



**The Impact of Liberalisation:  
Communicating with  
APEC Communities**

**Financial Services Sector in Peru**

November 1998

## Acknowledgments

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In Vancouver in November 1997, APEC Leaders and Ministers requested that work be undertaken to promote community understanding of the impact of liberalisation. A broad project was conceived by a Steering Group established under the APEC Committee on Trade and Investment (CTI).

This series of papers, "The Impact of Liberalisation: Communicating with APEC Communities", was prepared as part of the broader initiative. The papers include a review of research on the effects of liberalisation, a series of case studies and a summary report.

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THE IMPACT OF LIBERALISATION: COMMUNICATING WITH APEC COMMUNITIES



## Summary

The only foreign banking presence in Peru in 1990 was the single representative office of Citibank. Peru's finance sector was not an attractive place to be, with hyper inflation, a recession and real interest rates of more than 95 per cent.

A populist government had attempted to shape the course of the economy by ordering banks to: advance credit to select economic activities; convert all foreign exchange deposits to domestic currency; ban profit remittances and credit payments abroad; and control interest rates.

The entry of foreign banks was banned. Indeed, foreign banks operating in Peru had been nationalised by the earlier military government during the seventies.

The interventionist strategy resulted in medium and long term credit drying up altogether. The largest commercial bank, Banco de Credito, protected itself during the hyper-inflation years by not expanding the number of branches and channelling deposits into real assets. Although the financial environment was hostile, it faced little real competition. Service levels were poor, despite overstaffing. There was little investment in modernisation.

The first sign of a change came soon after the appointment of the new government of President Fujimori in August 1990. In its

first month, the government liberalised interest rates. A few months later, all exchange controls were scrapped. Exporters could keep their proceeds abroad and anyone could use foreign exchange.

It was the beginning of a dramatic liberalisation of the Peruvian economy. In the hyper-inflation era, there were price controls, multiple exchange rates, non-tariff trade barriers and subsidies to consumer goods. Under the new government, the domestic market, foreign trade and capital markets were freed almost simultaneously.

The urgent demand was to rein in the fiscal deficit and introduce competition to restrain price rises. The government unified the exchange rate, and liberalised trade to introduce some price competition. The liberalisation of finance markets was required so that domestic industry could gain access to the funds it required in order to be competitive.

A new banking law was introduced which created a deposit insurance fund, but which ended the guarantee of deposits by the Central Bank. Four commercial banks were closed, with substantial losses borne by depositors.

In a big break with the past, the government adopted a policy of non-discrimination between foreign, national, state or private sector banks. The market was opened to foreign banks and insur-

ance companies. Barriers to entry for domestic participants were also lowered, with the only requirements being that the owners have sound financial reputations and a minimum capital base equivalent to \$US 7 million.

While barriers to entry have come down, required prudential standards have gone up. Banks are required to diversify risk and have better capital adequacy ratios than the international standard. Loan loss reserves requirements are strictly enforced.

Banks are also subject to strong disclosure requirements. Their loan portfolio quality is published each month and they are required to get credit ratings reviewed by two credit rating agencies twice a year.

The result has been a much more robust banking system. A measure of the new confidence in the system has been the growth of bank deposits from just \$US 350 million in 1989 to \$US 12.2 billion by the end of 1997. The industry has become much more productive, with the loans per employee rising from \$US 27,000 in 1990 (which was only twice the yearly salary of a bank employee) to \$US 490,000 per bank worker by the end of 1997.

Improved competition and better quality services have resulted in a reduction in the spread between deposit and loan rates. At the beginning of 1992, it has come

down from 8 percent to 1 percent. Real interest rates have dropped from more than 40 percent to about 9 percent over the same period.

The market is succeeding in getting funds to sectors of the economy in a way that orders from the government could not. For example, lending to agriculture and livestock increased from just \$US 54 million in 1990 to \$US 440 million last year.

New banks are opening their doors. For example, the Banco del Nuevo Mundo, established in 1993, has become a highly profitable business focusing upon lending to medium sized firms and middle-class mortgages and gaining deposits from middle-class customers. Its deposits grew from \$US 72 million to \$US 311 million between 1993 and 1997.

Citibank now has company, with 13 of the 25 banks at least partly foreign owned. Banks with foreign ownership have a 32 percent share of bank deposits.

Established operators, such as the Banco de Credito, have responded to the competition by investing in technology, and improving customer service. The bank has become aggressive in its leasing, factoring and underwriting

activities. It has also ventured offshore, with its holding company acquiring banks in the United States and in several Latin American countries.

The wave of liberalisation has extended to other institutions. The stock exchange was privatised and, in 1996, a new capital market law was introduced which increased the scope of operations for broking firms. Mutual funds are encouraged and new legislation established a private pension fund scheme.

To get activity going, the government offered tax exemptions on both capital profits on stock transactions and interest income from bonds. The result has been that daily average turnover has increased from just \$US 240,000 to \$US 27 million through 1997. Companies raised \$US 1.4 billion through initial public offerings last year.

Pension funds have also been a success, with nearly 2 million members and accumulated funds of more than \$US 1.7 billion. Shares, bank deposits and corporate bonds account for 80 percent of their investments. There are five funds in operation with a sales force between them of about 4,500 people.

The biggest problem for the

pension funds and for the stock exchange is a scarcity of assets in which to invest. Although public raisings have increased dramatically, it has not yet been enough to satisfy rising demand. There are still some issues to be resolved in the pension fund scheme, among them the double taxation of contributions and pensions, and the lack of a special scheme for the self employed.

The banking system too still has its challenges. Supervision of financial institutions with branches abroad is difficult as is the treatment of financial derivatives. At the other end of the spectrum, some banks suffer from shortages of skilled staff and are unable to take advantage of economies of scale.

A problem which Peru, like other Latin American countries, faces is the extent of borrowings denominated in US dollars. This exacerbates the recessionary impact of any local currency devaluation. Peru, however, draws some comfort from high reserve requirements on US dollar deposits, a level of international reserves that is four times its liquidity in the domestic currency, and a sound macro-economic and banking regulatory policy framework.



## Background

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Although commercial banks in Peru date back to the mid-nineteenth century, the first monetary and banking reforms did not take place until the world economic crisis of the 1930s. During this time, some banks were forced to close. In 1931, the Central Bank of Peru was restructured, the Superintendency of Banking and Insurance was created and the first Banking Law was enacted. This system of regulation was upheld until the 1970's when major changes were introduced to Peru's banking system. The 1970s, under a military administration, were years of widespread government intervention. New commercial banks were prohibited from opening, while existing commercial banks were unable to open new branches and agencies. Foreign banks were nationalised and others were absorbed by the state. Further, compulsory conversion of foreign exchange deposits to domestic currency was enforced and interest

rates were subject to control.

When the country returned to democracy in 1980, more liberal regulations, such as permission to create new banks, reduction of reserve requirements and regulations allowing interest rates to reflect inflation, were introduced. These measures were restricted again in 1985 when President Garcia took office and reintroduced economic controls. The Garcia administration imposed checks on interest rates, converted foreign exchange deposits to domestic currency, forbid profit remittances and credit repayments from abroad, allotted credit to selected economic activities and applied differential reserve requirements.

In 1987, the Law of Nationalisation of the Financial System was enacted. Economic distortions and excessive interventionism generated a curbed financial market, the results of which generated a process of formal disintermediation and caused mid-

and long-term credit to virtually disappear. These measures, together with other populist macroeconomic policies, resulted in the recession and hyperinflation of the late 1980s. It was during these years that commercial banks were forced to channel loans to the economic activities favoured by the government.

When the Fujimori administration assumed power in the 1990s, a new economic program was launched to stabilise, liberalise and modernise the country. A priority of the new administration was to build an efficient and dynamic financial sector. New policies were introduced which created a competitive environment, enforced safer rules, and even allowed bankruptcy of some firms. The net result of these policies has been the slow recovery of Peru's financial system. The sector is now able to draw savings, increase the volume of credit, and contribute to the country's economic growth.

**A priority of the new administration was to build an efficient and dynamic financial sector.**

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## Policy Review

Since the start of the Fujimori government in August 1990, measures were taken to liberalise Peru's financial system. During the first month of the new administration, interest rates were liberalised. Then, in March 1991, there was a complete opening of the capital account. Exporters now could keep their export proceedings abroad, not being forced as before to hand the foreign exchange to the Central Bank. The government also decreed complete freedom in the holding and use of the foreign exchange.

The government also changed its monetary policy. The Central Bank was no longer allowed to give loans to Development Banks. Without financing from the Central Bank, these banks were forced to close.

A unique aspect of government reform at this time was the simultaneous liberalisation of different markets. As part of Peru's macro-economic stabilisation program, financial liberalisation was applied in the domestic market; the capital account was opened; foreign trade was liberalised; and the labour market experienced partial liberalisation.

The liberalisation of markets soon affected banking structures. A benefit of this process, particularly the opening of capital account and the lifting of interest rate controls, led to a substantial increase in financial intermediation, thus

reducing bank spreads.

In July 1991, new commercial bank law was introduced. Without receiving any assistance from the Central Bank to pay depositors, four commercial banks were forced to close in 1992 under this new legislation.

Each of these bank closures had losses that reduced their capital to less than the amount established by law. The banks were closed after the new banking law of 1991 introduced the Deposit Insurance Fund (DIF) that paid a limited amount per depositor. When first established, payment to depositors took some months as fund resources were primarily limited to a small fee charged to the banks according to the amount of their deposits. There was a weak political resistance to the closures because these banks were small and most of their depositors (although not of the amount of deposits) were covered by the deposit insurance. The cost of these closures was born by the shareholders and partially by depositors with deposits of more than \$US 5,000.

Banking law was redressed again in 1996. While maintaining the spirit of the previous law, it reinforced the powers of the banking sector regulator; the Superintendency. These laws changed the banking regulatory system. The scope for action of the banking Superintendency was

widened thus strengthening its regulatory powers.

Under 1996 legislation, a non-discriminatory policy between private and state banks, foreign and national banks, and between banks and other financial institutions was firmly established. Establishment of these rules marked a significant change with the past when state banks were favoured and when foreign ownership of banks was restricted. The market now was opened completely to foreign banks and insurance companies.

During the process of liberalisation, banks were forced to diversify risk through strong limits to credit concentration. At the same time, banks were allowed to expand within Peru and abroad. Universal banking was introduced, in opposition to the strictly commercial banking operations previously allowed.

Further, legislation required that interest rates be determined by the market, and that the minimum liquidity requirements could not discriminate between banks, term or currency denominations of the deposits.

Once barriers of entry to the banking sector were removed, the only remaining requirements of new banks were: 1) a minimum capital base, which stands now close to \$US 7 million; and, 2) sound financial reputations of bank owners.



At the same time, specialised institutions geared to the rural sector and to small firms were allowed entry with lower capital requirements. Provided prudential regulation and close supervision were enforced to reduce the risk of bank failures, the Superintendency believed that the market should determine the optimal number of banks. With these issues in mind, the Superintendency authorised most permits for the creation of new banks.

Banking Law before 1990 determined that deposits could not exceed 20 times the net worth. The new law introduced stricter parameters than those outlined by BIS guidelines. The new law states that risk-weighted assets should be lower than eleven times the net worth of the bank. Loan losses reserve requirements must be strictly enforced. Independently of the loan collateral, banks must constitute their reserves according to the quality of the individual loan. The requirements go from 1 percent of performing loans of the best quality to 100 percent of the loans that are being recovered in court. At present, depositors are covered only to about \$US 5,000 by the Deposit Insurance Fund. The bigger depositors assume their own risk.

Banking Law determines all banks must register their shares on the Stock Exchange. It also requires

banks to provide continuous information to the Security and Exchange Commission (CONASEV). Banks are required to publish their quarterly financial statements in the main newspapers. Further, the Superintendency publishes the loan portfolio quality of banks every month and the credit risk of banks must be assessed every semester by two credit rating agencies. This rating then is published in newspapers every semester.

At the end of 1991, the government published the Capital Market Law with the clear goal of improving its regulation in the newly liberalised market place. Some specific measures included: the privatisation of the Lima Stock Exchange; the licence to the broker agencies to make initial public offerings of risk classified securities; the creation of mutual funds; and the establishment of mechanisms to ensure better provision and use of information.

In October 1996, the new Capital Market Law was published. Although it maintained the basic guidelines of the market, it introduced some changes. For example, the new law established a unique minimum capital requirement for broker agencies (now about \$US 300,000) instead of the three levels that were operating until then. Broker agencies were thus empowered to conduct any and all operations provided for by law. In addi-

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**The main objectives were to strengthen the system itself and to channel higher amounts of financial investments to develop the domestic capital market.**

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tion, the new law introduced transactions that could be made by broker agencies. These included; the opportunity to manage of investment funds; the opportunity to make transactions in the international market with public debt instruments; the ability to act as trustee in securitisation; and the ability to operate with futures, options and other derivatives according to the requirements established by CONASEV.

Finally, by the end of 1992, the Peruvian government published the Private Pension System Law. The law created the private pension funds (that began operations in June of 1993) and their specific regulatory institution (the Superintendency). Peru was first Latin American economy to follow the example of Chilean pension system reform. Since then, other Latin American economies have followed suit, including, Argentina and Colombia (in 1994), Uruguay (in 1995), Mexico and Bolivia (in 1997), and El Salvador (in 1998).

The main objectives of pension reform were to strengthen the system itself and to channel higher amounts of financial investments in order to develop the domestic capital market. Interestingly, the new pension system coexists with the old one. As a result, the government holds a debt with the private system and must also finance the deficit of the old system. The debt with the

private system is based on the accumulated contributions made to the old system by the affiliates that are now in the new system. The mechanism chosen by the government in order to pay this debt has been the issue of bonds due at the time of retirement. Currently the government is dealing with the increasing deficit of the old system because there are no new affiliates to that system.



## Impact of Liberalisation

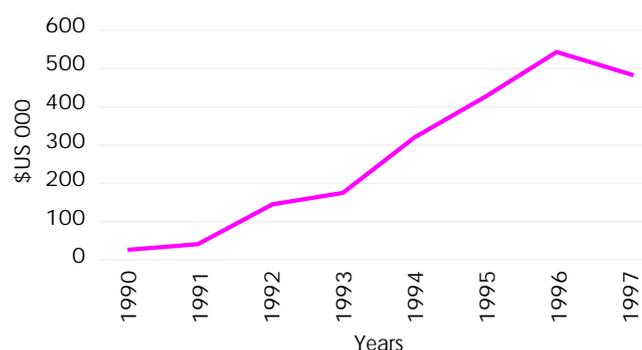
The main impact of liberalisation in Peru's financial sector has been: increased competition in banking system, development of capital markets, emergence of new institutional investors (private pension funds and mutual funds), and the growth of more sophisticated financial transactions.

Liberalisation of the financial system and macro-economic stability have led to a financial deepening of the economy. Bank deposits represented 9.68 percent of the GDP during 1991. In 1997, deposits were equivalent to 19.2 percent of a much bigger GDP. In dollar terms, the bank deposits were \$US 350 million in 1989, \$US 3.32 billion in 1991, and \$US 12.23 billion at the end of 1997.

The rapid growth of deposits, combined with the lifting of entry barriers and the presence of foreign banks, forced a modernisation and reduction of costs of the banks. This has been translated in a significant change in productivity. Deposits per bank employee were only \$US 53,000 in 1990. By the end of 1997, deposits had reached \$US 469,000.

The increase in the amount of loans per worker has been even more dramatic. It experienced an eighteen fold increase during the same period. While loans amounted to just \$US 27,000 in 1990 – or about twice the yearly salary of a bank employee – they were \$US 490,000 per bank worker by the end of 1997 (see chart 1).

Chart 1: Loans per Bank-Employee



The faster rate of growth of loans has been made possible by greater access to foreign lines of credit. While the standing amount of foreign bank loans to Peruvian commercial banks was less than \$US 300 million in 1991, it reached \$US 3.8 billion by the end of June of 1998.

The growth of the banking activity has not been limited to that of loans. Foreign trade operations of banks have increased six fold in the last seven years. The number of credit cards issued has grown from less than 40,000 in 1990 to 840,000 by the end of 1997.

The greater availability of funds and increased competition between banks has reintroduced in Peru mid and long term loans. Before 1990, the average maturity of a loan was less than four months. Now mortgages of up to 20 years have become quite common. Bank house mortgages standing amount was less than \$US 40 million in 1992, while at the end of 1997 it had surpassed \$US 1 billion. At the same time, people who did not have access to credit before 1997 have been able to obtain loans if they have a monthly income of more than \$US 150.

In spite of the closure of four commercial banks and the merger of several banks in the early 1990's, the number of banks and financial institutions has grown almost 30 percent between 1992 and 1997. The greater number of banks and the increased presence of foreign banks have improved the quality of banking services, and have contributed to a reduction of spread between the lending and the deposit rates. The spread in local currency, that was 8 percent monthly at the beginning of 1992, was less than 1 percent per month during 1997. Interest rates that were more than 40 percent in real terms during 1992 were close to 9 percent in 1997.

The reduction of spread in foreign currency (which represent about 68 percent of the loans and deposits of commercial banks) has been less dramatic. While the spreads are still high according to interna-

**People who did not have access to credit before 1997 have been able to obtain loans if they have a monthly income of more than \$US 150.**

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tional standards, partly due to the loan loss reserve requirements and the high liquidity requirements established by the Central Bank, the reduction of these spreads has clearly been beneficial to society.

Overall, benefits incurred by society as a result of restructuring Peru's banking system include: a decreased spread between lending and deposit rates; improved banking services; access to loans for people who did not have that access before; and the channelling of funds into economic activities that previously had been considered too risky. For example, agriculture and livestock received loans of only \$US 54 million during 1990, while they obtained \$US 440 million during 1997.

Economic indicators in the banking sector have also improved. During 1997, cash and deposits at the Central Bank were equivalent to 27 percent of its assets, loan loss reserves were 77 percent of non-performing loans, profits were 29 percent of its net worth, and risk weighted assets were less than 9 times its net worth.

The main cost of liberalisation of the banking sector has been mainly in terms of employment. The bank employees numbered 29,680 in 1990, 27,692 in 1993 and 26,069 at the end of 1997.

Liberalisation has also impacted the Peruvian securities sector. For example, the amount traded in the

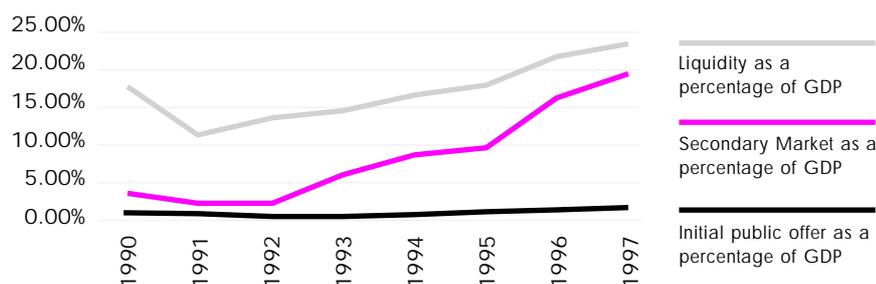
Stock Exchange rose from only \$US 60 million in 1990 to \$US 6.8 billion in 1997. In other words, the daily average exchange increased from \$US 240,000 to \$US 27 million. Public offerings of bonds rose from \$US 324 million in 1994 to \$US 1.43 billion in 1997. Market capitalisation increased 3.4 times between 1993 and 1997. The secondary labour market reached almost 85 percent liquidity of the financial system in 1997, up from 25 percent in 1990, while the primary market rose from 5 percent liquidity in 1990 to 16 percent in 1997.

The periods of highest growth in trading at Lima Stock Exchange were in 1993 (170%) and 1994 (105%). A key element in explaining this behaviour is the tax exemption existent until year 2000. Currently, this exemption is given to both capital earnings generated through stock exchange trading, and interest income obtained from any kind of bonds. Other factors influencing the high rate of trading in the 1993-4 period were the better performance of firms and the high growth of GDP.

The role of the private pension funds has been crucial in the increase of domestic saving. The pension saving is now about 2.6 percent of GDP and domestic saving is 19.4 percent of GDP, while in 1994 these numbers were 0.6 percent and 16.9 percent, respectively.



Chart 2: Financial Deepening



The number of people registered with a private pension firm is nearly 2 million, and accumulated funds amount to more than \$US 1.7 billion. The investment structure of these funds is concentrated on five financial assets: shares; time deposits on banks; corporate bonds; subordinate bonds; and financial leasing bonds. Together they total 97 percent of system portfolio, and the first three assets contribute to it by more than 80 percent. The proportion of shares is now at their limit of 35 percent of investment portfolio assigned by the Superintendency. Moreover, each time the authority modifies the limit to invest in shares, increasing it, pension funds rapidly reach the new ceiling. This behaviour has not occurred in the other securities demonstrating the preferences of these funds to invest in shares with the best yields.

After eight years of financial

liberalisation and strengthening of bank regulation, a deepened financial system has emerged in Peru (see chart 2). Greater solvency is now considered an asset by the government in times of economic troubles.

**Other factors influencing the high rate of trading in the 1993-4 period were the better performance of firms and the high growth of GDP.**

## Foreign Investment Developments

Throughout the 1970s and 1980s, due to the continuous worsening of macroeconomic and social conditions, Peru was unable to draw a significant level of foreign investment. The situation was reversed thanks to major structural changes undertaken in the 1990's.

Due to liberalisation of financial services throughout the 1990's, almost all access restrictions to Peru's domestic financial market, as well as any form of discrimination against national treatment for both the investor and provision of their services, have been eliminated. However, two caveats must be stated. First, although by the law commercial presence of foreign banks is required, it can take the

form of either a new bank or representation offices or branches. Second, the law states that whenever the public interest is affected the reciprocity principle will be applied.

In general, as a result of market liberalisation, structural reforms, economic stabilisation and successful anti-terrorist policies, country-risk has diminished significantly. Since 1994, Peru has become part of a group of emerging economies attracting significant foreign direct and portfolio investment into numerous economic activities. This can be observed in financial sector trends.

The stock of foreign direct investment in the Peruvian finan-

cial sector grew from \$US 135 million in 1990 to \$US 784 million in 1998. As a percentage of the total figure, investment in the financial sector has remained relatively stable, up from 7.9 percent in 1990 to 10.7 percent in 1998. The variation is less than 3 percent in its share of the financial sector, yet this contrasts with dramatic increases in other sectors, most notably communications (up 28%) and energy (up 19%). The ranking of economic sectors according to their share of total foreign direct investment in decreasing order in 1990 was: industry; mining; commerce; and finance. In 1998, the decreasing layout was: communications; energy; industry; mining; and finance.

In the financial sector, the banking system experienced investment inflows in two ways; 1) total or partial acquisition by foreign banks and economic foreign groups of domestic banks partially owned by the state; and 2) through the opening of new banks and agencies. For example, in 1990, Citibank was the only foreign firm to set up an office in Peru. Today around one third of the net worth of the banking system currently belongs to foreigners (total ownership by foreigners, as well as shared ownership with domestic banks). Banks such as Banco Santander (Spain) and Standard Chartered (UK) are almost completely owned

The Organisation for Economic Cooperation and Development (OECD), in its recent report *Open Markets Matter: the Benefits of Trade and Investment Liberalisation*, noted that foreign bank entry "improves standards, and that open financial systems are more efficient and offer better services". (p. 103). The report also notes that rapid expansion of the presence of foreign banks is not likely to undermine attempts at regulation but it is more likely that their presence will help to "improve transparency and overall banking regulation in the host country" (p. 103). The experience of Peru in these areas, summarised in the previous section, is consistent with both these observations. In further remarks relevant to economies that are faced with financial vulnerability, the OECD observes that "foreign banks are less likely to focus their lending on a small number of local firms, and they can draw on the capital of the parent company if there are liquidity problems. Foreign banks have often proved to be a stable source of funding in the face of adverse shocks in many countries, particularly developing ones" (p. 103).



Table 1: Main Sources of Foreign Direct Investment in the Financial Sector, 1997

COUNTRY	\$US Million	Share (%)
UK	277.34	35.37
Spain	160.80	20.51
USA	82.66	10.54
Chile	64.98	8.29
France	46.10	5.89
Other	152.15	19.40
TOTAL	784.03	100.00

by foreigners; foreign and native investors share ownership of other banks such as Banco Continental, Banco de Lima and Interbank. In addition, there are domestic banks that have associations with strategic foreign partners, such as Banco Sudamericano and Banco Wiese. By the end of December 1997, 13 of Peru's 25 banks were foreign owned and had 32 percent share of deposits.

As can be seen in table 1, the main sources of investment accruing to the financial sector are, in decreasing order: the UK; Spain; the United States; Chile; and France – covering around 81 percent of the total stock.

Current legislation allows banks to participate in the domestic financial market as insurance companies or stock exchange dealers. Pension fund management firms typically operate through foreign banks associated with non-bank domestic partners, mostly groups that also participate in the ownership of financial institutions.

At present, foreigners own almost half of the most actively traded shares in the Stock Exchange. At the end of 1997, foreigners held \$US 3.72 billion in shares and \$US 276 million in domestic private bonds.

**Today, around one third of the net worth of the banking system currently belongs to foreigners.**

## Response of Local Firms

This section will examine the evolution of four financial institutions after the financial reform. The first case concerns the oldest Peruvian bank. The second case deals with a new bank established in 1993. The third case is about a private pension fund, and the fourth case is about a stock exchange broker.

### Banco de Credito

The Banco de Credito was founded in 1889 by Italian migrants to Peru. For the past 50 years, it has been the largest commercial bank in Peru. At present, the Banco de Credito holds 29.9 percent of deposits and 23.32 percent of loans of the Peruvian commercial banking system. Its deposits have grown more than twelve fold during the financial liberalisation period, going from \$US 300 million at the end of 1990 to \$US 3.87 billion at the end of 1997. Its loans have grown almost 35 times during the same period. They amounted to \$US 86 million at the end of 1990 and to \$US 2.97 billion at the end of 1997.

When volume of deposits and loans are compared, the Banco de Credito is seen to have been extremely cautious in its lending operations, particularly during the years of hyperinflation (1988-1990) and during the first two years of the stabilisation program (1991-1992). In spite of being by far the bank with the greatest amount of deposits, it was also the bank with the second highest rate of outstanding loans during the years of 1991 and 1992.

During the hyperinflation years, the bank protected itself by channelling part of its deposits into real assets and by not expanding its branch numbers. During the initial years of stabilisation, when trade opened and relative prices incurred a significant change, the bank adopted a "wait and see attitude". Viewed retrospectively, this was probably a good thing in terms of solvency of the bank.

Before 1990, in part due to the nationalisation law issued in 1987, the Banco de Credito did not invest in modernisation. It was overstaffed and faced little competition since the creation of new banks was not allowed between 1968 and 1982. As a

result, it did not provide a good service and was reluctant to enter into new financial operations.

Since that time, the arrival of foreign banks, the growth of the capital markets, and the emergence of new Peruvian banks have resulted in an overhaul of the Banco de Credito. In the last few years, it has become very aggressive in leasing, factoring and underwriting activities. It was the first bank to channel a significant amount of credit to the private sector and to reintroduce the mortgage loans that had disappeared during the hyperinflationary years.

In addition, it has increased its number of credit and debit card holders by twenty fold during the last five years; added almost 100 new automatic tellers during that period; and reduced the average waiting time for the customers at the bank tellers queues from 28 to 8 minutes.

This modernisation of the operations of the bank has required an investment of close to \$US 80 million in processing equipment, a reduction of personnel of about 20 percent and the hiring of highly qualified executives, both Peruvian and foreigners.

During the last few years, the Banco de Credito has been expanding abroad. It has representative offices in the United States and in various countries of Latin American. It has grown through its holding company banks in the United States, The Cayman Islands, Bolivia, El Salvador, Colombia and Venezuela. The bank's holding company owns most of the largest insurance company in Peru (a financial company that specialises in small consumer loans) and the biggest Peruvian stocks trading company.

According to Banco de Credito officials, over the next two years, the bank's emphasis will be on improving



## Banco del Nuevo Mundo

its operations at home and in consolidating its presence abroad (where they are not planning to acquire new foreign banks). In the Peruvian market, the bank plans to enter the financing of small and micro enterprises to improve its foreign trade operation and to be more aggressive in investment banking.

The modernisation of the Banco de Credito, coupled with stronger competition in the banking sector, has led to a strong reduction of the interest rates. At present, the prime lending rate is around the European interest rate, LIBOR, plus 150 basis points for the biggest firms. This low rate is due to the strong growth of capital markets wherein demand for Peruvian stocks and bonds is strong, and to an increase in funds available to Private Pension Funds and Mutual Funds.

The reduction of interest rates and spreads has not affected the profitability and the solvency of the bank. This result is a consequence not only of the big increase in its volume of operations but also of its successful programs of cost reduction.

It should be stressed that in the last few years, bad loan loss reserves have been higher on average than the overdue loans. Since most of these non-performing loans have collateral, the net worth of the bank is higher than what appears in its accounts.

At present, however, the bank's overdue loans compared to its collateral are 130 percent, while bad loan reserves are 90 percent of the non performing loans. The bank's profitability is 6.61 percent and its spread represents 52 percent of their financial income.

The Banco del Nuevo Mundo was established in 1993. Its founders were members of the Peruvian Jewish community with a strong interest in the building sector. This bank appeared after the period of hyperinflation and the initial years of stabilisation when economic activity was expanding at a fast rate. At the time, the banking sector was beginning to face stronger competition not only between new banks but also between foreign banks. This business environment forced the owners of the Banco del Nuevo Mundo to establish from the start an efficient bank with relatively few personnel. Although the bank has grown quickly, it has been careful in the assessing of risk of its loan portfolio.

At the end of 1993, the bank had deposits of \$US 72 million. At the end of 1997, it reached \$US 311 million, increasing its share of Peruvian bank deposits from 0.1 percent to 2.3 percent.

Its loan portfolio also shows a dramatic increase during the years between 1993 and 1997.

Outstanding loans that amounted to \$US 38.5 million by the end of 1993 attained a level of \$US 319 million by the end of 1997. In terms of the Peruvian Banking System loans, the Banco del Nuevo Mundo's share has gone up during these four years from 0.1 percent to 2.5 percent.

The Banco del Nuevo Mundo has grown without the problems of older banks that were overstaffed and had a relatively high non-performing loan portfolio. The financial situation of the Banco del Nuevo Mundo, in spite of a recent cooling of the economy, remains fairly strong.

It has a strong liquidity position with cash and deposit at other banks representing 384 times the amount of

short-term deposits. Its bad loan portfolio represents 3 percent of its total loans. The reserves for bad loan represent 89 percent of the non performing loans. Its operating costs are 1.4 percent of its earning assets. Further, its financial margin represents 3.9 percent of earning assets, and its profitability is 22.4 percent of its net worth.

The growth of the bank in terms of personnel and number of branches has been cautious. At present, the bank has only 15 branches compared with 213 branches of the Banco de Credito; and it has only 356 employees compared to 5,887 at the Banco de Credito. The amount of deposits per employee is almost \$US 1.1 million.

The Banco del Nuevo Mundo currently orients its operations to the financing of mid-size firms, upper middle class customers and mortgage loans also within the middle class sector. According to the President of the bank, the bank intends to remain within these segments of the market while expanding its activities in new specialised mutual funds, particularly in those connected with the real state. At the same time, the bank plans to become more aggressive in investment banking through a new securitisation firm that will be wholly owned by the bank.

## Private Pension Funds: Horizonte AFP

The main activity of this firm is to manage the individual accounts of its affiliates for their retirement. This means the AFP competes for management of funds from the greatest number of people looking for efficiency, both in terms of low administrative costs and high investment performance.

Like the majority of financial firms in Peru, Horizonte AFP is a private firm with only a few important shareholders and with a small part of its shares traded on the Lima Stock Exchange. The main stockholder is Holding Continental, which is owned by Banco Continental (the second largest bank in the Peruvian system). Foreign investment is also very important in the firm: at least 65 percent of Horizonte AFP is owned by international investors. However, if the main stockholder of Banco Continental is taken into account, which is Banco Bilbao Vizcaya from Spain, the foreign investment on this AFP is even larger.

The private pension system was an important component of the Peruvian financial reform, and so it precludes an analysis of the performance of the firm before and after the reform. Nevertheless, something can be said about the strategy followed by Horizonte in the competitive market wherein it operates.

A main goal of the firm is to achieve excellence in the performance of its staff and employees. Special emphasis has been placed on investment decisions. Managers apply both fundamental and technical analysis to make the best possible financial decisions. Moreover, the firm has created two bodies to help make better and more informed investment decisions; the Investment Committee and the Financial Operations Committee. The Investment Committee

mainly fixes limits and terms of the investments, while the Financial Operations Committee makes the daily decisions according to the policies determined by the Investment Committee. As a result, Horizonte is the only AFP in obtaining the ISO 9002 Certificate for investment management of pension funds.

Horizonte also promotes marketing activities, such as, advertising, direct mailing (mailing birthdays and Christmas cards, as well as useful information to its customers), and development of software to estimate pension incomes and its delivery to the affiliates. As a result, Horizonte has won awards for customer service and has been perceived as the best AFP in the domestic market for the past two years.

Based on the data to December 1997, Horizonte has the largest equity of pension funds (about \$US 11 million, or, almost one third of the sum of the five AFPs). Horizonte is also the AFP with the largest number of affiliates (almost 447 thousand people, who represent 26% of the system), and the second highest amount of accumulated funds (\$US 363 million, 24% of the system). During the last year, the pension funds managed by Horizonte attained third place profitability in terms of affiliate yields, 10.73 percent in real terms. (The best performing pension fund achieved 11.88% in profitability.)

It should be noted, there is no great difference between funds' profitability because regulation establishes a minimum level. As such, no private pension firm can give its affiliates a yield lower than 2 percent below the average profitability of other funds.

In terms of profitability of the firm itself, Horizonte achieved second place among all pension funds during 1997 with \$US 4.4 million (40%

over equity and 25% over total assets). The firm's earnings in dollars were still relatively small because the system was only four years old in 1997. More over, 1997 was the first year in which the pensions system as a whole obtained earnings, and, total earnings were only \$US 6.5 million because two firms lost money.

Horizonte's employment history has been one of the most active, both in terms of hiring (and firing) people, and in terms of training them. Horizonte began with 900 people (15% of the system). Its minimum number was around 250 in the beginning of 1995 (25% of the system). Now Horizonte has almost 600 promoters/salespersons (20% of the system). Women account for slightly more than half of this number.

Productivity has fallen in recent years. This has occurred despite the adjustment in the number of promoters for reasons of cost reduction. The monthly average of affiliates per promoter reached its maximum in July 1993 (the first month of operations of the new system) of 25.1 for the whole system and 23.5 for Horizonte. It recorded its minimum for the whole system at 3.1 in 1994. The minimum for Horizonte was 3.5 recorded in May 1995. The average for the time period is 8.2 for the whole system and 8.9 for Horizonte. The current period's level is 3.7 for both. As the data show, Horizonte has always been near the average of the system, and significantly, it has achieved the highest minimum level of productivity.



## Stock exchange Broker: Credibolsa SAB

The traditional role of a firm like Credibolsa is to intermediate between people (buyers and sellers of securities) and the stock exchange. Securities trading only can be done through the participation of a brokerage firm (SAB) or a stockbroker. SABs are those that carry out the intermediation of securities. In recent years, some stockbrokers have been leaving the market and others have been joining partners to open new SABs. In general, SABs have fared better as intermediaries than individual stockbrokers. The number of registered stockbrokers has fallen from 30 individuals to 3 in the period 1990-98. On the other hand, SABs have increased to about 40 firms.

Credibolsa SAB is owned by Banco de Credito, which is one of the firms described in this paper. Credibolsa was founded in 1992. During the first years of the liberalisation process, many of the exchange brokers were owned by banks. This business, and the financial system as a whole, have provided a source of employment.

Because of the dramatic growth experienced in the domestic securities market after the financial liberalisation, there has been a significant rise in transactions made by broker agencies in terms of; 1) buying and selling orders on the Stock Exchange; and 2) informing and advising customers. Broker agencies which experienced the highest growth are those owned by banks established after the reforms. Such growth has been attributed mainly to an advantage in customer and branch numbers which made it easier for both customers and brokers to make transactions and manage their bank accounts.

Another important change generated by liberalisation has been the

authorisation of new operations for broker agencies. For example, brokers now can act as investment banks in order to perform initial public offerings and underwriting. Once again, the most successful brokers in these operations have been those firms owned by banks, likely due to a greater knowledge of the firms and the strong business relations between banks and companies raising money on public offerings.

The stock exchange brokers market is very competitive. There now are 40 firms in operation, up from 11 in 1990. Further, there has been a dramatic increase in the demand for broker services. Increased competition has resulted in important cost reductions, including lesser commissions charged by brokers.

Since its beginning, Credibolsa has been very active in the market. In 1993, after being in existence for just one year, the firm's trading rose ten fold. The company achieved second place in terms of trading volume on the Lima Stock Exchange. Its value was about \$US 500 million and it had a market share of 13 percent. Since then, Credibolsa has been number one on the market with an average share of 15 percent. In 1994 and 1995, trading continued to increase by more than two fold. During 1997, its trading volume was about \$US 3.20 billion (more than six times the quantity obtained five years before) reaching a market share of 13 percent.

In terms of the conventional measures of firm size, such as amounts of assets and equity, Credibolsa, on average, has ranked number three of all SABs. In 1997, its assets were \$US 4 million and its equity was \$US 3 million. An important difference between Credibolsa and other SABs

is that Credibolsa is bank owned (by the Banco de Credito). This means that Credibolsa's main fixed assets, such as the building where in it is located, are actually owned by the Banco de Credito.

Due to increasing competition, the average profitability of the system was in decline until 1995. Profitability loss was the main cause of closures and mergers of SABs during the 1996-7 period. To counteract the decline, Credibolsa adopted a new strategy – active trading in fixed income securities. In 1996, fixed income securities accounted for 45 percent of total trading and in 1997 they accounted for 60 percent.

Credibolsa was also one of the main underwriters of initial public offerings, both in domestic and foreign markets. The Banco de Credito, which employs high professional standards among its staff, supported Credibolsa in strengthening its market position. In order to fulfil the bank's requirements, Credibolsa has been applying high standards in its own for hiring and training personnel.

In the case of Credibolsa, diversification and specialisation of operations impacted on sales and yields. In 1996, profits rose to more than 300 percent and reached more than \$US 1 million. The recent Asian currency crisis, however, has taken its toll. Profits have dropped to \$US 850,000 and yields obtained from commissions and other services have fallen by 17 percent.

Overall, Credibolsa has been the leading SAB in terms of amount of earnings and profitability over assets and over equity. For example, during 1997 these ratios were 21 percent and 27 percent respectively.

## Future Challenges

**Sound macroeconomic policy, adequate banking regulatory systems, and high reserve requirements are contributing to a less painful adjustment.**

Although there has been great improvement in the quality of supervision and regulation in Peru's financial systems, there are still some unsolved issues. These include the consolidated supervision of financial institutions with branches abroad; and, as in the rest of the world, the challenge posed by the introduction of a growing number of sophisticated products such as the financial derivatives.

An additional problem facing Peru and other Latin American countries is the degree of dollarisation of bank loans and deposits, which in a case of strong currency depreciation, reinforces recessive effects.

Two immediate concerns for Peru are; 1) the exposure to the fall-out from the crises on world markets; and 2) a reduction in foreign capital inflow. Fortunately in the case of Peru, sound macroeconomic policy, adequate banking regulatory systems, high reserve requirements (45% in the case of dollar deposits), and international reserves at a level that is almost four times the liquidity in domestic currency, are contributing to a less painful adjustment.

In the case of banks, there are still some problems. These include high spreads, a mismatch between loans and deposits (the average maturity of deposits is much lower than the average maturity of loans), and poor quality of loans (although they are covered by provision

reserves). In addition, some banks have not attained economies of scale and do not have the technical staff to face competition from foreign banks in new financial operations.

A difficulty faced by the stock exchange is the scarcity of new financial assets where in new institutional investors (such as private pension funds and mutual funds) can invest. Although initial public offerings have increased dramatically, they have not been enough to satisfy the rising demand. Hence, it is important to promote intensively public offerings.

The pension system must also overcome some difficulties to make private funds more attractive. For example, it would be desirable to avoid double taxation policies. Currently, both present contributions and future pensions are taxed (as part of income tax). Further, the pension system must begin to incorporate independent workers, such as doctors, lawyers, and consultants. Professionals constitute an important part of the labour force in terms of numbers and income levels and could significantly impact pension profitability.