CE-22

Egan-Jones Ratings Company

Sovereign Rating Analysis: Republic of Peru

Tuesday, November 17, 2015

Egan-Jones Rating Company

History

- Egan-Jones Ratings was founded in 1995 with the purpose of issuing timely, accurate ratings. The firm rapidly gained credibility by flagging the failures of Enron and WorldCom, and has since established itself as a leading global provider of credit ratings. Egan-Jones is a Nationally Recognized Statistical Ratings Organization (NRSRO) and is recognized by the National Association of Insurance Commissioners (NAIC) as a Credit Rating Provider. Studies by the Federal Reserve and prestigious academic institutions confirm that over time, ratings from the largest NRSROs tend to converge toward the Egan-Jones Rating.

A track record of early and accurate calls

- First rating agency to downgrade Ireland in October 2010, and both Greece and Portugal in November 2010.
- Egan-Jones historical downgrades of Italy, Spain, France, Belgium and Austria all preceded cuts by S&P & Moody's.
- "Hits and Misses" shown below aims to measure the extent to which S&P and Moody's converge toward our rating:

Year	2014	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004	2003	2002	2001
Hits	**233**	**300**	**330**	**360**	**282**	**392**	**487**	**370**	**372**	**365**	**355**	**351**	**425**	**441**
Misses	19	20	25	23	11	26	26	18	17	16	14	13	16	15
	92%	94%	93%	94%	96%	94%	95%	95%	97%	96%	96%	96%	96%	97%

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Egan-Jones Ratings: Republic of Peru

Bond	Egan-Jones Rating (non-NRSRO)
Foreign Currency Bonds	**BB**
Local Currency Bonds ("Soberanos")	**BB-**
Land Reform Bonds	**D**

Key Pillars in Evaluating Sovereign Credit Risk

I. Institutional Strength

- Track record of repayment, data transparency, and other factors related to institutional quality

II. Economic Strength

- Real GDP growth, size/diversification of economy, and GDP per capita

III. Fiscal Strength

- Fiscal balance, debt stock, debt composition, debt affordability, and contingent liabilities

IV. External Strength/Event Risk

- Balance of payments, international liquidity (e.g., reserves), and other event risks

I. Institutional Strength

Our Assessment of Peru's Institutional Strength: *Weak*

A. Historical Defaults

- As a result of a sharp decrease in the export prices of mining products and the 1982-1983 El Niño phenomenon, Peru's balance of payments and fiscal accounts deteriorated. In 1984, Peru subsequently defaulted on $1.0 billion of bank debt.
- In 1986, the IMF declared Peru, which was led by then President Alan Garcia, ineligible for additional funds, and, in 1987, the World Bank suspended loan disbursements to Peru.
- In 1991, Peru finally began to repay the IMF and the World Bank, as well as the IADB and the Paris Club.
- In 1997, 13 years after the country initially defaulted on its commercial bank debt, Peru renegotiated a portion of its debt with international commercial banks under the Brady restructuring.
- Upon completion of the Brady restructuring, Peru ceased paying principal and interest to lenders who did not participate in the restructuring. These lenders included a private investment fund that obtained a $55.7 million judgment against Peru for non-payment of interest and an attachment of Peru's funds. As a result of the attachment, on September 7, 2000, Peru failed to make a required interest payment of $80.0 million on the Brady Bonds, even though it had deposited the requisite amount in its account at Chase Manhattan Bank of New York.
- On September 26, 2000, the private investment fund also obtained an injunction against Euroclear System that prevented it from receiving or distributing funds provided by Peru to pay interest on the Brady Bonds.

Our Assessment of Peru's Institutional Strength: *Weak*

B. Ongoing Default

- In 1969, Peruvian dictator General Juan Velasco Alvarado instituted an aggressive agrarian reform policy. Between 1969 and 1982, Peru expropriated approximately 23 million acres of land. Landholders were issued Land Reform Bonds as compensation, with terms ranging from 20-30 years.
- The Land Reform Bonds were issued in accordance with Peruvian Decree 17716. Article 175 of this Decree states that Peru guarantees the Land Reform Bonds.
- In the 1980s and 1990s, Peru experienced severe hyperinflation and twice changed its currency, leaving the Land Reform Bonds worthless based on face value. Peru began defaulting on the Land Reform Bonds in the 1980s, and by 1992 completely defaulted on the Land Reform Bonds.
- In 2001, Peru's Constitutional Tribunal issued a landmark decision affirming that the Land Reform Bonds should be paid based on the current value (i.e. compensated for hyperinflation).
- A series of rulings from Peru's highest courts upheld this requirement:
  - 2004 Constitutional Tribunal decision re-affirming the 2001 decision,
  - 2006 Supreme Court decision, and
  - 2010 Supreme Court decision.
- Based on these court decisions, Peru's monthly consumer price index was used as a basis for calculating the amount owed on the Land Bonds.
- In 2006, Peru's Congress conducted a study and acknowledged that the payment of the Land Bonds should be made and quantified the adjusted value of the outstanding debt as 10,025,618,044 Nuevos Soles (then $3.455 billion).
- Based on this study, the Peruvian Congress passed a bill in 2011 authorizing payment on the Land Reform Bonds using the CPI methodology but then President Alan Garcia did not sign the legislation after members of then President Elect Humala's party called it a fiscal "time bomb".

Our Assessment of Peru's Institutional Strength: *Weak*

B. Ongoing Default (Continued)

- On July 16, 2013, based on a decision signed by 3 out of 6 of the Justices,[1] Peru's Constitutional Tribunal called for the Land Reform Bonds to be paid based on a "Dollarization" method that has subsequently left the Land Reform Bonds virtually worthless. The Dollarization method departed from the commonly used CPI methodology, which is used to update government and other Peruvian debts.
- The Constitutional Tribunal justified the dramatic change in valuation formula by citing the government's inability to pay using the CPI methodology.
- Following the July 2013 decision, in January 2014 the Peruvian Ministry of Economy and Finance published an administrative decree providing for a maximum payout on the Land Reform Bonds of $12 to $24 million which can be delayed until 2021.
- Also concerning, this 2014 administrative decree:
  - allows the government to potentially delay payment by seven years,
  - reserves the right to determine the form of compensation paid to bondholders,
  - requires bondholders to irrevocably waive their rights just to register their Land Reform Bonds,
  - reserves the right for Peru **not** to pay if a minimum number of bondholders do not register,
  - contains a complicated mathematical formula to update the Bonds which yields less than 0.5% of the amount owed under the CPI methodology (i.e., a greater than 99.5% haircut), and
  - subordinates institutional investors who purchased the Land Reform Bonds on the secondary market.
- In our view, the 2014 administrative decree sets a very dangerous precedent for all Peruvian bonds, particularly the Soberanos which are also subject to Peruvian law.
- As recently as February 2015, former Peruvian Finance Minister, Ismael Benavides, described the Land Reform Bonds as a selective default and the 2014 administrative decree as a second expropriation. He estimated the total amount outstanding to be approximately $5.1 billion.

[1] The President of the Constitutional Tribunal, Oscar Urviola, one of the three justices who signed this July 2013 decision, declared his vote to be a tiebreaker and the decision signed by him to be the controlling decision.

Our Assessment of Peru's Institutional Strength: *Weak*

B. Ongoing Default: Recent Developments

- **Criminal Investigation – July 2013 Constitutional Tribunal Decision (April 2015 – Current)**
  - In April 2015, public prosecutors in Lima opened a criminal investigation after Augusto Pretel Rada, a land reform bondholder, noticed white-out in a scanned copy of the July 2013 Constitutional Tribunal decision affecting the Land Reform Bonds.
  - In August 2015, the Lima police department published a forensic report with clear evidence of white-out on the July 2013 judicial decision.
  - Egan-Jones has reviewed a copy of the forensic report and will make it available upon request.
- **Additional Criminal Complaint – July 2013 Constitutional Tribunal Decision (October 2015)**
  - As reported by the Financial Times,[2] a former Peruvian Constitutional Tribunal justice, Carlos Mesia, recently filed a second criminal complaint which alleges that a portion of the July 2013 Constitutional Tribunal Decision was illegally forged and attributed to him.
  - In his criminal complaint, Mesia also alleges that he requested a nullification of the earlier decision attributed to him.
  - Egan-Jones has reviewed a copy of the criminal complaint and will make it available upon request.
- **SEC Filing (October 2015)**
  - In its most recent prospectus supplement filed with the SEC on October 28, 2015,[3] Peru does not include any disclosure with respect to the status of its ongoing default nor any mention of the amount owed with respect to the Land Reform Bonds. This conflicts with recent independent estimates that value the debt between $4.0 billion and $5.1 billion.
  - In contrast, the October 2015 SEC prospectus supplement (along with Peru's annual 18-K filed on July 15, 2015) includes a detailed itemization of the amount owed with respect to Peru's outstanding debts.
  - Further, in the October 2015 SEC prospectus supplement, Peru also states that it "is not involved in any disputes with its internal or external creditors". Given some of the recent coverage of the Land Reform Bonds, this is a very questionable statement that strains Peru's credibility.[4]
- **Segura Testimony (November 2015)**
  - Finance Minister Alonso Segura announced before the Peruvian Congressional Budget Commission in early November and stated that the Land Reform Bond debt is not included in the 2016 public budget.[5]

[2] http://www.ft.com/fastft/414721/peruvian-judge-files-complaint-over-bond-ruling.
[3] https://www.sec.gov/Archives/edgar/data/77694/000119312515355983/d58194d424b5.htm.
[4] See page 1 of Peru's prospectus dated as of August 18, 2015 (attached to the October 2015 SEC prospectus supplement).
[5] "*Ya se cumplen los gatillos para usar recursos del Fondo de Estabilización Fiscal,*" Gestión, page 16, November 11, 2015.

Our Assessment of Peru's Institutional Strength: *Weak*

C. Weak data transparency

- Lack of data on the portion of government revenues that come from mining and other extractive industries.

D. Weak public investment execution track record related to the election cycle

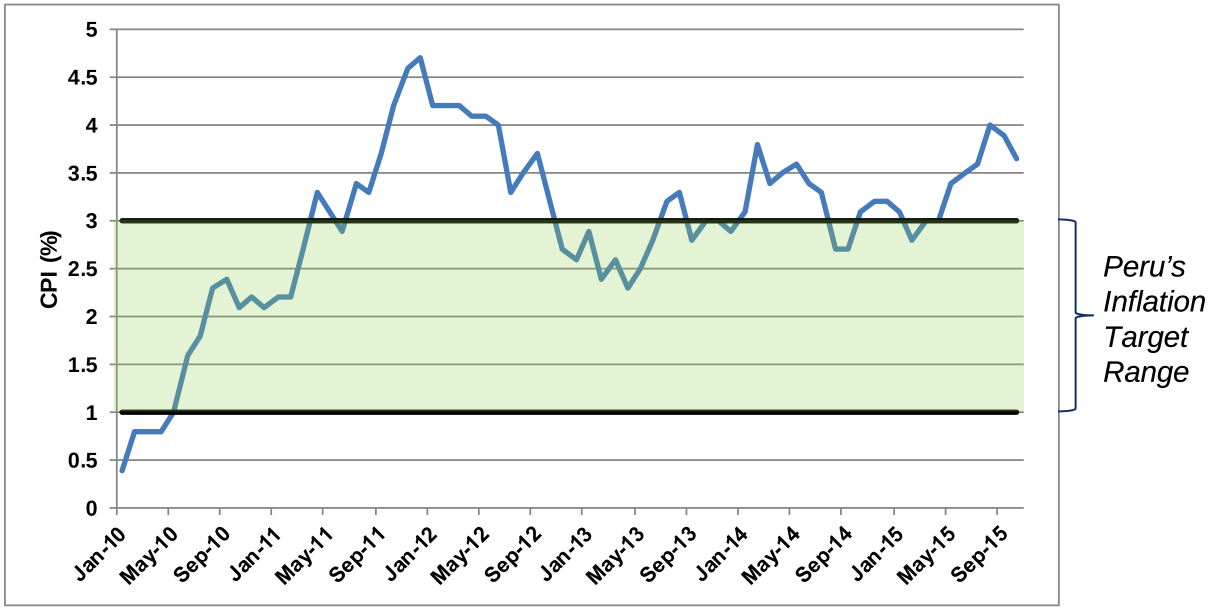
- As of October 2015, the government had executed only 54% of resources budgeted for public investment.
- This is a structural challenge that will reveal itself whenever there are elections in Peru.

E. High level of social conflicts

- Most of which are related to socio-environmental disputes in mining or other extractive industries.
- Increase the potential for politically destabilizing protests, leading to policy uncertainty.

F. Spotty inflation targeting track record

- One way to quantify the strength of a sovereign's institutions is adherence to inflation targeting.
- In Peru, inflation has spiked above the upper bound of the Banco Central de Reserva del Peru's (BCRP's) target range several times since 2010, with the October print at 3.7%.



II. Economic Strength

Our Assessment of Peru's Economic Strength: ***Moderate***

A. Growth

- Peru's growth is highly correlated to commodity prices.
- China slowdown has driven down commodity prices, ultimately leading to weaker growth in Peru.

B. Size and diversification of Peru's economy

- Typically, the size of a country's economy can be a proxy for diversification; this is not the case for Peru.
- Peru's economy is fairly sizeable, but remains undiversified and highly dependent upon commodities.
- Nearly 70% of the country's exports are primary goods.

C. GDP per capita

- Peru remains a poor country with GDP per capita in line with or below many emerging market sovereigns with lower ratings.

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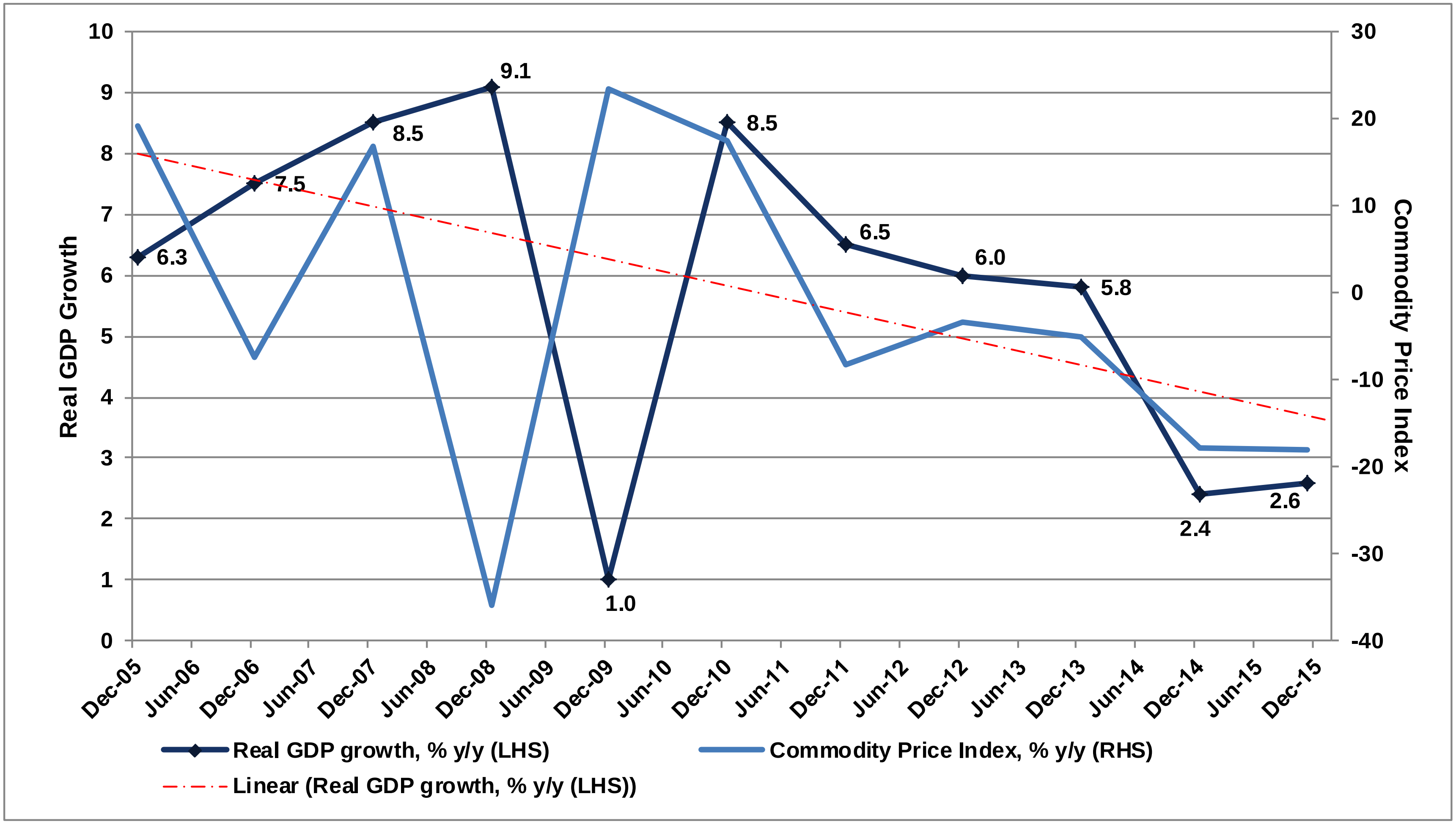
A. Growth: Highly Correlated with Commodity Prices

- Peru is a moderately sized, open economy whose growth is highly correlated with commodity prices.
- Correlation coefficient between growth and commodity prices since 2010 = 0.9.

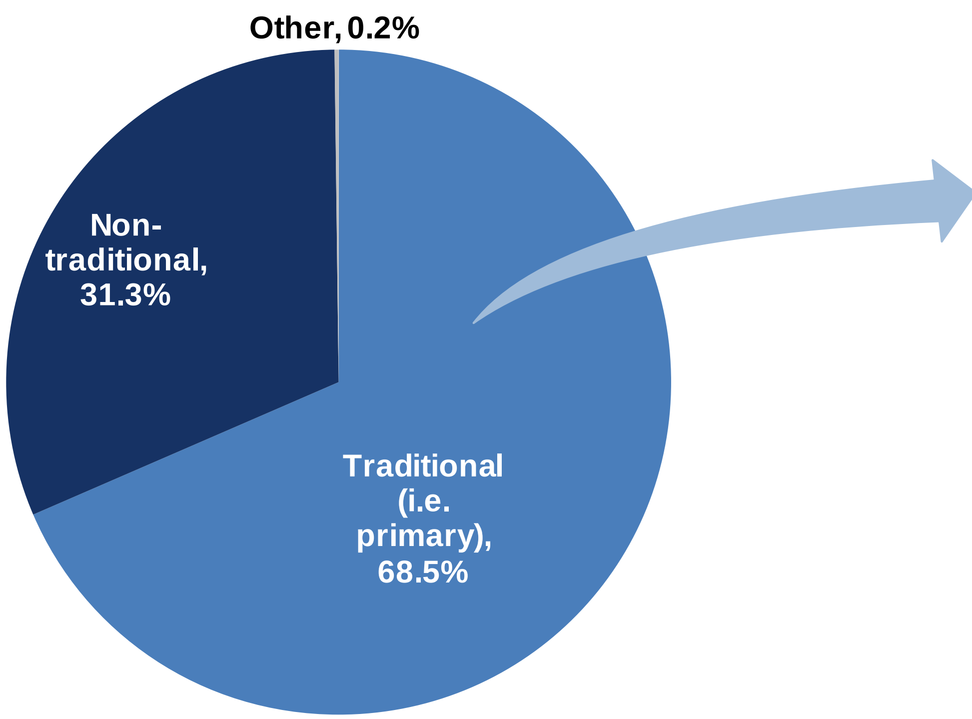


A. Growth: Challenges Ahead

- China slowdown has led to **lower commodity prices** and emerging market mini-crisis.
- Above target inflation in Peru and the Fed's impending rate hike will lead to **further rate hikes in Peru** as well.
- The BCRP intervenes in the exchange rate to stem the extent of depreciation, so **growth is unlikely to be supported by the exchange rate.**
- The government faces major **investment execution challenges** after elections. Regional/local elections took place in October 2014 and presidential elections are scheduled for April 2016, so fiscal stimulus via public investment will remain elusive.
- **El Niño** has the potential to reduce growth by up to 3 percentage points, depending on the severity of the event.
- The government has **lost reform momentum** because of a fragmented congress and pervasive social discontent.

B. Lack of Economic Diversification: High Concentration of Exports

- Although fairly sizeable, the Peruvian economy is not diversified. Primary goods account for 69% of total exports, of which mining products comprise the largest portion.

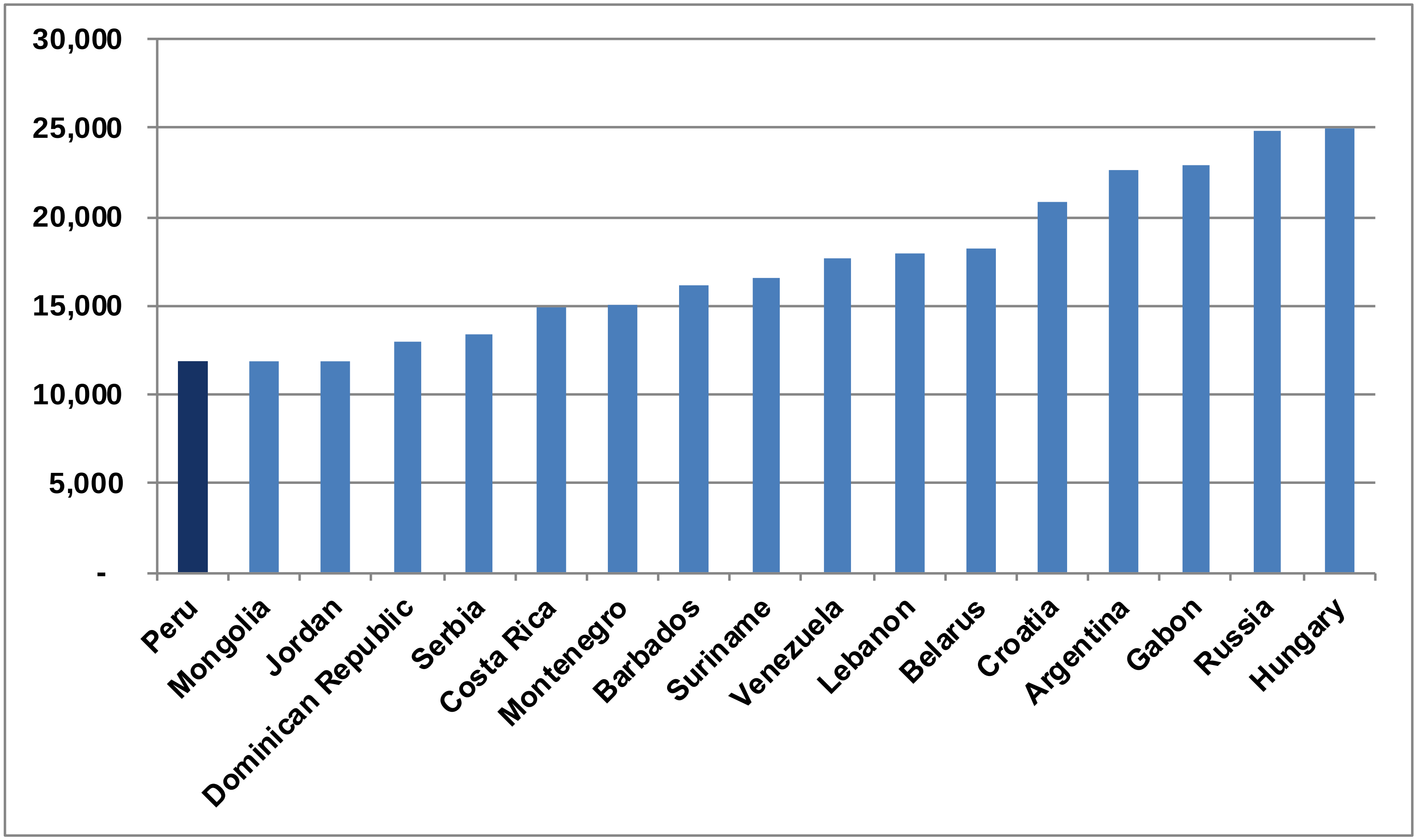


Traditional/Primary Goods Exports	
• Mineral	81%
• Petroleum and Natural Gas	10%
• Fishing	7%
• Agriculture	2%

C. GDP Per Capita Remains a Key Weakness for Peru

- Peru remains a poor economy, with GDP per capita (PPP terms) below many lower-rated emerging market sovereigns.

GDP per capita (Purchasing Power-Parity basis, US$)



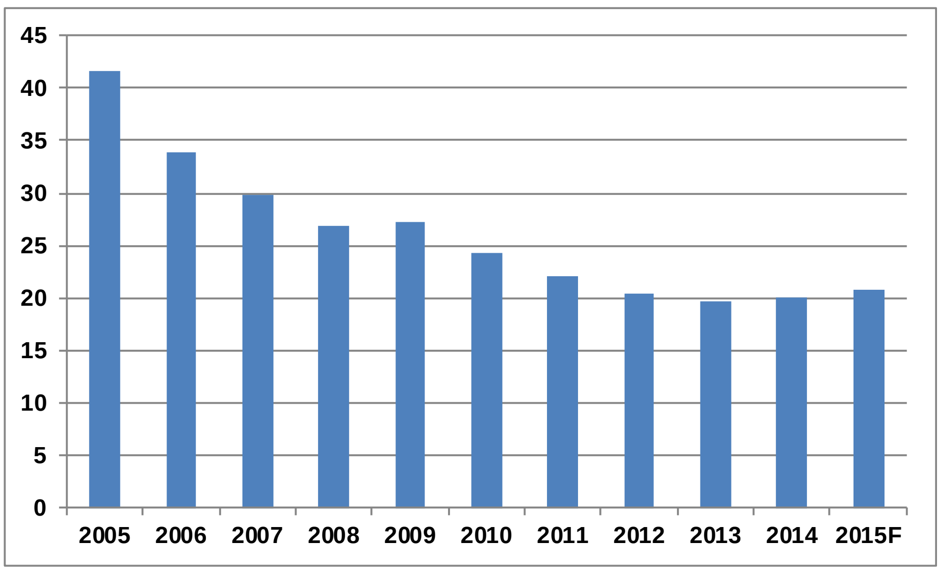
III. Fiscal Strength

Our Assessment of Peru's Fiscal Strength: ***Moderate***

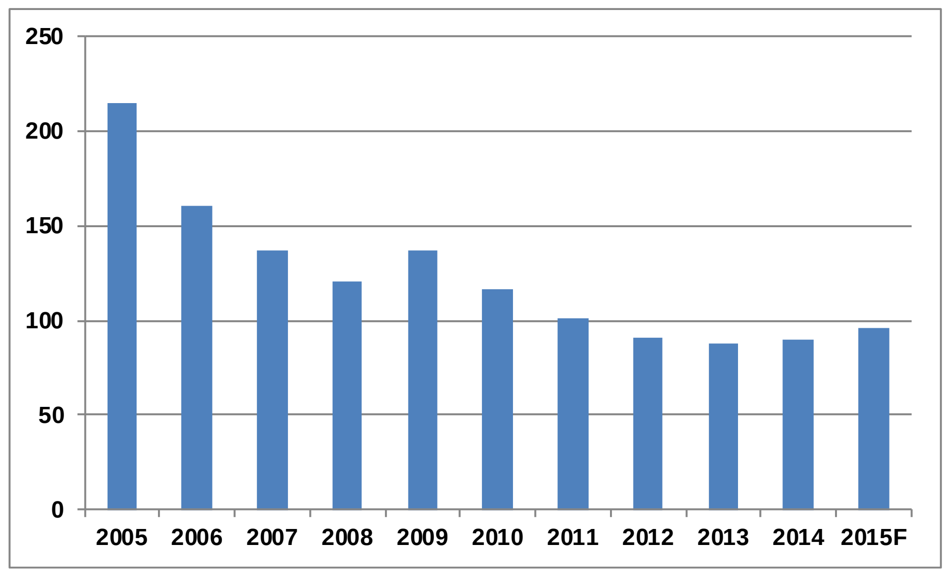
Government finances represent the country's greatest strength, but favorable debt ratios mask key vulnerabilities

- Peru's fiscal position has improved over the past decade, but debt ratios do not tell the whole story for any sovereign.
  - **A. Fiscal Balance** – linked to commodity prices. Fiscal balance and commodity prices have both deteriorated, and thus have led to a larger fiscal deficit.
  - **B. Debt Stock** – low but not the whole story. Peru's debt composition highlights key risks.
    - **Debt Composition Risks and Contingent Liabilities** – significant amount of domestic debt is held by non-residents, while dollarization in the banking sector poses a contingent liability for the government.
  - **C. Debt Affordability** – interest/revenue is low but not lower than many emerging markets sovereigns rated below Peru.

Debt/GDP (%)

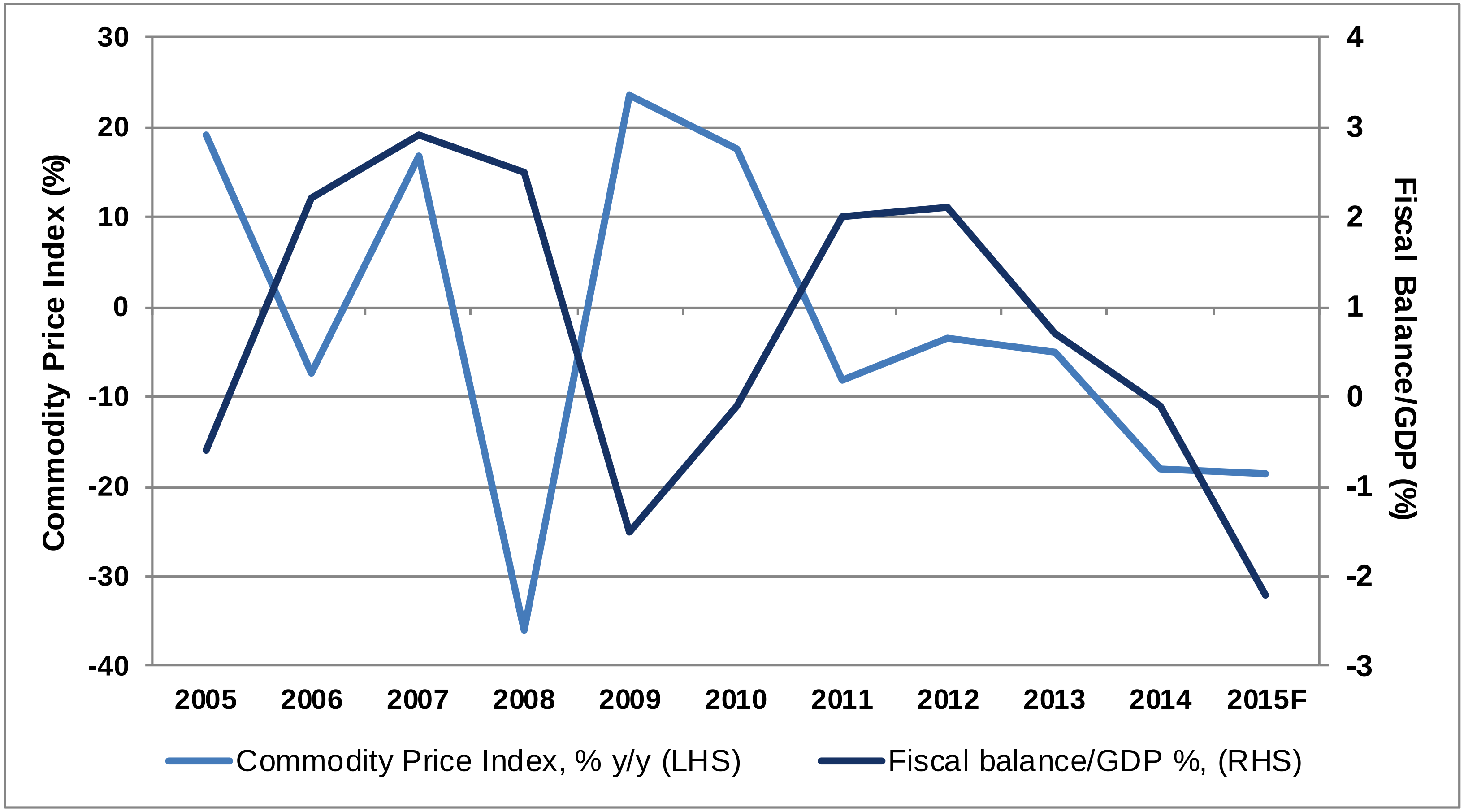


Debt/Revenue (%)



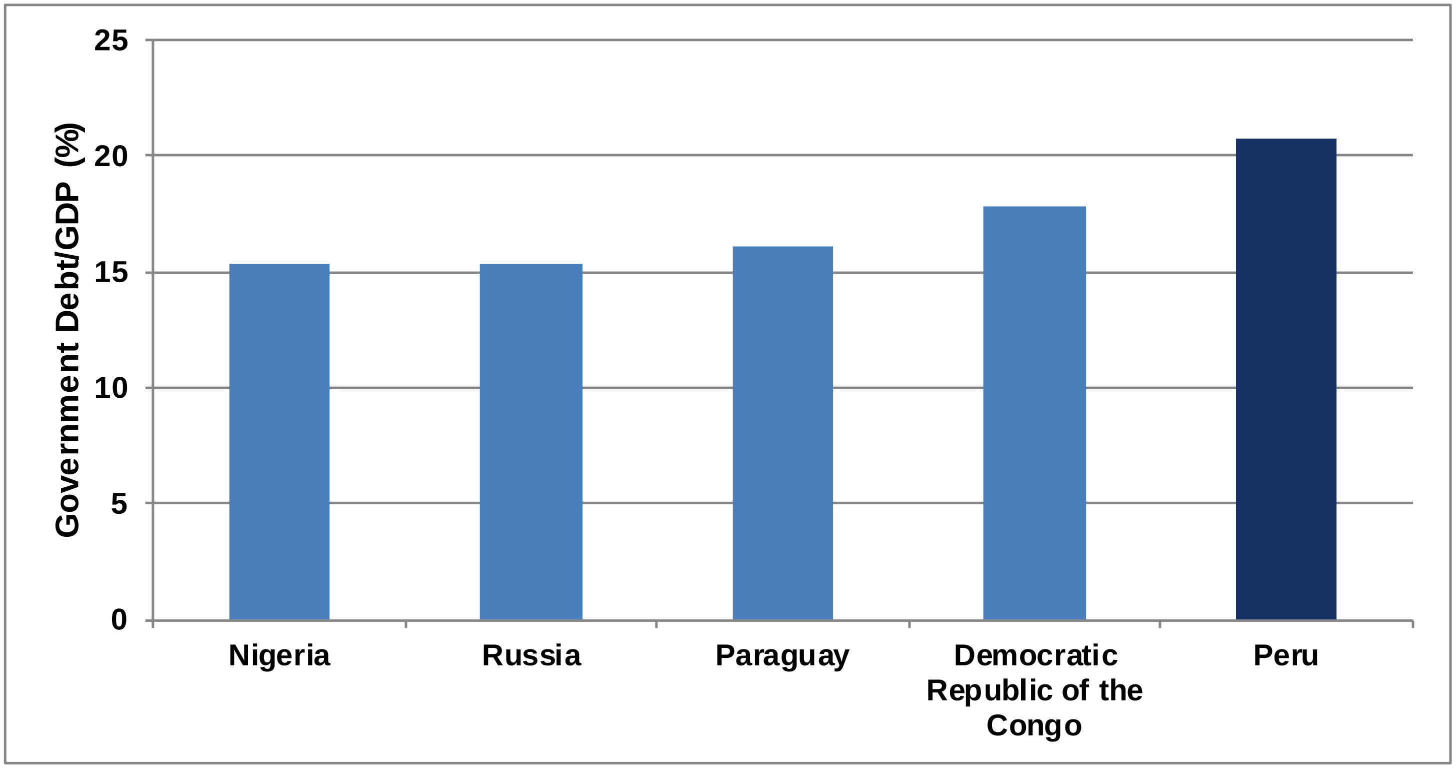
A. Fiscal Balance and Commodities

- Peru's fiscal deficit is moderate, but the overall fiscal balance fluctuates closely in line with commodity prices.



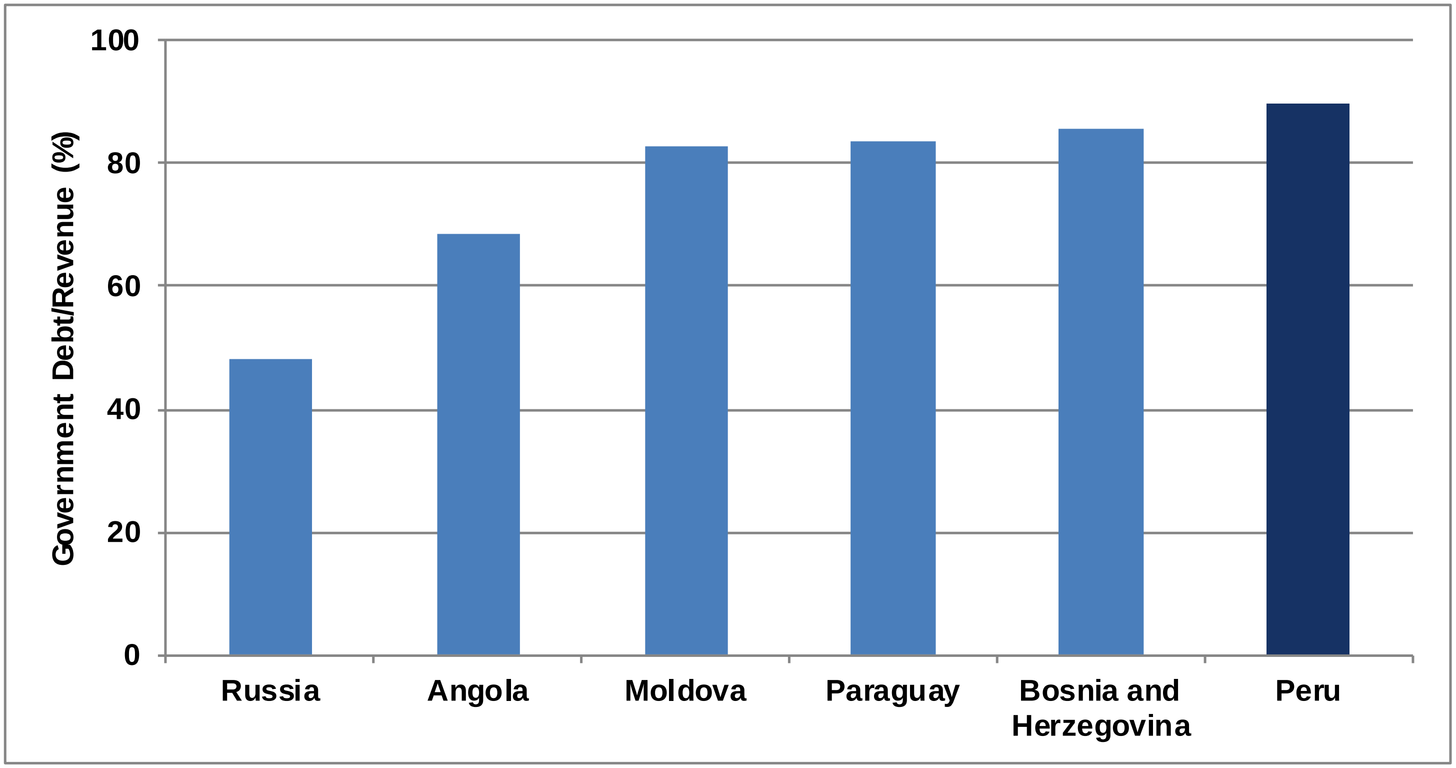
B. Low Debt Stock Does Not Tell the Whole Story

- Peru's debt/GDP ratio is very low; however, looking at this indicator alone fails to comprehensively analyze the sovereign. In fact, several lower rated emerging market sovereigns have lower debt/GDP ratios than Peru.



B. Low Debt Stock Does Not Tell the Whole Story (continued)

- Although Peru's debt/revenue ratio is low, there are several emerging market sovereigns rated below Peru that also have lower debt/revenue ratios.

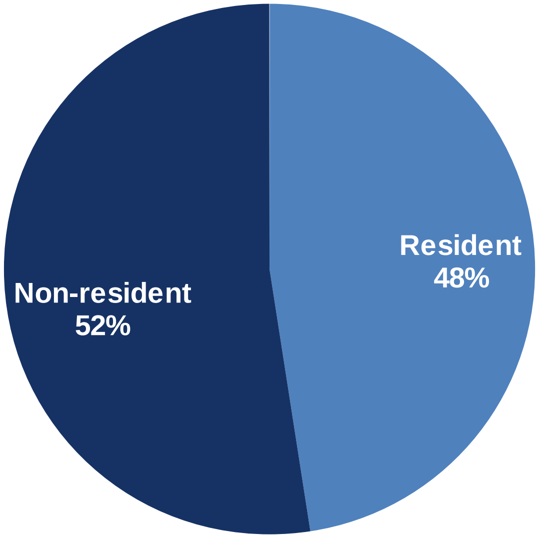


B. Debt Composition Risks and Contingent Liabilities

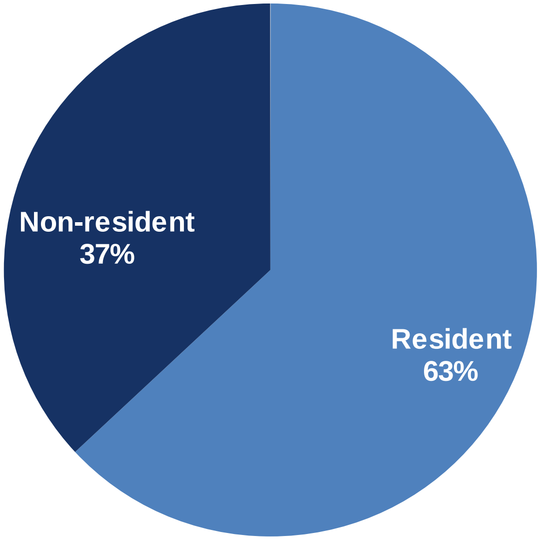
Although debt ratios are favorable, the composition of Peru's debt presents risks

- Half of the Peruvian government's debt is denominated in foreign currency, exposing the government to exchange rate risk.
- Over half of the total NFPS debt stock and nearly 40% of the domestic debt stock is held by non-residents.
  - Risk of reversal when the Fed hikes rates.
- High dollarization of the economy as a whole puts the banking sector at risk, representing a contingent liability for the government.

Total NFPS Debt by Holder

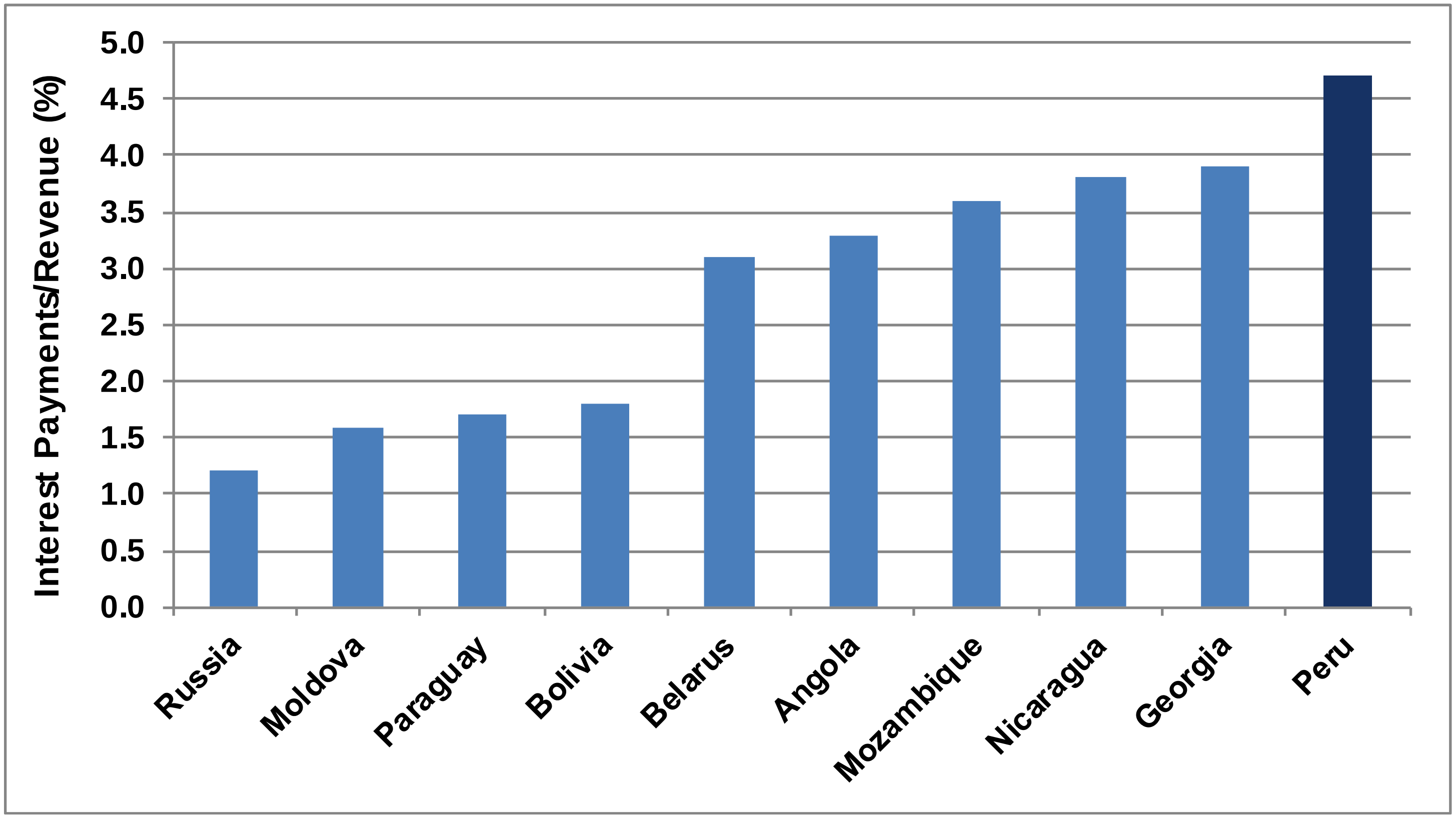


Domestic NFPS Debt by Holder



C. Interest Payments to Revenue

- Peru's debt affordability (as measured by interest payments/revenue) is strong but not markedly stronger than lower rated emerging market sovereigns.



IV. External Strength/ Event Risk

Our Assessment of Peru’s External Strengths and Vulnerability to Event Risk: *Moderate*

A. Current account deterioration

- Current account balance is closely linked to commodity prices.

B. Basic balance deterioration

- Current account deficit along with softening of foreign direct investment deteriorates the basic balance.

C. Net International reserves have declined

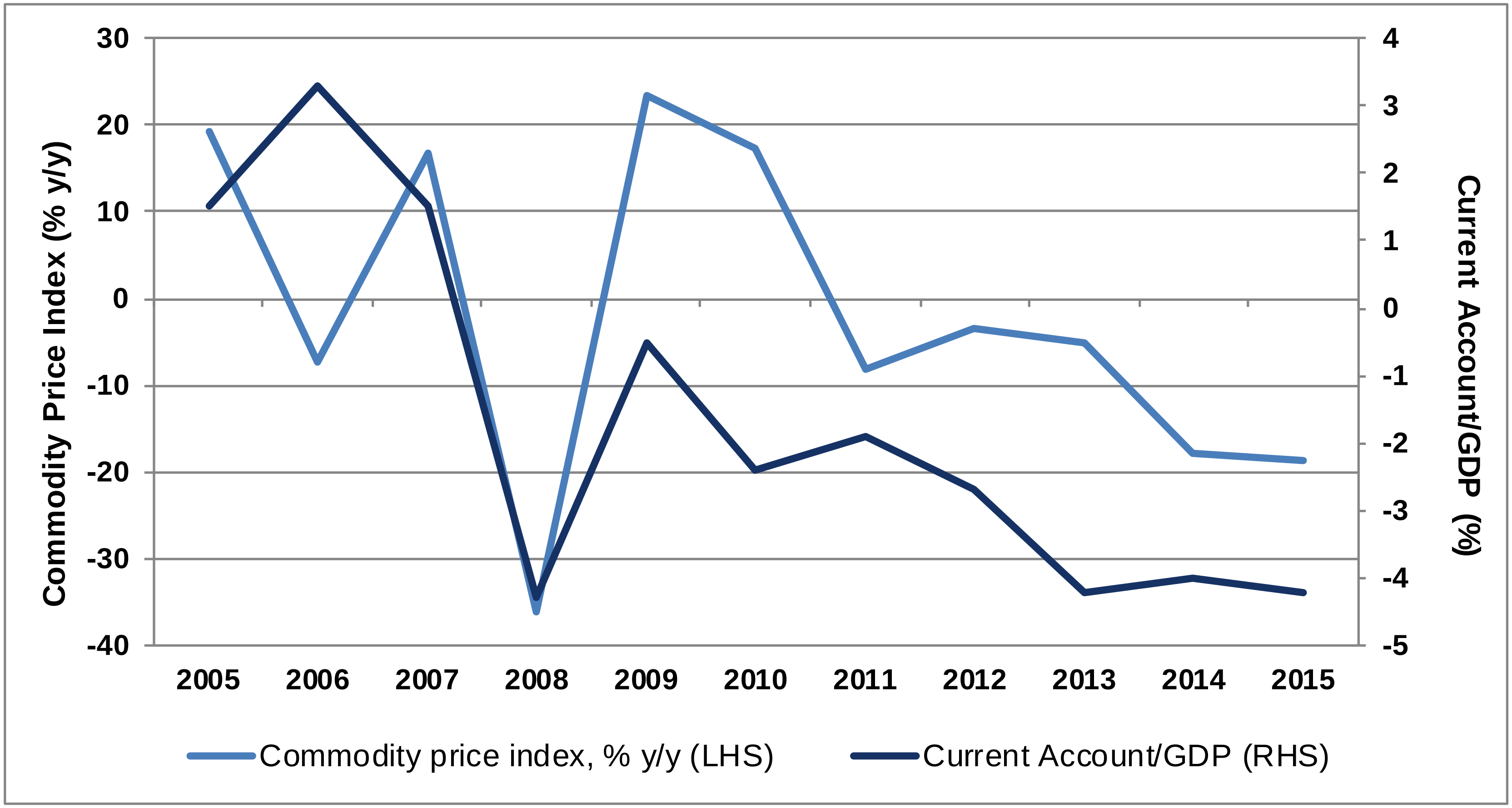
- External liquidity is steadily weakening, in line with balance of payments deterioration and BCRP’s exchange rate intervention.

D. Other event risks

- El Niño.
- Natural disasters/fault line.
- Commodity dependence.
- Political environment:
  - The current leading presidential candidates for the April 2016 elections are pro-market, which reduces political risk; however, the risk of an outsider candidate is always a possibility in Peru.
- Pervasive social conflict.
- Banking system dollarization.

A. Current Account and Commodity Prices

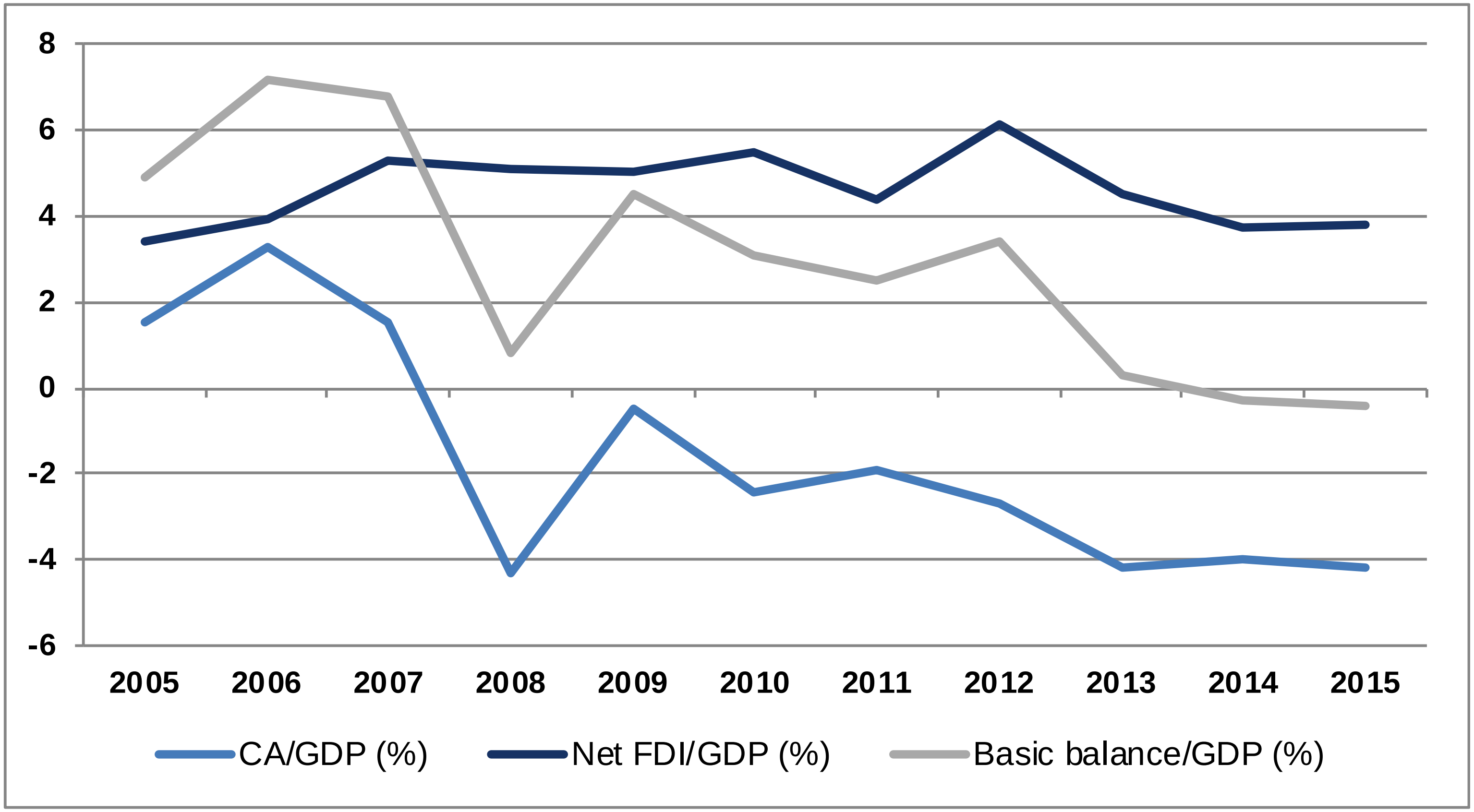
- As with growth and the fiscal balance, Peru's current account also moves in line with commodity prices.



B. Basic Balance (Current Account + Net Foreign Direct Investment)

Basic Balance Deterioration

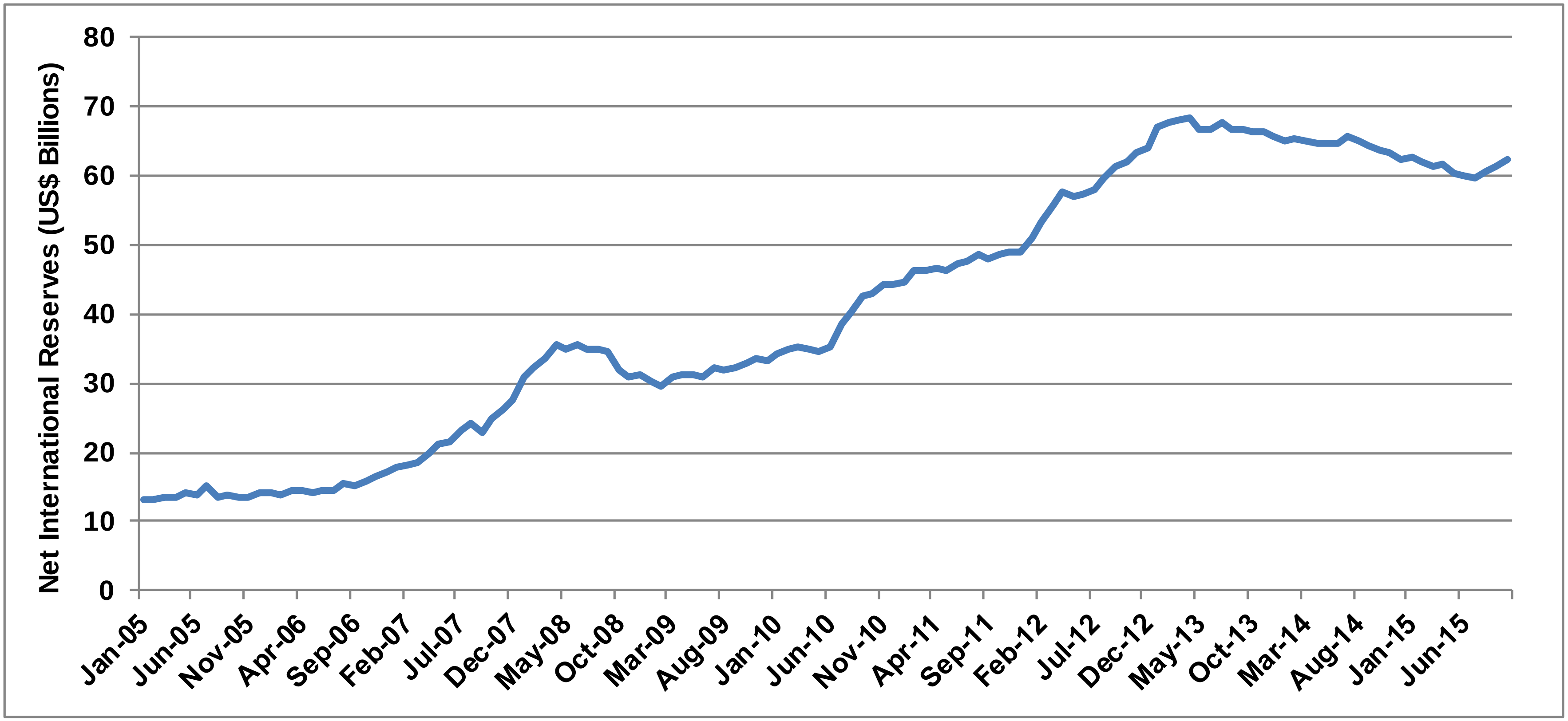
- While the current account has deteriorated, net foreign direct investment (FDI) has softened as well, leading to a deterioration in the overall basic balance (CA balance + net FDI).



C. Net International Reserves

Net international reserves have slowly deteriorated since 2013

- The decline in reserves is due to:
  1. BCRP's practice of intervening in the exchange rate, and
  2. The weakening balance of payments position.



C. Net Available International Reserves < Net International Reserves

Not all of Peru's net international reserves are available for monetary policy purposes

- Peru's net international reserves number masks the fact that a large portion of reserves are made up of commercial bank deposits (i.e., reserve requirements), the government's Fiscal Stabilization Fund, and other public sector deposits.
- The **most conservative** calculation of net available international reserves should subtract commercial bank deposits, the government's Fiscal Stabilization Fund, and other public sector deposits.

	USD bn
Net international reserves	**62.2**
o/w Banking system deposits	21.8
o/w Fiscal Stabilization Fund	9.2
o/w Other public sector deposits	4.8
Net available international reserves	**26.4**

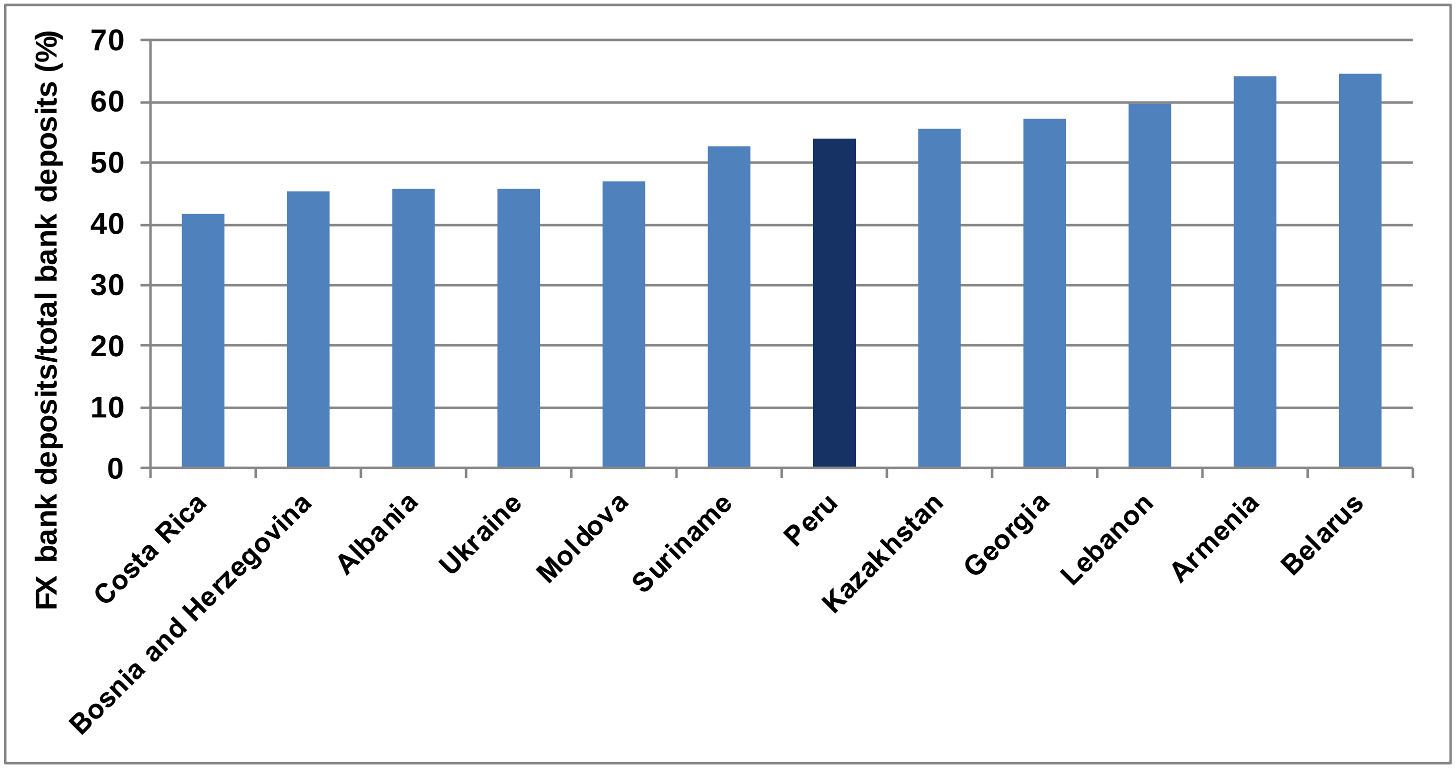
- A **less conservative** approach to net available international reserves should subtract only the government's Fiscal Stabilization Fund and other public sector deposits.

	USD bn
Net international reserves	**62.2**
o/w Fiscal Stabilization Fund	9.2
o/w Other public sector deposits	4.8
Net available international reserves	**48.2**

- In summary, the commonly cited net international reserves figure of $62 billion is an **inaccurate** portrayal of the central bank's firepower. Reserves available to the BCRP for the use of monetary policy amount to anywhere from **$26 to $48 billion**.

D. Banking System Dollarization is High Relative to Peers

- High levels of dollarization are indicative of an inherent lack of confidence in the local currency as a store of wealth, as indicated by the sovereigns with similar levels of dollarization.
- Peru has a highly dollarized banking system, leaving the system (especially mortgage and consumer credit) vulnerable to exchange rate depreciation; 68% of private sector credit is denominated in foreign currency.
- 54% of total banking system deposits are denominated in foreign currency.



Conclusion

Concluding Rationale

- Weak institutions
- Structural commodity dependence
- Vulnerability to event risk

Solid speculative grade credit, but inconsistent with Egan-Jones' criteria for an investment grade sovereign

Egan-Jones Rating (non-NRSRO)

- Foreign Currency Bonds: **BB**
- Local Currency Bonds ("Soberanos"): **BB-**
- Land Reform Bonds: **D**

NOTE: EGAN-JONES RATINGS OF ISSUERS OF ASSET-BACKED SECURITIES (ABS), AND GOVERNMENT, MUNICIPAL, AND FOREIGN GOVERNMENT SECURITIES, ARE NOT ISSUED OR MAINTAINED BY A REGISTERED NRSRO FOR THOSE SECURITIES.

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