FROB

Orientation on the methodology and procedures to determine the economic value of a credit entity as foreseen in Article 9 of R.D.L 9/2009

May, 2011

IMPORTANT NOTICE

This document is an orientation on methodology, scope, procedures and outputs regarding the assessment on the economic value of credit entities for the purposes envisaged in art. 9 of RD-law 9/2009, on bank restructuring and own resources reinforcement of credit institutions.

Consequently, this document does not replace nor condition the own judgment and professional practices of the specialized company in charge of carrying out the financial and Business Plan due diligences and valuations processes, but is a guideline to help them in the development of such activities.

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Glossary

AFS	Available for sale
AFSFA	Available-for-sale financial assets
BdE	Bank of Spain
CCF	Credit conversion factor
CIF	Collective investment undertakings
DCF	Discounted cash flow
DD	Due diligence
DDM	*Dividend Discount Model*
DRDS	Distribution of risk disclosure statement
EAD	Exposure at default
Euribor	*European Interbank Offered Rate*
FROB	Fund for Orderly Bank Restructuring
FS	Financial statements
FTD	Fixed term deposit
GAP	Difference
GW	Goodwill
haircut	Correction factor- percentage subtracted from the par value of assets used as collatoral in lending operations

LGD	*Loss given default*
LTV	*Loan to Value ratio*
PD	*Estimate of probability of default*
QoE	*Quality of Earnings* (measured in terms of permanence and sustainability)
Repos	Asset repurchase agreements
ROA	*Return on Assets*
ROE	*Return on Equity*
ROF	Results on financial operations
RWA	Risk weighted assets
RWA	*Risk Weighted Assets*
SE	Shareholders' equity
SIP	Institutional Protection System
SME	Small and Medium Enterprises based on the Europoean Union definition which establishes limits based on the number of employees, turnover and total volume of assets
ST	Short term
strike	Price at which a put or call option can be exercised, in interest rate floors and ceilings, Interest rate level at which an option is activated
Watch list	Term applied to lending operations which are not doubtful due to customer arrears but are closely monitored due to higher risk of impairment

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Executive summary

- Article 9.5 of RDL 9/2009 establishes that the price of share acquisitions or contributions of capital to credit institutions will be based on the value of these entities, which will be determined by one or several independent experts designated by the FROB.
- The FROB will initiate a competitive tender process for the designation of these independent experts.
- Prior to this, a panel of experts comprising professionals from KPMG, Nomura, PricewaterhouseCooper and Societé Generale have been requested by the FROB to prepare a working document including a definition of the methodologies, scope of the work and deliverables required as a basis for future section of advisors.
- In general, acquisition of an interest by the FROB in a credit entity will require three actions: preparation of a business plan as part of the Recapitalisation plan to be approved by the Bank of Spain, performance of a due diligence and finally valuation of the credit entity. The last two procedures will be carried out by independent experts.

Financial Due Diligence

Objective.-

- The objective of the due diligence is to provide relevant information for the valuation, contrasting the reliability in accordance with the scope and the procedures established by the FROB and confirming the reasonableness of the business plan for the credit entity.
- The due diligence will be carried out in two stages:
  - Firstly, an analysis of historical financial and business information (financial due diligence) and,
  - A second stage in which the entity's business plan will be reviewed, consisting mainly of an assessment of the reasonableness of the assumptions used and the indicators projected (business plan due diligence).

Other risk areas will also be identified and analysed (from a legal, regulatory, tax and labour perspective) that could have an impact on the valuation of the entity (e.g. clauses governing changes in control, penalisation for rescission of contracts, limitations to realisation of assets, fax assets, contingent liabilities, labour costs, etc.)

Financial due diligence(cont.)

Methodological approach.-

- The fundamental areas, from a methodological standpoint, of the financial due diligence are:
  - Loans and receivables and property (foreclosed assets, assets deriving from the settlement of debts, inventories or investment property)
  - Securities portfolio (including investees and equity instruments classified as available for sale)
  - Separation of business units
- The due diligence work on loans and receivables and property deriving from settlement of debts should pay special attention to the appropriate classificationn of risk and the re-estimation of impairment losses. The proposed model is the expected loss model.
- The work on the securities portfolio will require identification by sector of investees (differentiating between non-core and core business) and, in general, identifying and reassessing all impairment recorded (especially relating to goodwill) and identifying and assessing whether unrealised capital gains are reasonable and adequately supported.
- In the case of entities with large groups, the due diligence should report information differentiating between each business unit.

Financial due diligence(cont.)

Scope of work: procedures required-

- The procedures required will in each case be specified by the FROB but, in general, would cover: description of the entity and the business, comparative historical financial data, analysis of compliance with legislation, analysis of the income statement (quality and recurrence, extraordinary or non-recurrent results) loans and receivables (classification, evolution of key indicators and ratios, expected loss, refinancing), non-current assets held for sale, investees and AFS, structure of financing, financial instruments and hedging, liquidity risk, analysis of solvency, commitments, contingencies and other liabilities

Report

- The report will be in long-format and will include the most relevant aspects indentified in each of the areas reviewed together with the executive summary.
- The report will include pro-forma adjusted financial statements of the entity that are comparable with the business plan.

Executive summary

Business plan due diligence

Objective.-

- The objective of this due diligence is to confirm the reasonableness of the business plan providing relevant information for the valuation, taking the business plan as a starting point and the results of the financial due diligence.

Methodological approach and scope of the work-

- The review of the business plan will be based on the adjusted financial statements after the financial due diligence and will include:
  - Review of the reasonableness of the macro-economic assumptions and positions
  - Review of the reasonableness of the growth assumptions (per customer segment and asset and liability products)
  - Review of the reasonableness of the income assumptions (financial and gross margin, extraordinary items, impairment losses)
  - Review of the reasonableness of assumptions for rate of default and related provisions.
  - Review of the reasonableness of the cost assumptions (financial, general and repayment)
  - Review of the reasonableness of the synergy assumptions and restructuring plan
  - Review of the reasonableness of the assumption for the divestment plan
- The consistency between the financial projections and the base financial statements. Any adjustment already made to the current value of the base financial statements (e.g. impairment for expected loss) should be eliminated in the projections, the flows corresponding to business plan assets to be divested should not be further projected and the results generated on operations identified as non-recurrent should not be projected.

Report

- Based on the adjusted pro-forma financial statements resulting from the financial due diligence, the report will include an adjusted projection of the financial statements and an explanation of the assumptions finally considered.
- The report will also include a projection of the most relevant off balance sheet items and key indicators of the business.

Executive summary

Valuation

Objective-

- The objective of the valuation will be to issue an opinion on the market value of the entity and the percentage of capital equivalent to the investment to be made by the FROB.

Methodological approach and scope of work-

- The most commonly used methodologies by financial institutions, following going concern criteria, are the discounted future cash flows, especially the dividend discount model (hereinafter the DDM) and the comparable multiples of quoted companies and comparable transactions.
- The DDM is generally accepted by valuation experts, both from a theoretical and practical standpoint, to be the method that most efficiently incorporates all factors affecting the value of a business in the results of the valuation.
- The comparables methodology is based on the determination of the value of an entity based on the market value of comparable companies which are applied determining multiples or ratios on historical indicators of the business. Nevertheless, there are no 100% comparables, and, furthermore, due to the current conditions in the financial sector, to date, there is no relevant sample of recent transactions of fully comparable entities.
- Consequently, it is more advisable to use the DDM as the central valuation methodology, using the comparables methodology for the purposes of contrast.
- The valuer should conclude as to whether adjustments should be made to the value to adequately reflect the impact of the investment to be made by the FROB in aspects such as the lack of marketability of an investment, through application of a discount for lack of marketability which reflects the impact of the limitations to transfer of shares

Report

- The valuation report will describe in detail the procedures carried out, the methodology employed, whether or not adjustments should be made due to the lack of liquidity or marketability, the assumptions applied, the limitations (where appropriate) and will present a range of estimated values together with a sensitivity analysis.

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General considerations

- Royal Decree Law (RDL) 2/2011 of 18 February, which is intended to reinforce the financial system, has opened a new stage in the process of restructuring the Spanish financial system.
- In this new stage, the Fund for Orderly Bank Restructuring (hereinafter FROB) will once again play a fundamental role, adopting financial support measures such as acquisition of ordinary shares or share capital contributions to viable entities.
- Article 9.5 of RDL 9/2009 establishes that the price of acquisition of shares or subscription of share capital contributions by the FROB will be set in accordance with the economic value of these entities which will be determined by one or several independent experts to be designated by the FROB. In all cases the acquisition or subscription will be carried out in accordance with Spanish and European Union legislation governing State assistance.
- The valuation will be carried out following a procedure to be developed by the FROB following generally accepted methodologies.
- Appropriate valuation of credit entities for the abovementioned purposes is of paramount importance, especially in relation to the following three aspects:
  - From the point of view of European legislation governing competition, it should guarantee that public assistance is granted in market conditions.
  - Regarding the appropriate use of public funds, it would not be logical for the FROB to make a contribution of public funds without first having determined the acquisition or subscription price by applying procedures which are free from any type of controversy.
  - From the point of view of the entity itself, and interested parties, there is no doubt that an interest subscribed by the FROB should be paid up in market conditions, especially given the importance of effective participation of the FROB in the governing bodies of the entity.

General considerations

- In general, the valuation of viable entities will require three actions:
  - preparation of a business plan to be included in a Recapitalisation Plan, to be drawn up by the credit entity and approved by the Bank of Spain;
  - Performance of a due diligence procedure by independent experts designated by the FROB based on historical information and the business plan submitted by the Bank of Spain.
  - And finally, valuation of the credit entity by one or more independent experts designated by the FROB
- The business plans include assumptions on which the foreseeable evolution of the business is based and contain realistic objectives relating to the efficiency, profitability, leverage, liquidity and other key variables for the business (guaranteeing a reliable and sound valuation) representing a relevant basis for the valuation of the business.
- Through the due diligence, the purchaser (the FROB) should confirm the reliability of the historical information and the reasonableness of the business plan prepared by the credit entity through a due diligence process.
- Finally, the valuers designated by the FROB using their criteria will determine the value of the entity, making corrections that they consider necessary based on their judgment and applying the most appropriate valuation methods considering the above.
- To ensure the utmost effectiveness of the valuation work the FROB has decided to establish a panel to be formed by two renowned audit firms and two investment banks, to unite the expert's vision on performance of due diligence and/or valuations.
- Without prejudice to the RDL, the panel of experts will advise the FROB on procedures, criteria and methodologies that reflect best market practices in business acquisition processes and serve as a guide to harmonise the work to be carried out by independent experts designated by the FROB. These procedures , criteria and methodologies should be well founded and versatile in application, considering foreseeable time limitations and the need to guarantee that valuations are sound and reliable.

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Objective

- The main objective of the due diligence is to provide relevant, reliable information for the valuation, based on the scope and procedures established by the FROB.
- The due diligence will be carried out in two stages; firstly an analysis of historical financial and business information (financial due diligence) and a second stage in which the entity's business plan will be reviewed in order to evaluate its reasonableness (Business plan due diligence) The purpose of the financial due diligence will be to:
  - Provide adequate and relevant information to the FROB on the recent past, the current operations and business and the financial statements of the entity, together with the corresponding relevant comparative information.
  - Provide assurance that these adjusted financial statements reflect the actual situation of the entity at the date of the valuation.
  - Ensure that the financial information on which the business plan submitted to the Bank of Span is based is consistent with historical financial information.
  - Provide information relevant to the valuation which will include the following:
    - Adjusted pro-forma consolidated financial statements.
    - Consolidated comparative historical income statement disaggregating recurrent and non-recurrent results, with qualitative and quantitative information on the quality of earnings.
    - Calculation of the impact of the adjustments deriving from the due diligence on risk weighted assets (RWA).
    - The main balance sheet items on which the analysis will be based, given their relative importance, are as follows:
      - Loans and receivables, less corresponding provisions
      - Property, plant and equipment, foreclosed assets, assets deriving from the settlement of debts, and inventories which should be disclosed, revalued in accordance with market criteria.
      - Securities portfolio, identifying potential unrecorded gains and losses.
    - Liabilities should distinguish between wholesale and retail financing, differentiating financing that can be restructured from financing that cannot be restructured, and identifying maturity.
    - Goodwill should be tested for impairment.

Objective

- Other areas of risk should also be identified and analysed (from a legal, regulatory, fiscal and labour perspective) that could have an impact on the valuation of the entity, paying special attention to corporate governance and the extent to which the latter incorporates sector best practices.
- The due diligence of the business plan will consist of evaluation of the reasonableness of the assumptions and indicators projected and will include, the following:
  - Review of the macro-economic growth assumptions and positioning and leverage for the development of competitive advantage
  - Review of the income and growth assumptions for each product line, customer monitoring, prices and margins
  - Review of the assumptions for the main cost lines and projections closely linked to development of the macro components mentioned above.
  - Review of the assumptions and results expected from the plan to create and undo synergies
  - Review of the restructuring plan, offices affected in the domestic and foreign areas, jobs affected in offices and central services, expected costs, etc.
  - Review of value of investment portfolio, divestment plan, with effect on capital gains. RWA and solvency
- The level of compliance with the business plan will be reviewed if appropriate, with the objective of incorporating this input into the evaluation of the reasonableness of the assumptions and results included in the business plan

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Methodological approach– Loans and receivables

- As **loans and receivables** are the most relevant asset, this item should be analysed in detail:

Classification based on insolvency risk:

Operations incorrectly classified as due to customer arrears, substandard risk classified as standard, refinancing operations not adequately identified and doubtful exposures for reasons other than customer arrears classified as standard risk should be identified

Allowances and provisions for impairment:

Specific allowances and provisions made by the entity in accordance with Annex IX of Bank of Spain Circular 4/2004 should be verified for a significant sample of operations and general provisions and, where appropriate, country-risk allowance or provisions should be recalculated

- The proposed model to be applied to loans and receivables would be the **expected loss model**, the results of which should converge with the projection of future expected credit losses.
- The **objective** of this model is to quantify the total impairment of the loans portfolio (and foreclosed assets) considering not only losses incurred but also future expected losses, net of recoveries on collection of debts and execution of guarantees at realisable market value, all discounted to present value, that is, considering the finance cost of foreclosure.
- **This concept differs from the accounting loss**, and therefore the amount of the future expected loss could differ significantly from the accounting provisions recorded by the entity and the average level of provision in comparable entities in the market.

Methodological approach– Contrast with expected loss

0 Calculation of write-downs of loans and receivables + property from foreclosure of loans

- Expected loss model vs. Incurred loss model
- Model based on net exposure, less the value of stressed asset backed guarantees, in line with new Appendix IX of Circular 4/2004
- Differential treatment of wholesale and retail portfolios
- Standard treatment of haircuts in valuation of properties that are either collateral, foreclosed assets or asset swaps

1 Portfolio segmentation

- The proposed segmentation is:
  - Construction company
  - property developers
  - Large companies
  - SME
  - Retail mortgages
  - Consumer and other retail exposures
  - Public entities
  - Credit institutions
- Application of standardised bases for segmentation:
  - Obtain from distribution of risk disclosure statement

2 Calculation of net exposure

- Gross exposure (balance sheet exposure + guarantees + available cash*CCF) – adjusted guarantee
- Guarantees that reduce exposure:
  - Asset backed guarantees
  - Monetary and securities
- Correction of values of securities:
  - Haircuts on appraisals (based on ageing, type of assets, geographical location)
  - Contrasts with m2 value scales

3 Specific analysis

- Analysis of the exposure of the main economic groups considering a minimum level of review coverage
- Criteria for conclusions: lending experience, financial situation of borrower, rating/classification of entity, estimate of the value and timing of executing guarantees

4 Collective analysis

- Parameters affecting expected loss:
  - PD per segment
  - Beta of the impairment rate of the entity compared with the sector
  - LGD (severity)
  - Differentiation by LTV and by year of granting
  - Consideration of the costs of executing guarantees

5 Foreclosure

- Treatment of:
  - Foreclosure
  - Asset swap
  - Inventories
  - Real estate investments
- Consideration of exposure through real estate vehicles
- Avoid duplications of expected losses and adjustments to the value of investee-vehicle portfolio

Methodological approach– Contrast with expected loss(cont.)

Analysis under the **expected loss method** specifically considers the following aspects:

- **Portfolio segmentation**:
  - The segmentation of the portfolio for the purpose of calculating the impairment due to expected loss will be made considering the following:
    a) Type of borrower: wholesale (differentiating between large corporate clients and SMEs) and retail
    b) Sector of activity: identifying exposure of real estate developers through the distribution of risk disclosure statement
    c) Purpose of the operation: in retail portfolios, mortgage and consumer and other retail exposures

    This segmentation should be fully aligned to the segmentation for the purposes of the business plan projections, so that the results of the financial due diligence can be used for the business due diligence and to correct the projections if necessary, avoiding duplication of adjustments already made to the adjusted balance sheet and projected accounting provisions
- **Individually assessed impairment losses**:
  - Specific analysis will apply to the real estate development segment, construction companies, large companies and to foreclosed assets, as these assets are subject to the greatest impairment. In any case, a sufficient level of individual analysis coverage will be determined.
- **Collectively assessed impairment losses**:
  - For the remaining credit portfolio segments a general analysis will be performed based on estimating the present value of expected losses on unimpaired operations by applying a PD and LGD analysis projected for each segment.
  - For operations that are already impaired (doubtful) the corresponding specific provision will be projected
  - For operations classified as substandard, watch list and refinancing, additional stress factors will be applied.
- For the purposes of identifying hidden impairment, the impairment rate on securitised operations and non-securitised operations will be compared using similar bases (in respect of the lender and purpose of the operation), using the impairment rate on securitised operations as the most appropriate reference, increased by the amount of early repayments which are not consistent with market trends.

Methodological approach– Contrast with expected loss(cont.)

- **Guarantee valuation** (collateral) and valuation of foreclosed assets (including asset swap, inventories and real estate investments):
  - Appraisals by independent appraisers carried out using Bank of Spain criteria and recent Ministry of the Economy orders.
  - Realisable values will be compared with market values provided by independent experts in real estate assets so that these market values will identify estimated sales prices at the date of the future sale based on the foreseeable market evolution for each type of asset (housing, plot of land, rural land, etc) and considering their geographical location. The contrasting value will be calculated as the present value of the estimated price discounted from the date of the eventual sale to the present time based on a discount rate in line with the discount rates applied in recent transactions by purchasers of portfolios of comparable assets.
  - Prices that exceed the present value (calculated in accordance with the previous paragraph) will not be admissible.

Financial due diligence

Methodological approach– Securities portfolio

- The analysis of the **shareholdings** and **equity instruments classified as available for sale** should include the following:

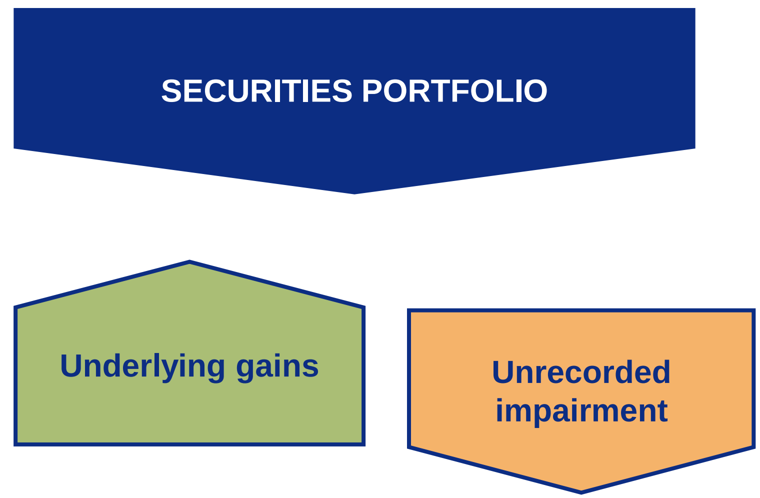
- **Idenfication of the investees per sector:** Equity investments core y non-core providing information on the evolution of the sector, listed and unlisted entities and indentifying core and non-core equity investments (pure financial investments)

- **Indentification of recognsised goodwill:** Goodwill should be tested for impairment

- **Identification of recognised capital gains:** A breakdown of capital gains should be included for investments recognised at fair value, together with the criteria used to calculate these revaluations at fair value

- **Indentification of capital gains that have not been recognised:** If capital gains exist which have not been recognised, the value should be included together with consideration of the source of the valuation. These may include recent transactions, external valuations carried out by fully recognised independent experts and irrevocable repurchase agreements.

- **Provision for impairment:** All provisions made for impairment should be identified and special emphasis given to real estate vehicle derivatives where impairment could have already been considered in the assessment of expected loss



Methodological approach– Separation of business units

- In the case of entities with large industrial groups which, given their characteristics require differentiated financial projections and subsequent valuation using the **sum of the parts method**, the financial due diligence should:
  - Segregate consolidated sub-balances of business units that will be valued separately
  - Identify adjustments corresponding to each of these sub-balances, providing an adjusted balance sheet for each of the business units that are projected separately
  - Prepare normalised pro-forma income statements for each of the different business units for which separate projections will be made. These statements should have at least the same level of detail as the projected income statements,

Methodological approach– Identification of other areas of risk

- The financial due diligence should be supplemented by a legal, regulatory, tax and labour review to identify the most relevant areas of potential risk for the valuation, although the scope of this work would not constitute a full due diligence for each of these areas. Examples of issues that should be included are as follows:
  - Review of the most relevant contracts of the entity to identify potential impacts deriving from the adjustments initially or in the financial projections, for example:
    - clauses governing changes in control
    - foreseen or ensuing penalisation for rescission or failure to comply with contracts:
      - distribution of financial or insurance products
      - shared management agreements
      - investment fund distribution agreements
      - custodian agreements
      - outsourcing agreements or for services by IT or other providers
  - Identification of permanent or temporary limitations affecting realisation of assets
  - Commitments deriving from prior or current integration processes (ISP or merger)
  - Quantification of contingent tax assets and identification of significant tax liabilities
  - Identification of labour costs deriving from restructuring processes underway.

Procedures required

The followings pages contain an initial outline of the main procedures to be applied during a financial due diligence process. The conclusions of each procedure and most significant matters revealed during the performance of each review and analysis will be included within the due diligence report.

The year-end financial statements used in the due diligence procedures will be those at the last accounting close for which consolidated financial statements were prepared and will cover the period between the last year end and the interim close and the two preceding complete years.

General

- An overall view of the entity’s business will be provided, and will detail the following:
  - Presentation of the entity’s legal structure.
  - Description of the structure and corporate governance policies together with an analysis of the extent to with these incorporate sector best practices (FSB recommendations, IIF, etc)
  - Description of the entity’s organisation (organigram, branch network and distribution channels).
  - Descriptive analysis of the network, with a breakdown of traditional business areas and areas of expansion (distribution of the business, quality of loans and receivables and deposits).
  - Review of the entity’s main business ratios and indicators.
  - Review of the main contracts with an impact on the entity’s business and an assessment of their financial implications.
- All the entity’s lines of business will be described individually:
  - Description of all the entity’s activities (corporate banking, personal banking, retail banking, etc.) and an analysis of the contribution of each line of business to the entity’s income (profitability).
  - List and detail of all the entity’s activities which are not related to its core business.

Procedures required (cont.)

Historical financial data

- A financial review of the entity will be carried out, detailing the following:
  - Review of the auditors' reports, annual accounts, supplementary reports and management letter for the previous two years and review of the latest financial information, together with the corresponding information for the same period in the prior year.
  - Review of other reports prepared by the entity and external advisors in the prior year as made available to us within the context of this analysis, in accordance with the confidentiality agreements adopted.
  - Review of the degree of compliance of the Strategic Plan prepared by the entity within the framework of the request made by the Bank of Spain, if the entity has previously requested aid from the FROB.
  - Identification and description of material extraordinary or non-recurring items and an explanation therefor.
  - Identification and description of any other non-banking items which have had a significant impact on the income statement.
  - Review of the reconciliations between management information and the audited financial information with an analysis of any related impact on the financial information used.
  - Verification of the reasonableness of the historical pro-forma financial statements reported by the entity.
- An accounting review of the entity will be carried out which will include the following details:
  - Analysis of the most significant accounting policies used, ascertaining whether they have been applied uniformly during the periods reviewed and commenting on the appropriateness of these policies for the various businesses.
  - Analysis of the impact of changes in accounting policies on the balance sheet, statement of changes in equity and income statement for the periods reviewed.

Procedures required (cont.)

Regulations

- Recent communication with the Bank of Spain will be analysed.
- A review will be performed of all the inspections carried out by regulatory bodies: the Bank of Spain and the Spanish Securities Market Commission (CNMV).

Balance sheet

- The nature and composition of the assets and liabilities reported on the entity's balance sheet will be analysed with a more detailed description of the most significant items.
- An analysis will be made of the main changes in the most material items in the entity's balance sheets for the periods analysed.
- Significant other assets and other liabilities will be reviewed, including a list of any unrecognised capital gains and losses which could give rise to unexpected future cash flows, on the basis of the information available.
- The reasonableness of material other provisions made, other than those relating to loans and receivables, will be assessed.
- A list will be prepared of significant items with carrying amounts substantially below their fair value which could give rise to unexpected future cash flows.
- Asset items which have been secured by third parties will be described and analysed.
- The analysis will be updated with any significant events between the reference date of the financial information used for the report and the date of issue of the report which could give rise to unexpected future cash flows.
- A list will be provided of any significant corrections made to capitalised expenses.

Procedures required (cont.)

Income statement

- The nature and composition of the items reported on the entity's income statement will be analysed with a more detailed description of the most significant items and the corresponding drivers.
- An analysis will be made of the main changes in the most material items in the entity's income statement for the periods analysed, with a view to obtaining individual degrees of recurrence to justify the figures used in the Business Plan for each item.
- The trends in the margins and results reported by the entity during the periods analysed (interest margin, gross margin, operating income/expense, profit/loss before tax and profit/loss for the year) will be examined.
- An analysis by type of product will be performed of the entity's income and profitability during the periods analysed (mortgages, corporate and consumer loans, cards, etc.), and of the corresponding spreads over the benchmark interest rate.
- An examination will be carried out of the cost of the main sources of financing used by the entity during the periods analysed (customer funds and debt issuance), and of the corresponding spreads over the benchmark interest rate.
- A description will be made of the main fees and commissions charged and paid by the entity (for origination, operational restructurings, brokerage, custody, management, etc.), their accounting recognition, the trends therein and the corresponding drivers during the periods analysed.
- The composition, recurrence and trends in the gains and losses of the entity's financial operations during the periods analysed will be examined by type of portfolio.
- The composition, recurrence, trends and drivers of other significant operating income and expense during the periods analysed will be examined.
- The composition, recurrence, trends and drivers of the entity's personnel expenses during the periods analysed will be examined. The tendencies in the workforce, average expense per employee (including and excluding variable remuneration) and the entity's efficiency ratio in the periods will also be analysed.
- If the entity has an ongoing restructuring plan, the deriving costs incurred will be identified and details will be provided for each item (together with any deviations from the budget) and those yet to be incurred per year.

Procedures required (cont.)

Income statement (cont.)

- The breakdown, recurrence, tendencies and drivers of the entity's main administrative expense items during the periods analysed, differentiating between the fixed and variable portions, will be examined.
- Once all the one-off operations in the year and two preceding years have been identified and explained, a normalised recurrent income statement will be prepared. For example, one-off operations to be identified in capital markets include those which give rise to capital gains and operations thereby allowing the entity to anticipate its future financial margin, such as structured repos, swaps and structured notes.

Commitments, contingencies and other liabilities

- All commitments to employees will be identified and described, including pension plans and retirement bonuses, and the related accounting treatment will be analysed.
- The commercial and financial implications of the existence of contingent liabilities identified by entity management will be assessed.
- The nature of any ongoing litigation reported by entity management will be analysed and any potential implications for the entity will be assessed.
- A description will be provided of the nature of items not reported on the balance sheet, particularly any assets which have been securitised via transfer to special purpose vehicles, the trends therein during the periods analysed, any risk held and assumed by the entity and any potential future impact on the entity's income statements.
- Exposure from guarantees in guaranteed funds and other structured products will be analysed.

Procedures required (cont.)

Loans and receivables

- The entity's loans and receivables portfolio will be analysed from a risk standpoint in order to study the concentration of the loans and receivables portfolios and assess the tools and procedures set up by the entity to measure and control credit risk and restrict the impairment rate.
- The entity's loans and receivables portfolio will be divided into six major categories: development and construction, big companies, small companies, retail mortgages, other retail and public entities.
- The risk policy will be analysed for each of the entity's six portfolio categories: request, approval, monitoring and recovery (in case of insolvency).
- The rating and credit-scoring tools used by the entity to assess potential customer risk for the six portfolio categories will be analysed.
- The valuation criteria, policies and appraisal of the collateral used to cover the risk assumed by the entity will be analysed and considered.
- The trends and drivers of the six portfolio categories during the periods analysed by risk situation (standard, arrears, doubtful for reasons other than arrears and substandard) will be analysed.
- The tendencies in the loan to value ratio of each other the entity's six portfolio categories during the periods analysed will be examined.
- An analysis will be made of the profitability of the six separate portfolio categories during the periods analysed, and of the corresponding spreads over the benchmark interest rate.
- The ageing and maturity of all the entity's six portfolio categories will be analysed.
- The concentration of each of the entity's six portfolio categories will be analysed.
- Floors and any ceilings below 10% and the related limits will be identified and detailed for the retail loan portfolio, specifying the corresponding strike levels, benchmark interest rate and maturity. Similarly the amounts of the loans and receivables relating to activated floors will be identified and classified by strike tranches.

Procedures required (cont.)

Refinancings

- All the entity's outstanding refinancing will be detailed.
- An analysis will be made of the criteria and policies used by the entity when granting refinancing as regards the mechanisms used to improve collateral, with particular emphasis on the risks deriving from the development and construction portfolio.
- The main credit risks deriving from refinancing operations will be listed and conclusions will be drawn as to the reasonableness of the amount provided for.
- The amount of uncollected interest accrued in prior years will be calculated for refinanced operations with grace periods granted to both the development and construction sector and to individuals. In the latter case, amounts relating to home purchases with LTVs of 100% or more will be specified.

Provision for insolvency

- The system and policies used by the entity to monitor and make provisions for operations in arrears and substandard risk will be described and analysed.
- An analysis and description will be made of the historical trends in the entity's provisions for insolvency and their impact on the income statement, differentiating between the portions representing general and specific provisions.
- The expected financial loss of the entity's six portfolio categories will be calculated individually using the methodology previously described in this document.
- The trends and drivers of the loan default ratio and coverage ratio of all six portfolio categories during the periods analysed will be examined.
- The trends and drivers of the general and specific provisions made for the six portfolio categories during the periods analysed will be analysed individually.

Procedures required (cont.)

Tangible assets and Non-current assets held for sale

- A historical detail of the additions and derecognition of foreclosed/acquired assets during the periods analysed will be prepared, to verify the foreclosure amount, the provisions made on foreclosure, appraised value, date of appraisal, carrying amount of the originating risk deriving from the loans and receivables portfolio (for additions) and the sale value (for derecogntions).
- A detail will be drawn up of the entity's significant tangible assets.
- The foreclosed/acquired assets and significant tangible assets which the entity intends to recognise in the next six months will be detailed, along with information of the corresponding appraised value and date of appraisal.
- Calculations will be made of the expected financial loss of available foreclosed/acquired assets and significant tangible assets which have been recently appraised using the methodology previously described in this presentation.
- The reasonableness of the provisions for foreclosed/acquired assets and tangible assets, including those made by ad-hoc special purpose vehicles, will be measured.
- The volume and sale trends of foreclosed/acquired assets connected to the corresponding loans and receivables portfolio giving rise to them will be analysed.

Investees and Available-for-sale financial assets

- A detail will be made of the entity's investee and available-for-sale financial assets portfolio, differentiating between direct investments and those held through investment vehicles.
- The sector trends in the concentration of the entity's investee and available-for-sale financial assets portfolio during the periods will be examined.
- The contribution of the entity's investee and available-for-sale financial assets portfolio to profit or loss during the periods analysed will be examined.
- A general high-level review will be carried out of the main equity investments (cost/recoverability of the investment).
- The reasonableness of the main items of goodwill recognised will be assessed, through reviewing the related reports and most recent impairment tests.

Procedures required (cont.)

Investees and Available-for-sale financial assets (cont.)

- A detail will be provided of all the unrecognised capital gains and losses identified by the entity's investee and available-for-sale financial assets portfolio.
- Generally, the entity's most significant subsidiaries will be analysed using their financial statements and overall financial position.
- Specifically, ad-hoc financial due diligence procedures will be carried out on those investees considered to be more important strategically and which represent the largest contributions to the value of the entity, specifically special purchase vehicles or entities whose activities are regulated.

Liquidity risk

- A review will be carried out of the directors' reports prepared by the entity with respect to the liquidity risk, with particular reference to recent trends and highlighting the following:
  - Analysis of liquidity gaps
  - Analysis of interest rate gaps
  - Analysis of foreign currency gaps
  - Analysis of availability of credit facilities (committed financial resources)
  - Analysis of debt issuances and maturities
  - Analysis of customer liabilities and an assessment of the level of customer loyalty
- A review will be carried out of the controls implemented by the entity for the monitoring and managing tasks carried out by the Assets and Liabilities Committee (COAP) of its foreign exchange and interest rate structural positions, global liquidity and shareholders' equity.
- **Those ratios or measures that, according to the auditor, are necessary to assess the state of liquidity of the entity will be calculated**

Procedures required (cont.)

Financing

- An analysis will be performed of the entity's financing items, which will specify the maturities and average financing cost and whether the remuneration is fixed, variable, restructurable or non-restructurable, and of the changes therein during the periods analysed, providing detail of the following:
  - Retail financing: i) demand deposits and ii) time deposits (FTDs and other)
  - Wholesale financing: i) deposits from central banks, ii) deposits from credit institutions, iii) general government, iv) subordinated liabilities, v) preference shares, vi) mortgage and covered bonds (including the trends in the value of the appropriate portfolio for issuing mortgage bonds) and vii) other.
- The trends in the entity's leverage ratios (loans/deposits, retail/wholesale financing, etc.) during the periods analysed will be examined.
- The trends in the off-balance sheet customer funds will be examined by type of product for the periods analysed, along with its impact on the entity's income statement.

Financial instruments (securities portfolio)

- The trends and drivers of the entity's securities portfolio during the periods will be analysed by type of portfolio (available-for-sale financial assets, financial assets measured at fair value and held-to-maturity investments classified between fixed income securities and quoted and unquoted variable income securities), and include the impact of these changes on the entity's income statement.
- The valuation of the entity's various financial instrument portfolios will be reviewed.
- All material compound and hybrid financial instruments which could be difficult to classify and measure will be identified.
- The entity's securities portfolio will be classified, distinguishing as far as possible, between its restructurable and non-restructurable securities (according to the difficulties to transform maturities and obtain refinancing extensions or early redemption, if required).

Procedures required (cont.)

Accounting hedges

- A review will be carried out of hedging and speculative derivatives of the entity, and an analysis of the reasonableness of the accounting treatment of hedges though derivative financial instruments and, where applicable, through macro-hedges.
- Any change in criteria in hedge criteria for portfolio hedges will be analysed that implies greater exposure to interest rate risk and that has been introduced to reduce costs derived from the contracting of hedging instruments
- In particular, an analysis will be carried out of sales of macro and micro hedges carried out by the entity in the two years to reduce future profits such as the sale of fixed-floating interest rate swaps related with the issue of mortgage and covered bonds or other debt instruments.
- An evaluation will be carried out of the main requirements for the application of hedge accounting:
  - Analysis of hedging instruments
  - Analysis of hedged instrument (e.g. current accounts in fair value hedges, highly probable provisions)
  - Initial documentation for hedges
  - Effectiveness testing and accounting treatment: i) recognition of ineffectiveness and ii) recognition of gains and losses in the income statement.

Procedures required (cont.)

Solvency

- An analysis will be carried out of the evolution of shareholders' equity and solvency ratios of the entity (core capital, Tier 1 and Tier 2), calculated based on the New Capital Accord (Basel III).
- A review of the compliance with minimum capital requirements of the entity will be carried out.
- A review will be carried out of the Risk weighted assets (RWA) by the entity and the evolution during the periods analysed.
- The latest Capital Self Evaluation Annual Report will be reviewed together with any updates or modifications.
- The capital consumption will be re-evaluated in accordance with the new directives related to Royal Decree law 2/2011 once the adjustments to equity deriving from the above analysis have been considered and the possible impact of this re-evaluation on the Business Plan will be evaluated
- The latest ratings of the entity issued by the different rating agencies will be requested and an analysis carried out of their evolution.
- The liquidity and operational risk mitigation procedures (and measurement) will be described and the procedures for mitigation of reputational risk (and measurement) used by the entity will be reviewed considering its level of compliance with industry practices. Capital consumption in addition to that generated by lending activity (credit risk) will be considered, as well as consumption derived from liquidity and operational risks.

Contents

Objectives and key issues for the review of the business plan

- **The objective sought by reviewing the business plan is to confirm its reasonableness by providing relevant information for its evaluation**
- **The starting point of the business plan review is the results of the financial or historical DD**
- **The review of the business plan** will comprise the assessment of the reasonableness of the assumptions and results associated with the BP, and will result in **the projected financial statements for the period, including any adjustments** required to assure the reasonableness of the BP.

- **Macroeconomic and sector assumptions:** Review of the assumptions related to macroeconomic growth, positioning and leveraging for the development of a competitive edge.
- **Growth assumptions for products, segments, prices and margins:** Review of income and growth assumptions by production line, client segment, price and margins.
- **Cost assumptions:** Review of the assumptions concerning the main cost lines and their future projections, closely linked to development of the above-mentioned items (i.e. macro)
- **Review of the plan to create and undo synergies:** Review of the assumptions and expected results from the plan to create and undo synergies
- **Review of the restructuring plan:** Review of the restructuring plan, branches affected (domestic and abroad), employees affected (branches and central services), expected costs, etc.
- **Review of investees and the divestment plan:** Review of the value determined for the portfolio of subsidiaries – divestment plan, impact on capital gains, RWA and solvency
- **Review of solvency indicators:** Declaration on the adequacy of these indicators (compared to the levels required by the market) and consistency with the rating objective and the cost of wholesale financing

Adjusted financial statements following the financial DD

+

Reasonableness of the BP assumptions and projections

=

Adjusted projections (if applicable) in the BP based on its reasonableness

Methodological approach to the business plan review

- **The review of the business plan** must be structured in a way that includes at least four stages to review the assumptions and development of the financial statement items, and will be preceded by the results of the financial due diligence on the entity and information on compliance with the prior business plan.
- **Emphasis will be placed on different issues considered to be key (e.g. creating/undoing brand synergies in SIP) depending on whether the model used for integration is by merger or by SIP**. Nevertheless, the same methodology with be used, which is described below:

Adjusted financial statements following the financial DD

Compliance with the prior business plan presented to the FROB

- Review of the quarterly compliance of the income statement and balance sheet: business segments, prices, NPL, costs, etc.
- Review of the compliance of synergies and restructuring: retirement, voluntary redundancies, closure of branches, personnel leaving head office and the associated costs
- Review of the compliance of the investee divestment plan
- Review of the compliance of strategic ratios: efficiency, solvency, return, liquidity and wholesale exposure

1 Assumptions on environment growth and positioning

- Review of the reasonableness of the macro assumptions and by key sector, as well as competitive positioning compared to the rest of the entities
- Review of the reasonableness of growth assumptions:
  - Client segments and key products
  - Loans and receivables mix by segment

2 Income assumptions

- Review of the reasonableness of growth, price and margin assumptions, and evolution of these factors:
  - By product line and client segment
  - Commissions, ROF and investees
  - Contribution to margins

3 Assumptions on non-performing loans (NPL) and provisions

- Review of the reasonableness of the assumption for non-performing loans (NPL) by product/client segment (once the projections have been adjusted to include the impact of the write-down introduced in the opening balance sheet)
- Review of the reasonableness of evolution in provisions and hedging levels

4 Cost assumptions

- Review of the reasonableness of the cost assumptions:
  - Financing costs
  - Personnel expenses
  - Administrative expenses
  - Rentals

5 Synergies, restructuring plan and divestment plan

- Review of the reasonableness of the plan to create and undo synergies
- Review of the reasonableness of the restructuring plan
- Review of the reasonableness of the value determined for the portfolio of subsidiaries – divestment plan

Methodological approach to the business plan review

1 **Assumptions on environment growth and positioning** | 2 Income assumptions | 3 Assumptions on non-performing loans (NPL) and provisions | 4 Cost assumptions | 5 Synergies, restructuring plan and divestment plan

Review of the reasonableness of the macroeconomic and positioning assumptions

- **Macroeconomic indicators**: Review and adjustment (if applicable) of the assumptions concerning various macroeconomic indicators, due to their repercussion on the plan:
  - **GDP**
  - **Unemployment**
  - **Interest rates (interest rate curve)**
  - **Price levels (CPI)**
  - **Household spending and saving**
  - **Trends in the money and debt markets**
  - **Evolution in the cost of wholesale and retail financing**
  - …
- **Sector perspectives:** Review and adjustment (if applicable) of the growth assumptions for sectors related to the entity's banking activities, such as the property market, services, etc.
- **Positioning:** Review and adjustment (if applicable) of the entity's main strategies that support its future positioning (vision and mission), such as the key segments to be developed, regions, key products, pricing and financing strategies, etc.
- At the same time, measures will be taken to ensure that certain exceptional circumstances that might affect the entity, such as the withdraw of the extraordinary financial facilities by the monetary authority or the impact on deposit rates of the restructuring of the Spanish banking sector, have been taken into account.

Review of the reasonableness of the growth assumptions

- Review and adjustment (if applicable) of the growth assumptions for segments, clients and products, and their support with respect to the macroeconomic and sector perspectives identified, as well as price levels, detailing the following segments/products as a minimum:
  - ***Products***
    - *Assets*
      - Construction company/developer loans
      - Loans with mortgage guarantee
      - Personal loans
      - Loans to large companies
      - Loans to SMEs
    - *Liabilities*
      - Fixed-term deposits (periods for resetting FTDs)
      - Deposits
      - Unsecured loans
  - ***Segments***
    - Private individuals
    - SMEs
    - Large companies
    - Institutional clients
- Review and adjustment (if applicable) of the mix resulting from loans and receivables over the projected period (weight of construction company/developer loans, wholesale mortgages, retail, consumer, etc.)
- Review and adjustment (if applicable) of the resulting mix of the funding sources during the projected period (who sale funding, retail, etc).

Methodological approach to the business plan review

1 Assumptions on environment growth and positioning | 2 **Income assumptions** | 3 Assumptions on non-performing loans (NPL) and provisions | 4 Cost assumptions | 5 Synergies, restructuring plan and divestment plan

Review of the reasonableness of income assumptions

- **Financial margin**
  - **Income**: Review and adjustment (if applicable) of the assumptions concerning loans and receivables, the annual calculation of repayments per product, as well as the reference interest rate and annual performance calculated for each item in the asset portfolio.
  - **Payment of interest and charges:** Review and adjustment (if applicable) of the financing cost assumptions by segment/product
- **Gross margin**
  - **Return on equity instruments:** Review and adjustment (if applicable) of the assumptions concerning the return on equity instruments, considering the portfolio of invested capital, the impact of the financial crisis on assets, etc.
  - **Net fee and commission income:** Review and adjustment (if applicable) of the assumptions for commission income, separating those assumptions related to bank services (transactions) from those which are not.
  - **ROF:** Review and adjustment (if applicable) of the assumptions concerning income from ROF
  - **Exchange rate differences:** Review and adjustment (if applicable) of the assumptions concerning income from exchange rate differences
- **Extraordinary items:** Review and adjustment (if applicable) of the assumptions concerning extraordinary items, descriptions of these items and levels compared to prior years
- **Asset impairment losses:** Review and adjustment (if applicable) of the assumptions on expected asset impairment losses, disclosing assets by impairment, amount and proposed impairment percentage, reason for impairment, etc.

Methodological approach to the business plan review

1. Assumptions on environment growth and positioning
2. Income assumptions
3. **Assumptions on non-performing loans (NPL) and provisions**
4. Cost assumptions
5. Synergies, restructuring plan and divestment plan

Review of the reasonableness of the assumption concerning non-performing loans and the hedging plan

- Review and adjustment (if applicable) of the assumptions concerning **non-performing loans** over the period, reviewing:
  - Estimated probability of default (PD) by loans and receivables segments (secured loans, loans with mortgage guarantee, etc.)
  - Estimated loss in the event of default – LGD – for non-performing items
- Review and adjustment (if applicable) of the assumptions concerning **provisions,** reviewing the following for the period:
  - General provisions (reconstitution levels for the general provision as a percentage of the Alfa parameter).
  - Specific provisions
- Review and adjustment (if applicable) of the assumptions concerning **the level of hedging** against risks affecting the credit portfolio, reviewing the development of loans and receivables, amounts appropriated to provisions and asset maturity calendars

Methodological approach to the business plan review

1. Assumptions on environment growth and positioning
2. Income assumptions
3. Assumptions on non-performing loans (NPL) and provisions
4. **Cost assumptions**
5. Synergies, restructuring plan and divestment plan

Review of the reasonableness of the cost assumptions

- **Financing costs:** Review and adjustment (if applicable) of the assumptions concerning financing costs before the recapitalisation to be carried out by the FROB, as well as the price levels affected by the interest rate curve and market spread by financing type (calculated based on the entity's rating)
  - The sustainability of financing structure and the balance between wholesale and retail funding will be considered as will be its impact on the cost of financing the entity.
  - The alignment of the entity's projected cost of financing with the expected rating of the entity will be also considered.
- **Overheads**
  - ***Personnel expenses***: Review and adjustment (if applicable) of the assumptions concerning personnel expenses, as well as the forecast number of employees joining/leaving the entity over the projection period
  - ***Administrative expenses:*** Review and adjustment (if applicable) of the assumptions concerning the main administrative expenses (rentals, maintenance, general services, etc.)
- **Amortisation and depreciation**
  - ***Amortisation and depreciation:*** Review and adjustment (if applicable) of the assumptions concerning the amortisation and depreciation of assets over the projection period

Methodological approach to the business plan review

1. Assumptions on environment growth and positioning
2. Income assumptions
3. Assumptions on non-performing loans (NPL) and provisions
4. Cost assumptions
5. **Synergies, restructuring plan and divestment plan**

Review of the reasonableness of the assumptions concerning synergies and the restructuring plan

- **The reasonableness will be reviewed and adjustments proposed (if applicable) to the synergies included in the business plan, analysing and comparing the following parameters:**
  - **Compliance of the synergies in the prior business plan**
  - **Review and adjustment (if applicable) of the plan's new synergies**
    - **Review of the assumptions considered:** Comparison of the synergy contents and concepts, coherence with the entity's strategy
    - **Review of the investment required and expected savings:** Comparison of the defined investment level required to make cost savings, the reasonableness of the expected savings and their distribution over time
    - **Review of the feasibility of the implementation of synergies:** Comparison of the effort required, the complexity of implementation and the risks involved, and the realistic calendar for implementation
- **The reasonableness will be reviewed and adjustments proposed (if applicable) to the restructuring plan, analysing and comparing the following parameters:**
  - Number of defined employee redundancies, broken down by early retirement, voluntary redundancies, estimated terminations of temporary contracts, and location (branch network or central services)
  - Average cost by type of redundancy, comparison with other procedures underway
  - Calendar of dismissals/branch closures
  - Calendar of expected savings

Review of the reasonableness of the assumptions concerning the divestment plan

- **The reasonableness will be reviewed and adjustments proposed (if applicable) to the divestment plan, analysing and comparing the following parameters:**
  - Liquidity of equity investments: listed/non-listed companies
  - Estimated timeframe for completion of the divestment
  - Carrying amount and unrealised gains/losses
  - Amount of financial goodwill
  - Discount applied by the market for the sale of a significant volume in the case of listed companies (based on the sale timeframe)
  - Loss of attributable dividends/profits due to the divestments to be carried out
  - Variation in core capital arising from the investment, capital consumption, impact on risk weighted assets and impact of the divestment on the entity's core capital
  - Financial cost of the investment (opportunity cost)

Consistency betwee the review of the business plan and the financial due diligence

- **One of the objectives of the review of the business plan is to make sure that the financial projections made are consistent with the adjusted financial statements which take the initial period as the starting point (t_0).**
- It is important to consider the financial statement adjustments required with respect to:
  - Elimination of projected adjustments for provisions or the impairment of assets which were fully adjusted at the start, for example:
    - Non-consideration of projected non-performing loans for the initial developer/construction company portfolio, the total write-down of which was calculated using the opening balance sheet.
    - Non-consideration of the future impairment of real estate assets (foreclosures, inventories, investment property) which have been fully adjusted in the opening balance sheet.
    - Elimination of the future impairment of goodwill which was fully adjusted in the opening balance sheet.
  - Elimination of the projected interest margin corresponding to loans and receivables considered as in arrears at the opening date.
  - Elimination of projected flows from non-core assets beyond the period in which they are expected to be sold.
  - Consideration of the impact on the projected income statement of one-off transactions carried out by the entity to anticipate results, and which lead to a reduction in income in the recurring income statement, for example:
    - Capital market transactions which cannot be repeated in the future.
    - Structured repo, swaps or structured note transactions or, in general, any transactions which imply anticipating results.
    - Portfolio sales.
    - **At the same time, the future estimates of the state of liquidity of the entity, bearing in mind its ability to meet its liabilities and its resilience in face of movements in the wholesale financial markets, will be considered.**

Consistency betwee the review of the business plan and the financial due diligence

- **Entities resulting from recent mergers or incorporation into a SIP (Institutional Protection System)**

❑ **Financial Due Diligence**

- In the case of entities resulting from a recent merger (within the last two years):
  - In addition to recent financial history (see previous section), the merger balance sheet and the corresponding statements of merger, including adjustments in valuation, impairments reclassifications and other accounting adjustments that have been carried out, will be examined.
  - When necessary, access to previous reports on due diligences and others related assessments drawn up due to merger, will be requested.
- In the case of entities involved in a IPS:
  - In addition to recent financial history of the entities involved in the IPS, the assets and liabilities transferred to the IPS central body and the adjustments in valuations will be examined, applying the most prudent criteria regarding the "*haircuts"* applied thereto.
  - When necessary, access to due diligences and independent expert reports drawn up due to the integration, will be requested
- At the same time, the future recovery of the deferred tax assets which have been booked at the time of the mergers, will be evaluated specifically.

❑ **Business plan due diligence**

- The rationale behind the synergies included in the Business Plan, will be studied, with special consideration given to those that show significant deviations from actual synergies that have been harnessed in other comparable mergers.
- The rationale behind the cost included in the business Plan caused by a possible loss of market share as a result of the merger, will be studied.
- The measures adopted in order to meet the regulatory requirements on risk concentration on a consolidated basis will be reviewed.
- The measures envisaged in the Business Plan to improve organizational, management and risk control practices of the entity will be examined

Contents

Report contents

Financial due diligence report

- Upon completion of the fieldwork a report will be prepared, reflecting the most relevant issues identified in each of the areas reviewed. This report will be structured as follows:
  1. Introduction and executive summary
  2. Support analysis:
     1. Current market and competition situation
     2. Loans and receivables
     3. Non-current assets held for sale
     4. Subsidiaries and equity instruments classified as AFSFA
     5. Liquidity, financial instruments and debt
     6. Solvency
     7. Other assets and liabilities
     8. Review of contracts and other regulatory, tax and labour issues
  3. Appendices

Report contents

Financial due diligence report (cont.)

- The report will include the sources used to obtain the information contained therein. The engagement will not include a comparison of this information with external evidence, except in those cases where the firm issuing the report deems it necessary to do so. Nevertheless, insofar as possible, it will be verified that the information presented is consistent with other data provided during the course of the due diligence work, in accordance with the terms and conditions of these specifications.
- The work will also include an analysis of those significant events or transactions which may take place up until the date on which the report is issued, which will take place once the field work has been substantially completed.

Pro forma financial statements for the entity

- Adjusted pro forma financial statements for the entity will be included, allowing comparison with the business plan.

Report contents

- **The DD report on the business plan will include an adjusted projection of the financial statements** (income statement and balance sheet) of the entity for the pre-established period. The adjustments to the business plan originally presented will be documented to support their reasonableness. Below is a breakdown of the income statement and balance sheet items to be reviewed, both for 2010 and the estimates for the projected period considered in the entity's business plan.

INCOME STATEMENT
Interest expense and similar charges
Intereses derivados de la emisión de preferentes
Return on equity instruments
Interest margin
Net fee and commission income
Gains and losses on financial assets and liabilities
Profits or losses of investees
Other operating income/expense
Gross margin
Personnel expenses
Administrative expenses
Amortisation and depreciation
Provisions
Profit/(loss) before impairment losses
Impairment losses
Profit/(loss) before tax
Income tax
Profit/(loss) for the year
Transfer to welfare funds
Profit/(loss) for the year (less transfer to WF)

ASSETS
Cash and balances with central banks
Financial assets held for trading
Other financial assets at fair value
Available-for-sale financial assets
Loans and receivables
Loans and advances to credit institutions
Loans and advances to other debtors (gross)
Provisions for insolvency
Other financial assets
Held-to-maturity investments
Hedging derivatives
Non-current assets held for sale
Equity investments
Reinsurance assets
Property, plant and equipment
Intangible assets
Tax assets
Other assets
Total Assets

LIABILITIES
Financial liabilities held for trading
Financial liabilities at amortised cost
Hedging derivatives
Liabilities associated with non-current assets held for sale
Liabilities under insurance contracts
Provisions
Tax liabilities
Welfare funds
Other liabilities
Equity
Shareholders' equity
Valuation adjustments
Total liabilities

Report contents

- Off balance sheet items and the main indicators in respect of returns, efficiency, solvency and liquidity to be reviewed qre listed below. These should include figures for 2010 and estimates for the projection period considered in the entity's Business plan

Off balance sheet

Assets

Contingent exposures and commitments

Liabilities

CIUs
Variable interest
Fixed interest
Others

Indicators

Returns

ROE = Net income / Shareholders' equity
ROA = Net income / Total average assets

Efficiency

Efficiency ratio= Admin expenses. / Gross margin

Solvency

CORE Capital = (Shareholders' equity – Intangibles) / Risk weighted assets(RWAs)
TIER I = Eligible capital resources/ RWAs

Liquidity

Cash (Cash and balances with central banks) / Total assets
Loans and advances to other debtors/ Total assetsl
Loans and advances to other debtors/ Retail deposits (deposits from other creditors)
Current liabilities/current assets

Contents

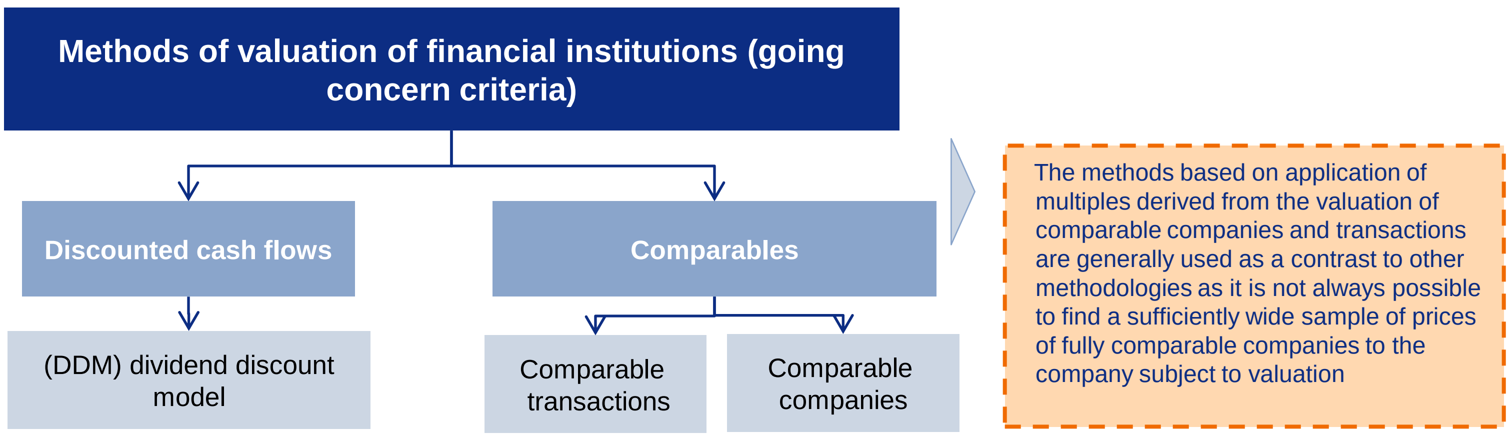
Procedures required

- The procedures to be carried out by advisor designated by the FROB for the valuation are as follows:
  - Obtain and analyse the following information on the entity to be valued:
    - Individual and consolidated financial statements for the last three years
    - Latest available financial statements for 2011
    - Business plan prepared by the entity and approved by the Bank of Spain
    - Financial due diligence and business plan
  - Conversations with management of the entity and the advisors commissioned by the FROB for the financial due diligence and the business plan
  - Application of valuation methodologies described below
  - Issue of an opinion on the market value of the entity and the percentage of capital equal to the investment to be made by the FROB

Contents

Introduction to valuation methodologies

- There is no single valuation model applicable to financial institutions. Nevertheless, there are certain methods that are generally accepted in the international investment community of specialised advisors, capital market analysts and academics, which are frequently used to estimate the value of financial institutions within the context of mergers and acquisitions.
- In general terms, the possible market value of a business is calculated as the higher of the value that can be reasonably estimated, based on the capacity of the business to generate profits and dividends or the amount that would be generated if the business were wound up. The possible market value of a business that generates a sufficient level of profit and dividends, compared with the assets required to obtain these, should be valued following going concern criteria.
- For the specific case of acquisition of shares or subscriptions of contributions to credit entities by the FROB, in the context of article 9 of Royal Decree Law 9/2009 modifying Royal Decree Law 2/2011, going concern valuation methodologies will be applied.
- The most commonly used methods for financial institutions, considering going concern criteria are the discounted cash flow method, especially the dividend discount model “DDM” and multiples of comparable quoted entities and comparable transactions.
- Alternatively, in the case of financial institutions with a significant non-financial asset component (industrial equity investments) the possibility of performing a sum of the parts valuation should be considered, in which the bank business in valued using the DDM and the rest of the industrial equity investments by using the discounted cash flow or comparables method, to obtain an integral value of the sum of each of the values obtained. In case the sum of parts methodology will be applied, the final reports should include a specific disclosure explaining the process.

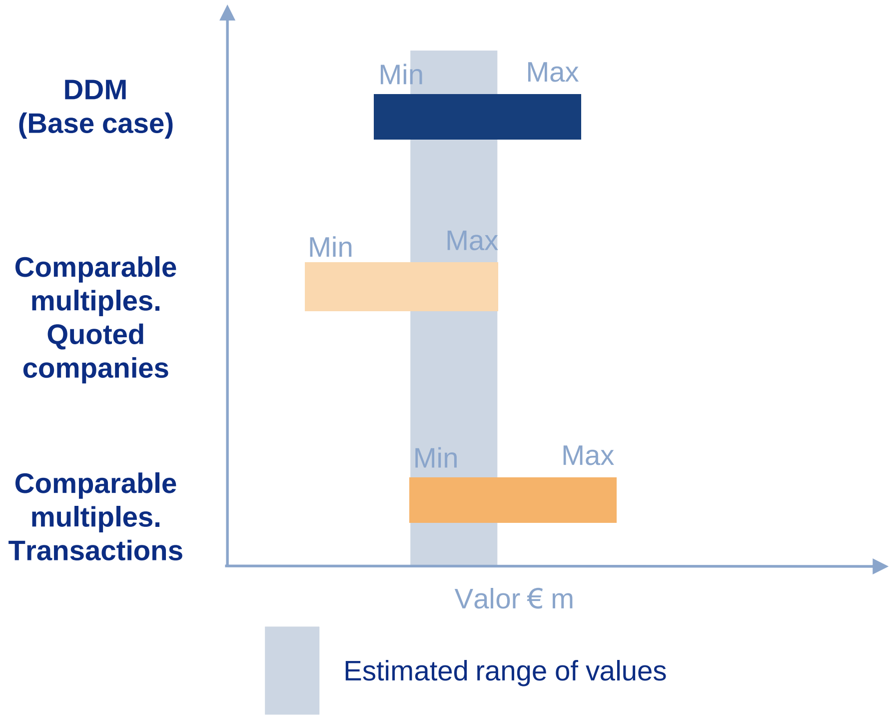


Introduction to valuation methodologies

- The DDM is generally accepted by experts in valuation, both from a theoretical and practical standpoint as the method that most efficiently incorporates all factors affecting the value of a business in the results of the valuation

- The comparables method determines the value of an entity based on market values of comparable companies that are applicable to the company subject to valuation based on certain multiples or ratios regarding the historical indicators of the business (in the case of banks, generally multiples of capital tangible net worth, core capital net income)
- Nevertheless, entities are not 100% comparable due to the diversity of the risk profiles and returns of the entities in the market.
- Furthermore, due to the current financial sector conditions, to date there is no relevant sample of recent transactions of fully comparable entities. Furthermore, the historical indicators of financial institutions in Spain are affected, among other factors, by the impact of the mergers and integrations that have taken place.
- Consequently, it is more advisable to use the DDM as the central valuation methodology, using the comparables methodology merely for comparison purposes.
- Furthermore, the results of the valuation should be adapted to the specific investment to be made by the FROB (previously defined amount to be invested) to consider factors such as liquidity.

Results of Valuation (illustrative example)



Contents

Dividend Discount Model ("DDM")

- Under the future dividend discount model the value of the shares of the entity subject to valuation would be the sum of the following components:
  - Present value at the date of valuation of future dividends that the entity is estimated to generate over the projection period.
  - Residual value calculated as the present value at the date of valuation of future dividends estimated to be generated by the entity after the final year projected.
- The key assumptions for the application of this method are the estimate of future dividends, the estimate of the residual value and the discount rate.

Estimate of future dividends and projection period

- The dividend flow is the amount of profit that could be distributed to the shareholders without compromising the future of the business.
- The dividend flow will be calculated as the flow derived from the activities of the entity less the amount withheld which is necessary for the company to continue operating and comply with the minimum regulatory capital
- In this case basic capital and minimum levels as defined by Royal Decree Law of 18 February 2011, or, in case it was higher, the level considered appropriate by the market.
- The financial projections included in the business plan will be used to estimate future dividends of the entity, adjusted, where appropriate, to reflect the results of the due diligence.

The time horizon of the financial projections will depend on the specific characteristics and current situation of the entity, the maturity of the market, volatility of operations, even when general practice is to prepare financial projections for periods of between five and ten years. In any case, the business plan to which the DDM valuation methodology should be applied should consider a projection period to the year in which a normalised level of return would be achieved.

Estimate of residual value

- Residual value represents the possible value of the entity at the end of the projection period.
- The calculation generally uses formulas that determine the income into perpetuity (normalised dividend) growing at a constant rate (g):

$$\text{Residual value} = CF_{t+1} / (Ke - g)$$

Where:

CF_{t+1} = Normalised sustainable dividend

Ke = Cost of capital(%)

g = Perpetuity growth rate (%)

Considering year on year projections for the periods1 to t

- To estimate the normalised sustainable dividend the growth of the business should be taken into account, together with the capital requirements into perpetuity and the long term sustainable RoE.
- The growth rate into perpetuity (g) should be estimated in accordance with the long term estimates of the principal macro economic indicators and the key variables of the business.

Dividend Discount Model ("DDM")

- Alternative methods should be used to contrast the estimate of the residual value such as the determination of an exit multiple at the end of the projection period (Exit Multiple Approach).

- **Determination of the discount rate**
  - The discount rate to be applied in the calculation of the current value at the date of valuation is based on the required rates of return on investments with similar risks. The discount rate represents the cost of equity capital of a company (hereinafter Ke) and is estimated using the Capital Asset Pricing Model (CAPM), using the following formula:

    $$Ke = Rf + \beta\,(Rm) + \alpha$$

    Where:

    Ke = Required rate of return or cost of equity capital
    Rf = Risk free rate (10 year treasury bond)
    β = Beta
    Rm = Market risk premium
    α = non-systematic risk premium

  - The risk free premium (Risk free or Rf) is generally estimated as the return on 10 year treasury bonds in Spain. Nevertheless, particular attention should be paid to this variable at present considering the significant variations in return on Spanish debt in recent months.
  - In the event that the entities to be valued within the context of Royal Decree Law 9/2009 are not listed, the β coefficient, which represents the systematic risk of the entity valued, is estimated taking the β coefficient of similar entities as a reference.
  - Special attention should be paid to the selection of comparable entities and the period used as a basis for the estimation of β given that the recent volatility of markets has distorted this variable.
  - The market risk premium (Rm) should be estimated based on empirical studies of long-run historical data series analysing the difference between the historical average return on diversified variable interest portfolio and the risk free rate. Generally different sources are used such as the "Stocks, Bonds, Bills and Inflation. Valuation Edition 2008 Yearbook" published by Ibbotson Associates.
  - The Alfa (α) coefficient represents the specific risk premium for the entity subject to valuation not recognised in the Beta (β) obtained through analysing the evolution of comparable quoted companies. This premium should reflect the particular risk associated with the entity subject to valuation considering factors such as: i) size of the entity compared to comparable entities, ii) uncertainties inherent in the achievement of the financial projections, iii) difficulties in achieving financing.
  - It is also advisable to compare the resulting discount rate with the discount rates implicit in the prices of the transactions or the market capitalisation of comparable entities, sector analysts' consensus and the internal rates of return required by specialised investors in the sector.

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Comparable multiples

- The comparable multiples valuation method consists of applying multiples obtained from a selection of historical and projected ratios of comparable entities and the market capitalisation or price paid in comparable transactions, that in the case of those transactions that resulted in a change in control of the entity involved in the transaction, usually include a "control premium" that means reflects the ability to exercise the management of the entity.
  - These ratios compare the market capitalisation and the amounts paid in similar transactions with similar financial indicators to the financial institution to be valued.
    - Generally for banking institutions the following indicators are used: tangible net worth (deducting goodwill and intangible assets) and core capital.
  - An estimate of the value of the entity is obtained by applying these multiples to the financial indicators of the institution
- To apply this methodology it is necessary to define a sample of quoted financial institutions and transactions that could be considered comparable taking into consideration: the risk profile, return, geographical diversification, size and market depth among other aspects. Financial institutions of a similar size quoted in the Spanish market or in other markets should be evaluated to determine whether they are comparable.
- The similarity of transactions considered comparable should also be assessed. The difficulty is, that to date, there have not been a relevant number of recent similar transactions, although floatations and private transactions may be carried out in the near future in the context of the plans to recapitalise the entities to be evaluated by the valuer.
- In addition to the difficulties in comparison mentioned in the previous paragraph, it should also be taken into account that as a result of the consolidation and restructuring processes underway in a significant number of entities, the principal indicators used for the valuation of multiples could be distorted by measurement at fair value of business combinations in the balance sheets or entities and the recognition of extraordinary restructuring costs.

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Adjustements

- The results of the valuation will have to be calculated without taking into account any control premium to be paid by the FROB as a consequence of its capacity to control the entity. To this purpose the valuer will consider the necessary adjustments, particularly when he has used for his assessment trading prices or payments made in similar transactions that could reflect the capacity to control the entity.

- In the same way, the valuer should conclude as to whether adjustments should be made to the value to adequately reflect the impact of the lack of marketability on the investment to be made by the FROB.

- The valuer should justify the reasons supporting the decision and, where appropriate, the methodology used and the results obtained.

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Deliverables to be issued by the advisor

- The valuation work and procedures carried out will conclude with the issue of two documents by the advisors commissioned to carry out this engagement:
  1. Valuation report
  2. Opinion on the market value of the entity and the percentage of capital that would be equal to the investment to be made by the FROB.

1. Valuation report

- The objective of the valuation report is to describe the procedures to be carried out by the advisors and the results obtained, principally a range of estimated values for the entity subject to valuation.
- The valuation report should contain the following aspects, among others:
  a) Executive summary
  b) Background
  c) Description of the transaction
  d) Brief description of the entity
  e) Methodologies used (with a specific disclose in case of applying the sum-of-the-parts methodology)
  f) Need to adjust the valuation due to p.e. lack of marketability
  g) Limitations to the work and difficulties faced
  h) Valuation assumptions
  i) Results of valuation or sensitivity analysis
  j) Sources of information used

2. Opinion

- The opinion should include at least the following:
  a) Valuers opinion on the market value of the entity and on the percentage of capital equivalent to the investment to be made by FROB
  b) Procedures upon which this opinion is based
  c) Limitations and difficulties
  d) Sources of information