The development of debt markets in Peru

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1. Introduction

The market-oriented reforms implemented since 1990, along with the recovery of macroeconomic stability, has encouraged the growth of the still small capital market in Peru.

However, the results have not been as good as expected. There are now important institutional investors and the market has a number of financing alternatives for corporations, but the number of firms – in particular medium sized enterprises – that have accessed the market is still low and Peru still lacks a government securities market.

The capital market dynamics observed in the last decade suggest that its growth and development to international standards will still take some time. Further reforms are needed, but the positive results already achieved are the best incentive to pursue them.

2. Primary debt markets

An overview

Beginning in 1990, Peru implemented a market-oriented reform package that included a set of laws expected to boost the development of the capital market. Since then, and complemented by the sustained achievement of macroeconomic stability, some Peruvian firms have used the capital market as an additional vehicle to bank credit in financing their operations. Some firms have even accessed developed capital markets, such as the United States, to raise capital through American Depository Receipts.

However, this reform package has not yet yielded decisive results. As the long-run horizon that disappeared with the hyperinflation process of the 1980s is still absent, there is almost no long-term financing available, either in the banking system or in the debt market.

Table 1

Private bonds outstanding, by maturity

(millions of US dollars)

Year	< 3 years	3-5 years	> 5 years	Total
1994	212	112	0	324
1995	244	351	0	595
1996	330	717	8	1,054
1997	419	920	92	1,432
1998	443	1,193	169	1,804
1999	491	1,093	300	1,885
2000	486	1,065	733	2,284
2001	473	933	981	2,387

Source: Central Reserve Bank of Peru.

This outcome reflects some structural factors that delayed the development of the debt market. There are two important characteristics of non-financial firms:

- The entrepreneurs' financing culture is highly linked to banking. This practice has allowed the firms to maintain a certain lack of transparency on their financial statements, as compared to the requirements for issuing debt or equity in the capital market.
- Many firms are still family-owned. This aspect of their corporate governance can be a problem when the firm lacks enough capital to finance the acquisition of new technology. This delays productivity improvements, bringing a decline in competitiveness.

Table 2 shows the evolution of the main sources of funds for the private sector since 1995, and the amount of bonds issued by financial institutions (subordinated debt and leasing bonds).

Table 2

Funding of non-financial firms

(outstanding stock at end-year; billions of US dollars)

Year	Bonds	Bank credit	Total	Memo item: Bonds issued by financial institutions
1995	0.2	8.2	8.5	0.4
1996	0.5	10.9	11.4	0.6
1997	0.7	13.8	14.5	0.7
1998	0.8	14.5	15.3	1.0
1999	0.9	13.9	14.8	1.0
2000	1.2	13.4	14.6	1.1
2001	1.3	13.4	14.7	1.1

Source: Central Reserve Bank of Peru

Banks continue to dominate the Peruvian financial market, with bank credit still the primary source of funding. Peruvian capital markets are complementary to bank credit in financing private corporations. In 1999, and particularly in 2000, the reduction in bank credit was partly offset by the funds raised in the capital markets. Nevertheless, in 2001 bank credit contracted as a consequence of the slowdown in economic activity.

Going back some years, it is important to remember that the "El Niño" weather phenomenon affected Peru in 1998, provoking a slowdown in economic activity. Its impact was reinforced by the aftermath of the international financial crisis, which severely affected the local economy, especially after the Russian financial crisis of October 1998. That year was a turning point in the availability of foreign credit lines to the local banks: in the following 12 months these mostly short-term lines were reduced by US$ 1 billion. This significantly restrained the domestic banks' foreign exchange liquidity (as those facilities had reached a level of approximately US$ 3 billion in previous years) and led to a severe contraction in bank credit. In order to diminish the adverse impact, the central bank reduced reserve requirements on bank deposits by 3 percentage points (freeing approximately US$ 450 million).

The government's debt management policy also played a role in capital market development. In the 1990s, government debt issuance was minimal, as a result of generally balanced budgets, the privatisation process and a strategy of not issuing domestic debt, but focusing on external financing through the Paris Club and multilateral loans. This in turn had two main consequences:

- The lack of a yield curve, which limited the development of efficient risk management techniques by domestic institutional investors, and also risk diversification.
- The very limited role of securities issued by sovereign borrowers in institutional investors' portfolios.

Hence, there was no benchmark for long-term debt in domestic currency, and, due to the high degree of dollarisation[1] in the economy, bonds with a maturity longer than one year were issued in the local currency but indexed to inflation or in dollars with the issuer bearing the implicit exchange rate risk.

Table 3

Private and public bonds outstanding

(millions of US dollars)

	Private sector				Public sector		
Year	**Foreign currency**	**Local currency: nominal**	**Local currency: indexed**	**Total**	**Foreign currency**	**Local currency**	**Total**
1992	67	0	0	67	...	...	18
1993	116	0	0	116	...	...	14
1994	296	0	28	324	...	...	295
1995	483	4	108	595	...	...	339
1996	669	42	343	1,054	...	...	295
1997	825	44	563	1,432	...	...	262
1998	1,259	18	527	1,804	...	...	270
1999	1,404	17	464	1,885	903	155	1,058
2000	1,774	21	489	2,284	917	137	1,054
2001	1,801	113	473	2,387	1,248	437	1,685

Source: Central Reserve Bank of Peru

The Peruvian dollarisation process reflects two factors. First, Peru suffered a prolonged inflationary process until the beginning of the 1990s, which eroded the public's confidence in the local currency. (The issuance of inflation-indexed instruments has surged only during the last few years.) Second, the availability of foreign credit lines, which currently total US$ 1.9 billion, helped to finance bank loans.

As a consequence, 81% of total bank credit, and most debt instruments, are denominated in US dollars. In 1999 and 2000 the Treasury issued US dollar-denominated debt instruments with a five-year maturity to finance its assistance to some financial institutions that initially faced liquidity problems and later a high proportion of non-performing loans. At the same time, some bonds were issued to implement rescue mechanisms for non-financial firms (agrarian and non-agrarian) but with a 15-year maturity. One problem derived from the issuance of foreign currency-denominated debt instruments is that the budget becomes more exposed to exchange rate risks, since most of the government revenues are denominated in local currency.

Instruments

By the end of 2001, the stock of bonds (issued by private corporations and financial institutions) authorised for issuance in the Public Registry was US$ 4.0 billion and the amount actually issued was US$ 2.2 billion, of which corporate bonds represented US$ 0.9 billion.

Around 80% of corporate bonds are rated investment grade (BBB, A, AA, AAA). The rest are considered speculative grade (BB or lower). Any private debt security must be rated by at least two

[1] More than 75% of the deposits in the banking system are denominated in dollars.

rating agencies. Two of the three domestic rating agencies operating in Peru are associated with international credit rating agencies.

The main debt instruments issued in the Peruvian capital markets are bonds, mostly linked to leasing, corporate and subordinated debt.

Table 4

Private bonds outstanding

(millions of US dollars)

	Corporate	Leasing	Mortgage	Securitisation	Subordinate	Total
1992	1	66	0	0	0	67
1993	12	104	0	0	0	116
1994	89	202	0	0	33	324
1995	208	291	0	0	96	595
1996	472	371	0	0	211	1,054
1997	699	450	0	0	283	1,432
1998	782	695	0	15	312	1,804
1999	813	757	0	39	276	1,885
2000	1,029	824	0	160	273	2,286
2001	931	816	25	247	274	2,293

Source: Central Reserve Bank of Peru.

Securitisation and the issuance of short-term securities (mainly commercial paper) face encouraging prospects. Very recently, and for the first time, a Peruvian corporation issued bonds based upon the securitisation of its cash flows over the next five years (US$ 50 million). Previously, credit card receivables had been securitised by one bank and another arranged two programmes of asset securitisation.

From the investors' point of view, one problem with the Peruvian capital markets was that most of the debt issued had been at floating rates, which complicates the valuation process. This characteristic is expected to disappear eventually, since interest rates are declining for both local and foreign currency issues, and the rate of inflation has been brought down to international levels.

The maturity of debt instruments has been lengthening as a consequence of the stabilisation of the economy and the increasing importance of institutional investors: the current average maturity is longer than five years, while it was shorter than five years in the middle of the 1990s.

Maturities are also related to the type of instrument. Banks issue subordinated bonds with long-term maturities (up to 10 years), similar to their affiliates' leasing bonds, while the corporate bonds issued are mostly medium-term (between three and five years).

Regulation is improving through "learning by doing". The standardisation of instruments' characteristics and the information transparency requirements have been the most important improvements. Both developments have enhanced the participation of new investors (local and foreign). Many local firms are now issuing debt instruments in compliance with international standards, especially those regarding the level of information.

Investors

Private pension and mutual funds, both in operation since 1993, are the more active investors. Currently, pension funds manage US$ 3.2 billion and mutual funds US$ 0.4 billion. All investors, including institutional investors and banks, use brokers to trade in the stock exchange.

Table 5

Holders and issuers of domestic debt securities

(billions of nuevos soles, end-2001)

	Issuers			
Holders	**Financial institutions**	**Central bank**	**Public sector**	**Corporate**
Central bank	...	.	0.36	...
Banco de la Nación	...	0.23	1.47	...
Banks	...	1.27	2.40	...
Private pension funds[1]	1.84	0.34	0.95	2.09
Others[2]	1.85	...	0.46	2.44

[1] November 2001. [2] Mainly mutual funds and insurance companies.

Source: Central Reserve Bank of Peru

All investors have the same opportunity of access to government and central bank securities. Most of the transactions in private sector instruments are conducted through private dealers or by public auctions. In this sense, the market for private debt instruments could be described as a hybrid.

3. Secondary debt markets

Peru has only one stock exchange, located in Lima, where equities and some debt instruments are traded. The transactions are undertaken electronically, with every order placed in a queue and then matched electronically by price on a continuous market.

There are no "market-makers", no specific institutions that hold a portfolio of instruments and regularly quote both bids and offers, being ready to make a two-sided market. However, market-makers are expected to emerge in the medium term, given the increasing importance of institutional investors. Foreign investors were active when the Lima Stock Exchange was experiencing a boom, during the first half of the 1990s.

The Peruvian secondary market for both public and private securities is neither liquid nor dynamic, even though the fees charged by intermediaries seem to be competitive by international standards. The market is also highly sensitive to any political or financial event, making it volatile and risky.

The liquidity of the market reflects the low scale of operations prevailing and the low number of securities traded. The main buyers are the institutional investors, mainly private pension funds. As their funding exceeds the supply of securities they act as "buy-and-hold" investors.

This lack of liquidity leads to high transaction costs. The market does not allow investors to realise a profit opportunity, because the market prices might collapse with just a small sale of securities. Another problem is that it is difficult to mark to market any portfolio.

The decreasing interest rate expectations also affect the dynamics of the market, promoting a "buy-and-hold" strategy. These expectations are based upon the achievement of macroeconomic stability, the declining international interest rates and the recovery of Peruvian financial deepening (between 1990 and 2001, bank credit grew from 5% to 26% of GDP).

Another problem that influences the dynamics of the capital market is the lack of sufficient information to value portfolios properly and to assess the true value of the outstanding debt securities in the market.

To overcome these problems, policymakers have been working to improve the availability of information in the market and the soundness of financial statements. However, one remaining problem is the lack of a liquid government securities' market to adequately shape a yield curve, which would be a useful reference for the valuation process.

4. Interactions between debt markets and banks

The largest players in the domestic money markets are banks, and the most important money markets are those for bank reserves and central bank certificates of deposit. The latter are used by the central bank to execute its monetary policy. The decline in bank credit has increased the excess liquidity held by the banks. Currently, US$ 0.5 billion (almost 17% of domestic currency denominated bank credit) of this has been invested in central bank CDs.

Debt instruments issued by Peru's largest corporations operating are very much in demand by institutional investors because of their creditworthiness. Furthermore, those corporations were issuers of debt in 1999 and 2000, when the capital market partly offset the reduction in bank credit. It is evident that banks and institutional investors compete to lend resources to the same borrowers, who take advantage of this fact and seek to obtain better credit conditions (longer maturities and lower interest rates).

The decrease in the quality of bank loans over the last three years has not been the result of the development of the capital markets. The deterioration is rather a consequence of other factors, mainly the international financial crisis and the slowdown in economic activity.

As stated above, the market for securitising bank-originated assets is not yet developed. There have been just two issues of such securities, both in 1999 and carried out between related companies.

In the 1990s, the capital markets and banking credit complemented rather than substituted for each other. The bank credit contraction which began in 1999 did not happen because of competition from capital markets, but due to problems derived from the management of information asymmetries.

Issues of commercial paper have been at the issuer's own risk. The participation of banks has been limited only to the process of structuring and offering.

5. Forces for change

Domestic debt markets and macroeconomic conditions

At the beginning of the 1990s, the return of macroeconomic stability was one factor that foreign investors considered as boosting Peru as a serious investment opportunity. It also allowed local firms to make long-term plans, encouraging investment and giving the right incentives to the issuance of debt as a financing vehicle.

These events paved the way for a credit boom that promoted private spending, which in turn boosted GDP. However, only the big firms took advantage of the capital markets. Small and medium-sized firms financed their investments by using short-term bank finance.

The fact that inflation has been almost halted has helped lengthen the maturity spectrum of debt securities. Market interest rates in domestic currency declined significantly in 2001, providing an incentive for local currency securities issuance. In 1995, the average term of a debt instrument was around five years; currently, it is around 10 years.

Social security reform

The social security system was reformed in 1993. Besides the objective of providing pensions, the reform was also intended to boost development of the local capital market. Currently, the pension funds manage a portfolio of US$ 3.2 billion. Table 6 shows the main legal limits on their investment portfolios.

Table 6

Investment portfolio of private pension funds

	Legal investment limits	Structure of portfolio
	(% of administered fund)	
Government and central bank securities[1]	40	11.9
Bank deposits and bonds issued by financial entities[2]	40	37.5
Subordinated bonds issued by financial entities	15	3.5
Bonds issued by corporations	40	12.9
Debt instruments issued for project finance	4	0
Stocks in local and foreign markets[3]	47.5	29.0
Others	65	5.2

[1] The limit for investment in Peruvian Brady bonds is 10%. As of October 2001, the share of investment in this instrument was 5%. [2] The limit for investment in bonds issued by financial entities is 25%. As of October 2001, the share of investment in this instrument was 12.3%. [3] The limit for investment in foreign securities is 7.5%. as of October 2001, the share of investment in this instrument was 4.1%. It also includes stocks acquired in the privatisation process (5% of the administered fund as of end-1999).

Investment by pension funds in domestic securities is not subject to any minimum credit rating. However, the lower the rating, the larger is the applicable reserve requirement.

A challenge for pension funds is that their funds are growing faster than debt issuance by local firms, a problem aggravated by the current state of economic activity. In 2000, pension funds were allowed to invest in securities transacted on foreign markets; currently, they may invest in Peruvian Brady bonds (10% of the portfolio) and in investment grade foreign securities (7.5% of the portfolio). Allowing investments abroad makes the portfolio more flexible and allows risk diversification, but it means that Peru is exporting capital. This issue is highly controversial, since Peru continuously shows a deficit in capital investment.

Pension fund investment in local corporate debt instruments benefits the largest firms. However, it does not help small and medium-sized firms, as they cannot afford the administrative costs implicit in any debt instrument issuance and obtaining a credit rating. These limitations make it easier and cheaper for them to use the banking system to finance their growth.

Despite these problems, pension funds constitute an important vehicle that supports the development of the debt market.

The fiscal role

In the 1990s, Peru accessed multilateral support programmes and regained access to international credit, particularly after the Brady agreement. The public sector did not access the Peruvian capital markets to finance its operations directly until very recently, when it issued local currency denominated bonds with maturities of two and three years. As expected, the demand for the instruments was generally greater than their supply.

Beginning in February 2001, the government has issued local currency denominated bonds for a total of 1.2 billion new soles (US$ 300 million) with two- and three-year maturity. Each issue is announced some weeks in advance, through its own prospectus. Bonds have been issued through public auctions, following the Dutch system. To the extent that investors' expectations for balanced budgets are met, the demand will be strong enough to allow for successful future issuance, which in turn will facilitate the formation of a liquid and dynamic market for these securities.

The lengthening of the maturity of government bonds is also helping to establish a benchmark for interest rates for longer maturities. Nevertheless, the scarcity of investment alternatives and the need of private pension funds to comply with portfolio limits restricts the possibility of a well developed secondary market, which in turn impedes the establishment of a yield curve. This situation is expected to change once the outstanding stock of public securities reaches a sufficient size.

Table 7

Treasury bonds

Date of issue	Maturity	Amount issued (millions of new soles)	Yield to maturity (%)
9 March 2001	2 years	100	12.5
5 April 2001	2 years	100	12.5
21 June 2001	2 years	54	12.5
21 June 2001	3 years	96	13.1
5 July 2001	2 years	51	12.4
5 July 2001	3 years	99	13.1
24 Sept 2001	2 years	250	10.5
15 Oct 2001	2 years	200	10.0
5 Nov 2001	2 years	150	9.2
5 Nov 2001	3 years	100	9.8

Source: National Securities Commission.

Monetary policy role

The main concern of monetary policy in Peru is maintaining price stability, which in turn reduces the long-term risk of any investment. Since investment is the main means to increase output and employment, the guarantee of price stability helps to ensure economic growth.

In order to accomplish its objective, the central bank uses market instruments to manage the amount of money in the economy. In doing this, its operational target is the daily average of the reserves held by the banks in current accounts at the central bank.

The monetary instruments are the reserve requirements, the discount window, open market operations, repo operations and swaps. The central bank may intervene in the foreign exchange market selling and buying dollars depending on the market conditions.

The central bank launched its open market operations by auctioning its own paper (CDBCRP) since there were not enough Treasury bonds in the market or held by the central bank. When the central bank needs to withdraw liquidity from the market it sells its CDBCRP. The main buyers are banks and private pension funds.

When the market needs more liquidity the central bank conducts repo operations using the CDBCRP and government bonds. The interest rates are then set by the market. Rates declined substantially during 2001 as inflation fell. The outstanding amount of CDBCRP is more than 25% of the money base.

High rated corporate bonds are also accepted as collateral for central bank credit. To the extent that the availability of such securities is still low, the existence of the collateralised credit facility may become an incentive for the banks to “buy-and-hold” these securities. At the same time, an extra distortion might be added by the collateralised credits. It gives an arbitrage opportunity to the issuers; because their paper will be sought after by banks, they may be able to raise funds at a lower cost.

Table 8

Central bank certificates (interest rates)

Date of issue	18 weeks	20 weeks	6 months	1 year	Total stock (millions of new soles)
Dec 2000	14.5	13.0	14.2	..	1,360
Jan 2001	13.0	13.1	13.1	13.2	1,950
Feb 2001	12.3	12.1	.	12.9	1,995
Mar 2001	11.6	12.0	11.7	12.9	2,055
April 2001	.	.	.	.	1,745
May 2001	.	13.5	.	.	1,665
June 2001	.	11.0	12.1	12.0	1,740
July 2001	10.9	11.2	.	11.7	1,515
Aug 2001	10.1	10.1	9.4	10.4	1,960
Sept 2001	.	.	8.0	9.1	1,990
Oct 2001	.	.	6.9	8.3	1,805
Nov 2001	.	4.8	5.8	6.6	2,025
Dec 2001	3.3	.	3.9	5.3	1,840

Source: Central Reserve Bank of Peru.

Nevertheless, these open market and repo operations help to develop the capital markets since they give liquidity to the paper in question and are an important variable for signalling interest rates to the market. However, since these operations' maturities run only from one week up to one year, they do not contribute to the long-term yield curve.

International debt issuance

Neither the government nor the private sector has issued debt instruments in international capital markets. The emergence of institutional investors as important funds suppliers was an important reason to stay in domestic markets. The corporate firms have been able to get funds at more reasonable rates than those available in the foreign markets. Another factor that limits the access to foreign debt market financing is the fact that sovereign risk perception is still high.

The aftermath of the financial crisis, the "El Niño" weather phenomenon and the political crisis were factors that negatively affected the perception of Peru's sovereign risk. However, the successful negotiation of the Brady bonds programme allowed Peru to be considered as creditworthy again in the international capital markets. It also helped Peruvian banks to obtain direct commercial and financing lines of credit that were transferred to local firms.

However, the government is working on a programme for issuing bonds in the international market, which should give investors a long-term benchmark.

6. Enhancing the liquidity of bond markets

One aspect that affects liquidity in the bond markets is expectations of further decreases in interest rate and the scarcity of alternative investments in the market. This leads the institutional investors to "buy-and-hold". The size of the country also matters to the extent that this has effects on the scale of operations of corporate firms.

However, taking into account that bank deposits are still low by international standards (25% of GDP) and that institutional investors play an even more important role, the capital markets are seen to have good prospects once the country regains its path of economic growth.

To the extent that the government successfully manages its fiscal deficit and macroeconomic stability is consolidated, the creditworthiness of, and demand for, government securities will improve. One element that sooner or later should be introduced in the government bond market are market-makers, agents that ensure the negotiability and liquidity of such securities.

The central bank is interested in this development, since it could use the yield curve as another instrument to monitor its objectives. One alternative could be the central bank's CDBCRP, but the problem is that the amount outstanding is just the amount required to execute the monetary policy. In the issuance of such securities, the central bank does not have in mind the requirements of the institutional investors to hold investment portfolios with a long-term outlook. As a result, the stock of CDBCRP does not allow continuous trading. The maturities of the CDBCRP are very short, only going up to one year.

On the other hand, the "buy-and-hold" behaviour of the large investors should alter in line with the development of the capital markets, as a larger number of instruments start to be traded.

The globalisation process that affects markets worldwide will also influence the development of capital markets in Peru. One of the relevant facts is consolidation of the banking industry. In many Latin American countries, Spanish banks are playing a large role in this process; Citigroup recently took a big stake in Mexico. It is very likely that these institutions invest their idle cash in highly marketable securities, such as governments bonds, but essentially in bonds issued by the country where their operations are undertaken. Therefore, these banks are diversifying their exposure in different countries not only by investing directly. However, the correlation among markets in Latin America is still very high, and that should limit such diversification.

The growth of other institutional investors such as mutual funds will also help to develop a liquid market since these investors may be more active in the market. However, it is important to increase the number of participants not only on the demand side of the market but also to encourage the entry of new issuers.

Are extra reforms needed to develop capital markets?

Most of the requirements for a buoyant secondary market seem to be in place in Peru. However, there are some complementary reforms that could help promote the secondary market, as well as the introduction of market-makers for government securities.

In the development of capital markets, size and liquidity matter. For this reason, it is necessary to encourage medium and small firms to issue debt in the capital markets, by persuading entrepreneurs of the benefits of capital markets for financing their growth. Disclosure of more transparent financial information is important to empower minority stakeholders. Improved corporate governance would increase the flow of capital into the economy.

One expected consequence of such reforms is the broadening of the range of debt instruments traded in the capital markets. It is also necessary that firms have access to more information about the financing alternatives provided by the capital markets. The emergence of more consultancy firms will complement the extension of possible instruments to be issued, since they may help to inform firms about the possibilities and advantages of the capital markets.

At the beginning, many debt arrangers competed in the capital market by structuring very complicated debt instruments, including special provisions and options. These instruments were too sophisticated for the investors. Besides broadening the range of debt instruments, it is important to encourage the issuance of standard debt instruments, as well as enhancing the creation of markets that could be used to hedge positions on different debt instruments.