RETHINKING THE PERUVIAN CAPITAL MARKET IN THE CONTEXT OF THE AFPs

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INTRODUCTION

Although many interesting things are occurring in our country, and there are hopeful signs for the future, there is also too much complacency in some areas. A relevant example of this is the capital market: although the political conditions seem favourable for a change, there is a lack of ambitious proposals to confront the problems that have already been identified.

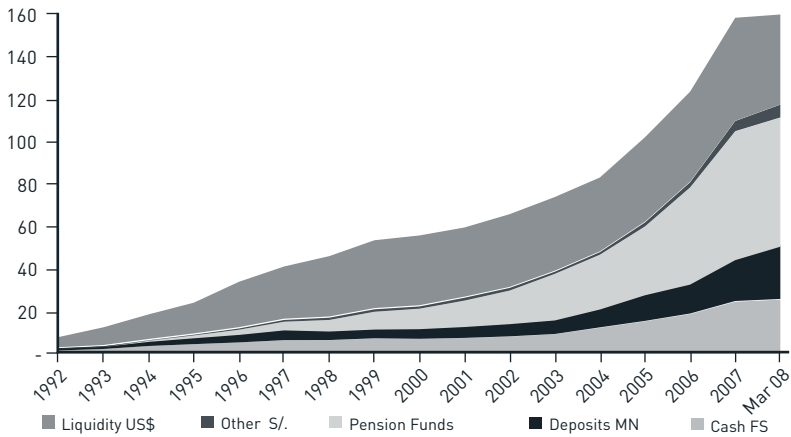
This document has the following structure. First of all, it points out the importance of private pension funds as a source of funding for investment and also the progress made in the Private Pensions System (PPS). Secondly, I have identified the issues that remain pending for the PPS and the Peruvian capital market and finally, I have summarized some proposals for reforming the Peruvian capital market.

I. IMPORTANCE OF PENSION FUNDS AND PROGRESS MADE IN THE PPS

How important are the pension funds to the Peruvian economy? According to the data summarized in Figure 1, these represent 73% of internal savings, 77% of total investment and 96% of private investment in the country. Undoubtedly, pension funds are very important as a source of funding for investment in our country.

Progress in the PPS has involved five key aspects: the relaxation of the limit on investments abroad; the creation of the multi-fund scheme; the elimination of limits per instrument and the establishment of limits per asset class; the establishment of limits per issuer on the basis of the size of the company; and the increase in the range of instruments available in the local market.

FIGURE 1
LIQUIDITY OF THE FINANCIAL SYSTEM (S/. MILLION)



SOURCE: PREPARED BY THE AUTHOR

II. PENDING ISSUES: PPS AND THE CAPITAL MARKET

It is a well known fact that there is excessive demand in the country for financial instruments. The institutional funds buy the securities that are available and hold them, particularly in the debt market. This is mainly a primary debt market. The opposite occurs with shares: there is a secondary share market and almost no primary market (the last important issue before the privatisation of the Intercorp group was Graña y Montero in 1997).

The first question is: can risk be diversified in Peru? And the second: Do we want to diversify risk in Peru?

MSC1[2] Peru is equivalent to 0.07% MSCI World; Peruvian debt is equivalent to 2.23% of the Global EMBI[3]; the emerging sovereign debt amounts to 5.1% of a diversified portfolio of global debt.

2 *Morgan Stanley Capital Index.*
3 *Emerging Markets Bond Index.*

So, for the typical pensioners who have their businesses in Peru, their home in Peru and their savings in Peru, the fact that over 85% of their pension is exposed to Peruvian country risk constitutes a serious financial mistake. What we suggest, therefore, is that the limit on foreign investment for pension funds should be eliminated and that the AFPs should decide the extent to which they wish to diversify the country's risk.

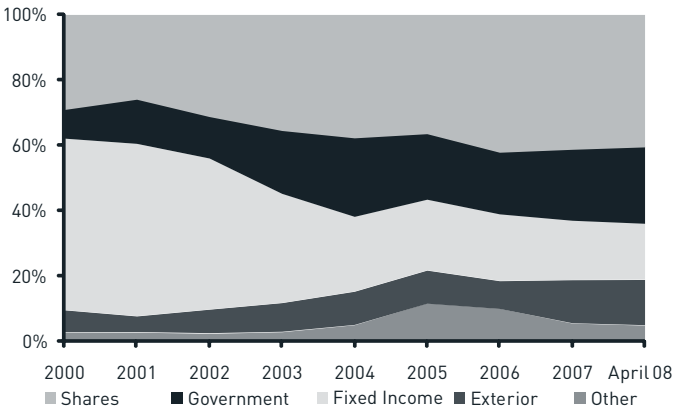
In this context, what is the transition faced by the AFPs? They is necessary that they move from being the dominant force in a market where they are the main purchasers of funds (which contributes to the excessive demand existing in the Peruvian capital market), with very good information, due to having directors in the companies in which they invest, to becoming just one investor among many, another client that is called up by the investment bank with offers of investment recommendations or information about a new issue that is they are going to bring out onto the market.

This is not a trivial matter; it is a complex transition that requires a full change in the way of handling the investment portfolio and designing investment policies, and we are not sure whether they are prepared.

There are also other issues to be discussed, also. In Figure 2, which shows the diversification of pension funds by instruments, we can see that the majority of the funds are invested in shares. Generally speaking, for a young system of pension funds, with many people still far from retiring age, this makes sense. However, we cannot ignore the limitations of the Peruvian capital market. The curve of Peruvian corporate debt is below the same curve in countries that have had the same degree of investment for years now. The relative value of a share in a cement company or a bank or a company in any sector you wish in Peru is greater than a similar share in countries with infinitely better prospects and a much higher degree of institutional development. In general, the Peruvian capital market trades at a premium against other emerging markets, which could be described as "the premium of local institutional investors" or the "premium of the AFPs."

In relation to the funds' exposure to direct sovereign risk, I still remember the analysts of the bank and pension fund administrators of the group where I worked in Argentina discussing why the portfolios were so much less exposed to the sovereign risk of Argentina compared with other countries where direct exposure of institutional portfolios to the respective sovereign risk was much higher.

FIGURE 2
DIVERSIFICATION OF THE PENSIONS FUND (% OF THE FUND)



SOURCE: PREPARED BY THE AUTHOR.

These discussions might well be a cause of mockery, now that we know what happened with the AFJP[4] in Argentina, however, something similar is happening in Peru. We only concentrate on the exposure of funds to the government and conclude that the AFPs in Peru have less public debt, on average, than the AFPs of other countries. However, what would have happened with that portfolio if Mr. Humala had been elected and taken similar decisions? Exposure to sovereign risk is much more than exposure to public debt.

How would investments be allocated if the Peruvian market were more efficient? The first column in Table 1 shows the distribution of the AFPs' portfolio of investments in shares at the end of 2007. On that date, 16% was in Credicorp; 14% in Minas Buenaventura; etc. The second column simulates a distribution of the share portfolio according to the capitalization of the respective companies on the stock exchange. If we were in an efficient market, that would be a *benchmark* and the administrators would decide whether to be over-weighted or under-weighted by reference to an index of this nature.

4 *Retirement and Pension Fund Administrators.*

TABLE 1
PARTICIPATION IN SHARE PORTFOLIO: CURRENT MARKET COMPARED WITH MORE EFFICIENT MARKET (DECEMBER 2007)

	Participation in share portfolio	Composition of "AFP-able index"	Over or under-weighting of this index	Investment/ stock market capitalization
Credicorp Ltd.	16.2%	10.7%	1.5	19.2%
Cía de Minas Buenaventura	14.4%	11.7%	1.2	15.6%
Southern Peru Copper corporation	11.5%	47.3%	0.2	3.1%
Volcan Cía. Minera	**9.4%**	**3.0%**	**3.0**	**40.0%**
Minsur	**6.6%**	**1.6%**	**4.2**	**52.7%**
Milpo	5.7%	2.6%	2.2	28.4%
Edegel	4.0%	1.8%	2.2	27.9%
Cementos Lima	3.7%	1.6%	2.4	30.3%
Atacocha	**3.6%**	**1.0%**	**3.5**	**44.7%**
Energía del Sur	3.6%	1.5%	2.3	29.5%
Alicorp	3.5%	1.2%	2.9	36.1%
Ferreyros	**3.3%**	**1.0%**	**3.4**	**42.4%**
Graña y Montero	3.0%	1.3%	2.3	29.5%
Intergroup	2.4%	2.4%	1.0	12.2%
Cementos Pacasmayo	2.2%	1.1%	2.0	25.9%
Edelnor	2.1%	0.9%	2.4	30.4%
Refinería La Pampilla	**16%**	**0.5%**	**3.0**	**37.5%**
Luz del sur	1.6%	1.2%	1.3	16.0%
Banco Continental	1.4%	4.2%	0.3	4.2%
Scotiabank Perú	0.1%	3.3%	0.0	0.2%
Empresa Editora El Comercio	0.0%	0.1%	0.5	6.3%

SOURCE: PREPARED BY THE AUTHOR.

The third column reveals precisely the over or under-weighting of the share portfolio compared with this index or, in other words, how much more does the respective share of the portfolio of the pensions fund represent, compared with what would be the case if the Lima Stock Exchange were efficient and investments were allocated following a stock exchange capitalization index.

The shaded parts of Table 1 identify those shares with "excessive" over-weighting of shares. It proves that the pension funds are over-weighted in, basically, commodities,

two mining companies, an oil refinery and a company that imports and produces capital goods for the Peruvian economy.

Although this is undoubtedly a very general and imperfect analysis, it provides a good illustration of the re-focusing that the AFPs would face if they passed from becoming the only investor in an inefficient capital market to being just one more stakeholder in an efficient capital market.

Table 1 shows cases of excess institutional demand, the flow of institutional demand as opposed to the flow of the supply of securities. We can see here a consistent excess in demand amounting to several billion dollars, which explains the higher relative value of the shares listed in the Lima Stock Exchange against other shares in emerging markets and why the corporate debt curve is consistently below the corporate debt curve of more highly diversified economies with greater institutional development, which have consistently had the level of investment for a long time.

A couple of examples will help us highlight this situation even further: AFP investment represents 53% of the stock exchange capitalization of Minsur; if the prospects of tin deteriorate, to whom will the AFPs be able to sell that 53% of stock in the company? Or if the future of zinc were to deteriorate, what would happen with the 40% of shares owned by the pension funds in Volcan and Atacocha?

III. ANALYSIS AND PROPOSALS FOR MODERNIZING THE CAPITAL MARKET IN PERU

This section presents a summary of the study entitled *Analysis and proposals for modernizing the capital market in Peru*[5]

Institutional aspects

The idea of the study was to generate a public-private forum to identify obstacles and generate initiatives that would help to develop the capital market in Peru. Similar instruments have been used by countries that show significant progress in their respective markets and they are especially necessary in our country, where, unfortunately, the public sector has few professionals of a high level because salaries have been reduced and because the risk of facing a trial in the public sector

5 *Study prepared by Felipe Morris, Javier Tovar and Pablo Secada (2007).*

is extremely high. In this context it is even more necessary to have a public-private forum to head up a reform proposal.

There was full agreement in the private sector that the regulator, or regulators, must face a process of reform, primarily the National Commission for the Supervision of Companies and Securities (Conasev), and proposals ranged from moderate to more aggressive. The most aggressive of all suggested setting up a Superintendence of Banks, Insurance and Securities (SBSV), with autonomy in terms of budget and finances, that would minimize the discretionary powers of the regulator.

As regards those reforms concerning corporate governance, consensus was less widespread. Corporate governance reform is being discussed by everyone, but not as much as it should be in a Stock Exchange that has become de-mutualized, nor as much as it should be in the AFPs' investment committees, for example.

Finally, the vast majority of people – including some businessmen – do not fully understand what a capital market is. For this reason it was proposed to adopt a program to publicise and modernise the capital market.

Demand: AFPs

On this occasion I am going to emphasize those proposals that are directly concerned with the AFPs. The matter of the limit on investments abroad did not generate consensus among the private sector actors involved in the capital market. The authors of the proposal for the reform of the capital market, including myself, suggested promoting more competition in pension administration, but the proposal was not accepted. In any case, this is a proposal which is valid and applicable to the entire administration of pensions, not only to voluntary contributions.

Supply

From the point of view of the supply of financial instruments, there are many things that can be done to encourage more companies to enter the capital market. One of the proposals was to generate a market for derivative papers and a more active money market. However, this proposal has gone backwards, partly due to the controls over capital imposed by the Central Bank in the last few months in order to reduce speculation in favour of the Sol (speculation that, in my opinion, stabilizes the currency exchange market – or stabilized it when needed – and not the contrary).

CONCLUSIONS

Undoubtedly the Peruvian capital market has progressed enormously (fifteen years ago, the entire Lima Stock Exchange traded a quarter of a million dollars, compared with some US$ 15-20 million at present) and this progress must be acknowledged. However, we must not rest on our laurels. There is much more to be done and specifically in connection with pension fund investments, which face a considerable financial risk.

It is therefore necessary to take the lead in the process of change and move towards a pension scheme with more highly diversified portfolios; with greater coverage; with increased competition; and with more and better services.

At the same time, we must improve our capital market. Some time ago, our television was showing an advertisement in which three little girls, dressed up as ladies, were imitating their conversation over tea. The idea being sold by the commercial was of little girls getting involved in adult affairs. This is precisely the impression I have, in some cases, when I hear discussion between operators of the Peruvian capital market: they are like over-grown little girls, who think they are operating on the London Stock Exchange or the New York Stock Exchange or the Futures Exchange in Chicago, when in fact they are buying and selling shares after someone has given them a tip as to how company profits will be looking in the next quarter.