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What comes next for credit unions in Costa Rica? From financial repression to the risks of a new financial environment

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ABSTRACT

During the 1980s many developing countries started to dismantle policies constraining the financial sector. Those policies were adopted in order to channel resources to the manufacturing sector, as well as other sectors (infrastructure, commercial agriculture for export) considered as key for economic development. We argue that financial repression spurred the growth of credit unions (CUs) in Costa Rica. These organizations took advantage of the opportunity to expand their customer base by serving borrowers that were routinely refused access to credit to finance consumption when banks attained the cap for consumption set up by authorities. Our article tackles a question of great social and economic importance, namely, have CUs in Costa Rica lost their overall competitiveness vis-à-vis other financial players in Costa Rica, after the liberalization of financial markets? If the answer is yes to this question, one would expect that the cooperative financial sector in Costa Rica and other developing countries can only be a marginal player in a financial sector that most likely will not return to the dirigiste policies of the past. We suggest avenues for future research on the topic.

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INTRODUCTION

During the 1980s many developing countries started to dismantle policies that constrained the financial sector. Those policies were adopted in order to channel resources to the manufacturing sector, as well as other sectors (infrastructure, commercial agriculture) considered as key for economic development. Negative interest rates were widespread; a minimum amount of bank lending was set up for the "modern" sectors of the economy, and a cap was set for some others, such as consumption.

Many researchers consider nowadays that those policies ─ called "financial repression"─ harmed the prospects of economic development of adopting countries, rather than fostering them (Lizano, 2004). Nevertheless, financial repression spurred the growth of credit unions (CUs) in Costa Rica (Rojas-Alvarado 2013, personal communication). They saw an opportunity serving borrowers that were routinely refused access to credit to finance consumption when banks attained the cap for consumption. By mid-1980s a process of reform of financial markets began, being completed by late 1990s (Lizano, op. cit.). Given the dismissal of the main factor behind the emergence of CUs in Costa Rica, we ask ourselves about the impact of the liberalization of financial markets on CUs.

Thus, our article aims to tackle a question of great social and economic importance, namely, have CUs in Costa Rica lost their overall competitiveness vis-à-vis other financial players in Costa Rica, after the liberalization of financial markets? If the answer is yes to this question, one would expect that the cooperative financial sector in Costa Rica can only be a marginal player in a financial sector that most likely will not return to the *dirigiste* policies of the past. Next section reviews the emergence of CUs in Costa Rica, as well as the liberalization of financial markets. This section also sets the hypothesis of our study. This is followed by a section discussing data and the methodology of our study, and another one devoted to its results. The article is wrapped up by a section containing concluding comments and suggesting avenues for future research.

1. FINANCIAL REPRESSION, EMERGENCE OF CREDIT UNIONS AND LIBERALIZATION OF FINANCIAL MARKETS IN COSTA RICA

Costa Rican economic policy between 1950 and the late 1970s was strongly interventionist. It was the result of a development strategy that has been labelled as import-substitution industrialization (ISI) (Lizano 2004). This development strategy was promoted by the United Nations Commission for Latin America (ECLA), and it was aimed at the creation of industrial infrastructure rapidly in countries with economic production dominated by agricultural production and raw material exports (see Baer 1972 for a detailed exposure of the implementation of ISI. He also provides an early criticism concerning the shortcomings of the policy). According to ISI advocates, industrialization should be implemented quickly, given the gap vis-à-vis the industrialized countries, which had the opportunity to develop and test over long periods mechanisms intended to facilitate industrialization. From the decade of 1950 most countries in Latin America began to promote policies to accelerate the manufacturing sector of the economy. This involved a set of economic policies that included the erection of a "wall" of tariffs on imports of manufactured products, to facilitate the substitution of imports by local production and the number of policies to facilitate the financing of the emerging manufacturing sector.

The adoption of high tariffs on manufactures was coupled in Costa Rica (and probably elsewhere in Latin America), by a number of policies intended to use the operation of the financial sector of the economy to channel resources to manufacturing development. Those policies included the setting on an annual basis of a minimum of the commercial bank loan portfolios going to the "modern" sectors of the economy (manufacturing and agro-export). Cap rates were also widespread in the case of loans made to the manufacturing sector and agricultural activities that could generate foreign exchange to the industrialization and modernization of the country. It was also common the setting of a maximum amount ("cap") of the bank loan portfolios to finance consumption. Negative interest rates were common during this period, especially towards the end of the ISI-dominated period (Lizano 2004). Some development theorists have labelled the policies described above as "financial repression."

An observer reported by the mid-1950s that commercial banks were nationalized in Costa Rica (Bannell 1956). In fact, the three State-owned commercial banks held nearly 60% of all assets of the financial system of the country as late as 1995, as we discuss below. Undoubtedly, the fact that the government controlled directly the main players in the financial sector facilitated financial repression.

According to a former manager of Coocique R.L., one of the largest cooperatives in Costa Rica, and who is now retired, it is in the context of financial repression that emerged most of the existing CUs in Costa Rica, particularly the larger among them (Rojas-Alvarado 2013, personal communication). In the view of this former manager, the emergence of such financial players was a collective response to a serious lack of credit for a widespread number of individuals in Costa Rica during the 1950s and 1960s. According to Mr. Rojas, who worked as an executive for one State-owned bank before joining Coocique, the constraints on credit imposed by economic authorities even affected individuals showing good credit histories and relatively high income levels. Before joining the cooperative as a general manager, Mr. Rojas noted that routinely the local branch of the Banco Nacional de Costa Rica (the largest bank in the country at the time and still today) where he worked refused loan applications for financing consumer durables to individuals who exhibited a low level of risk. Those applications where turned down simply because the bank had reached the “ceiling” or maximum that it can lend on this type of loans. This observation has led the Mr. Rojas to resign from his position at the bank and accept to become general manager of the credit union by mid 1960s. During the following decades the cooperative exhibited strong growth, because it took advantage of the absence of strong competition from state-owned banks, hampered by existing financial policies, and the virtual absence of private-sector players in the Costa Rican financial industry.

By mid 1980s “financial repression” policies began to be reformed. Between 1984 and 1987 the ceilings and floors in banks’ portfolios were dismantled for most activities (Lizano op. cit.).The new policies were bound to face significant challenges. For instance, a wave of bankruptcies in the late 1980s and early 1990s showed the limitations of a regulation system that was not prepared to deal with some of the private-sector players that ventured in commercial banking under the new rules. In spite of those early shortcomings, a return to the interventionist policies of the past does not seem likely (Calderón 2013, personal communication).

Being creatures from the time of financial repression, the dismissal of policies connected with it was supposed to hamper ability of CUs to compete with both new private players in the financial industry and the State-owned commercial banks that have been freed of the constraints that limited their capacity to attract new customers and offer attractive rates for both investors and lenders. Mr. Rojas, who ran Coocique during three decades, noticed a change in the environment as a result of the new policies, making more difficult to remain competitive. The wave of bankruptcies was followed by enhanced, more tightened regulation (and costly to comply with). By mid-1990s a new organization was set up to deal with regulation of players in the financial industry, which was until then the responsibility of a department of the central bank of the country. Calderón (2013, personal communication) argued that, although the new regulator, the Superintendencia General de Entidades Financieras (SUGEF) was critically important for the stability of the financial system as a whole, it was also designed with an “anti-

CUs' bias," further deteriorating the capacity of CUs to compete. For instance, according to Calderón, SUGEF rules include the obligation of supervised entities to report changes in ownership stakes. This is easy to do in the case of small privately-owned banks with less than 20 or 30 shareholders, but it is cumbersome, costly and unwarranted in the case with CUs that typically have several thousand members, if not ten of thousands.

The discussion above allows us to set up the hypothesis of our study. It relates to the evolution of competitiveness of CUs in Costa Rica. Given that CUs' emergence and growth in Costa Rica were mainly connected with the presence of policies connected with the so-called "financial repression," the dismissal of those policies should have led to loss of competiveness of CUs vis-à-vis other players in the financial market. Thus, we have set the following hypothesis:

> H.1 CUs in Costa Rica exhibit less growth in terms of the volume of assets that they hold, vis-à-vis other players in the financial market of Costa Rica.

2. DATA AND METHODOLOGY

In order to test our hypothesis, we compiled information about the volume of assets held by CUs and other important players in the financial industry that were likely to be affected by the dismissal of the financial repression policies and the emergence of a new regulatory environment in Costa Rica.

We have chosen the year 1995 as our vantage point. The new regulatory body of the financial industry in Costa Rica was set up in that year by the new Ley Orgánica del Banco Central de Costa Rica (No. 7558). The new regulator, the Superintendencia General de Entidades Financieras (SUGEF), acquired enhanced powers, more autonomy and its own governing board vis-à-vis its predecessor, the Auditoría General de Entidades Financieras (AGEF), which belonged to the Banco Central de Costa Rica (SUGEF 2014).

The creation of SUGEF is a major landmark in the development of today's Costa Rican financial system. Furthermore, the same law ended the monopoly that State-owned banks enjoyed over checking accounts. Under certain conditions, privately-owned banks were allowed to open checking accounts, a decision that considerably increased their access to new funds (El Financiero 2014).

The SUGEF started compiling accounting data on the entities that it regulated from its start in 1995. That database is available, free of charge, to the public in SUGEF's website. In order to test our hypothesis we downloaded information about total assets (net of SUGEF's estimates for uncollected receivables), for three major players in the Costa Rican financial system. Those actors are: the ensemble of the three State-owned commercial banks (Banco Crédito Agrícola de Cartago, Banco de Costa Rica, and Banco Nacional de Costa Rica); the ensemble of privately-owned commercial banks; and the ensemble of CUs. Table 1 presents the information on the value of assets held by each of the different types of players in the financial markets. Data are stated in thousands of nominal Costa Rican colones.

Table 1: Evolution of the Costa Rican financial sector, total assets (billion current CR colones)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Credits Unions[1]	n.a.	42,2	54,9	58,1	57,1	69,4	90,0	121,0	163,1	229,5
% of financial sector	-	3,7	4,1	3,3	2,9	2,8	3,2	3,6	4,0	4,3
State-owned comm. banks[2]	458,7	731,2	780,8	960,2	1 098,3	1 289,4	1 370,8	1 613,5	1 883,2	2 619,1
% of financial sector	60,8	65,0	58,9	54,7	55,1	52,7	49,1	47,5	45,8	49,1
Privately-owned comm. banks	173,5	213,0	297,1	415,3	480,6	662,7	831,1	1 019,5	1 299,7	1 554,8
% of financial sector	23,0	18,9	22,4	23,7	24,1	27,1	29,8	30,0	31,6	29,1
Financial sector as a whole[3]	754,7	1 125,8	1 324,7	1 755,4	1 992,1	2 446,2	2 789,2	3 397,8	4 109,9	5 339,0

1/ Includes only cooperatives which are regulated by SUGEF (assets of one billion Costa Rican colones or more).

2/ Includes the three State-owned commercial banks: Banco Crédito Agrícola de Cartago, Banco de Costa Rica y Banco Nacional de Costa Rica.

3/ The financial sector of Costa Rica comprises other players than cooperatives, State-owned and private-sector owned commercial banks.

Table 1 (continuation): Evolution of the Costa Rican financial sector, total assets (billion current CR colones)

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Credit unions[1]	349,3	505,0	747,8	938,0	1 083,9	1 126,1	1 325,4	1 587,4	1 934,8
% of financial sector	5,2	6,1	7,4	7,4	7,8	7,8	8,3	8,6	9,2
State-owned comm. banks[2]	3 151,6	3 824,4	4 526,2	5 301,9	6 040,9	6 463,3	6 940,7	7 989,4	9 238,3
% of financial sector	47,2	46,5	44,9	42,0	43,7	44,7	43,3	43,3	43,7
Privately-owned comm. banks	1 980,5	2 466,4	3 005,2	4 264,6	4 366,5	4 331,5	4 877,8	5 463,9	6 125,3
% of financial sector	29,7	30,0	29,8	33,8	31,6	30,0	30,4	29,6	29,0
Financial sector as a whole[3]	6 674,2	8 233,4	10 072,6	12 615,4	13 808,1	14 461,8	16 030,7	18 447,9	21 116,8

3. RESULTS AND DISCUSSION

The data presented in Table 1 does not uphold our hypothesis. CUs absorbed nearly 42.2 billion Costa Rican colones in 1996, i.e. 3.7 % of the nominal value of the assets held by all actors in the financial sector. In 2006 CUs managed nearly 505 billion Costa Rican colones, 6.1% of all assets being held by actors regulated by SUGEF. Assets controlled by CUs have grown to roughly 1.9 trillion colones, 9.2% of the total in 2013. This was almost three times the level in percentage terms, if we compare with the starting year.

Privately-owned commercial banks also exhibit important growth, although not as fast as CUs. In 1995 this type of banks held 173.5 billion Costa Rican colones, 23% of total assets. Ten years later those banks held almost two trillion current Costa Rican colones, about 30% of all assets managed by organizations reporting to SUGEF. Assets under management of privately-owned banks represented 29% of all assets held in 2013.

State-owned commercial banks lost considerable market share during the period under examination. In 1995 the three banks in the group absorbed 60.8% of assets under management. In 2013 the figure has lowered to just 43.7%. This reduction is more remarkable even than it appears at first sight for two reasons. Firstly, even if State-owned banks lost their monopoly over issuing of checking accounts, they should have also benefited from the removal of constraints that limited their competitiveness. Secondly, and arguably, much more important, it is worth to mention that deposits in privately-owned banks are not insured in Costa Rica. State-owned banks, on the contrary, are backed by the Ministry of Finance. This was highlighted in 1994, when Banco Anglo Costarricense, a State-owned bank went bankrupt and was closed down by the Costa Rican government. Deposit holders were fully compensated for their losses by the Ministry of Finance (Rodríguez 2013, personal communication).

4. CONCLUDING REMARKS

Our data do not uphold the hypothesis stated in our study. Against our expectations, CUs in Costa Rica exhibited an enhanced capacity to compete with other players, after liberalization of the financial industry in Costa Rica. This is truly surprising, given that CUs were, in many regards, creatures that directly emerged from the financial repression policies that were in place during the 1950s-late 1970s period. Furthermore, the financial sector reform of 1995 did not allow CUs to open checking accounts to the public, unlike State and privately-owned commercial banks.

We believe that our study presents an interesting result, calling for more in-depth analysis. One very interesting open question is: why CUs in Costa Rica were not saw a steep reduction in their capacity to compete after financial reform, but instead they seem to thrive? We hint a possible answer to the paradox. Under current legislation, SUGEF only regulates CUs managing over 1 billion Costa Rican colones (roughly 2 million US dollars) (Arias 2012). It is possible that larger CUs, regulated by SUGEF are able to merge with smaller CUs, which cannot to keep up as independent entities have been fuelling CUs' growth. If that is the case, the strategy of growth will erode rapidly as the interesting targets for mergers disappear. Future research could also benefit from more formal test of our hypothesis.

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