FROB Fondo de Reestructuración Ordenada Bancaria

The transfer prices to the Asset Management Company (Sareb) will be sharply adjusted to ensure its profitability

Press release – 29 October 2012

The Fund for the Orderly Bank Restructuring (FROB) has today completed the work on the structure and design of the Asset Management Company for Assets Arising from Bank Restructuring (Sareb) envisaged in the Memorandum of Understanding (MoU) agreed between the Spanish and international authorities on 20 July 2012. This company has been designed in such a way that the transfer of problematic real-estate-related assets by banks is made on the basis of prudent valuations, in order to ensure the profitability of the company over its maximum 15-year lifetime.

The creation of Sareb will substantially reduce any uncertainty over the viability of those banks requiring public support, since it will allow them to concentrate on their main business.

The MoU establishes that the real-estate-related assets of banks needing State aid must be transferred to an asset management company, for which blueprint and framework was prepared by the Spanish authorities in consultation with the European Commission (EC), the European Central Bank (ECB) the European Stability Mechanism (ESM) and the International Monetary Fund (IMF). Royal Decree-Law 24/2012 on credit institution restructuring and resolution and the Draft Royal Decree which was at the public-consultation stage until last week, specify the details of Sareb, which has to be operational in November 2012. Sareb will be set up as a for-profit company that will not be part of the sector general government.

The overall objective of Sareb will be the management and orderly divestment of the portfolio of assets received, maximising their recovery, over a maximum time horizon of 15 years. In pursuing its activity, Sareb has to contribute to the restructuring of the financial system, while minimising the use of public funds and any market distortions it may cause.

The design and start-up (including legal and financial structure, operational model, and business and divestment plans) are being carried out by the FROB, with advice from the international firm Álvarez & Marsal and in close collaboration with the Banco de España and the Ministry of Economic Affairs, as well as with the aforementioned international authorities.

1. Structure and governance of Sareb

Initially it will be a single company or corporate legal vehicle which, subsequently and in view of the management decisions taken by its management bodies, will have the power to set up specific asset funds on the basis of the risk-return profile of the portfolios transferred by the banks.

The own funds of Sareb will be approximately 8% of the volume of total assets and its capital structure will consist of a non-majority holding of the FROB and a majority holding by private investors. A portion of the own funds may be in the form of subordinated bonds.

The banks which transfer their assets may not be shareholders of the Sareb nor represented on its board of directors. In exchange for the assets contributed, the banks may receive bonds issued by the company and guaranteed by the State.

The governing bodies of Sareb shall be those established by the Share Capital Company Law (*Ley de Sociedades de Capital*) for public limited companies, with the following special features:

- The Board of Directors shall have a minimum of five members and a maximum of 15. They must be persons of recognised business and professional repute, as must be the general managers or similar officers of the company. At least one-third of the members of the Board of Directors shall be independent.

- It will be obligatory to have an Audit committee and a Remuneration and Appointments Committee, a majority of the members of which will be independent directors. To support the work of the Board of Directors, Sareb must have an Executive Committee, a Risk/Credit Committee, an Investment/Divestment Committee and an Assets and Liabilities Committee.

- Additionally, it shall have 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. 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 will ask Sareb for such periodic information as it may consider appropriate.

2. Scope of the assets and transfer price

As envisaged in the roadmap for the process of restructuring the banking sector, all the banks classified in Group 1 (BFA-Bankia, Catalunya Banc, Novagalicia Banco and Banco de Valencia) shall transfer the following categories of assets to Sareb in December 2012:

- Foreclosed assets whose net carrying amount exceeds €100,000.

- Loans/credits to real estate developers whose net carrying amount exceeds €250,000, calculated at borrower, rather than transaction, level.

- Controlling corporate holdings linked to the real estate sector.

Subsequently, once the members of Group 2 have been determined (banks that will require recapitalisation with State aid) and their restructuring plans have been approved, these banks will transfer the same categories of assets to Sareb, in 2013.

The volume of assets to be transferred to Sareb – taking into account only the portion corresponding to Group 1 banks – is estimated to be €45 billion. This will increase after the assets of Group 2 banks are included in 2013 but, under no circumstances, as stipulated by the Royal Decree currently at the public-comment stage, will it exceed €90 billion.

In order to determine the value of the assets which have to be transferred, it will be necessary, prior to their transfer, that all the relevant impairments, including those envisaged in the Royal Decree-Laws 2/2012 of 3 February 2012 and 18/2012 of 11 May 2012, have been realised.

The **transfer value** will be set on the basis of two components. Firstly, the economic value of the assets will be determined, both for the foreclosed assets and the loans related to the real estate development sector. For this purpose, the expected losses in the baseline scenario of the bottom-up exercise performed by Oliver Wyman for each of the banks transferring assets will be used as a reference. The value thereof is very close to the net value of the assets after having applied Royal Decrees 24/2012 and 18/2012. Secondly, the estimate of economic value will be adjusted by applying a discount due to the characteristics inherent to the transfer of the assets to Sareb. This is the result of aspects such as: the en bloc acquisition of the assets; the consideration of certain expenses borne by the banks' income statements which must now be assumed by the company, such as asset management and administration costs, including financial costs; the outlook for the timing of the divestment of the assets transferred to the company; and other factors that affect the viability of and the risks involved in the specific activity of Sareb. These adjustments to the economic value of the assets to be acquired by Sareb mean that the transfer prices cannot be used to value bank assets that have not been transferred to Sareb.

The transfer value, taking into account the above-mentioned haircuts, is very conservative. On average, it is estimated to represent a discount of approximately 63% on the gross book value of foreclosed assets. By asset type, the discount is 79.5% for land; 63.2% for unfinished developments and 54.2% for finished housing. The average discount in the case of loans to developers is 45.6%, including haircuts of 32.4% for finished projects and 53.6% for loans to finance urban land.

This transfer value does not determine, therefore, the economic value of the assets linked to the real estate sector held by Spanish banks on their balance sheets. It has been further reduced by taking into account the above-mentioned adverse impact of valuations arising specifically from the transfer of the assets to Sareb.

3. Provisional business plan

Based on the perimeter of the assets to be transferred and the transfer price, a provisional business plan was designed for Sareb over a horizon of 15 years, which envisages macroeconomic and financial developments in the Spanish economy and in the real estate market, in particular considering the market's absorption capacity based on each asset type and the region in which they are located.

In general, the company will have three main sources of funding: (i) State-guaranteed senior debt issued by Sareb as consideration for the assets received from the banks transferring them and which is subscribed by the latter; (ii) perpetual subordinated debt and (iii) common equity. Both the perpetual debt and the common equity will be subscribed in part by the FROB but the majority will be subscribed by private investors.

The return on equity (ROE) envisaged for the project as a whole in a conservative scenario is estimated to be around 14-15%. As a result of the characteristics of Sareb's business, the complicated macroeconomic environment and the maturation of this business in the medium term, the above-mentioned average return for the Company's equity instruments over 15 years considers the modest results and, even, temporary losses of the early years when a large stock of assets has to be financed while sales still represent a small part of the overall stock.

According to this business plan, Sareb will be set up as a for-profit company. The management of the assets transferred by financial institutions, by a management team composed of individuals of the highest repute, will be efficient and professional.

The draft of the provisional business plan will be discussed with potential investors over the next few days and will be approved by the governing bodies of the company itself, once it has been legally formed.

Sareb will be fully operational following the approval of the Royal Decree which establishes the legal regime of the asset management company and the transfer of the assets by Group 1 banks in December 2012.