

Exhibit RWS-021

Second Expert Opinion of Mr. Robert L. Clarke,  
September 24, 2012

UNDER THE RULES OF THE INTERNATIONAL CENTRE  
FOR SETTLEMENT OF INVESTMENT DISPUTES

*Renée Rose Levy de Levi,*  
Claimant

v.

*The Republic of Perú,*  
Respondent

ICSID Case No. ARB/10/17

**Second Expert Opinion of Mr. Robert L. Clarke  
Former United States Comptroller of the Currency**

1. My name is Robert L. Clarke, and I am currently a senior partner with Bracewell & Giuliani LLP, and was formerly the United States Comptroller of the Currency. As Comptroller, I supervised close to 5,000 nationally chartered commercial banks during a period of financial upheaval in the United States due to the savings and loan crisis in the 1980s. This opinion supplements my first opinion dated January 25, 2012.

2. In my first opinion, I concluded that the actions taken by Peruvian banking regulators – *i.e.*, the Superintendencia de Banca y Seguros (“SBS”) and Banco Central de Reserva del Perú (“BCR”) – in supervising and ultimately intervening (or closing) Banco Nuevo Mundo (“BNM”) were reasonable, fair, and in accordance with international best practices. In this opinion, I respond to statements in Claimant’s Reply on the Merits of May 29, 2012 that further evidence Claimant’s basic misunderstanding of the powers and duties of bank regulators. In particular, this opinion rebuts: (i) Claimant’s reliance on recent actions taken by U.S. and EU regulators during the global financial crisis as a relevant precedent for Peruvian banking

regulation a decade earlier; (ii) Claimant's contention that BNM posed a systemic risk; and (iii) Claimant's criticism of particular decisions made by Peruvian regulators.

## **I. The Global Financial Crisis Did Not Retroactively Redefine the Best Practices for Banking Regulation**

3. Claimant and her expert, Mr. Nicolás Dujovne, claim that Peru's regulators failed to employ the "best practices" used by U.S. and EU regulators to help banks during the global financial crisis.<sup>1</sup> Claimant reasons that Peru's regulators should have allowed BNM to recapitalize using illiquid assets and provided BNM with the liquidity that it needed in December 2000, just as the U.S. government allegedly purchased toxic assets from U.S. banks and extended emergency loans from the central bank in order to inject liquidity into the banking system.<sup>2</sup> Claimant's reliance on the actions of the United States and EU during the global financial crisis that began in 2008 is misplaced for many reasons.

4. First, the exceptional actions taken by banking regulators during the recent global financial crisis cannot be considered to be "international best practices." The recent global financial crisis is widely considered to be one of the worst financial crises in history. The actions taken by U.S. and EU regulators were designed not just to stabilize national banking systems, but also to prevent a global financial meltdown. Even Mr. Dujovne recognizes that the actions taken by U.S. and EU regulators during the recent global financial crisis were "unprecedented."<sup>3</sup> These programs are still hotly debated, both in terms of their efficacy and their appropriateness. Therefore, it does not make sense for Claimant and Mr. Dujovne to claim that the extraordinary

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<sup>1</sup> See Claimant's Reply on the Merits, May 29, 2012 ("Claimant's Reply on the Merits"), paras. 272-74; Expert Opinion of Mr. Nicolás Dujovne, May 15, 2012 ("Dujovne Expert Opinion"), paras. 32, 68-83.

<sup>2</sup> See Claimant's Reply on the Merits at paras. 272-74; Dujovne Expert Opinion at paras. 53-54.

<sup>3</sup> See, e.g., Dujovne Expert Opinion at paras. 82-83.

actions taken during the recent global financial crisis were “international best practices” that Peru’s regulators should have considered when facing Peru’s financial crisis.

5. Furthermore, the recent global financial crisis cited by Claimant occurred a decade after Peru’s financial crisis. The scale and scope of the programs that were used to try to stabilize global financial markets were unimaginable in previous crises. If the dramatic steps taken by the United States and the European Union to prevent a global financial meltdown were previously unheard of, it is hard to understand how they could have been considered “best practices” ten years earlier during Peru’s financial crisis. In fact, it is hard to understand how they can be characterized as “best practices” at all. These were exceptional measures that required passing new laws and expanding the powers of the regulators. Furthermore, in times of crises, the responses of government have to be tailored to the circumstances according to their best judgment. There is simply no formula or playbook for these types of situations and thus no “best practices.” Therefore, the actions of Peru’s regulators cannot be judged against innovations in banking regulation that may occur at some point in the future. We have no idea what steps governments and banking regulators will take to confront the next unprecedented financial crisis, and it would be illogical to require that Peru’s regulators to make such a prediction. Thus, Peru’s regulators should not be judged against the exceptional actions taken during the recent global financial crisis.

6. Even in a financial crisis, however, the fundamentals of banking supervision and regulation still apply: bank regulators still require banks to meet appropriate capital thresholds and to have sufficient liquidity on hand to cover their anticipated obligations. The evidence of this can be seen in the regulatory reforms that followed the recent global financial crisis. In the aftermath of the crisis, governments around the world increased banks’ capital and liquidity

requirements and took steps to address the problem of “too big to fail” in order to prevent the need to bail out systemically risky banks in future crises.

7. Claimant and her expert also misstate the actions that U.S. regulators actually took during the global financial crisis.<sup>4</sup> According to Claimant, Peru’s banking regulators should not have required BNM to recapitalize with liquid assets because, during the global financial crisis, “the United States bought toxic assets from troubled banks, rather than requiring a supply of liquid capital [to cover] losses suffered by the impairment of their assets.”<sup>5</sup> Mr. Dujovne also suggests that the Troubled Asset Relief Program (“TARP”) used US \$700 billion to purchase “toxic” assets.<sup>6</sup> This description of TARP is incorrect for a number of reasons.

8. First, the majority of TARP funds were actually used to purchase preferred stock in U.S. banks, rather than to purchase toxic assets.<sup>7</sup> In fact, no assets that could be accurately described as “toxic” were purchased in any of the U.S. government’s assistance programs related to the financial crisis. After the collapse of Lehman Brothers in September 2008, as credit markets around the globe froze, U.S. Treasury Secretary Henry Paulson *proposed* a plan to Congress, which he called “the Troubled Asset Relief Program.” Under Secretary Paulson’s original proposal, the U.S. government would have purchased so-called “toxic” mortgage-backed securities. The plan in its original form was criticized by many economists and rejected by the U.S. Congress. Because of the risk of moral hazard that it would have created and the potential losses to U.S. taxpayers, Congress insisted on adding provisions for more government oversight, limits on executive pay for participating companies, and an ownership stake for the government

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<sup>4</sup> Although I focus here on measures taken in the United States during the global financial crisis, it is my understanding that EU banking regulators took similar steps during the same time period.

<sup>5</sup> Claimant’s Reply on the Merits at para. 274.

<sup>6</sup> See Dujovne Expert Opinion at paras. 69-71.

<sup>7</sup> See United States Department of the Treasury, Office of Financial Stability, *Troubled Asset Relief Program: Two Year Retrospective*, October 2010 (“U.S. Treasury, *TARP Report*”), pp. 22-43 [Exhibit R-288].

in the banks in return for its investments. While the plan that was ultimately passed by the U.S. Congress provided broad authority to the U.S. Treasury to purchase financial instruments, U.S. Treasury Secretary Paulson used the TARP funds to purchase shares of preferred stock, instead of purchasing toxic assets, because of the logistical and financial difficulties of making such asset purchases.<sup>8</sup>

9. Therefore, contrary to what Claimant and her expert indicate, U.S. regulators did not spend the US \$700 billion in TARP funds to purchase toxic assets. This distinction is important because the U.S. Treasury did not simply give banks money in exchange for poorly-performing assets, as Mr. Dujovne suggests.<sup>9</sup> Rather, by purchasing shares of convertible preferred stock in banks, the U.S. Treasury conditioned the capital it was providing on *the significant dilution of the ownership interest of the shareholders* and the ability of the government to own a stake in the banks that would ultimately be sold. Thus, the government's assistance was not used to bail out banks' shareholders. In fact, the purpose of the TARP program was not to keep U.S. banks from failing: the U.S. government did not provide assistance to weak banks. As a result, several hundred banks have failed in the United States since 2008. Instead, the TARP program made investments in banks that the regulators judged to be relatively strong so that those banks would continue to lend and the economy would not grind to a halt.

10. Second, under the two other programs that Mr. Dujovne discusses, the Term Asset-Backed Securities Loan Facilities ("TALF") and the Legacy Securities Public Private Investment Program ("PPIP"), the U.S. government also did not purchase toxic assets. Under TALF, the Federal Reserve Bank of New York ("FRBNY") agreed to extend loans to borrowers to enable the purchase of AAA-rated asset-backed securities, which then served as the collateral

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<sup>8</sup> See U.S. Treasury, *TARP Report* at p. 22 [Exhibit R-288].

<sup>9</sup> See Dujovne Expert Opinion at paras. 72-75.

for those loans.<sup>10</sup> Thus, the purpose of TALF was not to remove toxic assets from banks' balance sheets, but instead to encourage private sector transactions that had come to a standstill during the financial crisis. In addition to requiring the highest-rated securities as collateral, TALF also limited risk by imposing premium interest rates and requiring that the borrowers absorb the first losses on the securities pledged as collateral.

11. Under PPIP, the U.S. Treasury provided approximately US \$22 billion in equity and debt financing to match fundraising by specially-created private investment funds, which then purchased mortgage-backed securities.<sup>11</sup> Therefore, PPIP was only a fraction of the total TARP funds. Furthermore, the private investment funds retained control over asset purchases so that they could pursue a viable investment strategy by investing in assets that had fundamental value. As they experienced gains, the investment funds distributed the profits to their investors, which included the U.S. government. Thus, under PPIP (as with the TARP and TALF programs), the U.S. government did not purchase toxic assets. Instead, PPIP was a public-private solution to attract private sector investment in assets whose market value had been adversely affected by the freeze in the credit markets during the financial crisis.

12. Using TARP as an example, Mr. Dujovne argues that Peruvian regulators had the funds and the authority to implement a similar program in order to rescue BNM.<sup>12</sup> But, Mr. Dujovne is mistaken about how TARP was implemented. TARP was part of landmark legislation that was voted on and approved by the taxpayers' representatives in Congress. The TARP program could never have been unilaterally implemented by U.S. bank regulators, who did not have the funds or the authority to commit the U.S. taxpayers to a US \$700 billion bailout

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<sup>10</sup> See U.S. Treasury, *TARP Report* at pp. 34-35 [Exhibit R-288].

<sup>11</sup> See U.S. Treasury, *TARP Report* at pp. 37-38 [Exhibit R-288].

<sup>12</sup> See Dujovne Expert Opinion at paras. 73-75 (citing Expert Opinion of Mr. Donald Powell, January 23, 2012, para. 32).

of the banks. It is therefore entirely inaccurate for Claimant and Mr. Dujovne to claim that, based on what happened in the United States, Peru's regulators should have unilaterally implemented programs along the lines of TARP. This was simply not what was done in the United States.

13. While Claimant and Mr. Dujovne characterize the actions of U.S. regulators as international best practices that Peru's regulators should have followed, they fail to mention the fact that the U.S. government did not provide assistance to every systemically important financial institution. The most notable example is that of Lehman Brothers, in which the U.S. government did not invest and which, as mentioned above, failed in September 2008. Other major financial institutions that the U.S. government did not bail out and that failed or were absorbed by other banks during the global financial crisis include: Washington Mutual, which was intervened by U.S. federal regulators and sold to JP Morgan; Wachovia, which was bought by Wells Fargo while the Federal Deposit Insurance Corporation ("FDIC") was arranging for it to be sold to Citigroup; and Merrill Lynch, which was bought by Bank of America while in distress. Therefore, while the U.S. government took unprecedented actions during the crisis, it did not rescue all financial institutions. Instead, the U.S. regulators used their discretion to decide how to best protect depositors and the stability of the financial system.

## **II. BNM Did Not Pose a Systemic Risk**

14. Claimant and Mr. Dujovne allege that BNM's intervention posed a systemic risk to Peru's financial system and, therefore, Peru's regulators were obligated to take action to prevent BNM's intervention.<sup>13</sup> In support of their characterization of BNM as a systemically important bank, they assert that BNM was the sixth largest bank in Peru and, therefore, was

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<sup>13</sup> See Claimant's Reply on the Merits at para. 468; Dujovne Expert Opinion at para. 13.



equivalent to U.S. Bancorp and Citibank in the United States.<sup>14</sup> According to Claimant and Mr. Dujovne, Peru's regulators should therefore have taken action akin to the unprecedented TARP program to bail out BNM. I do not agree that BNM posed a systemic risk in Peru.

15. It is inappropriate to compare the degree of systemic risk posed by the largest banks in the United States during the global financial crisis to the systemic risk allegedly posed by BNM to the Peruvian banking system (much less the global system). The principal motivation for the TARP program was to provide capital to U.S. financial institutions that were large by global standards and that were viewed as systemically important not only to the U.S. economy, but also to international financial markets. If the U.S. government had not acted to stabilize these institutions, the impact would have been devastating to the global financial system and economies around the world. In contrast, BNM's intervention did not pose a systemic risk either to Peru or to the global financial system. Even compared to the size and significance of some of the U.S. banks that *failed* during the global financial crisis – for example, Washington Mutual, Wachovia, and Merrill Lynch – BNM simply cannot be considered systemically important. This was proven when BNM's ultimate failure did not cause disruptions in the Peruvian financial system.

16. Even though BNM was the sixth largest bank in Peru at the time, it held a low percentage of Peruvian deposits – only 2.26% at the end of 1999, according to Claimant's other experts, Messrs. Walter Leyva and José Zapata.<sup>15</sup> Additionally, BNM accounted for only 4.11% of all loans in Peru.<sup>16</sup> Also, there were not many large banks in Peru at the time and thus there was a big difference between the five largest banks in Peru and the sixth largest bank (*i.e.*,

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<sup>14</sup> See Claimant's Reply on the Merits at para. 468; Dujovne Expert Opinion at para. 13.

<sup>15</sup> See Expert Report of Mr. Walter Leyva and Mr. Jose Zapata, May 10, 2012 ("Leyva-Zapata Expert Report"), para 51.

<sup>16</sup> See Leyva-Zapata Expert Report at para. 49.

BNM). For example, according to Messrs. Leyva and Zapata, the four largest banks in Peru at the time collectively held 70% of all deposits and 60.35% of all loans.<sup>17</sup> The fifth largest bank, Interbank, held 6.8% of all deposits and 7.97% of all loans at the end of 1999.<sup>18</sup> By these metrics, BNM was a distant sixth in Peru's banking system.

17. Claimant alleges that BNM should be considered the "equivalent" of Citibank.<sup>19</sup> Such a comparison is completely unfounded. For example, as of March 2012, Citibank held US \$1.3 trillion in assets and was one of the largest banks in the world.<sup>20</sup> In comparison, before BNM's intervention, BNM held S/. 2.178 billion or US \$618 million in assets.<sup>21</sup> In addition to a significant difference in asset size, large U.S. banks such as Citibank hold vast customer deposits, conduct billions of dollars of international business every day, and owe billions of dollars to other major financial institutions around the world. Such banks have been called "too big to fail" because their collapse could threaten the financial health of other major financial institutions around the world, thereby imperiling the entire global economy. In contrast, it is my understanding that other Peruvian banks were not overly exposed to BNM.

### **III. The Decisions of Peruvian Regulators Regarding BNM Were Consistent with the Practices Followed by Other International Bank Regulators**

18. Claimant blames BNM's failure on external factors, *i.e.*, the impact of Peru's financial crisis and economic downturn, as well as on the failure of multiple agencies of the

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<sup>17</sup> See Leyva-Zapata Expert Report at paras. 49, 51.

<sup>18</sup> See Leyva-Zapata Expert Report at paras. 49, 51.

<sup>19</sup> Claimant's Reply on the Merits at para. 252.

<sup>20</sup> See Federal Reserve Statistics, March 2012, *available at* <http://www.federalreserve.gov/releases/lbr/current/default.htm>, March 31, 2012 [Exhibit R-293].

<sup>21</sup> See SBS's Inspection Visit Report for BNM, Informe de Visita de Inspección No. DESF "A"-168-VI/2000, November 22, 2000 ("SBS's 2000 Inspection Visit Report"), p. 21 [Exhibit R-065]. The US dollar amount was calculated using the official exchange rate of 1 US dollar to 3.53 Peruvian Nuevo Soles, as provided to me by SBS. See Exchange Rates as Published by SBS [Exhibit R-095].

Peruvian government to prevent BNM's intervention. For example, Mr. Dujovne asserts that Peru's regulators violated international best practices by failing to provide sufficient help to BNM, denying BNM permission to increase its capital using land, and denying the bank a US \$12 million emergency loan from the Central Bank.<sup>22</sup> Claimant's blame is misplaced.

19. First, Claimant overstates the role that the crisis played in BNM's failure. During a financial and/or economic crisis, external factors affect all banks. The banks that survive are those with a plan in place for dealing with such situations and the management and financial capacity to execute the plan. In BNM's case, the bank failed as a result of managerial incompetence: BNM's management mishandled the bank's assets, its exposure to risk, and its liquidity. As I understand, there is also compelling evidence that BNM's management and directors engaged in self-dealing.

20. Second, Peruvian regulators warned BNM of the risks it faced and provided valuable forbearance measures. In fact, if Peru's regulators could be faulted for anything, it would be that they were too lenient with BNM. The onus to recapitalize the bank was on BNM's owners, but they failed to take this important step. As discussed below, in light of BNM's repeated failures to heed the warnings of Peru's regulators, it was entirely prudent and in line with the practices followed by other international bank regulators to deny BNM's request to recapitalize using illiquid assets and also to deny its request for a bailout loan of US \$10 million from the Central Bank.<sup>23</sup>

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<sup>22</sup> See Dujovne Expert Opinion at paras. 53-54, 61.

<sup>23</sup> I note that while Mr. Dujovne states that BNM requested US \$12 million from the BCR, Respondent has stated that BNM requested US \$10 million. This difference, however, is not relevant for the purposes of this opinion. See Dujovne Expert Opinion at para. 56.

A. BNM's Management and Directors Engaged in Mismanagement and Misconduct

21. In my first expert opinion, I concluded based on my review of the facts that BNM's failure was primarily attributable to mismanagement. It was clear that BNM had inadequate capital, low liquidity, low-quality assets, and high sensitivity to market risk due to a lack of deposit diversification. As I stated in my first opinion, "[T]hese were all problems that might have been remedied had the management reacted swiftly and effectively to regulators' warnings; they did not, however, and thus these problems ultimately combined to cause the bank's collapse."<sup>24</sup> I also understood that there was evidence that BNM's managers, directors, and shareholders engaged in misconduct.

22. I have now reviewed additional evidence in this case, and it strongly indicates that BNM's managers, directors, and shareholders (together, BNM's principals) were engaged in misconduct, including intentionally hiding the bank's deteriorating financial health and self-dealing. I have reviewed a series of reports written by Mr. Carlos Quiroz between April 2002 and July 2002, which were the product of an investigation that SBS conducted following BNM's intervention. As I understand it, the investigation followed up on various suspicious findings that SBS discovered during BNM's August to October 2000 inspection visit. In my opinion, the reports present compelling evidence that BNM's managers and directors were using highly-irregular accounting practices to make BNM appear to be in better financial condition than it actually was and were using the bank's resources to benefit other companies that they owned. As a result of this misconduct, they undermined the long-term viability of BNM.

23. In the SBS Report on Lifting of Liens on Land Owned by Gremco, Informe SBS No. 01-2002-DESF "A", dated April 16, 2002, Mr. Quiroz reports two significant findings: (1)

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<sup>24</sup> Expert Opinion of Mr. Robert L. Clarke, January 25, 2012 ("Clarke First Expert Opinion"), para. 23 [Exhibit RWS-010].

BNM accepted collateral from a related company called Gremco that was grossly overvalued;<sup>25</sup> and (2) in the midst of BNM's liquidity crisis – just before the bank was intervened – BNM's shareholders voted to release the bank's liens on Gremco's collateral.<sup>26</sup> The collateral that Mr. Quiroz believed to be overvalued included various plots of undeveloped land, which had been purchased for a total of US \$6 million.<sup>27</sup> These plots of land were valued by BNM at a surprising US \$72.3 million.<sup>28</sup> Based on suspicions that the land had been overvalued, SBS hired an appraiser to conduct a new valuation. The second appraiser determined that the land was worth only US \$12.2 million.<sup>29</sup> Mr. Quiroz concluded that there were clear indications that the overvaluation was done with the intention of enabling BNM to provide more financing to Gremco than was warranted based on the true value of Gremco's assets.<sup>30</sup>

24. With respect to the liens on Gremco's collateral, Mr. Quiroz documented a series of actions taken by BNM's shareholders to approve the lifting of these liens beginning in September 2000 and continuing up to December 1, 2000 – just four days before BNM's intervention.<sup>31</sup> He concluded in the report that, by attempting to shield Gremco's assets when BNM's shareholders suspected that BNM was about to fail, they acted intentionally to benefit a related company to the detriment of BNM, its depositors, and its creditors.<sup>32</sup>

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<sup>25</sup> See SBS Report on Lifting of Liens on Land Owned by Gremco, Informe SBS No. 01-2002-DESF "A", April 16, 2002, pp.1-2 ("SBS Report on Lifting Liens on Land Owned by Gremco") [Exhibit R-191].

<sup>26</sup> See SBS Report on Lifting Liens on Land Owned by Gremco at pp. 2-4 [Exhibit R-191].

<sup>27</sup> See SBS Report on Lifting Liens on Land Owned by Gremco at p. 2 [Exhibit R-191].

<sup>28</sup> See SBS Report on Lifting Liens on Land Owned by Gremco at pp. 1-2 [Exhibit R-191].

<sup>29</sup> See SBS Report on Lifting Liens on Land Owned by Gremco at p. 2 [Exhibit R-191].

<sup>30</sup> See SBS Report on Lifting Liens on Land Owned by Gremco at p. 6 [Exhibit R-191].

<sup>31</sup> See SBS Report on Lifting Liens on Land Owned by Gremco at pp. 2-4 [Exhibit R-191].

<sup>32</sup> See SBS Report on Lifting Liens on Land Owned by Gremco at p. 5 [Exhibit R-191].

25. In the SBS Report on Participation Shares in Fondo de Inversión Multirenta Inmobiliaria, Informe SBS No. 02-2002-VE/DESF “A”, dated May 9, 2002, Mr. Quiroz followed up on a finding from BNM’s 2000 inspection visit that BNM’s customers were purchasing shares in an investment fund owned by BNM’s shareholders (the “Fund”) and using those shares as collateral to secure their loans or leases with the bank.<sup>33</sup> Mr. Quiroz determined that the Fund’s capital had been primarily used to purchase real estate and other assets from Gremco and that BNM was one of the founding investors in the Fund.<sup>34</sup> Mr. Quiroz also determined that BNM was lending money to its customers to use for the purchase of BNM’s shares in the Fund.<sup>35</sup> The purchases were often subject to a repurchase agreement, in which BNM committed to repurchase the shares from the customers for a fixed interest rate after a certain amount of time.<sup>36</sup> This was a complicated scheme that made little economic sense and appears to be for the purpose of disguising the amount of money the bank was lending for the benefit of BNM’s shareholders. That is, it is not clear what, if any, purpose these transactions served other than to put BNM’s Fund shares in the name of BNM’s customers. As a result, it appeared that BNM owned fewer shares in the Fund. Indeed, Mr. Quiroz concluded that this scheme was part of a mechanism to provide indirect financing to Gremco and the Fund above the limits that Peru’s banking law places on the amount of direct and indirect financing that a bank may provide to a related company.<sup>37</sup>

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<sup>33</sup> See SBS Report on Participation Shares in Fondo de Inversión Multirenta Inmobiliaria, Informe SBS No. 02-2002-VE/DESF “A”, May 9, 2002 (“SBS Report on Participation Shares in the Fund”) [Exhibit R-192].

<sup>34</sup> See SBS Report on Participation Shares in the Fund at pp. 1, 3-4 [Exhibit R-192].

<sup>35</sup> See SBS Report on Participation Shares in the Fund at pp. 2, 4-5 [Exhibit R-192].

<sup>36</sup> See SBS Report on Participation Shares in the Fund at p. 2, 4 [Exhibit R-192].

<sup>37</sup> See SBS Report on Participation Shares in the Fund at p. 6 [Exhibit R-192].

26. In the SBS Report on Relevant Observations from the Inspection Visit Report, Informe SBS No. 03-2002-VE/DESF “A”, dated June 28, 2002, Mr. Quiroz conducted further investigations into the accounting irregularities that were discovered during BNM’s August to October 2000 inspection visit. The irregular accounting practices observed during the inspection visit served to understate the risk of BNM’s loan portfolio and hide BNM’s financial deterioration. For example, SBS found that BNM had systematically understated the risk of its loans. This discovery had a significant impact on BNM’s financial health. This is because, in order to ensure that a bank has sufficient resources to cover losses in the event that borrowers default on their loans, it is necessary for banks to assess the risk of default of their borrowers and to establish appropriate reserves for potential losses. They must then record an expense item on their income statement to reflect the amount transferred to such reserves.

27. In BNM’s case, the SBS inspection team found that BNM had understated the risk of a substantial portion of its loan portfolio. As a result, BNM had not recorded the appropriate amount of loan loss provisions on its income statement. The effect was that BNM’s loan portfolio appeared to be less risky and BNM looked more profitable and better capitalized than it actually was. According to SBS, once BNM recognized the expenses it had been avoiding, BNM’s capital would be 25% less than the bank had been reporting in its own financial data.

28. The SBS inspection team also found other irregular accounting practices that had the effect of hiding the bank’s delinquent (or overdue) loans. For example, when a borrower’s loan was overdue, SBS found that BNM’s management would refinance or restructure the loan but fail to record the loan properly as refinanced or restructured, which indicates the fact that such loans are considered riskier than new loans that are being paid on-time (*i.e.*, current loans). Instead, BNM’s management recorded these loans as new, current loans. The failure to record

these loans properly had several effects. This accounting tactic made BNM's loan portfolio appear to be less risky and enabled BNM to avoid recording the appropriate amount of loan loss provisions for those loans. This tactic also enabled BNM's management to record as income the interest BNM was earning on refinanced and restructured loans when Peru's accounting rules require interest from refinanced loans to be recorded as income only once the interest is collected.

29. In his investigation, Mr. Quiroz noted that BNM's management was well aware that these accounting practices violated Peru's banking laws and regulations because SBS had observed the use of these tactics in prior inspection visits and even sanctioned BNM for the repeated violations.<sup>38</sup> Nevertheless, BNM's management continued to engage in these practices throughout 2000, with full knowledge of the misleading effect these practices had on BNM's financial data.<sup>39</sup> Mr. Quiroz ultimately concluded that BNM's management employed these irregular accounting practices intentionally, in order to hide the fact that BNM's loan portfolio was deteriorating as a result of a number of the borrowers' incapacity to repay their loans.<sup>40</sup>

30. Finally, in the SBS Report on Loan Debts of the Levy Group, Informe SBS No. 05-2002-VE/DESF "A", dated July 12, 2002, Mr. Quiroz observed that BNM was the main source of financing for related companies.<sup>41</sup> He also found that BNM's management engaged in highly irregular transactions for the benefit of related companies by allowing them to miss payments to the bank, hiding the delinquency of their loans, and then not collecting on the

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<sup>38</sup> See SBS Report on Relevant Observations from the Inspection Visit Report, Informe SBS No. 03-2002-VE/DESF "A", June 28, 2002 ("SBS Report on Relevant Observations from the Inspection Visit Report"), p. 8 [Exhibit R-194].

<sup>39</sup> See SBS Report on Relevant Observations from the Inspection Visit Report at p. 8 [Exhibit R-194].

<sup>40</sup> See SBS Report on Relevant Observations from the Inspection Visit Report at p. 7 [Exhibit R-194].

<sup>41</sup> See SBS Report on Loan Debts of the Levy Group, Informe SBS No. 05-2002-VE/DESF "A", July 12, 2002 ("SBS Report on Loan Debts of the Levy Group"), p. 1 [Exhibit R-195].



outstanding obligations of these related companies to BNM.<sup>42</sup> For example, BNM's management allowed Gremco to "repay" its obligations to the bank by charging its checking account even though the account had an insufficient balance.<sup>43</sup> When such a transaction occurs, the owner of the checking account incurs an overdraft, which is essentially an unsecured loan from the bank to the customer. In BNM's case, rather than require Gremco to pay the overdraft, BNM's management would then extend more loans to Gremco to cover the overdraft.<sup>44</sup> As a result of these circular transactions, no money ever changed hands, Gremco never repaid its obligations to BNM, and all the while, BNM hid the delinquency of Gremco's loans. Mr. Quiroz also discovered that BNM frequently restructured and refinanced the loans and leases of Gremco and other related companies in order to give them particularly lenient terms, such as year-long grace periods in which no interest was due.<sup>45</sup>

31. These findings are disturbing because they indicate that BNM's managers, directors, and shareholders could not be trusted by Peru's regulators to protect the interests of their depositors and creditors. Instead, BNM's principals were mismanaging the bank, including through self-dealing, and putting the viability of the bank at risk in the process. In light of the findings in Mr. Quiroz's reports, I am even more convinced that BNM's principals were responsible for BNM's failure.

32. Under some circumstances, regulators can exercise a degree of forbearance and allow a bank's board and management to fix the financial problems that have been identified, but that requires the regulator to have confidence in the bank's management. In this case, SBS

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<sup>42</sup> See SBS Report on Loan Debts of the Levy Group at pp. 9, 13-14, 17 [Exhibit R-195].

<sup>43</sup> See SBS Report on Loan Debts of the Levy Group at p. 3 [Exhibit R-195].

<sup>44</sup> See SBS Report on Loan Debts of the Levy Group at p. 3 [Exhibit R-195].

<sup>45</sup> See SBS Report on Loan Debts of the Levy Group at pp. 5-6, 11-12 [Exhibit R-195].

clearly had lost confidence in the management of the bank, which I believe to have been appropriate. Repeat banking law violations,<sup>46</sup> failure to properly evaluate loans,<sup>47</sup> willful misstatements of the bank's financial condition and violation of accounting rules,<sup>48</sup> failure to establish proper reserves,<sup>49</sup> and particularly egregious abusive insider transactions<sup>50</sup> all combined to paint a picture of a management and ownership that a regulator could not trust to cure the deficiencies. Additionally, there was no credible plan for providing new equity capital or sources of liquidity. I would wholly agree with SBS's judgment if it had decided this was a group of managers, directors, and owners it could no longer trust. In fact, under the circumstances as I understand them, I would have taken strong action to address these abuses even earlier.

B. Peruvian Regulators Warned BNM of Risks and Provided Forbearance Measures

33. Rather than being to blame for BNM's failure, Peruvian regulators provided valuable assistance to BNM to help the bank improve its financial condition. Peruvian regulators helped BNM by alerting the bank that it urgently needed to recapitalize with liquid assets and warning BNM of the risk posed by the bank's overconcentration of public deposits. These warnings provided BNM with the opportunity to take corrective action. Peruvian regulators also provided forbearance measures to help to keep BNM afloat in hopes that, with time, its

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<sup>46</sup> See, e.g., SBS Report on Relevant Observations from the Inspection Visit Report at p. 8 [Exhibit R-194].

<sup>47</sup> See SBS Report on Relevant Observations from the Inspection Visit Report at p. 1 [Exhibit R-194].

<sup>48</sup> See, e.g., SBS Report on Relevant Observations from the Inspection Visit Report at p. 7 [Exhibit R-194].

<sup>49</sup> See SBS Report on Relevant Observations from the Inspection Visit Report at p. 1 [Exhibit R-194].

<sup>50</sup> See SBS Report on Loan Debts of the Levy Group at pp. 9, 13-14, 17 [Exhibit R-195]; SBS Report on Participation Shares in the Fund at p. 6 [Exhibit R-192]; SBS Report on Lifting Liens on Land Owned by Gremco at pp. 5-6 [Exhibit R-191].

shareholders would strengthen BNM's capital position.<sup>51</sup> Nonetheless, BNM's shareholders failed to recapitalize the bank, and ultimately, the mismanagement of BNM resulted in its failure.

34. Generally speaking, a regulator's first priority is to protect depositors and the stability of the banking system. *A regulator is never responsible for protecting shareholders or bankers.* In the United States, aside from the exceptional steps taken during the global financial crisis, regulators' primary tool for protecting depositors and the banking system is prevention: regulators monitor banks to make sure they are adequately capitalized and have sufficient liquidity, and when banks fall below the necessary levels of capital and liquidity, regulators require banks to take corrective action themselves. Providing assistance to banks is a last resort, and is entirely in the discretion of the regulator. It is also generally done only in circumstances where the assistance is necessary to control systemic risk.

35. SBS more than fulfilled its responsibility to BNM by monitoring the bank's financial health and warning BNM's principals when corrective action needed to be taken. For example, I understand that SBS warned BNM about its overconcentration of public deposits. Lack of diversity in a bank's sources of deposits is always a risk, regardless of the type of deposit. A basic lesson of "Banking 101" is that a bank needs to avoid a concentration of deposits and must have a contingency plan in the event that any concentration of deposits is withdrawn. Mr. Dujovne asserts that deposits from public institutions, one of the concentrations of deposits BNM held, are somehow different and should not be considered volatile because in Peru those deposits had been stable and growing for a number of years.<sup>52</sup> However, it is relevant that these deposits were term deposits, meaning that they could be withdrawn at will once the

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<sup>51</sup> In my first statement, I discussed all of the ways in which Peru's regulators actually assisted BNM by providing critical time-buying measures designed to help BNM recapitalize. See Clarke First Expert Opinion at paras. 28-31 [Exhibit RWS-010].

<sup>52</sup> See Dujovne Expert Opinion at para. 38.

term of the deposit expired. I note that a sizeable portion of those deposits were placed in banks through an auction, whereby banks bid for them.<sup>53</sup> That indicates that these deposits were more volatile than other, more predictable public deposits because, whenever they came up for renewal, they would go to the highest bidder. In any case, having over 30% of deposits come from public institutions, as BNM did, is simply too risky for any bank given that those deposits could be withdrawn at any time. The bank's management has a responsibility to (a) not overly rely on such deposits, and (b) have a plan in place to deal with any liquidity issues that could result from their withdrawal.

36. In addition to warnings and recommendations, Peruvian regulators also provided BNM with generous forbearance measures. For example, SBS's loan portfolio exchange program allowed BNM to temporarily exchange poorly performing loans for non-negotiable Treasury bonds, with a commitment to repurchase the troubled loans over the course of four years. SBS also allowed BNM to record a goodwill credit as part of its regulatory capital as a result of its merger with Banco del País. Compared to international best practices, it is particularly generous for a regulator to allow a bank to add an intangible goodwill credit from a merger to the bank's capital account. In fact, this is not allowed in the United States. Through these forbearance measures, Peru's regulators gave BNM sufficient time to recapitalize. However, instead of recapitalizing with cash as SBS recommended, BNM's principals made unrealistic proposals to recapitalize the bank using real estate and pinned the bank's survival on the hope that the BCR would provide BNM with emergency loans.

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<sup>53</sup> See SBS's 2000 Inspection Visit Report at p. 18 [Exhibit R-065].

37. Claimant assumes that BNM was entitled to these forbearance measures and that the regulators should have done much more to help BNM.<sup>54</sup> However, Claimant does not recognize that even if a regulator has various tools for helping banks in trouble, the regulator is not required to exhaust all of the regulatory options to try to rescue a particular bank. It would not be feasible or prudent for a regulator to make such a commitment. In fact, it would be detrimental to the stability and health of the banking system if the regulator extended a limitless guarantee to bail out all troubled banks because such a policy would encourage bankers to take excessive risks, armed with the knowledge that the regulator would come to their rescue anytime they ran into problems.

C. BNM's Attempt to Recapitalize Using Illiquid Assets

38. Claimant's expert concedes that BNM needed both recapitalization and liquidity.<sup>55</sup> But, according to Claimant, SBS should have allowed BNM to "recapitalize" with illiquid real estate, which Claimant alleges could have been used to secure an emergency liquidity loan from the BCR.<sup>56</sup> There are several reasons why it was prudent for SBS to reject this plan.

39. In general, real estate is not considered an appropriate asset for recapitalization during a liquidity crisis, because it is illiquid and difficult to value. Therefore, it does not solve the fundamental problem that the bank does not have enough cash on hand to pay its obligations. In fact, many countries have strict limits on the amount of real estate that a bank may hold. In the United States, for example, a bank may only hold real estate that it is using to house the facilities for the bank.

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<sup>54</sup> See, e.g., Claimant's Reply on the Merits at paras. 180-204.

<sup>55</sup> See, e.g., Dujovne Expert Opinion at para. 54.

<sup>56</sup> See Claimant's Reply on the Merits at para. 273; Dujovne Expert Opinion at paras. 53-54.

40. Claimant asserts that the land it wanted to use for recapitalization had been appraised by a professional appraiser,<sup>57</sup> but if the land were worth the value at which it was appraised, the owners of the land should have sold it and put the cash into the bank. However, as pointed out in the investigation report discussed above at paragraph 23, the bank regulator determined that there was strong evidence that the bank and the appraiser intentionally overstated the value of the land.

41. Even if the land had been properly appraised, however, BNM's proposal to use the land as new capital was risky because real estate – particularly real estate that has not yet been developed – takes time to sell and tends to lose value quickly, especially during an economic downturn. Thus, if SBS had allowed BNM to recapitalize using the land, BNM would have had difficulty selling it to gain the liquidity it needed. Even if BNM did succeed in selling the land quickly, BNM likely would have been forced to sell the land for less than it had been valued. As a result, BNM would have needed to write off the loss in value as a capital loss.

42. Claimant and Mr. Dujovne claim that the land could have served two purposes: to recapitalize the bank and to increase the bank's liquidity by using the collateral to obtain a loan from the BCR.<sup>58</sup> However, central banks generally do not accept illiquid assets as collateral. Additionally, in this case, I understand that the real estate in question was already encumbered. I strongly suspect that the BCR, like any central bank, would have been unwilling to accept encumbered land as collateral for a liquidity loan. Not only would this encumbrance have prevented the land from being used as collateral to secure a loan from the BCR, but the land could not have been easily converted into cash to provide BNM with additional liquidity because

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<sup>57</sup> See Claimant's Reply on the Merits at para. 271.

<sup>58</sup> See Claimant's Reply on the Merits at para. 273.

BNM would have had to reflect the loss of collateral on the underlying loan. Therefore, there were several good reasons for SBS to reject BNM's plan.

43. In the United States, one of the first things that a regulator does when examining a bank with liquidity problems is to require the bank to submit a detailed liquidity plan in which it identifies available lines of credit and assesses whether the bank can access the Federal Reserve's discount window or any other sources of liquidity. Through this process, the regulator is able to carefully scrutinize the bank's liquidity options. All banks need contingency plans because when a bank experiences a short-term liquidity problem, it is often unable to raise new deposits as a source of liquidity. Thus, if the regulator sees that a bank's assets have deteriorated such that it cannot access the Federal Reserve's discount window and there are no other options for accessing liquidity, there may be no option but to intervene. U.S. regulators also enjoy great discretion in assessing a bank's liquidity needs, and regulators routinely reject plans offered by management to recapitalize using illiquid assets. Therefore, the decision by SBS not to allow BNM to use real estate to recapitalize the bank was prudent and in line with international best practices.

D. Emergency Loans from the Central Bank

44. It is also unreasonable for Claimant to assert that the BCR should have put taxpayer money at risk by providing BNM with a bailout loan of US \$10 million when BNM did not have sufficient collateral to back a loan of that size.<sup>59</sup> I understand that the BCR, as is the case with most other central banks, is required by law to obtain sufficient collateral for its loans. Thus, based on its assessment of the value of the collateral that BNM had to offer, the BCR could only offer a loan of US \$1.2 million. The fact that BNM was unable to provide sufficient

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<sup>59</sup> See Claimant's Reply on the Merits at paras. 292-312.

collateral for a loan that could have addressed its liquidity needs demonstrates that BNM was effectively insolvent. It would have violated central bank best practices to put taxpayer money at risk by providing credit to such an insolvent institution.

45. Requiring a bank to provide high-quality collateral in order for a central bank to provide emergency funds is not uncommon. In the United States, for example, the Federal Reserve requires that banks provide highly liquid instruments such as securities or high-quality loans as collateral for emergency funds, and any loan extended through the Federal Reserve's discount window must be over-collateralized to reflect the higher risk that the Federal Reserve is assuming to provide emergency liquidity. Regardless of the quality of assets used as collateral, the Federal Reserve's decision to provide emergency liquidity is always discretionary and never obligatory. In BNM's case, the BCR's decision was not even a question of discretion. Because Peru's laws require that all BCR loans be collateralized, the BCR was not legally able to grant BNM's request.

#### **IV. Conclusion**

46. The generosity of Peruvian regulators could not offset the profound mismanagement of BNM and BNM's failure to act on the advice of SBS. Having received repeated opportunities to recapitalize and achieve solvency, BNM failed to do so. It is not the role of a banking regulator to provide unconditional support to a failing bank, or to stand by and watch while the public loses confidence in a failing bank. Even for a bank that is systemically important (which was decidedly not the case with BNM), regulators are not obligated to provide capital to it. In fact, recapitalization by the government is a discouraged practice among regulators. In declining to grant BNM limitless access to public funds and enforcing reasonable capital requirements, Peruvian regulators acted in conformity with international best practices.



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1.1. THE CLASSICAL LIMIT