Major Changes in Bank Lending in Costa Rica

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In the last two years Costa Rica has approved new legislation, and modified existing laws with the purpose of improving the country's competitiveness. One of the new laws created a fund to finance Costa Rican small and medium-sized enterprises (SMEs), resulting in a tax impact for cross border financing operations.

The most relevant laws approved are the (i) Law on Secured Transactions over Moveable Assets (in Spanish "Ley de Garantías Mobiliarias") dated May 7, 2014; and the (ii) Law on the Banking System for Development (in Spanish "Reforma Integral a la la Ley Nº 8634, Ley del Sistema de Banca para el Desarrollo y reforma de otras leyes") dated November 27, 2014, and modifying article 59 of the Income Tax Law (in Spanish "Ley del Impuesto sobre la Renta").

Below we summarize the key changes and its impact in the Costa Rican credit operations market.

Secured Transactions Over Moveable Assets.

Based on the Inter-American Law Model on Secured Transactions of the Organization of American States, which is based on the key concepts and principles of Article 9 of the Uniform Commercial Code, and after the approval of similar laws in countries of the region (e.g. El Salvador, Honduras, México, Perú, among others), the Law on Secured Transactions over Moveable Assets ("The Law") was approved by the Costa Rican Congress. The need for this Law arose because the modified Costa Rican law only allows security interests to be created over certain individually identifiable and tangible assets. It restricted the potential borrowers' ability to obtain credit using security interests over assets that cannot be easily and individually identified due to the business cycle, such as the inventory, and certain intangible assets.

The Law expands the definition of what collateral can be secured, allowing security interests to be created over previously unsecurable collateral. The concept of a "security interest over moveable assets" includes all (including already existing) "contracts, agreements, and clauses used to guarantee obligations over moveable assets, including (but not limited to) sale-leasebacks, guarantee trusts over moveable goods, floating pledges, factoring, financial leasing, agricultural, commercial or industrial pledges." The definition of what moveable assets can be granted as security under the Law is broad, which is a significant development from the legal framework that previous applied to secured transactions over moveable assets in Costa Rica.

Under the Law, security interests over moveable assets are created either by agreement between the secured debtor and creditor, or by law. It is very important to have in mind that security interests can be granted over one or more moveable assets, specific or generic groups of movable assets, present or future assets, and tangible or intangible assets.

One of the most important changes is related to the enforcement of the security interest and the foreclosure procedures as the Law establishes that the execution of security interests over movable assets can be performed by judicial procedures, extrajudicial procedures or repossession.

Last, but not less important, prior to the Law, filing, registration costs and expenses (which are still applicable for mortgages) of pledge agreements were based on the total amount of the loan. Now with the new Law on Secured Transactions, the borrower would only have to pay the cost of the forms to register, modify, release and enforce security; which significantly decreases the costs related to finance transactions.
Since the approval of the Law, local and foreign lenders have been rather conservative in using these new collateral mechanisms for corporate finance, as they are still new provisions and there are no judicial precedents.

Applicable Withholding Taxes.

The Law of the Banking System for Development ("Sistema de Banca para el Desarrollo") with its modification to article 59 of the Costa Rican Income Tax Law repealed the exception that financial entities recognized by the Central Bank of Costa Rica s as "banks of first order" or "institutions normally engaged in international operations¨, are not subject to withholding taxes on interest.

On the other hand, with the modification on article 59 of the Income Tax Law, the amount of any interest, fees and other financing costs (excluding principal) paid by Costa Rican corporations to non- domiciled lenders or financial institutions, as a result of the repayment of any loan, are subject to a withholding tax of: (i) 0% when the lender is a multilateral and bilateral development bank as well as non-profit organizations; (ii) 5.5% when the borrower is a local bank subject to the supervision and inspection in Costa Rica and the lender is a bank or an international financial institution not organized under the laws of Costa Rica subject to the supervision and inspection in their respective jurisdictions; and (iii) 15% when payments are made to any Lender that is not organized under the laws of Costa Rica and that do not meet the above-mentioned requirements.

Even after the approval of this amendment to the Income Tax Law, in the last two years several credits (secured and unsecured), credit lines as well as syndicated loans have been granted by foreign lenders to local entities, most of which have been to local banks.

Considering all these modifications, we could say that the new Law on Secured Transactions and the Law of the Banking System for Development have made an impact in the Costa Rican credit operations market, which may be viewed as positive or negative. We would expect that in the short term, the New Law of Secured Transactions over Moveable Assets will become a main driver on corporate finance and that the Costa Rican courts through case law ("jurisprudencia") will confirm among other issues, the flexibility for the extrajudicial foreclosures of security interest over moveable assets.

Additionally, even though the withholding tax rate has increased for almost all credit operations with foreign entities, lenders have covered this withholding with their gross-up clauses. This has been validly admitted by the Costa Rican authorities and accepted by local borrowers due to more competitive interest rates. In addition, there has been a growth in the government funds for the extension of corporate finance in favor of SME's.

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