Asset Management Company for Assets Arising from Bank Restructuring

Blueprint – 16 November 2012

1. INTRODUCTION

The Spanish authorities have taken a number of important measures to address the problems in the banking sector: cleaning up banks' balance sheets; increasing minimum capital requirements; restructuring the savings bank sector; and significantly increasing the provisioning requirements for loans related to real estate development and foreclosed assets.

On 25 June 2012, the Spanish Government requested external financial assistance in the context of the ongoing restructuring and recapitalisation of the Spanish banking sector. The Eurogroup agreed to this assistance and it was included in the Memorandum of Understanding (MoU) between the Spanish and European authorities, with the participation of the International Monetary Fund.

One of the main components of the programme is the reform of the weakest parts of the Spanish financial sector, which comprises the following three elements:

- Identification of individual bank capital needs through a comprehensive asset quality review of the banking sector and a bottom-up bank-by-bank stress test, based on that asset quality review (completed at the end of September 2012); this stress test, following the results of the top-down exercise published on 21 June 2012, estimates the capital shortfalls for individual banks.
- Recapitalisation, restructuring or resolution of weak banks, by means of implementation of plans to address any capital shortfalls identified in the stress test.
- Segregation of problem assets by those banks receiving public support into an external Asset Management Company for Assets Arising from Bank Restructuring (“Sareb”).

Problem assets of banks that have received State aid should be quickly removed from those banks' balance sheets. This applies, in particular, to loans related to real estate development and foreclosed assets. The transfer price of these assets will be based on their real economic value, with an additional haircut. The real economic value will be established on the basis of the asset quality review process, drawing on the individual valuations used in the stress test.

During October, the banks with capital needs have submitted their recapitalisation and restructuring plans detailing how they intend to meet the capital shortfalls identified.

The Spanish authorities and the European Commission have assessed the viability of the banks on the basis of the results of the stress test and the restructuring and recapitalisation plans.

For Group 1 banks, those in which the FROB already has a stake, the Spanish authorities and the European Commission started working on restructuring plans in late July 2012. These plans, finalised in light of the stress test results, must be approved by the European Commission in November 2012. On this basis, State aid will be granted and plans can be implemented immediately. The process of moving impaired assets to Sareb will be completed by year-end.

For Group 2 banks, the restructuring and recapitalisation plans have recently been submitted to the European Commission. Given the need to incorporate the stress test results, the approval process is expected to run until mid-December, when these banks will be restructured or recapitalised, or resolved in an orderly manner. All Group 2 banks include in their restructuring plan the necessary steps to move their impaired assets to Sareb.

For banks in Groups 1 and 2, aid will be provided when the European Commission has approved the final restructuring and recapitalisation or resolution plan.

Group 3 banks with significant capital needs – corresponding to more than 2% of risk-weighted assets – will, as a precautionary measure, be required to issue contingent convertible securities (COCOs) under the recapitalisation scheme to meet their capital needs by 31 December 2012 at the latest. COCOs will be subscribed for by the FROB using programme resources and can be redeemed until 30 June 2013 if the banks succeed in raising the necessary capital from private sources. Otherwise, they will be recapitalised through the total or partial conversion of the COCOs into ordinary shares. They will also have to present restructuring plans.

Group 3 banks planning whose capital needs are more limited – corresponding to less than 2% of risk-weighted assets – will be given until 30 June 2013 to do so. Should they not succeed, they will be recapitalised by means of State aid and will therefore have to present restructuring plans.

Group 3 banks that still require public support under this programme on 30 June 2013 will be required in their restructuring plans to transfer the impaired assets to Sareb, unless it can be shown for banks requiring less than 2% of risk-weighted assets in State aid that other means to achieve full off-balance sheet segregation are less costly.

The Spanish authorities, in consultation with the European Commission, the ECB, the ESM and the IMF, have prepared a comprehensive blueprint and legislative framework for the establishment and functioning of this asset segregation scheme. Specifically, Royal Decree-Law (RDL) 24/2012, now Law 9/2012 of 14 November 2012, and the Royal Decree implementing it, approved on 15 November, have laid down the legal bases on which Sareb will be set up, with a view to ensuring that Sareb is fully operational in late November 2012. This document summarises the principal elements of the above-mentioned plan and the regulatory framework of which it is a part.

2. OBJECTIVES

The overarching objective of Sareb is to manage and divest in an orderly manner the portfolio of real estate loans and assets received from participating banks within a timeframe of no more than 15 years while:

- Optimising levels of recovery and value preservation
- Minimising negative impacts on the Spanish economy, real estate market and banking sector
- Minimising costs and the burden on taxpayers
- Fully repaying its liabilities
- Utilising capital efficiently

Sareb will be focused on the efficient and professional management of the real estate assets transferred to it and will be highly proactive in divesting them in an orderly manner. Its approach will be that of a property restructuring company and not, therefore, that of a bank. Sareb is designed to meet the required conditions for it not to be consolidated in Spain’s general government sector.

Sareb’s operating model will be flexible to ensure that:

- It meets changing asset management requirements over time
- It minimises fixed costs
- It establishes relations with the best service providers

Sareb’s structure will ensure that it is able legally and financially to segment its portfolio of assets in the most effective manner from both capital utilisation and distribution standpoints, taking into consideration strict real estate market criteria. The problem assets of the Group 1 banks should be transferred to Sareb from 1 December 2012 , and this transfer should have been completed before year-end, as stipulated in the financial assistance agreement.

3. SCOPE AND TRANSFER PRICE

Participating banks

The initial transfer of assets will be from Group 1 banks (the “participating banks”): BFA-Bankia, Catalunya Banc, Novagalicia Banco and Banco de Valencia.

In the following phase, all the remaining Group 2 and, where appropriate, Group 3 banks receiving State aid for their recapitalisation plans will be obliged to transfer their assets to Sareb.

Assets to be transferred

In order to determine the scope of Sareb, extensive and detailed data mining, portfolio segmentation and stratification have been performed across Group 1 banks, both individually and on a consolidated basis.

The focus of Sareb will be the real estate development-related exposures and foreclosed assets in the participating banks. The different asset classes this encompasses have to meet specific selection criteria, but all transferred assets will be subject to a number of overarching criteria, such as asset documentation, loan classification and litigation disclosure.

The selection criteria are straightforward and not susceptible to subjective interpretation:

ASSET CLASS	SELECTION CRITERIA
Foreclosed real estate assets	➢ 100% of assets classified by the participating banks as foreclosed real estate assets, reported to the Banco de España as of 30 June 2012, subject to an individual minimum asset size of €100,000, measured in terms of net book value.
Real estate development loans: doubtful	➢ 100% of loans to real estate developers classified by the participating banks as doubtful in the respective banks’ submissions to the Central Credit Register as of 30 June 2012, subject to a minimum borrower exposure of €250,000, measured in terms of net book value.

Real estate development loans: sub-standard	➢ 100% of loans to real estate developers classified by the participating banks as sub-standard in the respective banks' submissions to the Central Credit Register as of 30 June 2012, subject to a minimum borrower exposure of €250,000, measured in terms of net book value.
Real estate development loans: normal	➢ 100% of loans to real estate developers classified as normal by the participating banks in the respective banks' submissions to the Central Credit Register as of 30 June 2012, subject to a minimum borrower exposure of €250,000, measured in terms of net book value.
Ownership interests linked to the real estate sector	➢ 100% of ownership interests in real estate companies, provided that these interests enable, at least, joint control or significant influence to be exercised over such companies . ➢ These assets will be included after due diligence is performed.

To determine the value of the assets to be transferred, all pertinent downward adjustments – including those envisaged in RDLs 2/2012 of 3 February 2012 and 18/2012 of 11 May 2012 – must have been made prior to their transfer.

Transfer Price

The transfer price, to be determined by the Banco de España, includes two differentiated elements. First, the economic value of the assets transferred, calculated using conventional valuation techniques. Second, the valuation adjustments resulting from consideration of the specific terms of the transfer operation to be conducted and the viability of the business plan of Sareb itself.

The starting point for determining the price for transferring loans and real estate under ownership to Sareb is thus the base scenario from the Oliver Wyman (OW) stress test completed at the end of September 2012. Notwithstanding, there are major conceptual differences between the objectives of the two exercises:

- The OW stress test was performed with a "fund focus": calculating the capital requirements of the banks at a fixed date, based upon an asset valuation that takes into account different assumptions, both at micro and macroeconomic levels;
- Sareb is guided by a "flow focus": its activity during the next 15 years will be the management and divestment of assets; and
- OW's model is on a "going concern" basis, while Sareb's objectives are to divest its portfolios in an orderly manner over a 15-year period, after which Sareb will be wound up, thus reflecting a "run-down" model.

Furthermore, OW used “indexed forward” adjustments when valuing foreclosed real estate assets, which cannot be directly extrapolated to Sareb:

- The valuation exercise considers a 2014 horizon, while Sareb considers up to an additional 13 years, and therefore the market volatility of these assets has to be reflected in the Sareb model.
- Sareb will have to finance a larger volume of assets for a longer period of time, and this effect must be included in the calculation of the lower residual value.

As regards the valuation adjustments, for a long-term forward-looking model such as Sareb, built on the basis of a business plan which includes a winding up after 15 years, the transfer pricing exercise must take into account the following elements that do not pertain to the estimation of the economic value of the assets:

- The operating costs associated with owning both loans and real estate assets;
- The costs of funding the portfolio while it is being held for sale;
- The fact that the sale to Sareb by each participating bank will be a major single portfolio sale;
- The overheads of Sareb;
- The costs of enforcement;
- The recovery costs of impaired loans.

These factors alone justify a significant haircut in respect of the estimated economic value of the assets. The existence of these haircuts – which are specific to the transaction between the transferring banks and Sareb – prevent the transfer price from constituting a direct reference for the general valuation of bank assets that have not been transferred to Sareb.

On average, it is estimated that the transfer value, taking into account the aforementioned haircuts, will represent a discount of approximately 63% with respect to gross book value for foreclosed assets. By asset type, the discount is 79.5% for land, 63.2% for developments in progress and 54.2% for finished housing. In the case of loans to developers, the average discount is 45.6%, including haircuts of 32.4% for finished projects and of 53.6% for urban land loans.

4. LEGAL STRUCTURE AND GOVERNANCE

Legal structure

The legal structure of Sareb was defined in RDL 24/2012, now passed as Law 9/2012. This structure of Sareb will pass through two phases in order that (a) it can be established in time for the transfer of assets as from 1 December; and (b) it will ultimately have the necessary flexibility to manage assets and to fund itself in the most commercially advantageous way.

Initially, it will be a single Spanish "sociedad anónima". In a second phase, it will potentially create a number of funds ("FABs", as defined in the draft Royal Decree implementing Law 9/2012) and a management company which will create and finance portfolios and sub-portfolios of assets in response to specific investor demand.

Governance

The corporate governance principles of Sareb will set out clearly the minimum standards for the conduct and integrity expected of the key personnel and committees. Its Board of Directors will be made up of representatives of shareholders (the FROB and other private investors) and of independent directors. Directors will comply with similar eligibility requirements to those set out in RD 1245/1995 for directors of credit institutions.

Given the singularity of Sareb in respect of its financial approach – the management of a challenging profit and loss account that is highly focused in sectoral terms – and its inherent need to maintain and administer a fluid relationship and communication with national and international institutions, it was deemed necessary to designate a Chairman for the company and a General Manager.

The following Committees will be set up (developed in Sareb's Bylaws):

- Executive Committee
- Risk/Credit Committee
- Investment Committee
- Assets &Liabilities Committee
- Appointments and Remuneration Committee
- Audit Committee

While the Banco de España will act as the administrative supervisory body of Sareb, there will additionally be a Monitoring Committee, outside the structure of Sareb, formed by four parties (Ministry of Economic Affairs and Competitiveness, Ministry of Financial Affairs and Public Administration, Banco de España and CNMV), to oversee compliance with the general objectives for which the company was formed. Other national and international authorities may participate in this Committee as observers. Its functions shall include analysis of the business plan and of possible deviations in it, and monitoring of divestment plans and of repayment of the guaranteed debt. This Committee may ask Sareb for such periodic information as it may consider appropriate.

5. OPERATING MODEL

From the outset, Sareb will be operational and effectively managing assets, while the services relating to the management of loans, foreclosed real estate assets and shares and other equity holdings will migrate progressively from the participating banks to competitively procured service providers.

Time and operational constraints mean that Sareb will use, particularly as it first commences operating, the services of the participating banks, which will retain the day-to-day management of the loan and asset portfolios and corporate holdings, subject to tightly structured service level agreements ("SLAs"). However, under the SLAs, the participating banks will have no discretionary authority over the assets.

Sareb will adopt as quickly as possible the envisaged final operating model, by undertaking a rigorous procurement process for outsourced functions, including those initially performed by the participating banks, in order to ensure that there is a flexible, cost-effective, robust and optimally performing organisation for the implementation of the divestment plan.

In addition to the services provided to Sareb, participating banks (as well as the corporate services providers) will produce and make available to the information technology (IT) data manager the necessary information to generate Management Reports and Dashboards for each of Sareb's activities.

6. FINANCIAL STRUCTURE

Accounting objectives

The main accounting objectives in designing the financial structure are to:

1. Achieve a full deconsolidation of Sareb from the banks' balance sheets; and
2. Achieve a full deconsolidation of Sareb from the Spanish general government sector.

In order to attain this latter goal, the design of Sareb has focused on the following six criteria:

Characteristic	Considerations
Full governance capacity	➢ Sareb’s Board will form a Management Committee to monitor its financial and operational management and to oversee the procurement process and key service providers.
Mainly owned by private investors	➢ Public ownership may not exceed 50% of the equity and the remainder will be owned by private investors.
Public institutions cannot retain major risk exposure	➢ Public institutions will retain less than 50% of the risk exposure under the business plan in the form of Sareb’s equity and subordinated debt.
Limited term	➢ A maximum life of 15 years has been defined by the Royal Decree implementing Law 9/2012.
Activity linked to financial crisis	➢ Sareb has been designed and formed for the sole purpose of acquiring and managing problem assets through a restructuring and recapitalisation plan for the banks worst affected by the financial crisis and that have had recourse to State aid.
Modest results in respect of the total volume of assets	➢ Transfer price has been fixed according to market conditions, by making conservative adjustments and using credible scenarios in order to mitigate Sareb’s potential losses as a percentage of the total assets transferred.

Financial structure of capital

SAREB will require two sources of funding:

1. Debt to be issued as consideration for assets transferred which is subscribed by the participating banks.
2. Funding for operational needs.

One or more tiers of intermediate debt might also be envisaged between 1) and 2).

Private investors will represent no less than 50% of both Sareb's equity and subordinated debt, both at inception and throughout its lifespan. Private investors may include banks (excluding the participating banks), insurance companies and other investors. Public and private sector investors will have identical rights and obligations.

Sareb will be empowered without limitation to: (i) issue securities; and (ii) borrow from credit institutions or under European or Spanish funding arrangements.

One of the overarching objectives of the creation of Sareb is to provide liquidity to the participating banks: they must be able to enter into repos with the ECB using the senior bonds that they receive. In order to maximise liquidity, consideration will be given to the eligibility criteria and procedures set out in the ECB's document "The implementation of monetary policy in the Euro area: general documentation on Eurosystem monetary policy instruments and procedures".

Debt to be issued as consideration for assets will be:

1. Subscribed by participating banks upon asset transfer;
2. Listed (potentially), subject to ordinary listing requirements (with CNMV surveillance);
3. Guaranteed by the State;
4. Structured to meet all the requirements to be accepted as collateral by the ECB;
5. Structured in a way that does not create undue liquidity pressure due to refinancing requirements;
6. Structured so as to not restrict Sareb's ability to manage assets freely, i.e. these assets will not affect the guarantee of the debt; and
7. Tradable without restriction.

7. BUSINESS PLAN

The overarching target is for Sareb to divest all its assets within a maximum period of 15 years. Sareb's objectives are to optimise recoveries and to protect the value of its assets without adversely impacting the broader Spanish economy or the banking or real estate markets.

Sareb will use all the means at its disposal to achieve the target divestment levels – from consensual restructurings of loans to the foreclosure and sale of assets – either on a wholesale or a retail basis. The execution of the divestment plan will be based on:

- Diligent asset and risk management;
- The use of all appropriate distribution channels;
- Monitoring macroeconomic and microeconomic movements closely so that Sareb can take advantage of market conditions without causing an adverse impact;

- Careful business planning at the portfolio, sub-portfolio and individual asset level;
- Aligning the interests of shareholders, Sareb, its employees and service providers, avoiding potential conflicts of interest;
- Operating to the highest professional and ethical standards.

A preliminary business plan has been drawn up and is being presented to potential investors, and it must be approved by the company once it has been formally incorporated. Under this preliminary plan, Sareb's activities and modus operandi are as summarised below:

Loans	
Sale of loans	➢ Sareb will consider, on a case-by-case basis, the sale or transfer of loans or loan portfolios to third parties if this makes commercial sense.
Debtors	➢ Sareb will work actively with all debtors and will engage in consensual restructuring, refinancing or termination of loans, based on what the optimal commercial strategy is. However, this will be subject to debtors being cooperative, transparent and realistic: ▪ Debtors will be required to pay 100% of their available cash flows to meet their obligations to Sareb. ▪ When appropriate, Sareb's policy will be to secure unencumbered assets as additional collateral.
Financing of debtors	➢ Sareb, under specific conditions, may advance additional financing to a debtor so as to improve recoveries and the value of the assets.
Real Estate Under Ownership	
Asset divestment strategy	➢ Sareb will segment and prioritise its portfolio of real estate under ownership to take an informed decision as to whether to sell an asset, invest in it, or hold it pending improved market conditions. Sareb's ultimate decision about whether to sell or not will be based on market conditions and the liquidity of the asset or portfolio in question.
Finished product	➢ Finished product will be sold – in portfolios or by individual asset as appropriate – or will be rented, if that is the most commercially viable strategy.
Unfinished product	➢ Unfinished developments may either be sold on an "as is" basis or completed if the business case for doing so is sufficiently sound. Sareb may invest directly or acquire a holding in a company to finish projects.

Land	➢ Land will either be sold or, under an appraisal procedure, be used in the construction of developments by companies.

As envisaged in the roadmap for the restructuring of the banking sector, before the end of the current year all the banks classified in Group 1 (BFA-Bankia, Catalunya Banc, Novagalicia Banco and Banco de Valencia) will transfer the asset classes mentioned in section 3 above to Sareb.

Later, once the composition of Group 2 (banks that will require recapitalisation with State aid) has been determined and the attendant restructuring plans approved, these banks will, in 2013, transfer the same aforementioned asset classes to Sareb.

The volume of assets to be transferred to Sareb – bearing in mind only the portion corresponding to the banks in Group 1 – is estimated at €45 billion. This will increase following the inclusion of the assets from the Group 2 banks in 2013, but, as stipulated in the Royal Decree implementing Law 9/2012, in no case will it exceed €90 billion.

The envisaged return on equity (ROE) for the project as a whole in a conservative scenario is estimated at around 14% per annum. The characteristics of Sareb's business, the complex macroeconomic environment and the maturation of this business in the medium term mean that the average profitability mentioned for the company's capital instruments over the course of 15 years will be consistent with modest results in the early years, in which a high stock of assets has to be financed, and, however, in which sales still account for only a small portion of such stock.