



Report on the process for the sale of NCG Banco, S.A.

The purpose of this report is to describe the process for the sale of NCG Banco, S.A. by the Fund for the Orderly Restructuring of the Banking Sector (FROB), placing emphasis on the transparency and objectivity applied throughout the process. Nevertheless, it should be borne in mind that the FROB is bound by a **duty to keep confidential the information it holds**, as stipulated in Article 59 of Law 9/2012 of 14 November 2012 on the restructuring and resolution of credit institutions, paragraph 1 of which states: *“The data, documents and information held by the FROB by virtue of the functions entrusted to it by this Law shall be confidential and, with the exceptions provided for in current regulations, may not be disclosed to any person or authority or used for purposes other than those for which they were obtained. They shall cease to be confidential when the parties concerned make public the facts to which such data, documents and information relate”*. In view of this legal duty of secrecy, and of the confidentiality required by the parties in the process, no detailed information can be given on each specific aspect of the aforementioned process. For example, various bidders expressly asked for their names not to be disclosed during the process.

This confidentiality of information must be respected at all times, but particularly during the periods of assessment of the institution, discussions with potential acquirers and reception of bids. However, this obviously does not prevent maximum **transparency with bidders** throughout the process.

Bidders also signed a confidentiality agreement, to be able to participate in the assessment and sale process and, in particular, to have access to all the available information.

Of course, all the actions of the FROB, including of its Governing Committee, are subject to review by the public bodies established by Law: Parliament, the courts, the Court of Auditors and the National Audit Office.

1. Process timetable and moment chosen for the sale

The Fund for the Orderly Restructuring of the Banking Sector (“FROB” by its Spanish acronym) is a public law entity with its own legal personality whose purpose is to manage credit institution restructuring and resolution processes. The FROB is regulated by Law 9/2012 of 14 November 2012 on the restructuring and resolution of credit institutions.

After the last injection of state aid and the hybrid instrument management exercise, **the FROB's final stake in the capital of NCG is 62.7%. The Deposit Guarantee Fund (DGF) has a 25.6% holding.** It should be noted that the **total state aid received** by NCG Banco to date amounts to **€8,981 million.**

The NCG resolution plan requires the Spanish authorities to initiate contacts with potential acquirers by mid-2015 at the latest and to endeavour **to conclude the sale by the end of 2016.** In the event of failure to conclude the sale, a divestiture trustee has to be appointed with a mandate to sell the institution by the end of September 2017.

Taking into account the time limit set under the Resolution Plan, a decision had to be made as to the best strategy to sell the institution.

1.1. Sale strategy for institutions in resolution

On 25 March 2013, the Governing Committee of the FROB awarded, by means of a tender procedure, the project for the preparation of a report describing and assessing the different strategies for the management of the institutions in which the FROB has a holding (including NCG) to the international consulting firm McKinsey, in collaboration with the investment bank Nomura. McKinsey proposed **rapid divestiture of NCG** as the best possible strategy, since waiting until 2015 might significantly impair the institution's value. According to the report by the consulting firm, this strategy would **maximise the selling price** for the institution and, therefore, minimise the use of state funds, since it would avoid further impairment of its value.

In order to implement the proposed strategy, on 4 July 2013, the Governing Committee of the FROB awarded the **contract for the assessment and possible sale of NCG** to BNP Paribas (BNPP), by means of a tender procedure. The contract stipulated that the process consisted of two stages:

- In the first stage, BNPP had to assess the institution's **economic and financial situation** and gauge market **appetite**, so that the FROB could decide whether the conditions for launching the sale process were appropriate.
- In the second, shorter stage, the **sale** process would be carried out, if applicable.

1.2. First stage: assessment of the institution and market interest

BNPP entrusted PwC with the performance of **financial, labour, tax and legal due diligence (DD)** on NCG. Simultaneously, the **expected loss on the loan portfolio was internally estimated** (and subsequently ratified by an independent third party, Mazars Auditores), the institution's contingencies were identified and the business plan was prepared and reviewed.

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Subsequently, BNPP made informal contacts with various credit institutions and private equity funds to gauge market appetite for NCG. On the basis of these contacts, it identified potential acquirers interested in participating in a possible process for the sale of NCG.

After completion of the due diligence and identification of potential acquirers interested in acquiring the institution, these potential acquirers were given access to the information required to assess the institution through a **virtual data room** (VDR). Before obtaining access to the information, all potential acquirers, and their advisory teams, had to sign a confidentiality agreement which imposed a duty of secrecy on them. Additionally, the duty of secrecy imposed on the FROB by law also prohibits it from disclosing information on the process or on the bids and bidders. As stated above, some bidders insisted that they did not wish the FROB to disclose their identity.

The VDR included detailed information on financial, legal, risk, labour, tax and information system matters. Furthermore, acquirers were given the opportunity to raise questions about the institution and to ask for clarification of the information made available to them.

In addition to analysing the information available in the VDR, interested institutions and funds held meetings with the managers of NCG, at which the latter presented the institution's business plan and clarified any doubts raised after potential acquirers had assessed the information made available to them.

Following these meetings, potential acquirers informed the FROB of their impressions of the institution and of their interest in participating in the sale process (subject to more detailed analyses).

1.3. Second stage: process for the sale of NCG Banco

On completion of the assessment of NCG and having received non-binding expressions of interest from potential acquirers, the Governing Committee launched the **second stage** of the process at its meeting on 19 November 2013. BNPP, as the financial advisers to the FROB, invited interested parties to participate, through a letter of procedure specifying the main procedural rules applicable. Potential acquirers had to submit their **bids by 13 December**. This letter was subsequently amended by two addenda dated 5 and 12 December, as described below:

- **Letter of procedure:** This letter, dated 21 November, stated that, in order to assess the binding bids, the FROB would take into consideration the price offered by each potential acquirer (adjusted for the cost of any guarantees it might require) and would also positively assess the fact that potential acquirers either did not propose any changes to the terms of sale offered by the FROB or only limited ones. This decision was explained by the need to minimise any additional state aid.

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- **First addendum:** On 5 December, BNPP sent another letter of procedure informing interested bidders of the extension of the bidding period (from 13 to **16 December**) and providing them with additional information on the assessment criteria and the submission of bids.
- **Second addendum:** Finally, on 12 December, BNPP sent another addendum simplifying the bidding process, following receipt of an interpretation from the Directorate General of Taxes (*Dirección General de Tributos*) relating to the impact on NCG Banco's deferred tax assets (DTA) of Royal Decree-Law 14/2013 of 29 November 2013 on urgent tax measures for the adaptation of Spanish Law to European Union Law on supervision and solvency of financial institutions.

All requests for information from potential acquirers were transmitted to the FROB and to NCG through BNPP. All the replies and additional information were made available to all the parties through the VDR.

2. Purpose of the sale

The purpose of the competitive bidding process was to select one or more acquirers of a **block of NCG shares**, with the possibility of joint or separate sale of **two NCG bad loan portfolios** (the bad loan portfolios would be sold by the institution itself).

2.1. Shares for sale

The block of **shares** for sale in this process related only to the **holdings of the FROB and the Deposit Guarantee Fund** in the institution. A total of 2,084,195,139 shares, representing **88.33% of NCG's share capital**, were offered for sale.

Article 64 of Law 9/2012 of 14 November 2012 on the restructuring and resolution of credit institution, relating to general administrative powers, states that the FROB shall have the power to order the transfer of shares, whoever their holders may be. Although this would empower the FROB to order the sale of **shares held by minority shareholders**, it was decided **not** to consider this option.

2.2. Bad loan portfolios

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The bid assessment criteria that were notified to all the bidders through the aforementioned letter of procedure take into account the price offered for each bad loan portfolio.

These portfolios include a portfolio of secured bad loans and a portfolio of unsecured bad loans, precisely identified, the details of which were made available to the bidders for appropriate assessment.

3. Potential bidders targeted by the process

As regards the institutions targeted by the process, the successful bidder for the contract for the assessment and possible sale of NCG (BNP Paribas) made initial informal contacts with various potentially interested **credit institutions and private equity funds**. Following these initial contacts and based on the expression of interest by other institutions once the process had been launched, potential acquirers were identified. It should be noted that the process was open to all interested credit institutions, i.e. no formal invitation from the FROB was required to participate in the institution assessment process. Following receipt of the non-binding expressions of interest, the FROB invited all the institutions which had participated in the assessment phase to the final sale phase.

It should be noted that the bidding process was targeted at domestic and international investors and that the participation of the latter was beneficial, since a higher number of participants helps maximise the selling price of the institution (and, thus, reduce the impact for taxpayers) and confirms the competitive nature of the process.

Also, the letter of procedure allowed for **pools of bidders** submitting a single joint bid for the block of shares for sale, provided that the FROB had been informed of the pool participants before receiving the binding bid.

4. Elements included in the basic package to be assessed by the various bidders

The purchase agreements with the FROB and with the Deposit Guarantee Fund include certain undertakings to NCG which were taken into account by potential acquirers in their bids. Specifically, **the FROB undertakes to compensate NCG for 85%** of the amounts that the latter is liable to pay as a result of:

- The adjustments envisaged in certain clauses of the agreement for the **transfer of assets** from NCG to **Sareb** (net of the adjustments in favour of the bank). In this case, the compensation would amount to 100% of the net adjustments, instead of the above-mentioned 85%.

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- Tax risks arising from the transfer of assets to Sareb, as a result of the removal of transactions from the VAT regime.
- Any amounts that NCG has to pay to certain **insurance companies** in connection with the **arbitration procedures** in which the bank may be involved or with the early termination of contracts owing to the **change in control at NCG Banco** as a result of the sale process.
- NCG Banco's **liability** arising from the **sale of hybrid instruments**, as determined in a final court judgment.
- NCG Banco's liability arising from claims relating to the **marketing of mortgage loans** containing **floor clauses**, granted after October 2008.
- Liability arising from the granting of **interest rate swaps** linked to mortgage loans to households and self-employed persons.

Furthermore, the agreement also provides for a guarantee that deferred tax assets can be used in the event that the new owner opts for a **merger by acquisition of NCG**.

However, the basic agreement did **not include any asset protection scheme** covering any portion of the institution. If a bid included an asset protection scheme, the bidder had to state its scope and its impact on the bid price. After receipt of the bids, the FROB had to estimate the cost of any such asset protection scheme, taking into account the expected loss calculated by the institution (and shared with all the bidders through the virtual data room). This guaranteed the uniform assessment of asset protection schemes with different scopes.

5. Bid assessment criteria

The sale process has at all times pursued the **objective of ensuring the most efficient use of public resources**, in conformity with Article 3 of Law 9/2012. Also, Article 26.6 of this Law states that to select the acquirer or acquirers, the FROB shall launch a **competitive procedure** with the following characteristics:

- It shall be **transparent**, bearing in mind the circumstances of each specific case and the need to safeguard the stability of the financial system. In this connection, all the institutions had access to the relevant information through the VDR and during the process were always informed in the same way of any measures or decisions which could have an impact thereon. Furthermore, all potential acquirers were aware of the rules governing the sale process (communicated in the letter of procedure) and BNPP's tasks included the obligation to keep all potential acquirers equally informed of the situation of the process. Finally, there was constant communication with the European

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Commission, specifically with the Directorate-General for Competition, throughout the process.

- **It shall not favour or discriminate against** any of the potential acquirers.
- The necessary measures shall be taken to **avoid** situations of **conflict of interest**.
- Its aims shall include **maximising the selling price and minimising the use of public funds**.

A similar commitment to sell under a competitive procedure was made by the Government to the European Commission in the term sheet governing state aid granted to NCG Banco.

On the basis of the foregoing, the FROB designed a transparent, non-discriminatory competitive sale process the ultimate aim of which was to maximise the selling price and, therefore, to reduce the impact on taxpayers. The sale process met the objective of maximising the selling price and fostering transparency and neutrality, since all the potential acquirers had the same opportunities, tools and access to information to assess the investment in NCG Banco.

The letter of procedure dated 19 November stated that, in order to assess binding bids, the FROB **would take into consideration the financial terms** offered by each potential acquirer (adjusted for any additional guarantees that might be requested) and would also positively assess the fact that potential acquirers either **did not propose any changes to the terms of sale** offered by the FROB or only limited ones.

The FROB had to assess the aforementioned binding bids and, if the best bid were not substantially more favourable than the second best bid, it had to hold a second round in which the **three potential acquirers** that had submitted the best bids in the first round would have the **opportunity to improve their bids**. The criteria set to determine whether a second round would be necessary were not modified during the process: there would be a second round if the best bid, adjusted for the sale of bad loans and the cost of the required guarantees, did not exceed the second best bid by 50% or by €200 million. In other words, there would be no second round if the best bid exceeded the second best by both these margins. In the second round, the scope of the final bids to be submitted would be that of the best bid in the first round. Had the second round taken place, the three bidders would have been informed of this scope before submission of their final bids.

For greater transparency in the process, the Governing Committee approved the sending of an addendum to the letter of procedure detailing the methodology to be used by the FROB to assess the bids (as described in Section 1.3). The letter dated 5 December established as follows:

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- The inclusion of a request for a FROB **guarantee** (with the related price increase) would be assessed by the FROB by deducting the fair value (estimated cost) of the guarantee, multiplied by **125%**, from the price increase offered.
- **Certain guarantees** (such as those that may affect Sareb or ESM bonds held by NCG or relating to the possible waiver of certain tax benefits) **would not be taken into account** by the FROB.
- Potential acquirers were asked for two prices, according to the estimates made of the effects on NCG of the approval of Royal Decree-Law 14/2013 of 29 November 2013 on urgent tax measures for the adaptation of Spanish Law to European Union Law on supervision and solvency of financial institutions. At the time, the Directorate General of Taxes had still not given its opinion on any query regarding the interpretation of this Law.

Finally, on 12 December 2013, the FROB announced through the VDR the **estimates made by the NCG Banco team** of the **effect** on the institution of the approval of **Royal Decree-Law 14/2013**. The NCG team gave its estimates for four possible scenarios and BNPP announced through the VDR the scenario that the FROB considered to be in line with the interpretation of the law provided that same day by the Directorate General of Taxes. A copy of the **communication received from the Directorate General of Taxes** is also included in the VDR. These clarifications simplified the submission of bids, obviating the need to submit two separate bids.

6. Possible assessment of the waiver of tax losses

Objective assessment of NCG Banco SA is hampered by the **deferred tax credits** it has built up as a consequence of the impact of the sizeable impairment provisions made in 2012, and the transfer of its real estate assets to Sareb. Before the approval of Royal Decree-Law 14/2013 of 29 November 2013, deferred tax assets, given their questionable capacity to absorb losses in very adverse scenarios, had to be progressively deducted from institutions' regulatory capital.

Some of the potential acquirers have stated that the FROB should have assessed the **use or possible waiver of the unused tax losses** of NCG Banco. Their argument was that the probability of some acquirers using these tax losses would be lower, given the smaller possibility of their exploiting synergies with other businesses in Spain, which would result in a lower future cost to the public purse. **The Governing Committee of the FROB decided and notified the parties on 5 December that this aspect would not be assessed**, on the basis of the following considerations:

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- The enormous difficulty of assessing whether a particular acquirer would be in a position to use these tax losses, since their use depends on the acquirer's capacity to generate profits over a very long period (up to 18 years) and implicitly on its business plan, the future profitability of NCG, etc. The difficulty has been increased by the regulatory change referred to (Royal Decree-Law 14/2013). Even those institutions that are in theory most likely to use the tax credits, i.e. domestic banks, are not in the same position to use them, since their starting point, i.e. their own deferred tax assets, varies considerably.
- RDL 14/2013 regulates the monetisation of certain deferred tax assets (temporary differences), ensuring that a substantial part of the tax assets of NCG will be used, regardless of the nature of the acquirer of NCG Banco and its capacity to generate profits. Accordingly, the likelihood of different interested parties using tax losses varies less than previously.
- The acquirer of NCG actually only acquires 88.33% of the shares (held by the FROB and the DGF), so it would hardly be acceptable for it to waive tax assets that benefit all the shareholders of the institution (including the holders of hybrid and subordinated instruments that were converted into NCG shares).
- The new Royal Decree-Law favours a greater capitalisation of the bank and that benefits the institution, whoever its owners may be, whether banks or funds. This greater value would be taken into account, benefiting the new owners of the bank, in the event of a transfer of blocks of NCG shares or their placement on the securities market.
- In any case, the value of the unusable tax credits cannot be equal to the nominal value of these credits. The fair value of the tax credits would always have to be calculated, which would depend on the assumptions made as to when they may be used, so that there would be a broad range of estimates. The fair value of the tax credits would be needed to calculate the regulatory value of the new regulation of DTA (their non-deductibility from the capital of the institution if they are monetised by the authorities). This value would not be exactly the same as the amount of the monetised fiscal assets, but calculations would have to be made based on the cost of capital generated by the new Decree-Law.
- The Directorate-General for Competition of the European Commission has stated that it does not approve of a procedure in which the waiver of the tax losses by a potential acquirer is assessed on the basis of the consequences of another party acquiring the institution (which might make greater use of such tax losses).

7. Possible assessment of other aspects.

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Similarly the question has been raised as to whether the FROB should assess other aspects of bids for NCG, such as the maintenance of employment, commitments to lend in the region, etc. The arguments that have led to these aspects not being taken into account are similar to the foregoing ones:

- The technical difficulties of assessing these aspects.
- The difficulty of control.
- The European Commission's disapproval of assessment of the second-round effects (on employment, social security, etc.) of the divestiture.

The most realistic way of taking these aspects into account would be by means of a conditional sale of the institution: final sale would be suspended if commitments on employment, lending, etc. were not fulfilled within a given period. This alternative appears to be clearly unviable given the legal and financial uncertainty that it might generate.