (Loss)	88	1	89	78	1	79
OTHER DATA						
Number of Offices	76		76	54		54
Number of Employees	3,019		3,019	2,071		2,071
RATIOS						
Capital/Assets	7.1%	16.7%	7.2%	5.4%	17.4%	5.5%
Capital/Earning Assets	15.6%	17.4%	15.7%	12.0%	18.8%	12.0%
Capital/Loans	21.4%	22.6%	21.4%	16.9%	18.8%	17.0%
Capital/Assets+Contingent	7.1%	16.7%	7.2%	5.4%	17.4%	5.5%
Capital/Loans+Contingents	21.4%	22.6%	21.4%	16.9%	18.8%	17.0%
Assets/Employees	13	ERR	14	14	ERR	14
Assets/Offices	532	ERR	537	519	ERR	521
Net Int. Inc./Assets	2.75%	9.85%	2.82%	4.11%	4.17%	4.11%
Net Int. Inc./Earn. Asset	6.06%	10.29%	6.14%	9.05%	4.51%	9.00%
Return on Assets	0.22%	0.25%	0.22%	0.28%	0.69%	0.28%
Return on Equity	3.07%	1.52%	3.03%	5.12%	4.00%	5.10%
Loans/Deposits	52.4%	ERR	53.5%	46.9%	ERR	47.6%
Liquid Assets/Deposits	46.2%	ERR	46.2%	43.9%	ERR	43.9%
Liquid Assets/Sight Dpsts	ERR	ERR	ERR	ERR	ERR	ERR

EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-85)

PRIVATE BANKS

(millions of colones)

ACCOUNT \ BANK ->	BANEX	BANCOMER	BCT	(CAPITAL) CONSTRUCCION	FOMENTO AGRICOLA	BANINDUS	INTERFIN
ASSETS							
Cash & due from banks	96	93	245	4	134	42	97
Earning assets:							
Securities	151	129	142	3	21	20	236
Loans	795	771	277	5	248	25	931
Sub-total	946	900	419	8	269	45	1,167
Other operating assets	130	39	23	104	101	10	[illegible]
Fixed assets	29	50	21	5	13	1	28
Total Assets	1,201	1,082	708	121	517	98	1,358
LIABILITIES							
Deposits:							
At sight							
Time							
Sub-total	0	0	0	0	0	0	0
Other Liabilities	1,058	949	597	113	411	37	1,222
Total Liabilities	1,058	949	597	113	411	37	1,222
EQUITY							
Capital	115	85	100	7	100	60	109
Reserves	9	12	3	1	1	0	10
Retained earnings	19	36	8	1	5	1	17
Net Worth	143	133	111	9	106	61	136
Total	1,201	1,082	708	122	517	98	1,358
Contingent Liabilities	0	0	0	0	0	0	0
Interest income	245	222	49	17	63	5	229
Interest expense	158	146	32	5	28	0	[illegible]
Net Interest Income	87	76	17	12	35	5	63
Other Income:							
Fee income	4	7	22	0	0	0	20
Other income	1	0	10	2	1	0	44
Total Other Income	5	7	32	2	1	0	[illegible]
Total Operating Income	92	83	49	14	36	5	127
General & Admin. Expense	58	45	32	13	29	4	[illegible]
Miscellaneous expense	1	7	3	1	1	0	16
Net Operating Income	33	31	14	0	6	1	47
Extraordinary Income	2	0	9	1	0	0	0
Extraordinary Expense	0	0	3	1	0	0	0
Net Income / (Loss)	35	31	20	0	6	1	47
OTHER DATA							
Number of Offices	1	1	1	1	1	1	1
Number of Employees	73	76	43	26	52	9	74
RATIOS							
Capital/Assets	11.9%	12.3%	15.7%	7.4%	20.5%	62.2%	10.0%
Capital/Earning Assets	15.1%	14.8%	26.5%	112.5%	39.4%	135.6%	11.7%
Capital/Loans	18.0%	17.3%	40.1%	180.0%	42.7%	244.0%	14.6%
Capital/Assets+Contingent	11.9%	12.3%	15.7%	7.4%	20.5%	62.2%	10.0%
Capital/Loans+Contingents	18.0%	17.3%	40.1%	180.0%	42.7%	244.0%	14.6%
Assets/Employees	16	14	16	5	10	11	18
Assets/Offices	1,201	1,082	708	121	517	98	1,358
Net Int. Inc./Assets	7.24%	7.02%	2.40%	9.92%	6.77%	5.10%	4.[illegible]
Net Int. Inc./Earn. Asset	9.20%	8.44%	4.06%	150.00%	13.01%	11.11%	5.40%
Return on Assets	2.91%	2.87%	2.82%	0.00%	1.16%	1.02%	3.46%
Return on Equity	24.48%	23.31%	18.02%	0.00%	5.66%	1.64%	34.56%
Loans/Deposits	ERR	ERR	ERR	ERR	ERR	ERR	ERR
Liquid Assets/Deposits	ERR	ERR	ERR	ERR	ERR	ERR	ERR
Liquid Assets/Sight Dpsts	ERR	ERR	ERR	ERR	ERR	ERR	----

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EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-85)

PRIVATE BANKS

(millions of colones)

ACCOUNT \ BANK ->	LYON	BANMETRO	BANJOSE	BANK AMERICA	WEEDEN	SANTANDER	COOPERATIVO COSTARRICEN.
ASSETS							
Cash & due from banks	9	2	59	121	16	197	105
Earning assets:							
Securities	0	12	74	43	1	24	60
Loans	5	7	43	459	56	146	790
Sub-total	5	19	117	502	57	170	850
Other operating assets	0	6	106	41	16	20	36
Fixed assets	4	3	7	115	58	55	28
Total Assets	18	30	289	779	147	442	1,019
LIABILITIES							
Deposits:							
At sight							
Time							
Sub-total	0	0	0	0	0	0	0
Other Liabilities	5	1	232	668	85	368	750
Total Liabilities	5	1	232	668	85	368	750
EQUITY							
Capital	1	30	60	93	68	35	220
Reserves	10	0	0	17	0	10	8
Retained earnings	3	(1)	(3)	1	(6)	29	41
Net Worth	14	29	57	111	62	74	269
Total	19	30	289	779	147	442	1,019
Contingent Liabilities	0	0	0	0	0	0	0
Interest income	14	278	22	131	17	67	164
Interest expense	0	177	10	83	15	25	94
Net Interest Income	14	101	12	48	2	42	70
Other Income:							
Fee income	3	26	14	2	2	4	[illegible]
Other income	0	39	6	0	6	4	[illegible]
Total Other Income	3	65	20	2	8	8	[illegible]
Total Operating Income	17	166	32	50	10	50	[illegible]
General & Admin. Expense	13	68	19	52	9	22	[illegible]
Miscellaneous expense	0	34	16	2	2	1	[illegible]
Net Operating Income	4	64	(3)	(4)	(1)	27	[illegible]
Extraordinary Income	0	1	0	13	0	1	
Extraordinary Expense	0	2	0	0	0	0	
Net Income / (Loss)	4	63	(3)	9	(1)	28	[illegible]
OTHER DATA							
Number of Offices	1	1	1	1	1	1	
Number of Employees	36	13	unknown	unknown	unknown	unknown	[illegible]
RATIOS							
Capital/Assets	77.8%	96.7%	19.7%	14.2%	42.2%	16.7%	26.
Capital/Earning Assets	280.0%	152.6%	48.7%	22.1%	108.8%	43.5%	31.
Capital/Loans	280.0%	414.3%	132.6%	24.2%	110.7%	50.7%	34.
Capital/Assets+Contingent	77.8%	96.7%	19.7%	14.2%	42.2%	16.7%	26.
Capital/Loans+Contingents	280.0%	414.3%	132.6%	24.2%	110.7%	50.7%	34.
Assets/Employees	1	2	ERR	ERR	ERR	ERR	[illegible]
Assets/Offices	18	30	289	779	147	442	1,0[illegible]
Net Int. Inc./Assets	77.78%	336.67%	4.15%	6.16%	1.36%	9.50%	6.[illegible]
Net Int. Inc./Earn. Asset	280.00%	531.58%	10.26%	9.56%	3.51%	24.71%	8.[illegible]
Return on Assets	22.22%	210.00%	-1.04%	1.16%	-0.68%	6.33%	3.[illegible]
Return on Equity	28.57%	217.24%	-5.26%	8.11%	-1.61%	37.84%	13.[illegible]
Loans/Deposits	ERR	ERR	ERR	ERR	ERR	ERR	[illegible]
Liquid Assets/Deposits	ERR	ERR	ERR	ERR	ERR	ERR	[illegible]
Liquid Assets/Sight Dpsts	ERR	ERR	ERR	ERR	ERR	ERR	[illegible]

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EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-85)

(millions of colones)

ACCOUNT \ BANK ->	PRIVATE BANKS: INTERNACIONAL EXPORTACIONES	COOPERATIVO DE ALAJUELA	POPULAR
ASSETS			
Cash & due from banks	9	1	252
Earning assets:			
Securities	7	0	405
Loans	44	1	5,819
Sub-total	51	1	6,224
Other operating assets	166	3	126
Fixed assets	2	3	225
Total Assets	228	8	6,827
LIABILITIES			
Deposits:			
At sight			
Time			4,553
Sub-total	0	0	4,553
Other Liabilities	129	3	876
Total Liabilities	129	3	5,429
EQUITY			
Capital	98	5	1,398
Reserves	0	0	
Retained earnings	1	0	
Net Worth	99	5	1,398
Total	228	8	6,827
Contingent Liabilities	0	0 0	0
Interest income	17	2	1,216
Interest expense	27	0	594
Net Interest Income	(10)	2	622
Other Income:			
Fee income	0	0	
Other income	5	0	29
Total Other Income	5	0	29
Total Operating Income	(5)	2	651
General & Admin. Expense	15	3	382
Miscellaneous expense	0	0	3
Net Operating Income	(20)	(1)	266
Extraordinary Income	13	0	0
Extraordinary Expense	2	0	0
Net Income / (Loss)	(9)	(1)	266
OTHER DATA			
Number of Offices	1	1	unknown
Number of Employees	unknown	unknown	unknown
RATIOS			
Capital/Assets	43.4%	62.5%	20.5%
Capital/Earning Assets	194.1%	500.0%	22.5%
Capital/Loans	225.0%	500.0%	24.0%
Capital/Assets+Contingent	43.4%	62.5%	20.5%
Capital/Loans+Contingents	225.0%	500.0%	24.0%
Assets/Employees	ERR	ERR	ERR
Assets/Offices	228	8	ERR
Net Int. Inc./Assets	-4.39%	25.00%	9.11%
Net Int. Inc./Earn. Asset	-19.61%	200.00%	9.99%
Return on Assets	-3.95%	-12.50%	3.90%
Return on Equity	-9.09%	-20.00%	19.03%
Loans/Deposits	ERR	ERR	127.8%
Liquid Assets/Deposits	ERR	ERR	5.5%
Liquid Assets/Sight Dpsts	ERR	ERR	ERR

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EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-85)

(millions of colones)	STATE BANKS		PRIVATE BANKS				
ACCOUNT \ BANK ->	SUB-TOTAL STATE BANKS	AVERAGE STATE BANKS	SUB-TOTAL PRIVATE BANKS	AVERAGE PRIVATE BANKS	TOTAL ALL BANKS	AVERAGE ALL BANKS	PRIVATE BANKS' SHARE OF TOTAL
ASSETS							
Cash & due from banks	28,196	7,049	1,220	76	29,668	1,413	4.1%
Earning assets:							
Securities	12,372	3,093	916	57	13,693	652	6.7%
Loans	31,117	7,779	4,558	285	41,494	1,976	11.0%
Sub-total	43,489	10,872	5,474	342	55,187	2,628	9.9%
Other operating assets	20,426	5,107	698	44	21,250	1,012	3.3%
Fixed assets	1,215	304	417	26	1,857	88	22.5%
Total Assets	93,326	23,332	7,809	488	107,962	5,141	7.2%
LIABILITIES							
Deposits:							
At sight	0	0	0	0	0	0	ERR
Time	0	0	0	0	4,553	217	0.0%
Sub-total	61,557	15,389	0	0	4,553	217	0.0%
Other Liabilities	25,714	6,429	6,496	406	33,086	1,576	19.6%
Total Liabilities	87,271	21,818	6,496	406	37,639	1,792	17.3%
EQUITY							
Capital	4,032	1,008	1,083	68	6,513	310	16.6
Reserves	329	82	81	5	410	20	19.8
Retained earnings	1,694	424	151	9	1,845	88	8.2
Net Worth	6,055	1,514	1,315	82	8,768	418	15.0
Total	93,326	23,332	7,811	488	46,407	2,210	16.8
Contingent Liabilities	0	0	0	0	0	0	ERR
Interest income	7,727	1,932	1,523	95	10,466	498	14.5
Interest expense	4,660	1,165	939	59	6,193	295	15.1
Net Interest Income	3,067	767	584	37	4,273	203	13.7
Other Income:							
Fee income	64	16	106	7	170	8	62.
Other income	323	81	113	7	465	22	24.
Total Other Income	387	97	219	14	635	30	34.
Total Operating Income	3,454	864	803	50	4,908	234	16.
General & Admin. Expense	3,845	961	463	29	4,690	223	9.
Miscellaneous expense	4	1	84	5	91	4	92.
Net Operating Income	(395)	(99)	256	16	127	6	201.
Extraordinary Income	717	179	27	2	744	35	3
Extraordinary Expense	107	27	6	0	113	5	5
Net Income / (Loss)	215	54	277	17	758	36	36
OTHER DATA							
Number of Offices	175	44	14	1	189	9	7
Number of Employees	7,129	1,782	446	28	7,575	361	5
RATIOS							
Capital/Assets	6.5%	6.5%	16.8%	16.8%	8.1%	8.1%	
Capital/Earning Assets	13.9%	13.9%	24.0%	24.0%	15.9%	15.9%	
Capital/Loans	19.5%	19.5%	28.9%	28.9%	21.1%	21.1%	
Capital/Assets+Contingent	6.5%	6.5%	16.8%	16.8%	8.1%	8.1%	
Capital/Loans+Contingents	19.5%	19.5%	28.9%	28.9%	21.1%	21.1%	
Assets/Employees	13	13	18	18	14	14	
Assets/Offices	533	533	558	558	571	571	
Net Int. Inc./Assets	3.29%	3.29%	7.48%	7.48%	3.96%	3.96%	
Net Int. Inc./Earn. Asset	7.05%	7.05%	10.67%	10.67%	7.74%	7.74%	
Return on Assets	0.23%	0.23%	3.55%	3.55%	0.70%	0.70%	
Return on Equity	3.55%	3.55%	21.06%	21.06%	8.65%	8.65%	
Loans/Deposits	50.5%	50.5%	ERR	ERR	911.4%	911.4%	
Liquid Assets/Deposits	45.8%	45.8%	ERR	ERR	651.6%	651.6%	
Liquid Assets/Sight Dpsts	ERR	ERR	ERR	ERR	ERR	ERR	

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EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-88)

STATE-OWNED BANKS

(millions of colones)	Banco Anglo Costarricense			Banco Credito Agricola de Cartago		
ACCOUNT \ BANK ->	Commercial	Mortgage	Total	Commercial	Mortgage	Total
ASSETS						
Cash & due from banks	8,868	4	8,872	8,732	25	8,757
Earning assets:						
Securities	3,757	68	3,825	1,254	35	1,289
Loans	6,167	9	6,176	2,063	724	2,787
Sub-total	9,924	77	10,001	3,317	759	4,076
Other operating assets	4,896	1	4,897	3,946	81	4,027
Fixed assets	830	0	830	978	41	1,019
Total Assets	24,518	82	24,600	16,973	906	17,879
LIABILITIES						
Deposits:						
At sight	11,688	0	11,688	4,620	71	4,691
Time	8,741	30	8,771	9,006	745	9,751
Sub-total	20,429	30	20,459	13,626	816	14,442
Other Liabilities	2,833	0	2,833	2,499	17	2,516
Total Liabilities	23,262	30	23,292	16,125	833	16,958
EQUITY						
Capital	705	40	745	452	68	520
Reserves	28	12	40	10	5	15
Retained earnings	523	0	523	386	0	386
Net Worth	1,256	52	1,308	848	73	921
Total	24,518	82	24,600	16,973	906	17,879
Contingent Liabilities	0	0	0	942		942
Interest income	2,161	6	2,167	786	161	947
Interest expense	1,362	2	1,364	642	141	783
Net Interest Income	799	4	803	144	20	164
Other Income:						
Fee income	210	0	210	259	1	260
Other income	103	0	103	40	2	42
Total Other Income	313	0	313	299	3	302
Total Operating Income	1,112	4	1,116	443	23	466
General & Admin. Expense	1,078	0	1,078	476	21	497
Miscellaneous expense	15	1	16	7	0	7
Net operating Income	19	3	22	(40)	2	(38)
Extraordinary Income	9	0	9	54	1	55
Extraordinary Expense	5	0	5	3	0	3
Net Income / (Loss)	23	3	26	11	3	14
OTHER DATA						
Number of Offices	38		38	8		8
Number of Employees	1,420		1,420	684		684
RATIOS						
Capital/Assets	5.1%	63.4%	5.3%	5.0%	8.1%	5.2%
Capital/Earning Assets	12.7%	67.5%	13.1%	25.6%	9.6%	22.6%
Capital/Loans	20.4%	577.8%	21.2%	41.1%	10.1%	33.0%
Capital/Assets+Contingent	5.1%	63.4%	5.3%	4.7%	8.1%	4.9%
Capital/Loans+Contingents	20.4%	577.8%	21.2%	28.2%	10.1%	24.7%
Assets/Employees	17	ERR	17	25	ERR	26
Assets/Offices	645	ERR	647	2,122	ERR	2,235
Net Int. Inc./Assets	3.26%	4.88%	3.26%	0.85%	2.21%	0.92%
Net Int. Inc./Earn. Asset	8.05%	5.19%	8.03%	4.34%	2.64%	4.02%
Return on Assets	0.09%	3.66%	0.11%	0.06%	0.33%	0.08%
Return on Equity	1.83%	5.77%	1.99%	1.30%	4.11%	1.52%
Loans/Deposits	30.2%	30.0%	30.2%	15.1%	88.7%	19.3%
Liquid Assets/Deposits	43.4%	13.3%	43.4%	64.1%	3.1%	60.6%
Liquid Assets/Sight Depos	75.9%	ERR	75.9%	189.0%	35.2%	186.7%

EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-88)

STATE-OWNED BANKS

(millions of colones)

ACCOUNT \ BANK ->	Banco Nacional de Costa Rica			Banco de Costa Rica		
	Commercial	Mortgage	Total	Commercial	Mortgage	Total
ASSETS						
Cash & due from banks	22,394	25	22,419	19,732	0	19,732
Earning assets:						
Securities	5,913	0	5,913	4,444	0	4,444
Loans	17,359	386	17,745	14,135	172	14,307
Sub-total	23,272	386	23,658	18,579	172	18,751
Other operating assets	23,068	18	23,086	9,760	13	9,773
Fixed assets	4,761	0	4,761	1,474	0	1,474
Total Assets	73,495	429	73,924	49,545	185	49,730
LIABILITIES						
Deposits:						
At sight	29,781	92	29,873	23,301	0	23,301
Time	27,766	127	27,893	19,152	157	19,309
Sub-total	57,547	219	57,766	42,453	157	42,610
Other Liabilities	12,192	144	12,336	4,847	2	4,849
Total Liabilities	69,739	363	70,102	47,300	159	47,459
EQUITY						
Capital	1,650	30	1,680	1,330	10	1,340
Reserves	112	36	148	230	16	246
Retained earnings	1,994	0	1,994	685	0	685
Net Worth	3,756	66	3,822	2,245	26	2,271
Total	73,495	429	73,924	49,545	185	49,730
Contingent Liabilities	430	0	430	1,623	0	1,623
Interest income	4,969	89	5,058	4,312	23	4,335
Interest expense	3,591	30	3,621	2,239	10	2,249
Net Interest Income	1,378	59	1,437	2,073	13	2,086
Other Income:						
Fee income	663	0	663	624	0	624
Other income	112	0	112	127	0	127
Total Other Income	775	0	775	751	0	751
Total Operating Income	2,153	59	2,212	2,824	13	2,837
General & Admin. Expense	3,201	61	3,262	2,589	13	2,602
Miscellaneous expense	5	0	5	3	0	3
Net Operating Income	(1,053)	(2)	(1,055)	232	0	232
Extraordinary Income	1,328	3	1,331	118	0	118
Extraordinary Expense	197	0	197	136	0	136
Net Income / (Loss)	78	1	79	214	0	214
OTHER DATA						
Number of Offices	84		84	62		62
Number of Employees	3,259		3,259	2,367		2,367
RATIOS						
Capital/Assets	5.1%	15.4%	5.2%	4.5%	14.1%	4.6%
Capital/Earning Assets	16.1%	17.1%	16.2%	12.1%	15.1%	12.1%
Capital/Loans	21.6%	17.1%	21.5%	15.9%	15.1%	15.9%
Capital/Assets+Contingent	5.1%	15.4%	5.1%	4.4%	14.1%	4.4%
Capital/Loans+Contingents	21.1%	17.1%	21.0%	14.2%	15.1%	14.3%
Assets/Employees	23	ERR	23	21	ERR	21
Assets/Offices	875	ERR	880	799	ERR	802
Net Int. Inc./Assets	1.87%	13.75%	1.94%	4.18%	7.03%	4.19%
Net Int. Inc./Earn. Asset	5.92%	15.28%	6.07%	11.16%	7.56%	11.12%
Return on Assets	0.11%	0.23%	0.11%	0.43%	0.00%	0.43%
Return on Equity	2.08%	1.52%	2.07%	9.53%	0.00%	9.42%
Loans/Deposits	30.2%	176.3%	30.7%	33.3%	109.6%	33.6%
Liquid Assets/Deposits	38.9%	11.4%	38.8%	46.5%	0.0%	46.3%
Liquid Assets/Sight Depos	75.2%	27.2%	75.0%	84.7%	ERR	84.7%

EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-88)

(millions of colones)

ACCOUNT \ BANK ->	PRIVATE BANKS						
	BANEX	BACOFISA	BANCOMER	CONTINENTAL	BCT	(CAPITAL) CONSTRUCCION	FOMENTO AGRICOLA
ASSETS							
Cash & due from banks	227	27	98	16	513	6	84
Earning assets:							
Securities	688	171	253	40	339	2	507
Loans	1,840	422	980	315	793	0	1,475
Sub-total	2,528	593	1,233	355	1,132	2	1,982
Other operating assets	122	41	52	122	58	133	153
Fixed assets	139	0	135	5	90	10	101
Total Assets	3,016	661	1,518	498	1,793	151	2,320
LIABILITIES							
Deposits:							
At sight	107	0	13	0	464	20	47
Time	2,440	427	1,171	319	952	0	1,856
Sub-total	2,547	427	1,184	319	1,416	20	1,903
Other Liabilities	118	29	35	6	37	81	175
Total Liabilities	2,665	456	1,219	325	1,453	101	2,078
EQUITY							
Capital	299	115	200	162	250	17	222
Reserves	23	6	25	2	13	0	10
Retained earnings	29	84	74	9	77	33	10
Net Worth	351	205	299	173	340	50	242
Total	3,016	661	1,518	498	1,793	151	2,320
Contingent Liabilities	900	367	446	24	273	190	509
Interest income	613	122	361	73	214	2	[illegible]
Interest expense	516	72	266	36	165	6	260
Net Interest Income	97	50	95	37	49	(4)	71
Other Income:							
Fee income	62	19	36	4	33	14	54
Other income	63	52	11	2	17	0	11
Total Other Income	125	71	47	6	50	14	65
Total Operating Income	222	121	142	43	99	10	136
General & Admin. Expense	125	75	74	26	63	25	97
Miscellaneous expense	34	0	6	1	1	0	1
Net Operating Income	63	46	62	16	35	(15)	38
Extraordinary Income	0	0	4	0	4	9	0
Extraordinary Expense	0	0	2	0	1	0	0
Net Income / (Loss)	63	46	64	16	38	(6)	38
OTHER DATA							
Number of Offices	1	1	1	1	1	2	1
Number of Employees	115	89	80	20	47	25	1[illegible]
RATIOS							
Capital/Assets	11.6%	31.0%	19.7%	34.7%	19.0%	33.1%	10.4%
Capital/Earning Assets	13.9%	34.6%	24.2%	48.7%	30.0%	2500.0%	12.2%
Capital/Loans	19.1%	48.6%	30.5%	54.9%	42.9%	ERR	16.4%
Capital/Assets+Contingent	9.0%	19.9%	15.2%	33.1%	16.5%	14.7%	8.6%
Capital/Loans+Contingents	12.8%	26.0%	21.0%	51.0%	31.9%	26.3%	12.[illegible]
Assets/Employees	26	7	19	25	38	6	[illegible]
Assets/Offices	3,016	661	1,518	498	1,793	76	2,320
Net Int. Inc./Assets	3.22%	7.56%	6.26%	7.43%	2.73%	-2.65%	3.04%
Net Int. Inc./Earn. Asset	3.84%	8.43%	7.70%	10.42%	4.33%	-200.00%	3.58%
Return on Assets	2.09%	6.96%	4.22%	3.21%	2.12%	-3.97%	1.44%
Return on Equity	17.95%	22.44%	21.40%	9.25%	11.18%	-12.00%	15.70%
Loans/Deposits	72.2%	98.8%	82.8%	98.7%	56.0%	0.0%	77.5%
Liquid Assets/Deposits	8.9%	6.3%	8.3%	5.0%	36.2%	30.0%	4.4%
Liquid Assets/Sight Depos	212.1%	ERR	753.8%	ERR	110.6%	30.0%	178.7%

EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-88)

(millions of colones)

ACCOUNT \ BANK ->	PRIVATE BANKS						
	FEDERADO	FINCOMER	BICSA	BANINDUS	INTERFIN	LYON	BANMETRO
ASSETS							
Cash & due from banks	4	12	77	98	341	38	6
Earning assets:							
Securities	277	17	297	8	704	20	35
Loans	143	130	616	37	2,474	3	69
Sub-total	420	147	913	45	3,178	23	1,05
Other operating assets	23	45	118	0	115	2	19
Fixed assets	5	13	138	1	68	5	8
Total Assets	452	217	1,246	144	3,702	68	1,39
LIABILITIES							
Deposits:							
At sight	0	0	9	0	39	35	
Time	23	98	743	1	3,166	0	1,0
Sub-total	23	98	752	1	3,205	35	1,0
Other Liabilities	3	7	146	10	125	5	
Total Liabilities	26	105	898	11	3,330	40	1,1
EQUITY							
Capital	400	100	300	100	285	1	2
Reserves	2	2	6	1	39	17	
Retained earnings	24	10	42	32	48	10	
Net Worth	426	112	348	133	372	28	2
Total	452	217	1,246	144	3,702	68	1,3
Contingent Liabilities	0	27	79	3	760	0	4
Interest income	47	54	200	13	782	4	
Interest expense	3	18	91	1	643	0	
Net Interest Income	44	36	109	12	139	4	
Other Income:							
Fee income	0	0	23	2	111	17	
Other income	0	0	12	0	81	0	
Total Other Income	0	0	35	2	192	17	
Total Operating Income	44	36	144	14	331	21	
General & Admin. Expense	18	27	80	11	157	14	
Miscellaneous expense	1	0	11	0	56	0	
Net Operating Income	25	9	53	3	118	7	
Extraordinary Income	0	0	0	0	0	0	
Extraordinary Expense	0	1	0	0	2	0	
Net Income / (Loss)	25	8	53	3	116	7	
OTHER DATA							
Number of Offices	1	2	1	1	2	1	
Number of Employees	13	54	57	13	138	22	
RATIOS							
Capital/Assets	94.2%	51.6%	27.9%	92.4%	10.0%	41.2%	
Capital/Earning Assets	101.4%	76.2%	38.1%	295.6%	11.7%	121.7%	
Capital/Loans	297.9%	86.2%	56.5%	359.5%	15.0%	933.3%	
Capital/Assets+Contingent	94.2%	45.9%	26.3%	90.5%	8.3%	41.2%	
Capital/Loans+Contingents	297.9%	71.3%	50.1%	332.5%	11.5%	933.3%	
Assets/Employees	35	4	22	11	27	3	
Assets/Offices	452	109	1,246	144	1,851	68	1
Net Int. Inc./Assets	9.73%	16.59%	8.75%	8.33%	3.75%	5.88%	
Net Int. Inc./Earn. Asset	10.48%	24.49%	11.94%	26.67%	4.37%	17.39%	
Return on Assets	5.53%	3.69%	4.25%	2.08%	3.13%	10.29%	
Return on Equity	5.87%	7.14%	15.23%	2.26%	31.18%	25.00%	2
Loans/Deposits	621.7%	132.7%	81.9%	3700.0%	77.2%	8.6%	
Liquid Assets/Deposits	17.4%	12.2%	10.2%	9800.0%	10.6%	108.6%	
Liquid Assets/Sight Depos	ERR	ERR	855.6%	ERR	874.4%	108.6%	4

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EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-88)

(millions of colones)

ACCOUNT \ BANK ->	PRIVATE BANKS					
	BANMER	BANSANJO	GERMANO CENTROAM.	INTERNACIONAL EXPORTACION	COOPERATIVO COSTARRICEN.	POPULAR
ASSETS						
Cash & due from banks	49	79	23	9	219	457
Earning assets:						
Securities	83	406	126	0	48	2,974
Loans	684	1,177	723	48	2,483	13,636
Sub-total	767	1,583	849	48	2,531	16,610
Other operating assets	140	466	374	62	304	138
Fixed assets	172	196	46	5	63	486
Total Assets	1,128	2,324	1,292	124	3,117	17,691
LIABILITIES						
Deposits:						
At sight	40	274	51	8	141	
Time	845	1,700	876	40	2,426	12,520
Sub-total	885	1,974	927	48	2,567	12,520
Other Liabilities	60	36	130	22	87	1,743
Total Liabilities	945	2,010	1,057	70	2,654	14,263
EQUITY						
Capital	153	250	200	54	313	3,428
Reserves	6	27	5	0	28	
Retained earnings	24	37	30	0	122	
Net Worth	183	314	235	54	463	3,428
Total	1,128	2,324	1,292	124	3,117	17,691
Contingent Liabilities	127	527	36	27	326	0
Interest income	279	388	107	18	591	3,027
Interest expense	239	309	47	44	439	1,899
Net Interest Income	40	79	60	(26)	152	1,128
Other Income:						
Fee income	23	57	26	15	104	
Other income	46	9	0	1	14	103
Total Other Income	69	66	26	16	118	103
Total Operating Income	109	145	86	(10)	270	1,231
General & Admin. Expense	45	88	44	44	170	941
Miscellaneous expense	39	7	2	0	9	11
Net Operating Income	25	50	40	(54)	91	279
Extraordinary Income	2	0	0	27	2	0
Extraordinary Expense	0	1	0	5	6	0
Net Income / (Loss)	27	49	40	(32)	87	279
OTHER DATA						
Number of Offices	3	5	1	1	1	unknown
Number of Employees	57	76	51	n/a	n/a	unknown
RATIOS						
Capital/Assets	16.2%	13.5%	18.2%	43.5%	14.9%	19.4%
Capital/Earning Assets	23.9%	19.8%	27.7%	112.5%	18.3%	20.6%
Capital/Loans	26.8%	26.7%	32.5%	112.5%	18.6%	25.1%
Capital/Assets+Contingent	14.6%	11.0%	17.7%	35.8%	13.4%	19.4%
Capital/Loans+Contingents	22.6%	18.4%	31.0%	72.0%	16.5%	25.1%
Assets/Employees	20	31	25	ERR	ERR	ERR
Assets/Offices	376	465	1,292	124	3,117	ERR
Net Int. Inc./Assets	3.55%	3.40%	4.64%	-20.97%	4.88%	6.38%
Net Int. Inc./Earn. Asset	5.22%	4.99%	7.07%	-54.17%	6.01%	6.79%
Return on Assets	2.39%	2.11%	3.10%	-25.81%	2.79%	1.58%
Return on Equity	14.75%	[illegible]	[illegible]	-59.26%	18.79%	8.14%
Loans/Deposits	77.3%	59.6%	78.0%	100.0%	96.7%	108.9%
Liquid Assets/Deposits	5.5%	4.0%	2.5%	18.8%	8.5%	3.7%
Liquid Assets/Sight Depos	122.5%	28.8%	45.1%	112.5%	155.3%	ERR

EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-88)

(millions of colones)	STATE BANKS		PRIVATE BANKS				
ACCOUNT \ BANK ->	SUB-TOTAL STATE BANKS	AVERAGE STATE BANKS	SUB-TOTAL PRIVATE BANKS	AVERAGE PRIVATE BANKS	TOTAL ALL BANKS	AVERAGE ALL BANKS	PRIVATE BANKS' SHARE OF TOTAL
ASSETS							
Cash & due from banks	59,780	14,945	1,987	105	62,224	2,593	3.2%
Earning assets:							
Securities	15,471	3,868	4,340	228	22,785	949	19.0%
Loans	41,015	10,254	15,041	792	69,692	2,904	21.6%
Sub-total	56,486	14,122	19,381	1,020	92,477	3,853	21.0%
Other operating assets	41,783	10,446	2,521	133	44,442	1,852	5.7%
Fixed assets	8,084	2,021	1,274	67	9,844	410	12.9%
Total Assets	166,133	41,533	25,163	1,324	208,987	8,708	12.0%
LIABILITIES							
Deposits:							
At sight	69,553	17,388	1,264	67	70,817	2,951	1.8[illegible]
Time	65,724	16,431	18,149	955	96,393	4,016	18.8[illegible]
Sub-total	135,277	33,819	19,413	1,022	167,210	6,967	11.6[illegible]
Other Liabilities	22,534	5,634	1,148	60	25,425	1,059	4.5[illegible]
Total Liabilities	157,811	39,453	20,561	1,082	192,635	8,026	10.7[illegible]
EQUITY							
Capital	4,285	1,071	3,633	191	11,346	473	32.0[illegible]
Reserves	449	112	219	12	668	28	32.8
Retained earnings	3,588	897	750	39	4,338	181	17.3
Net Worth	8,322	2,081	4,602	242	16,352	681	28.1
Total	166,133	41,533	25,163	1,324	208,987	8,708	12.0
Contingent Liabilities	2,995	749	5,111	269	,106	338	[illegible]
Interest income	12,507	3,127	4,477	236	20,011	834	22.[illegible]
Interest expense	8,017	2,004	3,332	175	13,248	552	25.[illegible]
Net Interest Income	4,490	1,123	1,145	60	6,763	282	16.[illegible]
Other Income:							
Fee income	1,757	439	626	33	2,383	99	26.[illegible]
Other income	384	96	358	19	845	35	42.[illegible]
Total Other Income	2,141	535	984	52	3,228	135	30.[illegible]
Total Operating Income	6,631	1,658	2,129	112	9,991	416	21.[illegible]
General & Admin. Expense	7,439	1,860	1,251	66	9,631	401	13.[illegible]
Miscellaneous expense	31	8	202	11	244	10	82.[illegible]
Net Operating Income	(839)	(210)	676	36	116	5	582.[illegible]
Extraordinary Income	1,513	378	49	3	1,562	65	3.[illegible]
Extraordinary Expense	341	85	20	1	361	15	5.[illegible]
Net Income / (Loss)	333	83	705	37	1,317	55	53.[illegible]
OTHER DATA							
Number of Offices	192	48	28	1	220	9	12.[illegible]
Number of Employees	7,730	1,933	1,014	53	8,744	334	11.[illegible]
RATIOS							
Capital/Assets	5.0%	5.0%	18.3%	18.3%	7.8%	7.8%	
Capital/Earning Assets	14.7%	14.7%	23.7%	23.7%	17.7%	17.7%	
Capital/Loans	20.3%	20.3%	30.6%	30.6%	23.5%	23.5%	
Capital/Assets+Contingent	4.9%	4.9%	15.2%	15.2%	7.5%	7.5%	
Capital/Loans+Contingents	18.9%	18.9%	22.8%	22.8%	21.0%	21.0%	
Assets/Employees	21	21	25	25	24	24	
Assets/Offices	865	865	899	899	950	950	
Net Int. Inc./Assets	2.70%	2.70%	4.55%	4.55%	3.24%	3.24%	
Net Int. Inc./Earn. Asset	7.95%	7.95%	5.91%	5.91%	7.31%	7.31%	
Return on Assets	0.20%	0.20%	2.80%	2.80%	0.63%	0.63%	
Return on Equity	4.00%	4.00%	15.32%	15.32%	8.05%	8.05%	
Loans/Deposits	30.3%	30.3%	77.5%	77.5%	41.7%	41.7%	
Liquid Assets/Deposits	44.2%	44.2%	10.2%	10.2%	37.2%	37.2%	
Liquid Assets/Sight Depos	85.9%	85.9%	157.2%	157.2%	87.9%	87.9%	

EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-91)

STATE-OWNED BANKS

(millions of colones)

	Banco Anglo Costarricense			Banco Credito Agricola de Cartago		
ACCOUNT \ BANK ->	Commercial	Mortgage	Total	Commercial	Mortgage	Total
ASSETS						
Cash & due from banks	21,646	1	21,647	34,877	40	34,917
Earning assets:						
Securities	9,542	64	9,606	1,663	380	2,043
Loans	7,006	2	7,008	3,177	652	3,829
Sub-total	16,548	66	16,614	4,840	1,032	5,872
Other operating assets	12,580	1	12,581	3,242	801	4,043
Fixed assets	2,841	0	2,841	2,318	41	2,359
Total Assets	53,615	68	53,683	45,277	1,914	47,191
LIABILITIES						
Deposits:						
At sight	23,271	0	23,271	6,807	810	7,617
Time	16,845	16	16,861	32,020	993	33,013
Sub-total	40,116	16	40,132	38,827	1,803	40,630
Other Liabilities	11,376	0	11,376	4,282	39	4,321
Total Liabilities	51,492	16	51,508	43,109	1,842	44,951
EQUITY						
Capital	1,378	40	1,418	1,021	68	1,089
Reserves	50	12	62	41	4	45
Retained earnings	695	0	695	1,106	0	1,106
Net Worth	2,123	52	2,175	2,168	72	2,240
Total	53,615	68	53,683	45,277	1,914	47,191
Contingent Liabilities	57	0	57	1,781		1,781
Interest income	3,841	15	3,856	2,166	228	2,394
Interest expense	2,864	5	2,869	1,933	194	2,127
Net Interest Income	977	10	987	233	34	267
Other Income:						
Fee income	713	0	713	643	1	644
Other income	209	0	209	128	5	133
Total Other Income	922	0	922	771	6	777
Total Operating Income	1,899	10	1,909	1,004	40	1,044
General & Admin. Expense	2,100	1	2,101	978	40	1,018
Miscellaneous expense	13	1	14	22	0	22
Net Operating Income	(214)	8	(206)	4	0	4
Extraordinary Income	326	0	326	16	2	18
Extraordinary Expense	66	0	66	11	0	11
Net Income / (Loss)	46	8	54	9	2	11
OTHER DATA						
Number of Offices	35		35	20		20
Number of Employees	1,239		1,239	846		846
RATIOS						
Capital/Assets	4.0%	76.5%	4.1%	4.8%	3.8%	4.7%
Capital/Earning Assets	12.8%	78.8%	13.1%	44.8%	7.0%	38.1%
Capital/Loans	30.3%	2600.0%	31.0%	68.2%	11.0%	58.5%
Capital/Assets+Contingent	4.0%	76.5%	4.0%	4.6%	3.8%	4.6%
Capital/Loans+Contingents	30.1%	2600.0%	30.8%	43.7%	11.0%	39.9%
Assets/Employees	43	ERR	43	54	ERR	56
Assets/Offices	1,532	ERR	1,534	2,264	ERR	2,360
Net Int. Inc./Assets	1.82%	14.71%	1.84%	0.51%	1.78%	0.57%
Net Int. Inc./Earn. Asset	5.90%	15.15%	5.94%	4.81%	3.29%	4.55%
Return on Assets	0.09%	11.76%	0.10%	0.02%	0.10%	0.02%
Return on Equity	2.17%	15.38%	2.48%	0.42%	2.78%	0.49%
Loans/Deposits	17.5%	12.5%	17.5%	8.2%	36.2%	9.4%
Liquid Assets/Deposits	54.0%	6.3%	53.9%	89.8%	2.2%	85.9%
Liquid Assets/Sight Dpsts	93.0%	ERR	93.0%	512.4%	4.9%	458.4%

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EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-91)

STATE-OWNED BANKS

(millions of colones)

	Banco Nacional de Costa Rica			Banco de Costa Rica		
ACCOUNT \ BANK ->	Commercial	Mortgage	Total	Commercial	Mortgage	Total
ASSETS						
Cash & due from banks	54,017	0	54,017	41,418	0	41,418
Earning assets:						
Securities	9,673	0	9,673	6,738	0	6,738
Loans	26,774	932	27,706	17,348	315	17,663
Sub-total	36,447	932	37,379	24,086	315	24,401
Other operating assets	61,725	20	61,745	13,198	18	13,216
Fixed assets	17,894	0	17,894	5,864	0	5,864
Total Assets	170,083	952	171,035	84,566	333	84,899
LIABILITIES						
Deposits:						
At sight	64,313	227	64,540	35,744	4	35,748
Time	57,072	91	57,163	37,517	289	37,806
Sub-total	121,385	318	121,703	73,261	293	73,554
Other Liabilities	39,183	604	39,787	4,998	14	5,012
Total Liabilities	160,568	922	161,490	78,259	307	78,566
EQUITY						
Capital	3,500	30	3,530	2,047	11	2,058
Reserves	11	0	11	93	15	108
Retained earnings	6,004	0	6,004	4,167	0	4,167
Net Worth	9,515	30	9,545	6,307	26	6,333
Total	170,083	952	171,035	84,566	333	84,899
Contingent Liabilities	2,855		2,855	1,574		1,574
Interest income	12,502	154	12,656	8,689	66	8,755
Interest expense	11,202	198	11,400	5,124	65	5,189
Net Interest Income	1,300	(44)	1,256	3,565	1	3,566
Other Income:						
Fee income	2,179	0	2,179	1,583	0	1,583
Other income	1,960	0	1,960	144	0	144
Total Other Income	4,139	0	4,139	1,727	0	1,727
Total Operating Income	5,439	(44)	5,395	5,292	1	5,293
General & Admin. Expense	7,164	4	7,168	5,668	26	5,694
Miscellaneous expense	128	0	128	20	0	20
Net Operating Income	(1,853)	(48)	(1,901)	(396)	(25)	(421)
Extraordinary Income	2,039	48	2,087	564	1	565
Extraordinary Expense	180	0	180	123	0	123
Net Income / (Loss)	6	0	6	45	(24)	21
OTHER DATA						
Number of Offices	79		79	74		74
Number of Employees	3,549		3,549	2,757		2,757
RATIOS						
Capital/Assets	5.6%	3.2%	5.6%	7.5%	7.8%	7.5%
Capital/Earning Assets	26.1%	3.2%	25.5%	26.2%	8.3%	26.0%
Capital/Loans	35.5%	3.2%	34.5%	36.4%	8.3%	35.9%
Capital/Assets+Contingent	5.5%	3.2%	5.5%	7.3%	7.8%	7.3%
Capital/Loans+Contingents	32.1%	3.2%	31.2%	33.3%	8.3%	32.9%
Assets/Employees	48	ERR	48	31	ERR	31
Assets/Offices	2,153	ERR	2,165	1,143	ERR	1,147
Net Int. Inc./Assets	0.76%	-4.62%	0.73%	4.22%	0.30%	4.20%
Net Int. Inc./Earn. Asset	3.57%	-4.72%	3.36%	14.80%	0.32%	14.61%
Return on Assets	0.00%	0.00%	0.00%	0.05%	-7.21%	0.02%
Return on Equity	0.06%	0.00%	0.06%	0.71%	-92.31%	0.33%
Loans/Deposits	22.1%	293.1%	22.8%	23.7%	107.5%	24.0%
Liquid Assets/Deposits	44.5%	0.0%	44.4%	56.5%	0.0%	56.3%
Liquid Assets/Sight Dpsts	84.0%	0.0%	83.7%	115.9%	0.0%	115.9%

EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-91)

PRIVATE BANKS

(millions of colones)

ACCOUNT \ BANK ->	BANEX	BACOFISA	BANCOMER	CONTINENTAL	BCT	(CONSTRUC.) CAPITAL	FOMENTO AGRICOLA
ASSETS							
Cash & due from banks	302	67	239	256	545	17	349
Earning assets:							
Securities	947	424	631	198	718	75	641
Loans	3,769	797	1,926	1,268	708	107	2,383
Sub-total	4,716	1,221	2,557	1,466	1,426	182	3,024
Other operating assets	478	80	237	85	71	194	209
Fixed assets	256	28	131	29	33	60	160
Total Assets	5,752	1,396	3,164	1,836	2,075	453	3,742
LIABILITIES							
Deposits:							
At sight	232	0	24	55	454	105	249
Time	4,395	909	2,413	1,362	1,113	47	2,858
Sub-total	4,627	909	2,437	1,417	1,567	152	3,107
Other Liabilities	252	59	86	48	48	56	146
Total Liabilities	4,879	968	2,523	1,465	1,615	208	3,2[illegible]
EQUITY							
Capital	588	300	415	310	300	323	350
Reserves	67	30	54	23	33	0	[illegible]
Retained earnings	218	99	172	38	127	(78)	107
Net Worth	873	429	641	371	460	245	4[illegible]
Total	5,752	1,397	3,164	1,836	2,075	453	3,742
Contingent Liabilities	1,130	727	849	493	649	190	1,034
Interest income	1,454	353	757	457	330	58	931
Interest expense	1,199	198	654	353	234	8	774
Net Interest Income	255	155	103	104	96	50	157
Other Income:							
Fee income	133	92	113	21	63	13	106
Other income	326	7	129	73	31	0	84
Total Other Income	459	99	242	94	94	13	190
Total Operating Income	714	254	345	198	190	63	347
General & Admin. Expense	310	148	200	105	97	78	249
Miscellaneous expense	220	2	37	12	2	14	16
Net Operating Income	184	104	108	81	91	(29)	[illegible]
Extraordinary Income	0	0	0	0	3	4	0
Extraordinary Expense	0	0	3	0	6	3	0
Net Income / (Loss)	184	104	105	81	88	(28)	[illegible]
OTHER DATA							
Number of Offices	1	1	2	1	1	1	1
Number of Employees	165	110	118	53	48	21	1[illegible]
RATIOS							
Capital/Assets	15.2%	30.7%	20.3%	20.2%	22.2%	54.1%	13.1[illegible]
Capital/Earning Assets	18.5%	35.1%	25.1%	25.3%	32.3%	134.6%	16.2[illegible]
Capital/Loans	23.2%	53.8%	33.3%	29.3%	65.0%	229.0%	20.5[illegible]
Capital/Assets+Contingent	12.7%	20.2%	16.0%	15.9%	16.9%	38.1%	10.2[illegible]
Capital/Loans+Contingents	17.8%	28.1%	23.1%	21.1%	33.9%	82.5%	14.3[illegible]
Assets/Employees	35	13	27	35	43	22	29
Assets/Offices	5,752	1,396	1,582	1,836	2,075	453	3,742
Net Int. Inc./Assets	4.43%	11.10%	3.26%	5.66%	4.63%	11.04%	4.[illegible]
Net Int. Inc./Earn. Asset	5.41%	12.69%	4.03%	7.09%	6.73%	27.47%	5.1[illegible]%
Return on Assets	3.20%	7.45%	3.32%	4.41%	4.24%	-6.18%	2.1[illegible]
Return on Equity	21.08%	24.24%	16.38%	21.83%	19.13%	-11.43%	16.[illegible]
Loans/Deposits	81.5%	87.7%	79.0%	89.5%	45.2%	70.4%	76.7%
Liquid Assets/Deposits	6.5%	7.4%	9.8%	18.1%	34.8%	11.2%	11.2[illegible]
Liquid Assets/Sight Dpsts	130.2%	ERR	995.8%	465.5%	120.0%	16.2%	140.2[illegible]

EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-91)

PRIVATE BANKS

(millions of colones)

ACCOUNT \ BANK ->	FEDERADO	FINCOMER	BICSA	BANINDUS	INTERFIN	LYON	BANMETRO
ASSETS							
Cash & due from banks	191	116	223	177	905	71	435
Earning assets:							
Securities	408	587	397	4	850	49	681
Loans	2,190	530	1,189	52	4,679	108	1,504
Sub-total	2,598	1,117	1,586	56	5,529	157	2,185
Other operating assets	656	171	149	2	488	20	336
Fixed assets	64	49	47	2	140	13	168
Total Assets	3,509	1,453	2,005	237	7,062	261	3,124
LIABILITIES							
Deposits:							
At sight	10	0	109	7	254	47	294
Time	2,488	845	1,138	0	5,727	44	2,123
Sub-total	2,498	845	1,247	7	5,981	91	2,417
Other Liabilities	382	67	71	21	268	7	158
Total Liabilities	2,880	912	1,318	28	6,249	98	2,575
EQUITY							
Capital	428	400	486	100	450	96	350
Reserves	85	13	46	2	102	10	32
Retained earnings	116	128	155	107	261	57	167
Net Worth	629	541	687	209	813	163	549
Total	3,509	1,453	2,005	237	7,062	261	3,124
Contingent Liabilities	457	444	1,306	16	420	203	1,704
Interest income	650	267	671	21	1,881	37	684
Interest expense	458	221	369	0	1,555	9	566
Net Interest Income	192	46	302	21	326	28	118
Other Income:							
Fee income	50	0	46	3	170	29	55
Other income	11	14	63	0	119	0	95
Total Other Income	61	14	109	3	289	29	150
Total Operating Income	253	60	411	24	615	57	268
General & Admin. Expense	121	92	173	18	329	58	184
Miscellaneous expense	3	0	52	0	23	1	[illegible]
Net Operating Income	129	(32)	186	6	263	(2)	8[illegible]
Extraordinary Income	7	135	0	0	0	6	
Extraordinary Expense	0	0	2	0	0	0	
Net Income / (Loss)	136	103	[illegible]	6	263	4	8[illegible]
OTHER DATA							
Number of Offices	1	2	1	1	3	1	
Number of Employees	50	54	70	13	172	33	10
RATIOS							
Capital/Assets	17.9%	37.2%	34.3%	88.2%	11.5%	62.5%	17.
Capital/Earning Assets	24.2%	48.4%	43.3%	373.2%	14.7%	103.8%	25.
Capital/Loans	28.7%	102.1%	57.8%	401.9%	17.4%	150.9%	36.
Capital/Assets+Contingent	15.9%	28.5%	20.7%	82.6%	10.9%	35.1%	11.
Capital/Loans+Contingents	23.8%	55.5%	27.5%	307.4%	15.9%	52.4%	17.
Assets/Employees	70	27	29	18	41	8	[illegible]
Assets/Offices	3,509	727	2,005	237	2,354	261	3,1[illegible]
Net Int. Inc./Assets	5.47%	3.17%	15.06%	8.86%	4.62%	10.73%	3.[illegible]
Net Int. Inc./Earn. Asset	7.39%	4.12%	19.04%	37.50%	5.90%	17.83%	5.[illegible]
Return on Assets	3.88%	7.09%	9.18%	2.53%	3.72%	1.53%	2.[illegible]
Return on Equity	21.62%	19.04%	26.78%	2.87%	32.35%	2.45%	15.[illegible]
Loans/Deposits	87.7%	62.7%	95.3%	742.9%	78.2%	118.7%	62
Liquid Assets/Deposits	7.6%	13.7%	17.9%	2528.6%	15.1%	78.0%	18
Liquid Assets/Sight Dpsts	1910.0%	ERR	204.6%	2528.6%	356.3%	151.1%	148

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EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-91)

(millions of colones)

ACCOUNT \ BANK ->	BAHMER	BANSANJO	BANSOL	POPULAR
	PRIVATE BANKS			
ASSETS				
Cash & due from banks	300	691	30	1,268
Earning assets:				
Securities	465	377	111	5,519
Loans	1,282	2,100	102	19,553
Sub-total	1,747	2,477	213	25,072
Other operating assets	133	756	8	2,781
Fixed assets	314	433	4	1,854
Total Assets	2,494	4,357	255	30,975
LIABILITIES				
Deposits:				
At sight	26	1,010	2	0
Time	1,817	2,496	129	20,482
Sub-total	1,843	3,506	131	20,482
Other Liabilities	134	87	25	2,082
Total Liabilities	1,977	3,593	156	22,564
EQUITY				
Capital	328	315	76	8,411
Reserves	21	63	2	0
Retained earnings	168	386	21	0
Net Worth	517	764	99	8,411
Total	2,494	4,357	255	30,975
Contingent Liabilities	243	714	67	0
Interest income	616	948	43	3,427
Interest expense	583	717	18	1,792
Net Interest Income	33	231	25	1,635
Other Income:				
Fee income	82	115	1	0
Other income	115	14	0	72
Total Other Income	197	129	1	72
Total Operating Income	230	360	26	1,707
General & Admin. Expense	139	189	14	1,175
Miscellaneous expense	45	13	0	2
Net Operating Income	46	158	12	530
Extraordinary Income	0	13	0	0
Extraordinary Expense	0	19	0	0
Net Income / (Loss)	46	152	12	530
OTHER DATA				
Number of Offices	3	5	1	unknown
Number of Employees	103	96	12	unknown
RATIOS				
Capital/Assets	20.7%	17.5%	38.8%	27.2%
Capital/Earning Assets	29.6%	30.8%	46.5%	33.5%
Capital/Loans	40.3%	36.4%	97.1%	43.0%
Capital/Assets+Contingent	18.9%	15.1%	30.7%	27.2%
Capital/Loans+Contingents	33.9%	27.1%	58.6%	43.0%
Assets/Employees	24	45	21	ERR
Assets/Offices	831	871	255	ERR
Net Int. Inc./Assets	1.32%	5.30%	9.80%	5.28%
Net Int. Inc./Earn. Asset	1.89%	9.33%	11.74%	6.52%
Return on Assets	1.84%	3.49%	4.71%	1.71%
Return on Equity	8.90%	19.90%	12.12%	6.30%
Loans/Deposits	69.6%	59.9%	77.9%	95.5%
Liquid Assets/Deposits	16.3%	19.7%	22.9%	6.2%
Liquid Assets/Sight Dpsts	1153.8%	68.4%	1500.0%	ERR

EXHIBIT B

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
FINANCIAL ANALYSIS
(12-31-91)

(millions of colones)	STATE BANKS		PRIVATE BANKS				
ACCOUNT \ BANK ->	SUB-TOTAL STATE BANKS	AVERAGE STATE BANKS	SUB-TOTAL PRIVATE BANKS	AVERAGE PRIVATE BANKS	TOTAL ALL BANKS	AVERAGE ALL BANKS	PRIVATE BANKS' SHARE OF TOTAL
ASSETS							
Cash & due from banks	151,999	38,000	4,914	289	158,181	7,190	3.1%
Earning assets:							
Securities	28,060	7,015	7,563	445	41,142	1,870	18.4%
Loans	56,206	14,052	24,694	1,453	100,453	4,566	24.6%
Sub-total	84,266	21,067	32,257	1,897	141,595	6,436	22.8%
Other operating assets	91,585	22,896	4,073	240	98,439	4,475	4.1%
Fixed assets	28,958	7,240	1,931	114	32,743	1,488	5.9%
Total Assets	356,808	89,202	43,175	2,540	430,958	19,589	10.0%
LIABILITIES							
Deposits:							
At sight	131,176	32,794	2,878	169	134,054	6,093	2.1%
Time	144,843	36,211	29,904	1,759	195,229	8,874	15.3%
Sub-total	276,019	69,005	32,782	1,928	329,283	14,967	10.0%
Other Liabilities	60,496	15,124	1,915	113	64,493	2,932	3.0%
Total Liabilities	336,515	84,129	34,697	2,041	393,776	17,899	8.8%
EQUITY							
Capital	8,095	2,024	5,615	330	22,121	1,006	25.4%
Reserves	226	57	615	36	841	38	73.1%
Retained earnings	11,972	2,993	2,249	132	14,221	646	15.8%
Net Worth	20,293	5,073	8,479	499	37,183	1,690	22.8%
Total	356,808	89,202	43,176	2,540	430,959	19,589	10.0
Contingent Liabilities	6,267	1,567	10,646	626	16,913	769	62.9
Interest income	27,661	6,915	10,158	598	41,246	1,875	24.6
Interest expense	21,585	5,396	7,916	466	31,293	1,422	25.3
Net Interest Income	6,076	1,519	2,242	132	9,953	452	22.5
Other Income:							
Fee income	5,119	1,280	1,092	64	6,211	282	17.6
Other income	2,446	612	1,081	64	3,599	164	30.0
Total Other Income	7,565	1,891	2,173	128	9,810	446	22.2
Total Operating Income	13,641	3,410	4,415	260	19,763	898	22.3
General & Admin. Expense	15,981	3,995	2,504	147	19,660	894	12.7
Miscellaneous expense	184	46	440	26	626	28	70.3
Net Operating Income	(2,524)	(631)	1,471	87	(523)	(24)	-281.3
Extraordinary Income	2,996	749	169	10	3,165	144	5.3
Extraordinary Expense	380	95	34	[illegible]	414	19	8.2
Net Income / (Loss)	92	23	1,606	94	2,228	101	72.
OTHER DATA							
Number of Offices	208	52	27	2	235	11	11.5
Number of Employees	8,391	2,098	1,354	80	9,745	443	13.
RATIOS							
Capital/Assets	5.7%	5.7%	19.6%	19.6%	8.6%	8.6%	
Capital/Earning Assets	24.1%	24.1%	26.3%	26.3%	26.3%	26.3%	
Capital/Loans	36.1%	36.1%	34.3%	34.3%	37.0%	37.0%	
Capital/Assets+Contingent	5.6%	5.6%	15.8%	15.8%	8.3%	8.3%	
Capital/Loans+Contingents	32.5%	32.5%	24.0%	24.0%	31.7%	31.7%	
Assets/Employees	43	43	32	32	44	44	
Assets/Offices	1,715	1,715	1,599	1,599	1,834	1,834	
Net Int. Inc./Assets	1.70%	1.70%	5.19%	5.19%	2.31%	2.31%	
Net Int. Inc./Earn. Asset	7.21%	7.21%	6.95%	6.95%	7.03%	7.03%	
Return on Assets	0.03%	0.03%	3.72%	3.72%	0.52%	0.52%	
Return on Equity	0.45%	0.45%	18.94%	18.94%	5.99%	5.99%	
Loans/Deposits	20.4%	20.4%	75.3%	75.3%	30.5%	30.5%	
Liquid Assets/Deposits	55.1%	55.1%	15.0%	15.0%	48.0%	48.0%	
Liquid Assets/Sight Dpsts	115.9%	115.9%	170.7%	170.7%	118.0%	118.0%	

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EXHIBIT C

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
AUDITED FINANCIAL STATEMENTS
(12-31-91)

(millions of colones)

ACCOUNT \ BANK ->	STATE-OWNED BANKS * V NACIONAL	COSTA RICA	SUB-TOTAL 2 BANKS	AVERAGE 2 BANKS
Name of Local Auditors:	Herrero V.	Herrero V.		
International Affiliation:	Deloitte	Deloitte		
Opinion:	qualified	qualified		
ASSETS				
Cash & equivalents	98,393	43,735	142,128	71,064
Earning assets:				
Securities	20,105	5,890	25,995	12,998
Loans:				
Total	48,795	20,130	68,925	34,463
Less: Allowance	2,306	2,224	4,530	2,265
Net Loans	46,489	17,906	64,395	32,198
Sub-total	66,594	23,796	90,390	45,195
Interest receivable	3,159	unknown	3,159	1,580
Other recvbl's (if shown)	1,775	unknown	1,775	888
A/R's related companies			0	0
O.R.E.O. and O.A.O.	939	unknown	939	470
Other operating assets	403	1,550	1,953	977
Fixed assets	9,893	4,517	14,410	7,205
Other Assets	3,610	6,729	10,339	5,170
Net Claim on BCCR, re: FX	9,333	1,588	10,921	5,461
Total Assets	194,099	81,915	276,014	138,007
LIABILITIES				
Deposits:				
At sight	32,599	24,180	56,779	28,390
Time and Savings	123,058	43,612	166,670	83,335
Sub-total	155,657	67,792	223,449	111,725
Certificates of Investment			0	0
Overdrafts			0	0
Loans payable	15,713	2,215	17,928	8,964
Payable related companies			0	0
Interest payable	2,358	unknown	2,358	1,179
Other payables	2,249	unknown	2,249	1,125
Other liabilities	4,635	5,437	10,072	5,036
Provision for employee benefits			0	0
Total Liabilities	180,612	75,444	256,056	128,028
MINORITY PARTICIPATION	3,348		3,348	1,674
OTHER	166		166	83
EQUITY				
Capital	3,547	2,912	6,459	3,230
Additional paid-in capital	3		3	2
Revaluation of assets	3,309	3,450	6,759	3,380
Reserves	407	109	516	258
Retained earnings	2,707		2,707	1,354
Net Worth	9,973	6,471	16,444	8,222
Total	194,099	81,915	276,014	138,007
Contingent Liabilities:		unknown		
Bank guarantees	342		342	171
Ltrs.of Crdt.&Bank. Accept.	11,807		11,807	5,904
Loans discounted			0	0
Total	12,149	0	12,149	6,075

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EXHIBIT C

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
AUDITED FINANCIAL STATEMENTS
(12-31-91)

(millions of colones)

ACCOUNT \ BANK ->	BANEX	BACOFISA	BANCOMER	CONTINENTAL	BCT	(CONSTRUC.) CAPITAL
	PRIVATE BANKS					
Name of Local Auditors:	Ceciliano	Peat Marwick	Peat Marwick	Venegas Piz	Information	
International Affiliation:	Coopers & Lyb			BDO	unavailable	
Opinion:	unqualified	unqualified	unqualified	unqualified		unaudited
ASSETS						
Cash & equivalents	1,115	67	239	256		7
Earning assets:						
Securities	129	424	634	198		138
Loans:						
Total	3,811	807	1,971	1,278	0	106
Less: Allowance	42	10	45	9		
Net Loans	3,769	797	1,926	1,269		106
Sub-total	3,898	1,221	2,560	1,467	0	244
Interest receivable	208	35	76	31		
Other recvbl's (if shown)		34	117			
A/R's related companies	3					
O.R.E.O. and O.A.O.		6	21			
Other operating assets		5	11			
Fixed assets	223	29	48	28		29
Other Assets	59		92	54		155
Net Claim on BCCR, re: FX						
Total Assets	5,506	1,397	3,164	1,836	0	435
LIABILITIES						
Deposits:						
At sight						
Time and Savings	11			404		53
Sub-total	11	0	0	404	0	53
Certificates of Investment	2,248	478	1,910	379		
Overdrafts	218					
Loans payable	1,854	432	511	580		
Payable related companies	37					
Interest payable	136		79	25		
Other payables	100	36	21	63		
Other liabilities		23	2	14		127
Provision for employee benefits	29					
Total Liabilities	4,633	969	2,523	1,465	0	180
MINORITY PARTICIPATION						
OTHER						
EQUITY						
Capital	588	300	415	310		323
Additional paid-in capital		19				26
Revaluation of assets	79	2	92			
Reserves		30	53	23		
Retained earnings	206	77	81	38		(94)
Net Worth	873	428	641	371	0	255
Total	5,506	1,397	3,164	1,836	0	435
Contingent Liabilities:						unknown
Bank guarantees	179	167	397	634		
Ltrs.of Crdt.&Bank. Accept.	257	559	452	349		
Loans discounted	108			72		
Total	544	726	849	1,055	0	0

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EXHIBIT C

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
AUDITED FINANCIAL STATEMENTS
(12-31-91)

(millions of colones)

	PRIVATE BANKS					
ACCOUNT \ BANK ->	FOMENTO AGRICOLA	FEDERADO	FINCOMER	BICSA	BANINDUS	INTERFIN
Name of Local Auditors:	Ceciliano	Peat Marwick	Peat Marwick	Peat Marwick	Audited	Ceciliano
International Affiliation:	Coopers & Lyb				Information	Coopers & Lyb
Opinion:	unqualified	unqualified	unqualified	unqualified	unavailable	unqualified
ASSETS						
Cash & equivalents	853	185	136	276		1,371
Earning assets:						
Securities	80	647	588	405		384
Loans:						
Total	2,124	2,220	566	1,204	0	4,717
Less: Allowance	50	30	36	15		38
Net Loans	2,074	2,190	530	1,189		4,679
Sub-total	2,154	2,837	1,118	1,594	0	5,063
Interest receivable	100	63	23	50		212
Other recvbl's (if shown)	406	58	29	103		
A/R's related companies						
O.R.E.O. and O.A.O.		10	93			
Other operating assets				1		
Fixed assets	73	52	49	37		60
Other Assets	134	17	9	5		106
Net Claim on BCCR, re: FX						
Total Assets	3,720	3,222	1,457	2,066	0	6,812
LIABILITIES						
Deposits:						
At sight						
Time and Savings	253					
Sub-total	253	0	0	0	0	0
Certificates of Investment	1,527	857	564	726		3,618
Overdrafts	12					
Loans payable	1,345	1,348	286	422		1,935
Payable related companies						
Interest payable	62	52		70		193
Other payables		266				196
Other liabilities	27	70	53	161		57
Provision for employee benefits	5		11			
Total Liabilities	3,231	2,593	914	1,379	0	5,999
MINORITY PARTICIPATION						
OTHER						
EQUITY						
Capital	350	428	400	486		450
Additional paid-in capital			32			
Revaluation of assets	40					
Reserves	32	85	15	46		
Retained earnings	67	116	96	155		363
Net Worth	489	629	543	687	0	813
Total	3,720	3,222	1,457	2,066	0	6,812
Contingent Liabilities:						
Bank guarantees	233	121	405	407		438
Ltrs.of Crdt.&Bank. Accept.	1,391	570	34	906		763
Loans discounted						136
Total	1,624	691	439	1,313	0	1,337

EXHIBIT C

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
AUDITED FINANCIAL STATEMENTS
(12-31-91)

(millions of colones)

ACCOUNT \ BANK ->	PRIVATE BANKS				
	LYON	BANMETRO	BANMER	BANSANJO	BANSOL
Name of Local Auditors:	Peat Marwick	Peat Marwick	Ceciliano	Ceciliano	Audited
International Affiliation:			Coopers & Lyb	Coopers & Lyb	Information
Opinion:	qualified	unqualified	unqualified	unqualified	unavailable
ASSETS					
Cash & equivalents	69	220	292	437	
Earning assets:					
Securities	49	689	480	370	
Loans:					
Total	113	1,530	1,286	2,126	0
Less: Allowance	5	26	10	31	
Net Loans	108	1,504	1,276	2,095	
Sub-total	157	2,193	1,756	2,465	0
Interest receivable	3	38	51	53	
Other recvbl's (if shown)	16	86	32		
A/R's related companies					
O.R.E.O. and O.A.O.		1			
Other operating assets					
Fixed assets	13	129	318	433	
Other Assets	4	200	45	645	
Net Claim on BCCR, re: FX					
Total Assets	262	2,867	2,494	4,033	0
LIABILITIES					
Deposits:					
At sight					
Time and Savings					
Sub-total	0	0	0	0	0
Certificates of Investment	44	1,661	1,614	1,602	
Overdrafts				296	
Loans payable		463	202	888	
Payable related companies					
Interest payable			66	55	
Other payables	47	78	36	401	
Other liabilities	6	140	47		
Provision for employee benefits	2	18		26	
Total Liabilities	99	2,360	1,965	3,268	0
MINORITY PARTICIPATION					
OTHER					
EQUITY					
Capital	96	350	328	315	
Additional paid-in capital		20			
Revaluation of assets	10	37	21	226	
Reserves		31	120	63	
Retained earnings	57	69	60	160	
Net Worth	163	507	529	764	0
Total	262	2,867	2,494	4,032	0
Contingent Liabilities:					
Bank guarantees	199	655	175	679	
Ltrs.of Crdt.&Bank. Accept.	1	887	66	1,070	
Loans discounted				5	
Total	200	1,542	241	1,754	0

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EXHIBIT C

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
AUDITED FINANCIAL STATEMENTS
(12-31-91)

(millions of colones)

ACCOUNT \ BANK ->	PRIVATE BANKS SUB-TOTAL 14 BANKS	PRIVATE BANKS AVERAGE 14 BANKS	PUBLIC AND PRIVATE BANKS TOTAL 16 BANKS	PUBLIC AND PRIVATE BANKS AVERAGE 16 BANKS
Name of Local Auditors:				
International Affiliation:				
Opinion:				
ASSETS				
Cash & equivalents	5,523	395	147,651	9,228
Earning assets:				
Securities	5,215	373	31,210	1,951
Loans:				
Total	23,859	1,704	92,784	5,799
Less: Allowance	347	25	4,877	305
Net Loans	23,512	1,679	87,907	5,494
Sub-total	28,727	2,052	119,117	7,445
Interest receivable	943	67	4,102	256
Other recvbl's (if shown)	881	63	2,656	166
A/R's related companies	3	0	3	0
O.R.E.O. and O.A.O.	131	9	1,070	67
Other operating assets	17	1	1,970	123
Fixed assets	1,521	109	15,931	996
Other Assets	1,525	109	11,864	742
Net Claim on BCCR, re: FX	0	0	10,921	683
Total Assets	39,271	2,805	315,285	19,705
LIABILITIES				
Deposits:				
At sight	0	0	56,779	3,549
Time and Savings	721	52	167,391	10,462
Sub-total	721	52	224,170	14,011
Certificates of Investment	17,228	1,231	17,228	1,077
Overdrafts	526	38	526	33
Loans payable	10,266	733	28,194	1,762
Payable related companies	37	3	37	2
Interest payable	738	53	3,096	194
Other payables	1,244	89	3,493	218
Other liabilities	727	52	10,799	675
Provision for employee benefits	91	7	91	6
Total Liabilities	31,578	2,256	287,634	17,977
MINORITY PARTICIPATION	0	0	3,348	209
OTHER	0	0	166	10
EQUITY				
Capital	5,139	367	11,598	725
Additional paid-in capital	97	7	100	6
Revaluation of assets	507	36	7,266	454
Reserves	498	36	1,014	63
Retained earnings	1,451	104	4,158	260
Net Worth	7,692	549	24,136	1,509
Total	39,270	2,805	315,284	19,705
Contingent Liabilities:				
Bank guarantees	4,689	335	5,031	314
Ltrs.of Crdt.&Bank. Accept.	7,304	522	19,111	1,194
Loans discounted	321	23	321	20
Total	12,315	880	24,464	1,529

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EXHIBIT C

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
AUDITED FINANCIAL STATEMENTS
(12-31-91)

(millions of colones)

ACCOUNT \ BANK ->	STATE-OWNED BANKS * V NACIONAL	COSTA RICA	SUB-TOTAL 2 BANKS	AVERAGE 2 BANKS
	INCOME STATEMENT			
Interest income:				
Loans	12,663	7,522	20,185	10,093
Investments	4,975	1,462	6,437	3,219
Related companies			0	0
Total interest income	17,638	8,984	26,622	13,311
Interest expense:				
Deposits	10,977	4,474	15,451	7,726
Certificates of Investment			0	0
Loans	2,865	380	3,245	1,623
Related companies			0	0
Commissions	586	397	983	492
Total interest expense	14,428	5,251	19,679	9,840
Net Interest Income	3,210	3,733	6,943	3,472
Exchange differences (net)			0	0
Allowance for loan losses	1,577	764	2,341	1,171
Other operating income:				
Fee income	2,489	1,528	4,017	2,009
Other income	3,153	711	3,864	1,932
Total Other Income	5,642	2,239	7,881	3,941
Total Operating Income	7,275	5,208	12,483	6,242
Other operating expense:	all V	all V		
Personnel			0	0
General & Admin. Expense	7,037	5,031	12,068	6,034
Miscellaneous expense	63	155	218	109
Total other op. expense	7,100	5,186	12,286	6,143
Net Operating Income	175	22	197	99
Extraordinary Income			0	0
Extraordinary Expense			0	0
Net op.inc.before participation	175	22	197	99
Less: Minority Interest	166		166	83
Pension fund	1	2	3	2
Education loans fund			0	0
Net Income / (Loss)	8	20	28	14

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EXHIBIT C

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
AUDITED FINANCIAL STATEMENTS
(12-31-91)

(millions of colones)

ACCOUNT \ BANK ->	BANEX	BACOFISA	BANCOMER	CONTINENTAL	BCT	(CONSTRUC.) CAPITAL
	PRIVATE BANKS					
	INCOME STATEMENT					
Interest income:						
Loans	1,322	187	676	368		11
Investments	134	141	78	75		42
Related companies	1					
Total interest income	1,457	328	754	443	0	53
Interest expense:				all \/		
Deposits				347		7
Certificates of Investment	601	154	493			
Loans	571	39	161			1
Related companies	13					
Commissions	14			6		
Total interest expense	1,199	193	654	353	0	8
Net Interest Income	258	135	100	90	0	45
Exchange differences (net)	98		61	40		4
Allowance for loan losses	7	2	22	unknown		1
Other operating income:						
Fee income	122	45	114	68		13
Other income		73	47			10
Total Other Income	122	118	161	68	0	23
Total Operating Income	471	251	300	198	0	71
Other operating expense:						
Personnel	191	122	92	50		
General & Admin. Expense	112	23	103	67		52
Miscellaneous expense		4				22
Total other op. expense	303	149	195	117	0	74
Net Operating Income	168	102	105	81	0	(3)
Extraordinary Income	15					
Extraordinary Expense						
Net op.inc.before participation	183	102	105	81	0	(3)
Less: Minority Interest				all \/		
Pension fund	18	10	11	12		
Education loans fund	9	5	5			
Net Income / (Loss)	156	87	89	69	0	(3)

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EXHIBIT C

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
AUDITED FINANCIAL STATEMENTS
(12-31-91)

(millions of colones)

ACCOUNT \ BANK ->	PRIVATE BANKS					
	FOMENTO AGRICOLA	FEDERADO	FINCOMER	BICSA	BANINDUS	INTERFIN
	INCOME STATEMENT					
Interest income:			all V			
Loans	845	559	222	524		1,666
Investments	84	67		113		215
Related companies						
Total interest income	929	626	222	637	0	1,881
Interest expense:			all V			
Deposits	350					
Certificates of Investment	424	239	221	250		1,016
Loans		215		121		534
Related companies						
Commissions						
Total interest expense	774	454	221	371	0	1,550
Net Interest Income	155	172	1	266	0	331
Exchange differences (net)	44		135			110
Allowance for loan losses	27	10	26			
Other operating income:						
Fee income	106	74	46	70		170
Other income		12	14	23		6
Total Other Income	106	86	60	93	0	176
Total Operating Income	278	248	170	359	0	617
Other operating expense:			all V			
Personnel	97	78		89		158
General & Admin. Expense	113	22	67	40		151
Miscellaneous expense		11		46		46
Total other op. expense	210	111	67	175	0	355
Net Operating Income	68	137	103	184	0	262
Extraordinary Income	14					
Extraordinary Expense						
Net op.inc.before participation	82	137	103	184	0	262
Less: Minority Interest						
Pension fund	8		10	19		26
Education loans fund	4	7	5	9		13
Net Income / (Loss)	70	130	88	156	0	223

EXHIBIT C

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
AUDITED FINANCIAL STATEMENTS
(12-31-91)

(millions of colones)

ACCOUNT \ BANK ->	PRIVATE BANKS				
	LYON	BANMETRO	BANMER	BANSANJO	BANSOL
	INCOME STATEMENT				
Interest income:	all V	all V	all V	all V	
Loans	29	684	616	948	
Investments					
Related companies					
Total interest income	29	684	616	948	0
Interest expense:	all V	all V	all V	all V	
Deposits					
Certificates of Investment	9	560	570	717	
Loans					
Related companies					
Commissions		6	13	15	
Total interest expense	9	566	583	732	0
Net Interest Income	20	118	33	216	0
Exchange differences (net)					
Allowance for loan losses	4	18			
Other operating income:					
Fee income	33	131	82	115	
Other income	4	19	115	14	
Total Other Income	37	150	197	129	0
Total Operating Income	53	250	230	345	0
Other operating expense:	all V	all V	all V	all V	
Personnel					
General & Admin. Expense	55	165	139	190	
Miscellaneous expense		1	45	8	
Total other op. expense	55	166	184	198	0
Net Operating Income	(2)	84	46	147	0
Extraordinary Income	6	1		9	
Extraordinary Expense		1		4	
Net op.inc.before participation	4	84	46	152	0
Less: Minority Interest					
Pension fund	1	9	5	15	
Education loans fund		4	2	8	
Net Income / (Loss)	3	71	39	129	0

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EXHIBIT C

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
AUDITED FINANCIAL STATEMENTS
(12-31-91)

(millions of colones)

ACCOUNT \ BANK ->	PRIVATE BANKS SUB-TOTAL 14 BANKS	PRIVATE BANKS AVERAGE 14 BANKS	PUBLIC AND PRIVATE BANKS TOTAL 16 BANKS	PUBLIC AND PRIVATE BANKS AVERAGE 16 BANKS
	INCOME STATEMENT			
Interest income:				
Loans	8,657	618	28,842	1,803
Investments	949	68	7,386	462
Related companies	1	0	1	0
Total interest income	9,607	686	36,229	2,264
Interest expense:				
Deposits	704	50	16,155	1,010
Certificates of Investment	5,254	375	5,254	328
Loans	1,642	117	4,887	305
Related companies	13	1	13	1
Commissions	54	4	1,037	65
Total interest expense	7,667	548	27,346	1,709
Net Interest Income	1,940	139	8,883	555
Exchange differences (net)	492	35	492	31
Allowance for loan losses	117	8	2,458	154
Other operating income:				
Fee income	1,189	85	5,206	325
Other income	337	24	4,201	263
Total Other Income	1,526	109	9,407	588
Total Operating Income	3,841	274	16,324	1,020
Other operating expense:				
Personnel	877	63	877	55
General & Admin. Expense	1,299	93	13,367	835
Miscellaneous expense	183	13	401	25
Total other op. expense	2,359	169	14,645	915
Net Operating Income	1,482	106	1,679	105
Extraordinary Income	45	3	45	3
Extraordinary Expense	5	0	5	0
Net op.inc.before participation	1,522	109	1,719	107
Less: Minority Interest	0	0	166	10
Pension fund	144	10	147	9
Education loans fund	71	5	71	4
Net Income / (Loss)	1,307	93	1,335	83

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EXHIBIT C

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
AUDITED FINANCIAL STATEMENTS
(12-31-91)

(millions of colones)

ACCOUNT \ BANK ->	STATE-OWNED BANKS			
	* V NACIONAL	COSTA RICA	SUB-TOTAL 2 BANKS	AVERAGE 2 BANKS
QUALITATIVE DATA				
Number of Offices			0	0
Number of Employees	3,549	2,757	6,306	3,153
RATIOS				
Capital Adequacy				
Capital/Assets	5.1%	7.9%	6.0%	6.0%
Capital/Earning Assets	15.0%	27.2%	18.2%	18.2%
Capital/Loans	21.5%	36.1%	25.5%	25.5%
Capital/Assets+Contingent	4.8%	7.9%	5.7%	5.7%
Capital/Loans+Contingents	17.0%	36.1%	21.5%	21.5%
Asset Quality				
Management				
Assets/Offices	ERR	ERR	ERR	ERR
Assets/Employees	55	30	44	44
Earnings				
Net Int. Inc./Assets	1.65%	4.56%	2.52%	2.52%
Net Int. Inc./Earn. Assets	4.82%	15.69%	7.68%	7.68%
Return on Assets	0.00%	0.02%	0.01%	0.01%
Return on Equity	0.08%	0.31%	0.17%	0.17%
Liquidity				
Loans/Deposits	29.9%	26.4%	28.8%	28.8%
Liquid Assets/Dposts.+Inv.Cert.	76.1%	73.2%	75.2%	75.2%
Liquid Assets/Sight Deposits	363.5%	205.2%	296.1%	296.1%

* Consolidated with Banco Internacional de Costa Rica

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EXHIBIT C

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
AUDITED FINANCIAL STATEMENTS
(12-31-91)

(millions of colones)

ACCOUNT \ BANK ->	PRIVATE BANKS					
	BANEX	BACOFISA	BANCOMER	CONTINENTAL	BCT	(CONSTRUC.) CAPITAL
QUALITATIVE DATA						
Number of Offices	1	1	2	1	1	1
Number of Employees	165	110	118	53	48	21
RATIOS						
Capital Adequacy						
Capital/Assets	15.9%	30.6%	20.3%	20.2%	ERR	58.6%
Capital/Earning Assets	22.4%	35.1%	25.0%	25.3%	ERR	104.5%
Capital/Loans	23.2%	53.7%	33.3%	29.2%	ERR	240.6%
Capital/Assets+Contingent	14.4%	20.2%	16.0%	12.8%	ERR	58.6%
Capital/Loans+Contingents	20.2%	28.1%	23.1%	16.0%	ERR	240.6%
Asset Quality						
Management						
Assets/Offices	5,506	1,397	1,582	1,836	0	435
Assets/Employees	33	13	27	35	0	21
Earnings						
Net Int. Inc./Assets	4.69%	9.66%	3.16%	4.90%	ERR	10.34%
Net Int. Inc./Earn. Assets	6.62%	11.06%	3.91%	6.13%	ERR	18.44%
Return on Assets	2.83%	6.23%	2.81%	3.76%	ERR	-0.69%
Return on Equity	17.87%	20.33%	13.88%	18.60%	ERR	-1.18%
Liquidity						
Loans/Deposits	34263.6%	ERR	ERR	314.1%	ERR	200.0%
Liquid Assets/Dposts.+Inv.Cert.	55.1%	102.7%	45.7%	58.0%	ERR	273.6%
Liquid Assets/Sight Deposits	ERR	ERR	ERR	ERR	ERR	ERR

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EXHIBIT C

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
AUDITED FINANCIAL STATEMENTS
(12-31-91)

(millions of colones)

ACCOUNT \ BANK ->	PRIVATE BANKS					
	FOMENTO AGRICOLA	FEDERADO	FINCOMER	BICSA	BANINDUS	INTERFIN
QUALITATIVE DATA						
Number of Offices	1	1	2	1	1	3
Number of Employees	130	50	54	70	13	172
RATIOS						
Capital Adequacy						
Capital/Assets	13.1%	19.5%	37.3%	33.3%	ERR	11.9%
Capital/Earning Assets	22.7%	22.2%	48.6%	43.1%	ERR	16.1%
Capital/Loans	23.6%	28.7%	102.5%	57.8%	ERR	17.4%
Capital/Assets+Contingent	9.2%	16.1%	28.6%	20.3%	ERR	10.0%
Capital/Loans+Contingents	13.2%	21.8%	56.0%	27.5%	ERR	13.5%
Asset Quality						
Management						
Assets/Offices	3,720	3,222	729	2,066	0	2,271
Assets/Employees	29	64	27	30	0	40
Earnings						
Net Int. Inc./Assets	4.17%	5.34%	0.07%	12.88%	ERR	4.86%
Net Int. Inc./Earn. Assets	7.20%	6.06%	0.09%	16.69%	ERR	6.54%
Return on Assets	1.88%	4.03%	6.04%	7.55%	ERR	3.27%
Return on Equity	14.31%	20.67%	16.21%	22.71%	ERR	27.43%
Liquidity						
Loans/Deposits	819.8%	ERR	ERR	ERR	ERR	ERR
Liquid Assets/Dposts.+Inv.Cert.	52.4%	97.1%	128.4%	93.8%	ERR	48.5%
Liquid Assets/Sight Deposits	ERR	ERR	ERR	ERR	ERR	ERR

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EXHIBIT C

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
AUDITED FINANCIAL STATEMENTS
(12-31-91)

(millions of colones)

	PRIVATE BANKS				
ACCOUNT \ BANK ->	LYON	BANMETRO	BANMER	BANSANJO	BANSOL
QUALITATIVE DATA					
Number of Offices	1	1	3	5	1
Number of Employees	33	106	103	96	12
RATIOS					
Capital Adequacy					
Capital/Assets	62.2%	17.7%	21.2%	18.9%	ERR
Capital/Earning Assets	103.8%	23.1%	30.1%	31.0%	ERR
Capital/Loans	150.9%	33.7%	41.5%	36.5%	ERR
Capital/Assets+Contingent	35.3%	11.5%	19.3%	13.2%	ERR
Capital/Loans+Contingents	52.9%	16.6%	34.9%	19.8%	ERR
Asset Quality					
Management					
Assets/Offices	262	2,867	851	807	0
Assets/Employees	8	27	24	42	0
Earnings					
Net Int. Inc./Assets	7.63%	4.12%	1.32%	5.36%	ERR
Net Int. Inc./Earn. Assets	12.74%	5.38%	1.88%	8.76%	ERR
Return on Assets	1.15%	2.48%	1.56%	3.20%	ERR
Return on Equity	1.84%	14.00%	7.37%	16.88%	ERR
Liquidity					
Loans/Deposits	ERR	ERR	ERR	ERR	ERR
Liquid Assets/Dposts.+Inv.Cert.	268.2%	54.7%	47.8%	50.4%	ERR
Liquid Assets/Sight Deposits	ERR	ERR	ERR	ERR	ERR

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EXHIBIT C

COSTA RICA FINANCIAL SECTOR REPORT
COMMERCIAL BANKS
AUDITED FINANCIAL STATEMENTS
(12-31-91)

(millions of colones)

ACCOUNT \ BANK ->	PRIVATE BANKS SUB-TOTAL 14 BANKS	PRIVATE BANKS AVERAGE 14 BANKS	PUBLIC AND PRIVATE BANKS TOTAL 16 BANKS	PUBLIC AND PRIVATE BANKS AVERAGE 16 BANKS
QUALITATIVE DATA				
Number of Offices	27	2	27	2
Number of Employees	1,354	97	7,660	479
RATIOS				
Capital Adequacy				
Capital/Assets	19.6%	19.6%	7.7%	7.7%
Capital/Earning Assets	26.8%	26.8%	20.3%	20.3%
Capital/Loans	32.7%	32.7%	27.5%	27.5%
Capital/Assets+Contingent	14.9%	14.9%	7.1%	7.1%
Capital/Loans+Contingents	21.5%	21.5%	21.5%	21.5%
Asset Quality				
Management				
Assets/Offices	1,454	1,454	11,677	11,677
Assets/Employees	29	29	41	41
Earnings				
Net Int. Inc./Assets	4.94%	4.94%	2.82%	2.82%
Net Int. Inc./Earn. Assets	6.75%	6.75%	7.46%	7.46%
Return on Assets	3.33%	3.33%	0.42%	0.42%
Return on Equity	16.99%	16.99%	5.53%	5.53%
Liquidity				
Loans/Deposits	3261.0%	3261.0%	39.2%	39.2%
Liquid Assets/Dposts.+Inv.Cert.	59.8%	59.8%	74.1%	74.1%
Liquid Assets/Sight Deposits	ERR	ERR	315.0%	315.0%

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EXHIBIT D
BANCO INTERNACIONAL DE COSTA RICA LIMITED
Balance Sheet

(thousands of U.S. dollars)

ASSETS	12-31-90	12-31-91
Cash and due from depository institutions	173,569	332,345
Investments	47,533	70,923
Loans		
Loans	160,579	136,840
Less:		
unearned discount	250	75
allowance for possible loan losses	9,252	9,293
Loans, net	151,077	127,472
Customers' liabilities for bankers' acceptances	9,221	13,237
Property and equipment	3,393	7,186
Other assets	8,904	8,984
Total Assets	393,697	560,147
LIABILITIES		
Demand deposits	44,618	66,372
Savings deposits	2,074	2,083
Time deposits	275,730	411,114
Total deposits	322,422	479,569
Acceptances outstanding	9,221	13,237
Other liabilities	9,304	11,862
Total other liabilities	18,525	25,099
Total Liabilities	340,947	504,668
Shareholders' Equity		
Share capital	50,000	55,000
General reserves	751	949
Unrealized loss on noncurrent equity securities	(498)	(376)
Valuation account on foreign currency translation	(1,900)	(3,093)
Retained earnings	4,397	2,999
Total Shareholders' Equity	52,750	55,479
Total Liabilities and Shareholders' Equity	363,697	560,147

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EXHIBIT D
(continued)
BANCO INTERNACIONAL DE COSTA RICA LIMITED
Income Statement

(thousands of U.S. dollars)

	12-31-90 12 months	12-31-91 12 months
Interest Income		
Interest on loans	15,416	17,192
Interest on time deposits	13,223	14,419
Interest on investments	6,188	5,106
Total interest income	34,827	36,717
Interest and Commission Expense	24,767	26,184
Net interest income	10,060	10,533
Net loss on foreign currency transactions	107	0
Provision for possible loan losses	1,341	1,494
Total interest income net of provision for loan losses	8,612	9,039
Other Operating Income		
Commissions	3,386	3,803
Gain on foreign currency transactions, net	0	776
Other income	1,148	589
Total other operating income	4,534	5,168
Total interest and other operating income	13,146	14,207
Other Operating Expense		
Salaries and employee benefits	5,598	6,495
Occupancy expense	1,192	1,557
Other operating expense	3,018	3,036
Total other operating expense	9,808	11,088
Net operating income	3,340	3,118

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EXHIBIT E

BANCO INTERNACIONAL DE COSTA RICA LIMITED - MIAMI AGENCY

Balance Sheet

(thousands of U.S. dollars)

ASSETS	12-31-90	12-31-91
Cash and due from depository institutions	83,012	176,299
Obligations of U.S. Government Agencies	3,104	3,062
Federal funds sold & repo's	48,000	31,800
Loans:		
U.S. banks	17,500	47,000
Foreign banks	9,497	13,861
Other financial institutions	4,024	0
Commercial and industrial	17,812	8,989
Acceptances of other banks	21,027	18,277
Foreign governments & institutions	11,520	22,171
Other	1,217	650
Sub-total	82,597	110,948
Less: unearned income	217	74
Total Loans	82,380	110,874
Customers' liabilities for bankers' acceptances	8,300	11,736
Other assets (claims on nonrelated parties)	1,821	1,950
Total Assets	226,616	335,721
Percent share of all State of Florida licensed foreign bank agencies	2.10%	3.12%
LIABILITIES		
Demand deposits	18,709	23,542
Other credit balances	4,304	6,994
Nontransaction accounts (mostly money market accounts)	61,724	70,827
International Banking Facilities (IBF) deposit obligations	30,507	56,606
Total deposits & credit balances	115,244	157,969
Federal funds purchased & repos	75,010	137,054
Liability for bankers' acceptances outstanding	9,196	12,780
Other liabilities (to nonrelated parties)	657	688
Net due head office & other related institutions	26,510	27,230
Total Liabilities	226,617	335,721
CONTINGENT LIABILITIES		
Standby letters of credit	6,996	4,332
Commercial letters of credit	49,999	20,631

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EXHIBIT E
(continued)
BANCO INTERNACIONAL DE COSTA RICA LIMITED - MIAMI AGENCY
Income Statement
(thousands of U.S. dollars)

	12-31-90 12 months	12-31-91 12 months
Interest Income		
Interest and fees on loans	5,566	4,873
Interest on balances with depository institutions	5,114	5,989
Federal funds sold and repo's	7,028	5,482
Interest on obligations of U.S. Government agencies	259	195
Interest on other bonds, notes and debentures	34	0
Total interest income	18,001	16,539
Interest Expense		
Interest on time deposits of $100,000 or more	4,855	3,745
Interest on other deposits (mostly money market)	2,582	2,734
Interest on Fed funds purchased and repo's	6,640	5,872
Interest on other borrowed money	107	0
Total interest expense	14,184	12,351
Net interest income	3,817	4,188
Provision for possible loan losses	202	214
Total interest income net of provision for loan losses	3,615	3,974
Other Operating Income		
Service charges on deposit accounts	447	532
Other service charges, commissions, and fees	1,468	1,633
Other income	10	(42)
Total other operating income	1,925	2,123
Total interest and other operating income	5,540	6,097
Other Operating Expense		
Salaries and employee benefits	2,057	2,255
Occupancy expense	460	563
Other operating expense	1,102	928
Total other operating expense	3,619	3,746
Net operating income	1,921	2,351

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