# Responsible Business Conduct in the Financial Sector

# COSTA RICA

OECD

# Responsible Business Conduct in the Financial Sector in Costa Rica

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# Foreword

This report analyses policies and practices around the integration of environmental, social and governance (ESG) criteria in the institutional investment and commercial lending (banking) industries of Costa Rica. It is published alongside two related reports: *Responsible Business Conduct in the Financial Sector in Latin America and the Caribbean,* and *Responsible Business Conduct in the Financial Sector in Panama*.

The OECD is uniquely positioned to analyse the progress of institutional investors and corporate lenders in embedding key ESG considerations, including climate risk and responsibilities to mitigate adverse impacts on people, the environment and society. Based on the framework developed to drive responsible business conduct (RBC) in the corporate lending sector and in institutional investment, this report takes stock of current practices and identifies challenges and opportunities to further embedding RBC in this sector in the LAC region.

The report opens with an overview of salient ESG risks for financial institutions investing or lending to corporate entities operating in Costa Rica and regulatory actors in the financial sector. It describes sustainable finance regulations and initiatives and sustainable finance policies and practices in financial institutions.

This report was undertaken within the framework of the RBCLAC project which promotes smart, sustainable and inclusive growth in the region by supporting responsible business practices in line with international instruments. The RBCLAC project is implemented by the OECD in partnership with the International Labour Organisation (ILO) and the United Nations Office of the High Commissioner for Human Rights (UNOHCHR). For the first time, these three organisations are joining forces, with the support of the European Union, to promote responsible business conduct within the framework of a joint regional project. The project includes a mix of regional and country-specific activities. The latter are implemented in nine countries: Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador, Mexico, Panama and Peru.

# Acknowledgements

This publication has been prepared by the OECD Centre for Responsible Business Conduct, led by Allan Jorgensen. The report was supervised by Froukje Boele, Manager for Latin America and the Caribbean at the Centre. It was drafted by Hughes Létourneau, Associate Director and Leader of Responsible Investment at SHARE. The report also benefitted from the guidance of Barbara Bijelic and Tyler Gillard from the OECD RBC Centre. The report benefitted from comments by representatives of the UN Office of the High Commissioner for Human Rights and the International Labour Organisation and by officials from Panama. Further contributions were received from Germán Zarama, Inmaculada Valencia, Jorge Gálvez Méndez, Duniya Dedeyn, Roxana Glavanov and Valeria Patiño, also at the OECD RBC Centre.

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# Abbreviations and acronyms

| | |
|---|---|
| ASBA | Asociación de Supervisores Bancarios de las Américas |
| BCCR | Banco Central de Costa Rica |
| BCR | Banco de Costa Rica |
| BNCR | Banco Nacional de Costa Rica |
| BNV | Bolsa Nacional de Valores |
| CONASSIF | Consejo Nacional de Supervisión del Sistema Financiero |
| EP | Equator Principles |
| ESG | Environmental, social and governance |
| GIZ | Deutsche Gesellschaft für Internationale Zusammenarbeit GmbH |
| IFC | International Finance Corporation |
| IOSCO | International Organisation of Securities Commissions |
| OPC | Operadoras de Pensiones Complementarias |
| RIVM | Régimen de Invalidez, Vejez y Muerte |
| RBC | Responsible business conduct |
| SAFI | Sociedades Administradoras de Fondos de Inversión |
| SARAS | Sistema de Análisis de Riesgo Ambiental y Social |
| SBN | Sustainable Banking Network |
| SUGEF | Superintendencia General de Entidades Financieras |
| SUGEVAL | Superintendencia General de Valores |
| SUGESE | Superintendencia General de Seguros |
| SUPEN | Superintendencia de Pensiones |
| SWF | Sovereign wealth funds |
| UNGC | United Nations Global Compact |
| UNEP-FI PRB | United National Environment Program – Finance Initiative Principles For Responsible Banking |
| PRI | Principles for Responsible Investing |

# Executive summary

This country spotlight report analyses policies and practices around the integration of environmental, social and governance (ESG) issues in the institutional investment and commercial lending (banking) industries of Costa Rica. The paper uses the term "ESG" and "sustainable finance" to reference the integration of environmental, social and governance issues into both institutional investment and corporate lending practices. The analysis of the 10 largest institutional investors and commercial lenders points to a sizeable gap between the integration of environmental and social risk in commercial lending, where practices are more mature, and institutional investment portfolios. The OECD Responsible Business Conduct due diligence framework, and the associated responsibilities of corporate lenders and institutional investors under the OECD Guidelines for MNEs, informed this report.

The analysis and findings in this country spotlight report is based on desk research and interviews with Costa Rican financial sector practitioners. The analysis of ESG practices at financial institutions is split into two sections: 1) the assessment of ESG integration in commercial loan portfolios of Costa Rica's ten largest lenders and 2) the integration of ESG issues within the institutional investment portfolios of the five largest asset owners (e.g. pension funds, insurance firms, etc.) and the five largest asset managers.

## Key findings

- Sustainable finance policies and practices in the country's lending sector are more mature than those of the institutional investment industry.
- While at the time of writing there was no regulation touching on the integration of ESG risk in lending portfolios, Costa Rican lenders were increasingly adopting ESG risk management systems and positive impact products. The country's largest commercial lenders comprise a mix of state-owned commercial lenders, savings and credit cooperatives, mutual savings associations, private banks and worker-owned lending institutions. As of December 2020, four institutions had an operational ESG risk analysis system -often referred to as SARAS (Sistema de Análisis de Riesgo Ambiental y Social) for corporate loans and three lenders were setting those up. The timing behind the adoption of these practices is broadly consistent with the adoption of the banking sector's *Protocolo Verde*, a voluntary agreement to embed sustainability issues in industry practices, in November 2019.
- Costa Rican lenders are increasingly setting up positive impact products such as green loans – some institutions are doing so with the support of development finance institutions while others have a longstanding mandate of supporting social and community development. However, Costa Rican lenders have yet to report data and demonstrate a breakdown of ESG risk profiles by sectors.
- The adoption of ESG practices in institutional investment remains marginal. Despite some anecdotal examples of ESG integration in real estate, the practices and policies of asset owners

and managers are lagging behind those of lenders in Costa Rica. This gap may be partly explained by the structural portfolio tilt toward domestic public sector fixed income holdings, industry initiatives and collaboration between lenders and development finance institutions. The Costa Rican marketplace is relatively small and does not offer many options to diversify large portfolios. This, combined with the dominant role of domestic public sector, fixed income and short-term (money market) holdings in the portfolios of asset owners and managers poses some challenges to popular strategies such as ESG integration in public equity holdings.

- Costa Rican regulators have adopted a limited set of sustainable finance rules. Pension regulation stipulates that regulated entities may incorporate responsible investment considerations in their investment policies. The securities regulator clarified the requirements to label debt issuances or investment funds to as “green” or “sustainable” – thereby lifting a barrier that was cited by some industry practitioners. Institutional investors do not have mandatory ESG reporting requirements. The banking regulator plans to adopt regulation to integrate climate risks into the formal risk management framework and governance of supervised financial intermediaries.

# 1. Salient ESG Risks in Costa Rica

Between 2015 and 2020, Costa Rica's financial sector grew at 5% per annum while the GDP grew at a rate of 1.3% per year and at year end 2020, it accounted for 6% of the country's GDP (BCCR, 2021[1]).[1] The sector is dominated by the banking sector (80% of financial system assets) which comprises a mix of state owned and state created banks, private banks – locally and foreign headquartered – and mutual savings credit unions (IMF, 2018[2]). The Costa Rican asset management industry is important in the Central American region; the country's 14 investment fund managers managed USD 6 billion in net assets as of June 2021 (compared to USD 2.8 billion in Panama).[2] Finally, public debt is the dominant asset in the country's capital markets and the trading of such assets in the secondary market is not liquid (IMF, 2018[2]).

The identification of salient ESG risks are important for financial institutions that want to implement responsible business conduct practices. Under the OECD RBC Due Diligence Framework, corporate lenders and institutional investors are expected to identify and assess actual and potential adverse environmental and social impacts to effectively uphold their responsibilities under the OECD Guidelines for MNEs (see 5. Annex B). Salient ESG risks in Costa Rica for corporate lenders and institutional investors were identified based on a) the importance of the sectors in lending and institutional investment portfolios and b) the sector's footprint in the country's economy[3] and c) sectors cited by financial institutions (reports and interviews).

Interviewees identified the agriculture sector as a potential high-risk sector for ESG issues. Costa Rica is an important exporter of agricultural products, which can be associated with a range of social and environmental risks. Agricultural exports - including bananas, sugar, coffee, pineapples and melons – account for more than 20% of exports.[4] Seasonal and informal employment in the agricultural sector can amplify adverse labour rights impacts. Costa Rican pineapple producers along the country's northern border often rely on Nicaraguan migrant workers who are not documented to work in the country and who do not benefit from social security protection (Echavarria and Prunier, 2020[3]). Trade unions and Costa Rican academics have reported precarious working conditions and occupational health and safety risks at pineapple plantations in the country's northern region (Castro Méndez et al., 2020[4]; Rel-UITA, 2021[5]). In recent years, a wave of chronic disease has afflicted sugar cane workers (NPR, 2015[6]). Between 2008 and 2018, Costa Rica was ranked as the largest average user of pesticide per area of cropland (FAO, 2021[7]).

Costa Rica has made important inroads in the eradication of child labour in the country but there are persisting risks. Indeed, the country has seen a decline in the number of children working from 42,571 in 2011 to 6,706 in 2020 and is committed to ending child labour (Government of Costa Rica, 2021[8]). Child labour is still reported in cattle farming and coffee harvesting (US DOL, 2020[9]). The worst forms of child labour generally occur on smallholder farms in the formal sector and family farms in the informal sector (US Department of State, 2021[10]). Every year, members of the Ngabe y Buglé, an indigenous group from northern Panama, migrate to southern Costa Rica for coffee harvest season. More than 90% of the Ngabe y Buglé live in extreme poverty and when family units migrate to Costa Rica, children are often called upon to care for family members or work in the field (Imas/UNICEF, 2019[11]). Approaches such as the development of a network of *Casas de Alegria*, which provide a form of childcare during coffee harvests have been adopted to mitigate child labour (Imas/UNICEF, 2019[11]).

Construction projects in the real estate and infrastructure sectors were also cited as high-risk sectors by interviewees. Investors are paying increasing attention to the resiliency of real estate assets to climate risks and the transition to a low carbon economy (GRESB, 2021[12]). The construction sector has a high level of informal employment combined with an important reliance on migrant workers, mainly from Nicaragua (OECD, 2018[13]). The important health and safety risks in the construction sector combined with inadequate access to social security amplify risks for workers. Forced child labour reportedly occurred in the construction sector (US Department of State, 2021[14]).

Corporate lenders and institutional investors are exposed to these ESG risks through their loans and investments, respectively.

# 2. Mapping of Financial Sector Regulatory Actors in Costa Rica

Costa Rica has four financial sector regulators, each of which is overseen by the *Consejo Nacional de Supervisión del Sistema Financiero* (CONASSIF) and under the aegis of the *Banco Central de Costa Rica* (BCCR). CONASSIF, which was created in 1998 (Law No. 7732) issues guidelines and regulations as proposed by the four supervisory bodies (see Table 2.1):

a. The *Superintendencia General de Entidades Financieras* (SUGEF), which regulates financial intermediaries such as banks, savings and credit cooperatives, mutual savings associations and worker-owned lending institutions.

b. The *Superintendencia General de Valores* (SUGEVAL), which regulates securities.

c. The *Superintendencia de Pensiones* (SUPEN), which regulates pension funds.

d. The *Superintendencia General de Seguros* (SUGESE), which regulates the insurance sector.

The BCCR sets the country's monetary policy and maintains internal and external stability of the Costa Rican Colón, the national currency. The BCCR was created in 1950 and it now functions under Law No. 7558, adopted in 1995.

The financial regulators and central bank participate in sustainability focused initiatives. SUGEF is a supporting institution of the United Nations Environment Program-Finance Initiative (UNEP-FI), which convenes financial institutions on a regional basis to improve ESG practices. It has also joined the Sustainable Banking Network (SBN), an International Finance Corporation (IFC) convened initiative. SUGESE joined the UNEP-FI Principles or Sustainable Insurance initiative as a "supporting institution" in 2016. Furthermore, the BCCR is a member of the Network of Central Banks and Supervisors for Greening the Financial System (NGFS).

### Table 2.1. Financial Sector Regulators in Costa Rica

| Entity Name | Competency | Governance | Legal Reference | Participation in key international initiatives |
|---|---|---|---|---|
| **CONASSIF** | Approve regulation, appoint superintendents, and order suspension of regulated entities or intervention by regulators | 7 members: five members are appointed by the BCCR board and cannot be public servants; the chairman is selected by and appointed amongst these five members; the other two members are the Minister of Finance and the central bank governor | Ley Reguladora del Mercado de Valores (Law No. 7732, 1997), Ley Reguladora del Mercado de Seguros (Law No. 8653, 2008), Ley de Protección al Trabajador (Law No. 7983, 2000), Ley del Régimen Privado de Pensiones Complementarias (Law No. 7523, 1995), Ley Orgánica del del Sistema Bancario Nacional (Law No. 1644, 1953) | |
| **SUGEF** | Ensure the stability of the national financial system and | Autonomous body overseen by CONASSIF and operating | Ley Orgánica del Banco Central de Costa Rica (Law No. 7558, 1995), Ley | ASBA, UNEP-FI, SBN |

| Entity Name | Competency | Governance | Legal Reference | Participation in key international initiatives |
|---|---|---|---|---|
| | supervise financial intermediaries (banks, mutual savings associations and worker-owned lending institutions and cooperatives) | under the aegis of BCCR | Reguladora del Mercado de Valores (Law No. 7732, 1997), Ley Orgánica del del Sistema Bancario Nacional (Law No. 1644, 1953) | |
| **SUGESE** | Authorise, regulate, and supervise the insurance and reinsurance industry | Autonomous body overseen by CONASSIF and operating under the aegis of BCCR | Ley Reguladora del Mercado de Seguros (Law No. 8653, 2008) | IAIS, ASSAL, A2ii, PSI, UNEP-FI |
| **SUPEN** | Regulate and supervise the pension system and pension providers | Autonomous body overseen by CONASSIF and operating under the aegis of BCCR | Ley del Régimen Privado de Pensiones Complementarias (Law No. 7523, 1995), Ley de Protección al Trabajador (Law No. 7983, 2000) | IOPS, RED-PLAC (IADB), AIOS |
| **SUGEVAL** | Regulate and supervises the activities of securities market participants, including issuers and investors | Autonomous body overseen by CONASSIF and operating under the aegis of BCCR | Ley Reguladora del Mercado de Valores (Law No. 7732, 1997) | IOSCO, IIMV |

Source: SUGEF (n.d.), https://www.sugef.fi.cr; SUGESE (n.d.[15]), https://www.sugese.fi.cr/; SUPEN (n.d.[16]), https://www.supen.fi.cr/; SUGEVAL (n.d.[17]), https://www.sugeval.fi.cr/; CONASSIF (n.d.[18]), https://www.conassif.fi.cr

Financial regulators across Latin America and the Caribbean are accelerating their adoption of ESG disclosure and due diligence requirements (see *Responsible Business Conduct in the Financial Sector in Latin America and the Caribbean)*. Financial regulators in Costa Rica are contributing to this trend with their recent adoption of ESG-focussed regulation, as described in the next section.

# 3. Sustainable Finance Regulation and Initiatives in Costa Rica

There is increasing interest in improving sustainable finance practices in Costa Rica. This is evidenced by the recent organisation of sustainable finance roundtables and the adoption of sustainability focused industry initiatives along with regulation. Regulation to clarify the requirements to brand fixed income and investment funds as green or sustainable was adopted in 2020 and there are plans to adopt regulation focusing on the management of environmental and social risks and climate-related risks in lending portfolios. Furthermore, a voluntary initiative was adopted in 2019 to improve the integration of environmental and social issues in the banking sector.

## 3.1. Regulatory Initiatives aimed at driving ESG integration in the financial sector

Financial industry participants were convened by regulators for a series of sustainable finance-themed roundtables in 2019. SUGEF and SUGESE collaborated with the Ministry of Environment and Energy (MINAE) to host a series of eight roundtables on climate risk in the financial sector *(Mesas de Diálogo Climático con el Sector Financiero)*. This was done with the support of the *Acción Clima* programme of the *Deutsche Gesellschaft für Internationale Zusammenarbeit GmbH* (GIZ), a German development agency. These roundtables set the scene for the development of sustainability-linked regulation by the securities and banking supervisors.

The Government of Costa Rica's decarbonisation plan (2018-2050) acts as a backbone for the financial sector's involvement in the transition to a low carbon economy. While it does not cite a specific role for regulators, it mentions a strategy to work with investment funds and the financial system. It also assigns a role to the Central Bank in the consolidation of a structure to access climate finance (Government of Costa Rica, 2018[19]).

### *3.1.1. ESG focused regulation for lending institutions*

SUGEF, the banking regulator, is drafting a "Regulation for the management of environmental and social risks, and climate-related risks in the loan portfolio". The objective of this regulation will be to integrate climate risks into the formal risk management framework and governance of supervised financial intermediaries (i.e. banks). As of March 2021, the timeline to adopt this regulation has been delayed due to the adoption of new laws linked to the country's accession process to the OECD and the Covid-19 emergency.

In a separate but complementary process, SUGEF intends to begin collecting data from regulated entities on the climate resiliency of new loans in 2021. It worked with an international consulting firm to create a green taxonomy in 2020 and is adding reporting requirements into the current reporting templates for regulated entities. The reporting requirements will apply to new credit operations and will be compulsory, but the metrics-focussed component has been left out of the regulation which is under development.

### 3.1.2. ESG focussed regulation for institutional investors

Costa Rica does not have regulation requiring asset owners or asset managers to disclose how they incorporate ESG factors across their portfolios. Nonetheless, in November 2020, securities regulation CNS 1620/11 was amended to place a set of requirements for investment funds seeking to label themselves as sustainable.[5] Fund managers must now obtain a third-party verification (from entities approved by the Climate Bonds Initiative or SUGEVAL) if they wish to label an investment fund as green, social or sustainable. This designation that can only be claimed if 100 percent of the fund's assets are invested according to the given sustainability criteria.

In November 2018, a new regulation on asset management was issued by SUPEN, the pension regulator, and clarified how pension funds can incorporate ESG actors. The regulation enables regulated entities to establish "socially responsible asset management policies" as part of a fund's investment policy (SUPEN, 2018[20]).

SUGESE, the insurance regulator, has not adopted specific ESG regulation but has been active in promoting the integration of ESG issues within existing regulations. The regulator has concluded that there are no barriers to the integration of ESG factors within insurer operations. It has also incorporated a sustainability objective in its strategic plan: it will raise awareness around the integration of ESG issues in corporate governance and enterprise risk management systems through a survey of practices and workshops. SUGESE plans to undertake this with the support of the UNEP-FI and Germany's GIZ.

### 3.1.3. ESG focussed securities regulation

The November 2020 amendments to Costa Rica's securities regulation placed new requirements for fixed income products (alongside investment funds) to be designated as sustainable. Issuers who wish to label credit products as "green", "social" or "sustainable" must similarly obtain a third party review from verifiers approved by the Climate Bonds Initiative or SUGEVAL. This is meant to ensure the accuracy of information provided to investors. This reform affects the regulation on public offering of securities, financing of infrastructure projects and securitisation.[6] The *OECD Guidance on RBC for Institutional Investors* was referenced in the reform.[7]

## 3.2. Voluntary and Industry Initiatives

Financial industry participants have adopted various measures to drive the adoption of sustainable finance in Costa Rica. In 2019, a green protocol was adopted in the banking sector. Furthermore, the Costa Rican stock exchange created voluntary guidance for sustainability reporting and a green bond standard.

### 3.2.1. ESG initiatives focusing on lending institutions

The 2019 roundtables on climate risk in the financial sector culminated in the launch of a green protocol for the banking sector *(Protocolo Verde para la Banca)*. The Chamber of Banks and other Financial Institutions *(Cámara de Bancos e Instituciones Financieras)* spearheaded the development of this voluntary initiative. It was adopted in October 2019 and signed by eight financial institutions along with SUGEF, SUGESE and MINAE as "honour witnesses". Five additional financial institutions have since joined the protocol.[8]

Protocol signatories make a voluntary commitment to implement the following five principles: 1) offer financial products that foster environmental sustainability; 2) consider social and environmental impacts and costs in the management of assets and risk analysis of projects; 3) promote the responsible use of resources in the internal operations of the signatories; 4) inform and raise awareness regarding the institutions' policies and practices among interested stakeholders and 5) promote cooperation and integration of efforts among protocol signatories.

Principles 1 and 2 are most closely aligned with the OECD RBC Due Diligence framework (an overview of the OECD Due Diligence framework and specific recommendations for the financial sector is provided in Annex B and discussed in more detail in the report *Overview of Sustainable Finance Policies, Regulations and Practices in Latin America and the Caribbean*). The first principle promotes the creation of products that have a positive impact; the second principle touches on the adoption of environmental and social risk analysis for investments and loans.

To implement the protocol, the Chamber of Banks created a sub-committee of protocol signatories. The *Asociación Empresarial para el Desarollo* (AED), an association focused on building responsible business conduct (RBC) capacities and practices (and the Costa Rican chapter of United Way), facilitates the forum since May 2020. One year into the protocol's adoption, signatories were surveyed with a self-assessment to assess their progress and priorities. One observation raised during the survey was the possibility of adopting a basic set of requirements for signatory institutions – given that the initiative currently relies on voluntary principles.

### *3.2.2. ESG initiatives for institutional investors*

In the insurance sector, in 2018, SUGESE alongside Costa Rican insurance industry associations signed a Declaration for the development of a strategy for sustainable insurance in Costa Rica. This did not however commit individual companies to specific requirements. Furthermore, in 2016, SUGESE joined the UNEP-FI Principles or Sustainable Insurance initiative as a "supporting institution".

The Costa Rican investment fund association *(Cámara de Fondos de Inversión* - CAFI*)* and the pension industry have not adopted any sustainable finance initiatives or protocols.

### *3.2.3. ESG initiatives focused on securities and disclosure*

The *Bolsa Nacional de Valores* (BNV), Costa Rica's stock Exchange, has adopted a green bond issuance standard and voluntary sustainability reporting guidance.[9] The green bond standard applies to all issuers who seek to issue green bonds and is inspired by the International Capital Market Association's Green Bonds Principles.

The attraction of the BNV as a platform to issue green bonds does however face regional competition. For instance, in January 2021, *Banco Promerica de Costa Rica*, a Costa Rican financial institution (part of Panama's *Grupo Promerica*) issued a sustainable bond on the Panama Stock Exchange.[10]

Financial regulators in Costa Rica are moving in line with regional peers in assessing the merits of ESG regulation. While some regional peers have ESG due diligence (e.g. corporate lenders in Peru and Brazil) and ESG reporting regulations (e.g. pension funds in Chile, Brazil), Costa Rican regulators, with the regulation on labeling requirements for sustainable funds, has adopted a more focused approach which impacts a smaller segment of the financial industry (additional details in *Responsible Business Conduct in the Financial Sector in Latin America and the Caribbean)*. With respect to voluntary initiatives, lending institutions have followed regional peers in the creation of a sustainable finance protocol.

# 4. Sustainable Finance Policies and Practices of Financial Institutions in Costa Rica

The analysis of ESG integration in Costa Rica's financial sector is divided in two parts: firstly, the integration of ESG risks into the operations of the 10 largest commercial lending institutions in the country are reviewed. This is followed by an assessment of the integration of ESG issues into 10 of the country's largest institutional investors – which are further sub-divided between asset owners and asset managers. On a sector wide basis, a key finding is that the integration of ESG risk analysis at lending institutions is progressing more rapidly than the integration of ESG into institutional investment portfolios within Costa Rica's financial sector.

## 4.1. ESG Risk Management Practices in Commercial Lending Portfolios

The top 10 commercial lenders in Costa Rica have lending portfolios ranging from USD 6.1 billion to USD 443 million as of May 2021. They are regulated by SUGEF[11] and comprise a diverse set of institutions: two state-owned commercial banks *(banco comercial del Estado)*, one worker-owned bank created by special law *(bancos creados por leyes especiales)*, savings and credit cooperatives, two mutual savings and credit associations *(asociaciones mutualistas de ahorro y préstamo)*, four private banks *(bancos privados)* and one credit union owned by teachers and Ministry of Education employees. The four private banks are the Costa Rican subsidiaries of foreign groups from Colombia, Canada and Panama (see Table 4.1).

### Table 4.1. Top 10 Commercial Lenders in Costa Rica

**Loan portfolio at 1 May 2021**

| Name of entity | Type of entity | HQ country (parent) | Commercial loan portfolio (USD Mln) | Largest sector exposures |
|---|---|---|---|---|
| **Banco Nacional de Costa Rica** | State owned comercial bank | Costa Rica | 6 067.2 | Construction, services, utilities, retail |
| **Banco de Costa Rica** | State owned comercial bank | Costa Rica | 4 384.2 | Construction, services, manufacturing, agriculture |
| **Banco BAC San José** | Private bank; local subsidiary of publicly-listed foreign group | Colombia (Grupo Aval) | 3 041.9 | Construction, retail, services, manufacturing |
| **Banco Popular y de Desarrollo Comunal** | Bank created by special law; owned by the assembly of workers of Banco Popular | Costa Rica | 2 437.8 | Construction, utilities, retail, agriculture |

| Name of entity | Type of entity | HQ country (parent) | Commercial loan portfolio (USD Mln) | Largest sector exposures |
|---|---|---|---|---|
| **Banco Davivienda (Costa Rica)** | Private bank; local subsidiary of privately-held foreign group | Colombia (Grupo Bolivar) | 1 877.3 | Construction, retail, real estate, manufacturing |
| **Scotiabank de Costa Rica** | Private bank; local subsidiary of publicly-listed foreign group | Canada (Scotiabank) | 1 821.5 | Services, construction, retail, agriculture |
| **Banco Promerica de Costa Rica** | Private bank; local subsidiary of privately-held foreign group | Panama (Promerica Financial Corporation) | 1 023.0 | Real estate, construction, services, retail, services |
| **Grupo Mutual Alajuela la Vivienda de ahorro y Préstamo** | Mutual savings and credit association | Costa Rica | 963.0 | Construction, real estate, retail, agriculture |
| **Caja de Ahorro y Préstamo de la Ande** | Owned by teachers, employees and retirees from the Ministry of Education | Costa Rica | 546.2 | Construction, agricultura, services, retail, agriculture |
| **Mutual Cartago de Ahorro y Préstamo** | Mutual savings and credit association | Costa Rica | 442.8 | Construction, real estate |

Note: Loan portfolio figures (excluding consumer loans [“consumo”]) and sector exposures from SUGEF data *(Cartera de crédito clasificada por actividad económica y categoría de riesgo)*; loan figures converted into USD using 1 May 2021 exchange rate.
Source: SUGEF (n.d.), Cartera de crédito clasificada por actividad económica y categoría de riesgo según normativa aplicable https://www.sugef.fi.cr/ReportesSUGEF/InformacionCrediticia/ActividadEconomicayCategoriaRiesgo

### *4.1.1. ESG risk due diligence policies and practices in corporate lending*

An increasing number of top 10 lenders are setting up ESG risk due diligence systems in their corporate lending portfolios (Table 4.2). As of December 2020, four institutions had an operational ESG risk analysis system[12] for corporate loans. Those four institutions are local subsidiaries of foreign banks: Banco BAC San José, Scotiabank de Costa Rica, Banco Davivienda (Costa Rica) and Banco Promerica de Costa Rica. Grupo Mutual Alajuela, a mutual credit association, began incorporating ESG risks in integral risk management in 2019. Additionally, three local Costa Rican institutions are slated to have an ESG risk analysis system operational in 2021: Banco Nacional de Costa Rica (BNCR), Banco de Costa Rica (BCR) and Banco Popular y de Desarrollo Comunal (Banco Popular). The timing behind the adoption of these three firms practices is broadly consistent with the adoption of the *Protocolo Verde* in November 2019.

The ESG risk management systems in operation or under development share similar design elements. The most common practice is to have a 3-tier system which ranks loans on ESG risk from low, medium to high, as per the IFC’s ESG categorisation.[13] Four of the top 10 lenders use (or are setting up) a system with three or more tiers (BNCR, Banco BAC San José, Banco Popular, Banco Davivienda (Costa Rica)); three of the lenders do not elaborate on the scale they use.

Four lenders stated that they had an exclusion policy. Commonly excluded activities include weapons manufacturing, casinos, commercial logging in primary tropical forests and activities that use forced and/or child labour.

## Table 4.2. ESG Risk Management Practices of the Top 10 Commercial Lenders in Costa Rica

| Bank name | ESG risk management system in commercial lending | Application criteria and thresholds of ESG risk management | Reporting on ESG risk due diligence | ESG integration in executive or board committee |
|---|---|---|---|---|
| **Banco Nacional de Costa Rica** | Setting up 4-tier ESG risk profile for loans; exclusion policy | Expected to be operational in Q1-2021 for credits above USD 1M | Not disclosed | ESG not mentioned in board committee mandates |
| **Banco de Costa Rica** | Setting up ESG risk management in lending | Not disclosed | Not disclosed | Culture, ethics and performance executive committee oversees sustainability |
| **Banco BAC San José** | Yes: loans ranked according to 3-tier ESG risk profile; exclusion policy | All commercial credits above USD 1M are screened, ESG risk mitigation included in contractual clauses for risky transactions | Yes: Loan breakdown according to ranking system | Social responsibility management system for BAC; no committee with ESG oversight at Grupo Aval |
| **Banco Popular y de Desarrollo Comunal** | Setting up 3-tier ESG risk management in lending; exclusion policy; historical “impact” mandate | Will apply to all credits | Not disclosed | ESG not mentioned in board committee mandates |
| **Banco Davivienda (Costa Rica)** | Yes: loans ranked according to 3-tier ESG (including climate) risk profile, exclusion list | Apply to commercial credits; objective of applying ESG risk rating to all credit applications | Yes: loan breakdown by industry according to ranking | Board risk committee oversees environmental risk; sustainability committee includes board member at parent |
| **Scotiabank de Costa Rica** | Yes: environmental (and climate) risk considered in credit evaluation, EP-eligible loans ranked accordingly | EPs apply to project finance (USD 10M+) and project related corporate loans | Yes: number of internal requests for technical advice, loans screened | Board of parent org. oversees ESG |
| **Banco Promerica de Costa Rica** | Yes: ESG risk in loans; preferential terms for green construction; developed impact measuring tool | Apply IFC PS to loans of USD 10M+ with term of 3+ years | Not disclosed | ESG not mentioned in board committee mandates |
| **Grupo Mutual Alajuela la Vivienda de Ahorro y Préstamo** | Began incorporating ESG risk in integral risk management in 2019 | Not disclosed | Not disclosed | Sustainability policy implementation presented to board annually |
| **Caja de Ahorro y Préstamo de la Ande** | ESG risks not cited in 2019 annual risk report | Not disclosed | Not disclosed | Executive environmental management committee |
| **Mutual Cartago de Ahorro y Préstamo** | Green loan product line | Eligible technologies for green loans listed; | Not disclosed | ESG not mentioned in board committee mandates |

Note: For each bank, information is sourced from publicly available sources including company website, financial statements, annual reports, annual risk reports, corporate governance reports, sustainability reports and UNGC Communications on Progress available as of January 2021. In cases where entity representatives were interviewed, interview findings supplemented public disclosures.
Source: Adapted from company filings

The scope of application of the ESG risk management varies across lending institutions. Two lenders apply (or will apply) their ESG risk management to commercial loans above USD 1million (BNCR, Banco BAC San José). Banco Promerica de Costa Rica uses a threshold of USD 10 million and a loan period of three years to trigger its ESG analysis. Scotiabank de Costa Rica applies a climate risk analysis to all commercial loan. Furthermore, as signatory of the Equator Principles (EP) (the only signatory firm among the top 10 lenders) it applies this framework for project finance and project related loans above USD 10 million – although no projects were assessed under the Principles in Costa Rica over the course of 2020. Banco

Davivienda (Costa Rica) has an objective of applying its ESG risk system to all corporate loans in Costa Rica. In 2019, it carried out eight ESG risk management system (*Sistema de Análisis de Riesgo Ambiental y Social,* SARAS) evaluations for USD 58 million of credits (vs. 78 evaluations in the banks' Colombian operations).

The lenders tend to escalate the depth of their due diligence based on risks identified and they are also building in measures to monitor risk on an ongoing basis. For instance, Banco Popular will determine the depth of its due diligence according to 1) the size of the credit and 2) the ESG risk category. When a loan is characterised as high risk, the recipient will need to hire an external expert to evaluate the adequacy of ESG mitigation measures at the outset and on an ongoing basis. When there is a lack of compliance with the ESG risk mitigation plan in the credit agreement, a corrective action plan will be put in place.

Reporting on the implementation and application of ESG risk due diligence systems is low due to the recent adoption of such systems, the lack of reporting on Costa Rican operations (for foreign headquartered entities) or out of date information. Banco Davivienda (Costa Rica) reported the sectors in which it applied its SARAS in Costa Rica: residential and commercial construction (50% of evaluations), the food industry (25%), the chemical industry (13%) and others (13%) but did not provide additional information on risk profile in those sectors.

While ESG risks are increasingly evaluated in loan portfolios, there continues to be an opportunity to improve their integration in governance frameworks. Only two entities (Banco Promerica de Costa Rica and Grupo Mutual Alajuela– La Vivienda de Ahorro y Préstamo) cited environmental and/or social risks in their annual risk reports, a regulatory filing required under SUGEF Agreement 2-10. Moreover, the integration of ESG risks in the mandates of board or executive committees remains limited. Only three out of ten lenders explicitly include environmental, social or sustainability issues within executive or board committee mandates. In cases where ESG issues are included in committee's mandates, the responsibilities remain somewhat broad.

Internal staff capacity and assignment of responsibilities around ESG risk management can help assess the rigour of an entity's practices. Among lenders who have or are in the process of creating a SARAS, approaches include the aspiration to hire staff to manage the ESG risk analysis (e.g. BCR) while others are embedding ESG risk analysis within credit departments. Some foreign headquartered lenders (e.g. Scotiabank) have centralised the ESG process at the parent's headquarter. With eight employees in a sustainability department housed at the conglomerate level, BNCR is at the higher end of Costa Rica based staff with sustainability responsibilities.

### *4.1.2. Positive "impact" in corporate lending*

Costa Rican lenders are also making headways in the development of impact loans. For some institutions, this is a newer offering related to the transition to a low carbon economy while other entities have had a social mandate since their creation.

As a worker-owned bank, Banco Popular has a social impact mission. The bank's highest structure, the National Assembly of Workers, is made up of 290 delegates that represent social sectors across the country. The Assembly appoints four board members and the government appoints the remaining three. The bank finances community development associations, cooperatives, trade unions and municipalities, as per its social impact mandate, which is to "provide economic protection and welfare to workers, artisans and small producers by promoting savings and satisfying credit needs" (Banco Popular, 2020[21]).

At least two lenders offer "green" loans that must be used for activities or technologies that respond to specific sustainability criteria. Mutual Cartago de Ahorro y Préstamo and Banco Promerica de Costa Rica list the activities and technologies eligible for finance under their commercial green credit lines. The proceeds from the issuance of Banco Promerica de Costa Rica's January 2021 sustainable bond, the first to be issued in Central America, will notably go toward financing these credit lines.[14]

Multilateral finance institutions are playing an active role in supporting Costa Rican institutions that wish to create green products. Banco Davivienda (Costa Rica) has received a USD 60 million loan from the IFC to finance sustainable projects, including real estate and renewable energy.[15] Similarly, IDB Invest advised Banco Promerica de Costa Rica on the use of funds framework, which contains the criteria for selection, monitoring and evaluation of projects, aligned with the principles of green and social bonds of the International Capital Markets Association (ICMA), and it is providing a partial financial backing for the bond.[16]

During the Covid 19 pandemic, financial institutions across Latin America played an important role as providers of financial support and liquidity through guarantees, subsidies and refinancing plans. In Central America, local banks with development mandates, such as Banco Poplar in Costa Rica, injected more funds in their country's economy to respond to Covid-19 than regional and multilateral banks (ECLAC, 2021[22]). This is one of the ways in which local financial institutions demonstrated societal impact during the pandemic.

### *4.1.3. Participation in international initiatives and reference to international principles*

The top 10 commercial lenders in Costa Rica participate in a range of national and international initiatives (see Table 4.3). At the national level, eight lenders have signed on to the *Protocolo Verde.* The lenders were assessed for their participation in the following international initiatives: the United Nations Global Compact (UNGC), the UNEP-FI PRB and the EP. The UNGC is the most popular international initiative amongst the top 10 lenders – it has been signed by four local entities. Amongst foreign headquartered lenders, one has signed the UNGC for its Costa Rican operation while two have signed at the level of the parent. The United National Environment Program – Finance Initiative Principles for Responsible Banking (UNEP-FI PRB) have yet to make substantial headway in the country – it has only been signed by one of the top 10 lenders: Banco Promerica de Costa Rica. Finally, only one of the top 10 lenders is a signatory to the EP: Scotiabank de Costa Rica and this is at the level of the parent organisation level.

#### Table 4.3. Participation in international and national initiatives by top 10 lenders

| | UNEP-FI PRB | UNGC | EP | Protocolo Verde |
|---|---|---|---|---|
| **Banco Nacional de Costa Rica** | No | Yes | No | Yes |
| **Banco de Costa Rica** | No | Yes | No | Yes |
| **Banco BAC San José** | Yes | Yes | No | Yes |
| **Banco Popular y de Desarrollo Comunal** | No | Yes | No | Yes |
| **Banco Davivienda (Costa Rica)** | No | Parent (Grupo Bolivar): Yes | No | Yes |
| **Scotiabank de Costa Rica** | No | Parent: Yes | Parent: Yes | No |
| **Banco Promerica de Costa Rica** | Yes | No | No | Yes |
| **Grupo Mutual Alajuela la Vivienda de ahorro y Préstamo** | No | Yes | No | Yes |
| **Caja de Ahorro y Préstamo de la Ande** | No | No | No | No |
| **Mutual Cartago de Ahorro y Préstamo** | No | No | No | Yes |

Note: For local subsidiaries of foreign headquartered parents, the information is provided for local subsidiaries unless otherwise noted. Current as of June 2021 expect for the category of Protocolo Verde, which is current as of March 2021.

Source: UNEP-FI (2021), Signatories to the PRB, https://www.unepfi.org/banking/bankingprinciples/prbsignatories/; EP (2021), EP Association Members and Reporting, https://equator-principles.com/members-reporting/; Protocolo Verde para la Banca (2019), https://www.sugese.fi.cr/seccion-publicaciones/MesaDialogo/Mesa6-Protocolo_Verde_Banca.pdf; UNGC (2021), Our participants, https://www.unglobalcompact.org/what-is-gc/participants

The top 10 lenders also reference international standards and principles in their policies. The IFC Performance Standards and its ESG Categorization are the most cited, with four mentions. The OECD Guidelines for Multinational Enterprises are not cited in the disclosures of the top 10 lenders – neither at the local nor parent organisation level.

#### *4.1.4. Challenges and opportunities to the integration of ESG risk management in corporate lending*

Costa Rican lending institutions are progressing in their adoption of ESG risk due diligence and positive impact products. Some institutions already have positive impact mandates. Some of the opportunities to accelerate the trend across the lending sector include a) better governance oversight of sustainability in lending portfolios and b) the adoption of goals and objectives under the *Protocolo Verde*.

While an increasing number of lenders are improving their practices around the integration of ESG in lending portfolios, governance oversight for these systems and practices remains disparate across lenders. There is no clear trend amongst the top 10 lenders for the assignment of those responsibilities at the board or executive committees. The assignment of ESG risk management in risk committees at the board or executive level offer one avenue to ensure that sustainability issues are not separated from traditional risk factors. The planned adoption of regulation on ESG risk due diligence in lending operations is likely to tackle governance oversight of sustainability issues.

The adoption of the *Protocolo Verde* was an important step forward because it created sector-wide momentum for the integration of sustainability issues into lending portfolios. The addition of time-bound targets related to ESG risk screening or positive impact products along with a reporting mechanism could be considered to elevate signatory accountability. The convening mechanism recently created under the Protocol could also be an important information sharing platform as institutions start to gather better information around ESG risk from the systems they have (or are beginning to) set up.

## 4.2. ESG Integration in Institutional Investment Portfolios

The integration of ESG issues in institutional investment portfolios is at an early stage in Costa Rica. Amongst the top five asset managers and asset owners in Costa Rica, none have yet adopted a systematic strategy to integrate ESG issues across their funds. There is anecdotal evidence of ESG integration in the real estate portfolios of some asset managers, where a preference for LEED certified buildings and commitments to providing affordable housing are mentioned.

The integration of ESG issues into institutional investment portfolios was assessed for the 10 largest asset owners and asset managers in Costa Rica. The asset owners that were within the scope of analysis were SUPEN regulated pension funds, SUGESE regulated insurance firms and sovereign wealth funds (SWFs) (there are no such funds in Costa Rica); the investment fund managers within scope were SUGEVAL-licensed *Sociedades Administradoras de Fondos de Inversión* (SAFI). The five entities with the largest assets under management in each group were retained for an in-depth analysis.

Costa Rican asset owners have a larger asset footprint than asset managers. The country's 14 investment managers oversee a total of USD 6.0 billion in net assets (SUGEVAL, 2021[23])[17] - while the top five asset owners have more than USD 20 billion in invested assets (see Table 4.4). Costa Rica's asset management sector is the largest one in Central America – Panama, has the second largest with USD 2.8 billion in AUM.[18]

Fixed income is the dominant asset class in the portfolios of the largest asset owners and asset managers. For instance, as of June 2021, 57% of the top five asset managers' net assets are invested in domestic money market funds, which tend to comprise short term fixed income holdings (SUGEVAL, 2021[23]). The top five asset owners also have a heavy exposure to domestic public sector[19] fixed income holdings; this ranges between 95% at the high end to 70% at the low end.

### *4.2.1. ESG Integration Practices of Asset Owners in Costa Rica*

The top five asset owners in Costa Rica include four pension funds and one insurance firm (see Table 4.4). The largest pension fund is the old age and disability scheme, the *Régimen de Invalidez, Vejez y Muerte* (RIVM), a contributory, mandatory earnings scheme which is managed by the Caja Costarricense del Seguro Social, the social security fund. The second largest asset owner is the retirement fund for the country's educational sector (i.e. teachers), the *Régimen de Capitalización Colectiva del Magisterio Nacional*, a mandatory substitute to the RIVM for the sector's workers. Popular Pensions (complementary pension operator arm of Banco Popular y de Desarrolo Comunal) and BN Vital (complementary pension operator arm of BNCR) are the third and fourth largest asset owners. Those two entities are the largest *Operadoras de Pensiones Complementarias* (OPC) in the country[20] and they provide mandatory individual retirement account which are part of the country's 2nd pillar of social security. The fifth largest asset owner is Grupo INS, a state-owned insurance enterprise which has the largest investment portfolio amongst insurance companies regulated by SUGESE.

## Table 4.4. ESG Integration of the Top 5 Asset Owners in Costa Rica

| Name of entity (HQ country) | Type of entity | AUM (USD Mln) | Description of portfolio | Description of ESG Integration | Signatory to PRI |
|---|---|---|---|---|---|
| **CCSS Régimen de Invalidez, Vejez y Muerte (Costa Rica)** | Social security pension fund manager | 5 938.5 (April 2021) | Investments (long-term) in public sector fixed income (95.1%), national banking system certificates of deposit (1.9%), domestic financial sector fixed income (2.8%), domestic non-financial corporate fixed income and or equity (0.1%); planned to increase diversification in global markets and public works in 2020 | No mention of ESG investment stewardship in disclosures (including Regulation on the Investments of the RIVM, CCSS Reglamento 8200) | CCSS OPC, an affiliated entity, is a signatory |
| **Régimen de Capitalización Colectiva del Magisterio Nacional (Costa Rica)** | Occupational pension fund | 5 214.1 (March 2021) | Public sector fixed income (86.4%), domestic private sector (6.1%) (dominated by fixed income); equity accounts for approximately 0.02% of portfolio], domestic investment funds (7.4%); also provides loans to members | No mention of ESG investment stewardship in disclosures; plan to align activities with SDGs but no mention of investment stewardship | No |
| **Popular Pensiones (Costa Rica)** | Mandatory complementary pension operator (OPC) | 5 628.5 (May 2021) | Public sector fixed income (59.6%), international index tracking funds (33.8%), domestic private sector fixed income (5.1%), and domestic investment funds (1.4%) | No mention of ESG investment stewardship in disclosures; creation of a Sustainability and Communication department in 2019 | No |
| **BN Vital (Costa Rica)** | Mandatory complementary pension operator (OPC) | 2 810.6 (May 2021) | Public sector fixed income (72.1%), domestic private sector – including fixed income and equities (13.2%), foreign issuers via international asset managers (13.0%), domestic investment funds (1.8%) | No mention of ESG investment stewardship in disclosures | No |

| Name of entity (HQ country) | Type of entity | AUM (USD Mln) | Description of portfolio | Description of ESG Integration | Signatory to PRI |
|---|---|---|---|---|---|
| **Grupo INS (Costa Rica)** | Insurance firm | 2 543.3 (April 2021) | Public sector fixed income (85.5%), foreign issuers (fixed income and equity) (9%), domestic private sector (fixed income and equity) (5.1%), others (2.7%) | Commitment to incorporate sustainability in decision making (including investments), cites OECD MNE Guidelines; no ESG investment stewardship strategy disclosed | No |

Note: AUM figures drawn from SUPEN's May 2021 *Informacion por cuentas*, SUGESE's April 2021 investment portfolio statistics, April 2021 financial statements for RIVM and March 2021 financial statements for RCCMN. Description of portfolio information drawn from SUPEN's fund by fund portfolio structure tool for December 2020 and supplemented by individual entity's financial statements; description of ESG information drawn from entity websites, annual reports, strategic plans and financial statements available online up to February 1st 2021.
Source: SUPEN (2021), *Informacion por Cuenta*, https://www.supen.fi.cr/informacion-por-cuentas; SUGESE (2021), Cartera de inversiones aseguradoras, https://www.sugese.fi.cr/seccion-estadistica/hist%C3%B3ricos; RIVM (2021), Balance IVM Abril 2021, https://www.ccss.sa.cr/financiero; RCCMN (2021), Estados Financieros - Marco 2021, https://www.juntadepensiones.cr/contenido/estados-financieros

The integration of ESG into investment stewardship practices is limited amongst the top five asset owners. While there is no indication of ESG integration in the investments of the CCSS RIVM, the CCSS OPC, a sister organisation, was the first Costa Rican signatory to the Principles for Responsible Investing (PRI) (in July 2020). The *Régimen de Capitalización Colectiva del Magisterio Nacional* plans to align its activities with SDG principles but there is no indication that this will apply to investments (JUPEMA, 2020[24]). Popular Pensiones and BN Vital do not disclose any strategy to integrate ESG into investments, although Popular Pensiones recently created a sustainability department. Finally, Grupo INS has made a formal commitment to incorporate sustainability considerations across its activities, including investments, but there is no indication that this has yet to translate into ESG integration. Grupo INS is the only financial institution evaluated to reference the OECD Guidelines for Multinational Enterprises – as part of a broader list of international and national norms and frameworks.[21]

The top five asset owners have a heavy exposure to domestic public sector[22] fixed income holdings. This exposure ranges from 95% at the high end to 70% at the low end (see Table 4.4). The RIVM allocates more than 95% of its portfolio to public sector fixed income. The regulation on the investments of the fund (Reglamento 8200, 2007[25]) sets the key investment parameters and recently, the investment committee has set an objective to increase diversification in international markets and public works projects (CCSS, 2019[26]).

Popular Pensiones and BN Vital, the two complementary pension fund operators have a lower – albeit high – exposure to domestic public sector fixed income (60% and 71% respectively). They also have some exposure to foreign markets (equity and fixed income) via global asset manager products (e.g. State Street, BlackRock). They can invest up to 25% of their holdings abroad (up to 50%, pending approval from SUPEN) and must also invest 15% of their holdings in domestic mortgage-backed securities (Law No. 7983, 2000[27]). A 2018 regulation on asset management enables the funds to invest up to 25% in public equity but largest upper limit maintains a fixed income bias – up to 80% of the portfolio can be invested in domestic public sector fixed income (Procuraduría General de la República, 2018[28]).

The *Régimen de Capitalización Colectiva del Magisterio Nacional* invests in financial instruments and it has a portfolio of loans to its members: Costa Rican teachers and Ministry of Education employees and retirees. Investment portfolio limits are set by Law No. 7531. The fund must invest a minimum of 30% of assets to be invested in public sector securities and, since 2009 (Law No. 8721), a new investment class is the provision of personal, home and micro-enterprise loans to affiliates of the *Magisterio Nacional*. In 2019, USD 386 000 had been lent under this programme.[23]

The investment guiding principles that govern the investment policies of insurance sector companies are described in Law No. 8653. Grupo INS sets its investment policy in line with these guiding principles and more than 85% of its portfolio is in domestic public sector fixed income holdings.

### *4.2.2. ESG Integration Practices of Asset Managers in Costa Rica*

The top five asset managers' portfolios are heavily invested in two asset classes: money market instruments and real estate. Money market instruments are short term, fixed income instruments – they accounted for 57% of the top five's net assets in June 2021; real estate funds accounted for 33% of net assets (SUGEVAL, 2021[23]). The remainder of the collective portfolios are invested project development funds along with fixed income and public equity funds (see Table 4.5).

The top five asset managers are beginning to integrate ESG into investments on an anecdotal basis. This is most apparent in real estate and project development funds. BCR Investments, the largest investment fund manager (SAFI), has included a line item on the cost for LEED certification for its *Parque Empresarial Lindora* project development fund (BCR SAFI, 2019[29]). *Multifondos* is working to add LEED certification to some of its real estate fund holdings. According to one manager, there is increasing demand for LEED certification, particularly from multinational enterprises operating in Costa Rica. Popular SAFI has signed a collaboration agreement to create real estate fund with an affordable housing element[24] and plans to launch a green fund in 2021.

While the landscape is evolving, progress remains for fund managers to display robust ESG integration. For instance, environmental, social or governance issues have yet to be incorporated into fund prospectus.

As of June 2021, there were no Costa Rican PRI signatory asset managers.

## Table 4.5. ESG Integration of the Top 5 Asset Managers in Costa Rica

AUM figures at mid-June 2021

| Name of entity | HQ country (parent) | AUM (USD Mln) | Description of portfolio | Description of ESG integration | Signatory to PRI |
|---|---|---|---|---|---|
| **BCR SAFI** | Costa Rica (Conglomerado BCR) | 1 330.1 | 4 money market funds (52.8% of net assets), 4 real estate funds (45.5%), 2 income funds (fixed income) (0.2%), 1 real estate project development fund (1.5%) | Real estate project development fund will develop LEED certified building; no other description of ESG integration | No |
| **BN SAFI** | Costa Rica (Conglomerado BNCR) | 1 106.3 | 7 money market funds (84.3% of net assets), 7 growth funds (fixed income and equity) (13%), 1 real estate project development fund (2.6%), | No description of ESG integration | No |
| **Popular SAFI** | Costa Rica (Conglomerado Banco Popular) | 851.2 | 4 money market funds (87.5% of net assets), 2 real estate funds (12.5%) | Organisational mandate to foster environmental and social wellbeing; agreement to create real estate fund with affordable housing element; creation of a green fund planned for 2021 | No |
| **Multifondos de Costa Rico SAFI** | Costa Rica | 578.1 | 1 real estate fund (38% of assets), 4 income funds (fixed income) (38%), 2 money market funds (24%), 1 real estate project development fund (0.1%), 1 growth fund (1%) | Triple bottom line mandate at group level; favour LEED certified buildings in real estate; no other description of ESG integration | No |
| **IMPROSA SAFI** | Costa Rica (Grupo Financiero Improsa) | 550.7 | 4 real estate funds (97.4% of assets), 1 real estate project development fund (2.6%) | No description of ESG integration | No |

Note: "AUM" and "description of portfolio" figures drawn from SUGEVAL's Boletín de Fondos de Inversion for mid-June 2021; "description of ESG integration" drawn from fund individual fund prospectus and fund manager websites.
Source: SUGEVAL (2021), *Boletín Fondos Inversión - Junio 2021, Quincena II*, https://aplicaciones.sugeval.fi.cr/InformesEstadisticas/BoletinFondosInversion

### *4.2.3. Challenges and opportunities to the integration of ESG in Costa Rica's institutional investment sector*

Some of the barriers to the acceleration of ESG integration in asset management include market structure (and portfolio composition), limited demand from clients, the need for regulatory clarifications, and the allocation of incentives from development finance institutions.

The Costa Rican marketplace is relatively small and does not offer many options to diversify large portfolios.[25] The dominant role of domestic public sector, fixed income and short term (money market) holdings in the portfolios of asset owners and managers poses some challenges to ESG strategies. Indeed, the most widespread responsible investment practice is the integration of ESG issues into the analysis of public equity (PRI, 2016[30]). Costa Rican asset managers and owners could begin to integrate ESG issues by favoring ESG-screened investment products in their international market exposure. For asset managers, the integration of ESG issues into the prospectus of real estate and project development funds could be an initial step to the ESG integration in the domestic market.

Asset managers cited the lack of demand from clients as a barrier to the integration of ESG issues. This suggests that there is an opportunity for country's largest asset owners to embed ESG issues into their investment policies and to raise expectations from asset managers.

An additional barrier cited by asset managers was the lack of regulatory guidance around the parameters to designate products as sustainable or green. This was addressed in November 2020, when SUGEVAL amended the regulation on investment fund managers to clarify requirements for a fund to brand itself as "green" (Reglamento 762, 2020[31]).

One asset manager mentioned that development finance institutions have provided financial and technical support to lending institutions on the development of green loans but that such collaboration has yet to occur with the local asset management industry.

The development of a sector wide sustainable finance protocol could be an avenue to drive enhanced ESG practices in institutional investment. The *Protocolo Verde* adopted in the banking sector could serve as a useful template for this purpose.

# 5. Conclusion

The ESG integration practices of financial institutions in Costa Rica rest on sector wide voluntary principles and limited regulation. There is no requirement for corporate lenders and institutional investors to carry out ESG due diligence nor are there mandatory ESG reporting requirements. As of December 2020, four of the country's top 10 lenders had an operational ESG risk analysis system[26] for corporate loans and three additional lenders were setting those up. The timing behind the adoption of these practices is broadly consistent with the adoption of the banking sector's *Protocolo Verde*, a voluntary agreement to embed sustainability issues in industry practices, in November 2019. The addition of time-bound targets related to ESG risk screening along with a reporting mechanism could be considered to elevate signatory accountability to the protocol. Furthermore, this would enable protocol signatories to further align their practices with the OECD RBC Due Diligence Framework.

In the institutional investment sector, there is no investor focused ESG initiative or best practices code and ESG practices amongst the country's top asset owners and managers are weak. Only one of the top five asset owners had demonstrated commitment to integrating ESG by signing on to the PRI while practices amongst the top five asset managers were also limited – despite anecdotal examples such as Popular SAFI's plan to create a real estate fund with an affordable housing element. A sustainable finance protocol targeted at the institutional investment sector could be an opportunity for sector wide attention to ESG integration.

As regulators consider regulations around the ESG duties of financial institutions, they will be able to draw from voluntary initiatives in Costa Rica and emerging practices from regional peers. This includes regulation in countries like Brazil and Peru where the responsibilities of financial institutions to mitigate adverse environmental and social impacts, are being incorporated into regulation alongside the mitigation of climate risk. In this regard, the OECD RBC due diligence framework for institutional investors and corporate lending institutions could be useful reference tools.

# Annex A. Methodology

The analysis and findings of this paper are based on publicly available information and interviews with Costa Rican financial industry practitioners and regulators. The research consisted in a review of the financial sector's role in the Costa Rican economy; the structure of the Costa Rican marketplace along with a mapping of key financial sector regulatory actors and industry associations on the banking and institutional investment side the sector, planned adoption or lack thereof of sustainability initiatives in the field of institutional investment (i.e. fund management, pensions and insurance), corporate lending (i.e. banks, cooperatives) and securities disclosure.

Salient ESG risks were identified on a sector basis based on a) the importance of the sectors in lending and institutional investment portfolios; b) the sector's footprint in the country's economy; and c) sectors cited by financial institutions (reports and interviews).

The analysis of ESG practices[27] at financial institutions was split into two sections: 1) the assessment of ESG integration in commercial loan portfolios and 2) the integration of ESG issues in institutional investment portfolios. The top 10 institutions were isolated for in-depth analysis in both sectors. On the commercial lending side, the 10 largest commercial lenders were identified using the SUGEF data on the outstanding loan portfolios of regulated entities on 1 May 2021.

For the analysis of institutional investor practices, the analysis was divided between asset owners and asset managers – five of each were selected for in-depth analysis. Institutional investors that qualified as asset owners included SWF, pension funds and insurance firms. The five asset owners with the largest assets under management were subject to further analysis. The pool of asset managers eligible for analysis all had investment fund manager (SAFI) licenses from the securities regulator, SUGEVAL.

The 20 entities that were subject to in-depth analysis included locally and foreign headquartered groups. In cases where the entity had a foreign parent organisation, the local (Costa Rica) disclosures along with the foreign parent's disclosures were analysed. This provided further clarity around the application (or not) of parent organisation policies (e.g., application of the EP) to the local operations of a given entity.

The research focussed primarily on the ESG policies and RBC due diligence practices associated with the human rights, employment and environment chapters of the OECD Guidelines for Multinational Enterprises and it considered information on climate risk.[28] The OECD's Due Diligence for Responsible Corporate Lending and Securities Underwriting was a key reference document in analysing the maturity of practices in corporate lending activities, while the OECD's Responsible Business Conduct for Institutional Investors played a similar role in the research on institutional investment (see Annex B).

Interviews were conducted with Costa Rican regulators, corporate lenders and asset managers. The *Asociación Empresarial para el Desarrollo* (AED), an association focused on building RBC capacities and practices (and the Costa Rican chapter of United Way) provided support in identifying key contacts to interview. Interview requests were sent to 19 entities and 9 interviews were conducted. Interviewees included regulators (SUGEF and SUGESE), asset managers (Multifondos, Popular SAFI, BCR SAFI) and lending institutions (BNCR, BCR, Banco Popular y de Desarrollo Communal, Scotiabank de Costa Rica). Supplementary information was also kindly provided by AED. The information obtained through interviews were used to supplement the analysis of public disclosures and they informed the overall analysis.

# Annex B. OECD Standards on Responsible Business Conduct

The OECD Guidelines for Multinational Enterprises are the most comprehensive international standard on RBC. The Guidelines reflect the expectation from governments to businesses on how to act responsibly. They cover all key areas of business responsibility, including human rights, labour rights, environment, bribery, consumer interests, as well as information disclosure, science and technology, competition, and taxation. The Guidelines were adopted in 1976 and last updated in 2011. To date, 50 countries have adhered to the Guidelines. In Latin America, there are four OECD member countries and eight adherents to the OECD Guidelines. The member countries are Mexico, Chile, Colombia and Costa Rica and Brazil is a key partner. The countries that have adhered to the Guidelines are Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico, Peru and Uruguay.

A key element of RBC is risk-based due diligence – a process through which businesses should carry out to identify, prevent and mitigate their actual and potential adverse impacts and account for how those impacts are addressed. This process should be an integral part of business decision-making and risk management systems. It concerns adverse impacts caused or contributed to by enterprises as well as those adverse impacts that are directly linked to their operations, products or services through a business relationship.

The OECD RBC framework calls on companies to identify and mitigate their adverse impacts on people (e.g. workers, communities, indigenous communities) and the environment (e.g. biodiversity, climate change). Under this approach, RBC risk is considered independently of its financial or commercial impact (OECD, 2019[32]). The financial relevance and impact of environmental and social factors is dynamic and evolving. Many environmental materiality issues will become financially material over time and contribute to long-term (financial) value, as the physical impacts of climate change become more widespread, damaging and costly, and as climate regulation becomes more ambitious. With respect to social issues, one example of dynamic materiality could be a company's reliance on suppliers that rely on forced labour to manufacture goods and export them around the world. In this instance, the purchasing multinational company would be causing an adverse human rights impact. If the company's largest export market was to adopt and enforce legislation prohibiting the import of products that are manufactured using forced labour, or mandate due diligence, this could cause a material social risk for the company.

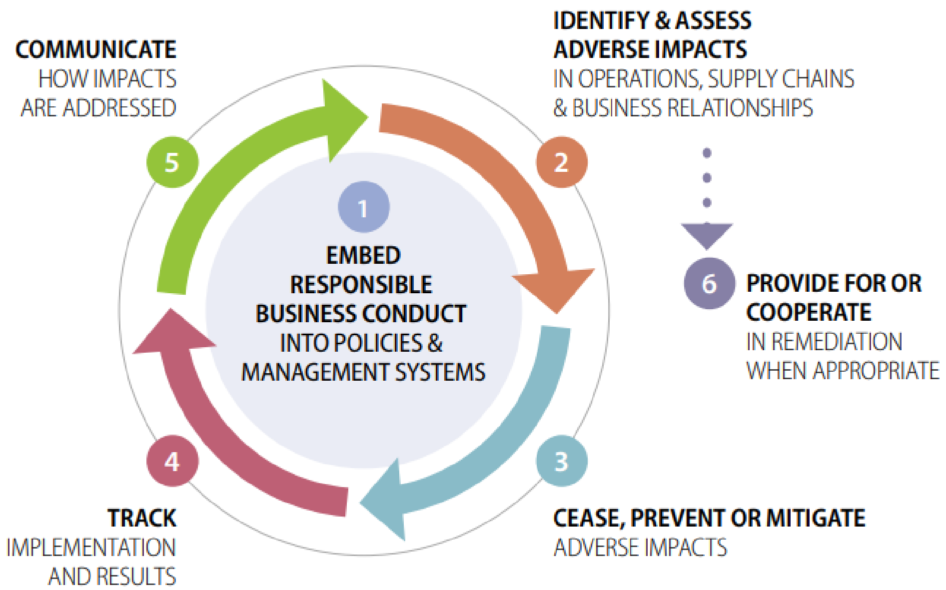
RBC due diligence involves a 6-step process:

1. Embed RBC into the enterprise's policies, management systems and business relationships
2. Identify and assess actual and potential adverse impacts associated with the enterprise's operations, products or services
3. Cease, prevent and mitigate adverse impacts
4. Track implementation and results
5. Communicate how impacts are addressed
6. Provide for/cooperate in remediation, when appropriate (see also Figure A B.1)

These steps are all inter-related, dynamic and iterative; learnings from each element feed and build into one another. RBC due diligence is also defined by key characteristics of due diligence. In this respect due diligence should:

- Be preventative
- Involve multiple processes and objectives
- Be commensurate with risk (risk-based)
- Involve risk-based prioritisation
- Be dynamic (i.e., ongoing, responsive and changing)
- Avoid shifting responsibilities
- Concern internationally recognised RBC standards
- Be appropriate to an enterprise's circumstances
- Be adapted to deal with the limitations of working with business relationships
- Be informed by engagement with stakeholders
- Involve ongoing communication

Importantly, RBC due diligence moves away from traditional compliance approaches. Rather it espouses a risk-based approach based on preventing and mitigating the most significant environmental and social impacts, incorporating stakeholder engagement and allowing for continuous improvement and evolution of expectations over time.




Source: OECD (2018), Due Diligence Guidance for Responsible Business Conduct, http://mneguidelines.oecd.org/due-diligence-guidance-for-responsible-business-conduct.htm

The OECD Due Diligence Guidance for Responsible Business Conduct (OECD, 2018[33]) provides practical support to enterprises on the implementation of the OECD Guidelines for Multinational Enterprises by providing plain language explanations of its due diligence recommendations and associated provisions. Like the Guidelines, it covers all sectors of the economy, addressing a range of risks in business operations, supply chains and value chains, including labour, the environment and integrity. The Guidance includes additional explanations, tips and illustrative examples of due diligence which may be of use to companies, including those in operating in the financial sector.

Additionally the OECD has also developed sector specific guidances on due diligence for the financial sector, namely:

- Responsible Business Conduct for Institutional Investors (OECD, 2017[34])
- OECD Due Diligence Guidance for Responsible Corporate Lending and Securities Underwriting (OECD, 2019[32])

These guidances reflect the core expectations of the OECD RBC framework but included practical guidance adapted to the specific activities and contextual circumstances of commercial banks and institutional investors (see Table A B.1). They have been approved by 50 governments and developed in partnership with business, trade unions and civil society through a multi-stakeholder advisory group.

## Table A B.1. Due Diligence Process: Application in Corporate Lending and Institutional Investment

| Due Diligence Step | Application in corporate lending | Application in institutional investment |
|---|---|---|
| **Embed RBC into policies and management systems** | Describe approaches to due diligence and assign roles to relevant business units | Adopt a policy which includes a commitment to relevant RBC standards and maintain management systems which enable investors to consider RBC risks in investments |
| **Identify actual and potential adverse RBC impacts** | Develop a *first* screen and *second* screen for enhanced identification, and develop a process for assessing a bank's involvement with an adverse impact. | Integrate RBC risk identification into existing processes to inform risk evaluation prior to investment and screen investment portfolios |
| **Cease, prevent or mitigate adverse impacts** | Incorporate RBC expectations in contractual documents or written agreements, engaging with clients, and well as collaborating to address systemic issues. | Integrate RBC requirements in investment mandates and decisions and engage with a company to exert leverage to mitigate adverse impacts |
| **Track implementation and results** | Request clients to report on issues and in high risk cases, require third party review of compliance. | Track investee and own performance against RBC commitments |
| **Communicate how impacts are addressed** | Publicly communicate on RBC policies and number of corporate lending transactions subjected to enhanced due diligence. | Publicly communicate on RBC policies, engagements, and proxy votes to prevent and mitigate or remediate actual or potential impacts at investee companies |
| **Provide for or cooperate in remediation when appropriate** | Seek to use leverage to encourage clients to provide for or cooperate in remediation and enable access to remediation by establishing a bank-level grievance mechanism. | Establish operational-level grievance mechanism and cooperate with judicial or state-based non-judicial mechanisms |

Source: OECD (2019), Due Diligence for Responsible Corporate Lending and Securities Underwriting, http://mneguidelines.oecd.org/due-diligence-for-responsible-corporate-lending-and-securities-underwriting.pdf; OECD (2017), Responsible business conduct for institutional investors, https://mneguidelines.oecd.org/RBC-for-Institutional-Investors.pdf

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# Notes

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[2] Costa Rica data from SUGEVAL's Boletín Fondos Inversión, Quincena 2 – June 2021 (Available here: https://aplicaciones.sugeval.fi.cr/InformesEstadisticas/BoletinFondosInversion); Panama data from the Superintendencia del Mercado de Valores de Panamá, March 2021 Report (Available here: https://supervalores.gob.pa/wp-content/uploads/2021/05/Inf-Mensual-Valores-Mar-2021.pdf ).

[3] Services account for 73.9% of GDP, industrial activity (including construction) accounts for 21.2% and agriculture accounts for 4.9%. See details here: https://www.azofras.com/datos-generales/

[4] See export data here: https://www.datasur.com/datamerica/costa-rica/exportaciones-productos-2018/

[5] Amendments were made to Articles 17, 18, 29, 31 of the *Reglamento sobre oferta pública de valores*; Articles 27, 28 of the *Reglamento sobre Financiamiento de Proyectos de Infraestructura*; Articles 40, 42, 43 of the *Reglamento sobre procesos de titularización*; Article 15 of the *Reglamento General sobre Sociedades Administradoras y Fondos de Inversión* (https://www.sugeval.fi.cr/normativa/Paginas/ReglamentosdelMercado.aspx).

[6] Amendments were made to Articles 17, 18, 29, 31 of the *Reglamento sobre oferta pública de valores*; Articles 27, 28 of the *Reglamento sobre Financiamiento de Proyectos de Infraestructura*; Articles 40, 42, 43 of the *Reglamento sobre procesos de titularización*; Article 15 of the *Reglamento General sobre Sociedades Administradoras y Fondos de Inversión* https://www.sugeval.fi.cr/normativa/Paginas/ReglamentosdelMercado.aspx.

[7] The OECD's Guidance *Responsible Business Conduct for Institutional Investors* is referenced in there "whereas" clauses of CNS-1620/11. See Paragraph F: http://www.conassif.fi.cr/wp-content/uploads/2020/12/1620-11-ADZ.docx (accessed 3 March 2021).

[8] The original signatories were Banco Nacional de Costa Rica, Banco de Costa Rica, Banco Popular y de Desarrollo Comunal, BAC Credomatic, Banco Davivienda, Banco Promerica, Banco Lafise, Financiera Cafsa. The signatories that joined at a later date are Grupo Mutual Alajuela-La Vivienda de Ahorro y Préstamo, Mutual Cartago de Ahorro y Préstamo, Coopeservidores R.L., Coopeande No.1 R.L. and Financiera Gente S.A.

[9] Information here:
https://www.bolsacr.com/sites/default/files/239/estandar_bonos_verdes_bnv.pdf

[10] Information here: https://sseinitiative.org/all-news/exchange-in-focus-panama-stock-exchange-first-sustainable-bond/

[11] SUGEF regulates a total of 46 institutions as of January 2021. For a list of institutions and categories, see here:
https://www.sugef.fi.cr/entidades_supervisadas/lista_entidades_supervisadas_por_SUGEF.aspx.

[12] Often referred to as SARAS (Sistema de análisis de riesgo ambiental y social)

[13]https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/sustainability-at-ifc/policies-standards/es-categorization.

[14] The bond was issued in January 2021 on the Panama Stock Exchange. For more information see here: https://sseinitiative.org/all-news/exchange-in-focus-panama-stock-exchange-first-sustainable-bond/

[15] Use of loan proceeds are described here: https://www.pv-magazine-latam.com/2019/07/25/ifc-presta-us35-millones-a-davivienda-costa-rica-para-promover-proyectos-verdes/ ; Banco Davivienda cites that it received a USD 60M loan on its 2019 sustainability report.

[16] Ibid.

[17] Figure converted from Costa Rican Colon to USD using June 15th 2021 midmarket rates.

[18] Figures provided for March 2021 by Panama's SMV. See here:
https://supervalores.gob.pa/wp-content/uploads/2021/05/Inf-Mensual-Valores-Mar-2021.pdf

[19] Domestic public sector investments include issuances by the government, state owned financial, and non-financial institutions along with financial institutions created by special laws (e.g. Banco Popular).

[20] There are six registered OPC. See details here: https://www.supen.fi.cr/web/supen/inversion-de-los-fondos-de-pension;jsessionid=86d98113a77a703d00d09ae53a06

[21] See

https://www.ins-cr.com/media/2574/pol%C3%ADticadesostenibilidadgrupoins20192020.pdf

[22] Domestic public sector investments include issuances by the government, state owned financial, and non-financial institutions along with financial institutions created by special laws (e.g. BPDC).

[23] See https://www.juntadepensiones.cr/admin/archivos/contenido/archivo/63/true.

[24]See https://www.popularsafi.com/archivos-pagina/05.BoletinesInformativos/2017 INFORME_PLAN_DE_SOSTENIBILIDAD.pdf.

[25] One of the reasons cited for the low diversification of the RIVM (Annual report).

[26] Often referred to as SARAS (Sistema de Análisis de Riesgo Ambiental y Social).

[27] The scope of RBC and ESG/ESR criteria are highly related. Both relate to understanding and quantifying the impacts of business activities on environmental and social issues. However, RBC is specific to the standards and recommendations set out in the MNE Guidelines and pertains primarily to impacts to the environment and society, independent of financial materiality. While no formal, widespread definition exists for "ESG" and "ESR" and its diversity with respect to how these concepts are instrumentalised by financial institutions and intermediaries, they often pertain primarily to environmental and social risks which also pose financial risks.

[28] This is consistent with the approach adopted in the OECD Due Diligence for Responsible Corporate Lending and Securities Underwriting.

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