FROB Fondo de Reestructuración Ordenada Bancaria

Report on the Catalunya Banc sale procedure

The aim of this report is to describe the sale procedure for Catalunya Banc (CX) conducted by the FROB. The process was a transparent one whose main aim was to maximise the sale price and minimise the cost for taxpayers, in accordance with the provisions of Article 3(c) of Law 9/2012 of 14 November 2012 on the restructuring and resolution of credit institutions.

It should be recalled that, under Article 59 of this Law, the FROB is bound to keep secret the information it holds which, combined with the confidentiality demanded by the parties, means that the information included in this report does not contain all the details of the process. However, further to the signing of the related confidentiality agreements, the potential buyers have had access to all the relevant information needed to make their bids.

In any event, all the FROB measures, including those adopted by its Governing Committee, are subject to the control of the public bodies stipulated by the Law: Parliament, Courts of Justice, Court of Auditors and IGAE (National Audit Office).

1. Background: recapitalisation of the financial system

The financial assistance programme for recapitalisation included in the Memorandum of Understanding (MoU), signed by the Spanish authorities in July 2012, required that a stress test be conducted on the main credit institutions to determine their capital needs. In the baseline scenario of this stress test, the capital requirements of CX amounted to €6,488 million and, in the adverse scenario, to €10,825 million.

Against this background, two types of processes were defined for those situations where a capital shortfall was involved and for those where the contribution of public funds was necessary: restructuring processes and resolution processes. Catalunya Banc was declared to be an institution in resolution, insofar as it was considered inviable; therefore, to provide for the injection of public funds, the FROB drew up a resolution plan which was approved by the Banco de España and the European authorities. Before adopting this decision, three independent experts hired by the FROB estimated the institution’s liquidation value at -€17,846 million.

2. Resolution plan for Catalunya Banc

The Resolution Plan for CX, approved in November 2012, acknowledged capital needs totalling €9,084 million, following the transfer of assets to SAREB (the asset management company for assets arising from bank restructuring) and the burden-sharing exercise:

- The transfer of assets to SAREB was made on 31 December 2012, with the transfer price at €6,708 million.
- The burden-sharing exercise, approved by the FROB Governing Committee on 7 June 2013, originally had a positive impact on net worth of €1,676 million. This figure will be altered by the results of the arbitration process and legal demands.

Following the injection of public assistance and the burden-sharing exercise, the FROB's capital holding in CX amounted to 66.01%. The Deposit Guarantee Fund of Credit Institutions (DGF) – as a result of the mechanism set in train to endow with liquidity the unlisted shares of nationalised institutions in retail hands, derived from the conversion of hybrid instruments – held 32.39% of the institution's capital, after investing €1,003 million. The remaining 1.6% was in the hands of minority shareholders or were own shares.

CX received a volume of public assistance, both before and after the approval of its Resolution Plan, totalling €12,052 million.

The resolution plan for Catalunya Banc establishes the obligation of the Spanish authorities to initiate contact with potential buyers of the institution by July 2015 at the latest, making every effort to complete the sale by no later than year-end 2016. Should the sale not be concluded, a Divestiture Trustee shall be appointed with a mandate to sell the institution by end-September 2017.

3. Sale strategy for Catalunya Banc

On 12 April 2012, the FROB Governing Committee resolved to initiate the divestment of its holding in CX by means of a competitive bidding process. However, on 21 June 2012, the decision was taken to temporarily postpone this process until the results of the valuation processes (stress tests) being conducted under the financial assistance programme agreed by the European Union were conclusive.

On 16 November 2012, once the results of the stress tests and the terms of the financial support announced some days earlier by the Eurogroup were known, the FROB announced the resumption of the sale process. Nonetheless, in light of the results of the non-binding bids phase, the FROB announced the suspension of the process for the award of the institution on 4 March 2013.

On 25 March 2013, the FROB Governing Committee awarded a contract to an international consultancy, in collaboration with an investment bank, to draft a report describing and evaluating the different strategies for managing the institutions in which the FROB had holdings (including CX). The report recommended the swift sale of the institutions in resolution as the best alternative for preventing any loss of value in these institutions.

To implement the proposed strategy, the FROB Governing Committee, at its meeting on 18 July 2013, awarded a contract for the analysis and future sale of Catalunya Banc to N+1 Corporate Finance S.A. This contract structures the process in two phases: first, a market analysis so the FROB may ascertain whether the conditions are right to launch the sale process; and a second, shorter phase in which the sale would, if appropriate, be made.

3.1. First phase: analysis of the bank and of market interest

N+1 engaged Ernst & Young, S.L. to prepare a financial, labour, tax and legal due diligence report on CX, and hired Baker & McKenzie as the legal adviser for the operation. In parallel with this process, an in-house estimate was made of the expected loss on the loan portfolio, substantiated by an independent third party. Further, the institution's contingencies were identified and a business plan was drawn up and reviewed.

Thereafter, N+1 entered into informal contact with different investors to sound out the market appetite for CX and it identified potential buyers interested in taking part in the future sale of the institution.

This phase stretched out over time owing to the fact that the FROB decided to sell NCG Banco in the final quarter of 2012.

Finally, in the report submitted by N+1 on 27 March earlier this year, it was recommended that a specific portfolio of little commercial value and a volume of approximately €6,392 million gross and provisions totalling €2,205 million (the "Hercules" portfolio) be sold. The sale of the Hercules portfolio would make for an improvement in the institution's financial ratios and increase competition in the process for the sale of CX, maximising the price that the FROB would obtain from the operation as a whole.

3.2. Sale of the "Hercules" portfolio

In March 2014, CX set in motion the sale of the Hercules portfolio, appointing N+1 as adviser and coordinator of the process, and Baker & McKenzie as the legal adviser.

N+1 entered into informal contact with different funds expressing a potential interest. At least 80 investors were invited to take part and 47 of these signed confidentiality agreements to gain access to the information provided in the Virtual Data Room (VDR).

The first signs of interest were expressed on 27 May, with 12 consortia submitting their non-binding bids. After analysis of these by CX and N+1, five candidates were selected to participate in the binding phase. On 10 July, four binding bids were received.

The process letter envisaged a second binding phase if the best bid were not 10% higher than the second-placed bid, so as to maximise the sale price and ensure that the auction were conducted under conditions of maximum transparency and competition. On 15 July, the two candidates selected for the second binding phase submitted their improved bids.

Finally, on 17 July 2014 the sale process for the Hercules portfolio concluded with the award of this portfolio to Blackstone for an amount equal to its book value, namely €4,187 million (€6,392 million gross less provisions of €2,205 million), with the investor providing €3,615 million and the FROB €572 million. The sale process was highly competitive. Illustrating this was the 10.4% improvement, on average, in the binding bids relative to the non-binding bids.

The operation was structured through the creation of a securitisation special-purpose entity (SSE) that will be registered with the CNMV (the National Securities Market Commission). The SSE's assets will include the portfolio of loans transferred by CX, without the latter having to

record in this connection any negative equity impact, and the SSE will issue two types of bonds:

- Class A (senior) bonds, to be subscribed by the investor.
- Class B bonds, to be subscribed by the FROB and of lower seniority.

The senior bonds will yield a return until the agreed level of return of 13% is reached; once that level is attained, the additional yield on the portfolio derived from the cash flows obtained shall be distributed on a pro rata basis between the investor and the FROB.

Furthermore, the FROB shall extend a credit line to the SSE with a ceiling of €500 million exclusively to finance existing liquidity commitments in the portfolio arising from new provisions in the revolving mortgage contracts included in the portfolio. This credit line will have arm's-length conditions as regards interest and commissions (they will be the same as those for the external financing raised by the SSE) and it will have a preferential position in terms of the seniority of the SSE's loans.

The FROB has extended a series of guarantees to the SSE, to hold it harmless for claims in connection with a limited number of contingencies. These guarantees are habitual practice in sales of portfolios on the market; the particularity of this case is that, given the imminent sale of CX, the FROB opted to directly grant these guarantees:

- Whereas the investor shall assume the portfolio risks from the cut-off date (31 March 2014), but not before, the FROB shall compensate the SSE in the case of legal rulings that invalidate the floor clauses of contracts making up the portfolio in the part prior to the cut-off date and that oblige the SSE to pay them.
- The FROB shall compensate the investor for damages arising from the furnishing of incorrect information in relation to the characteristics of the loans, their collateral, etc. This guarantee will be enforceable within the eighteen months following the closure date of the operation and provided that any such informational flaws exceed 1% of the outstanding balance of the portfolio sold.

The maximum liability of the FROB for all these guarantees to the SSE is set at twenty-five per cent (25%) of the price paid by the investor in senior bonds.

3.3. Second phase in the CX sale strategy: sale of the institution

With the first phase having concluded with the recommendation for the sale of the institution, and with the sale of the Hercules portfolio under way, the Governing Committee, at its meeting on 13 May 2014, approved the basic rules of the procedure for the sale of CX under the Resolution Plan.

Once apprised of the non-binding bids for the Hercules portfolio and with the market appetite for the operation having been confirmed, the Governing Committee resolved on 2 June to formally open the bidding process for the institution, calling on entities that had expressed an interest to directly submit their binding bids. On 3 June, the process letter was sent to potential buyers, detailing the attendant rules. Beforehand, potential buyers signed the related confidentiality agreements and received a formal invitation with the rules of access to the Virtual Data Room (VDR) and the results of the updated due diligence report by Ernst & Young.

Along with the financial, tax, legal and labour information in the VDR, there was the further possibility of requesting clarification on the reports, asking questions about the institution and holding meetings with the Ernst & Young and CX teams.

The process letter sent on 3 June set Monday 14 July as the date for receipt of the first binding bids, extending this to 18 July given the complexity of the Hercules operation. The letter, supplemented with a subsequent addendum, addressed the object of the sale and the rules for the submission and evaluation of the different bids.

The process was very similar to that followed for the sale of NCG Banco, with some differences regarding the changes permitted and their valuation, as set out below.

4. Basic package to be valued

To determine the basic price, potential buyers received a sale agreement including the object of the sale and establishing specific commitments in favour of CX.

4.1 Object of sale

Each potential buyer was asked to identify two prices in its initial bid (in which it accepted the basic guarantees provided by the FROB, without taking into consideration any changes proposed):

- A first price that they would be prepared to pay to acquire 98.4% of the shares of CX, corresponding to the holdings of the FROB (66.01%) and the Deposit Guarantee Fund (32.39%).
- A second price for 100% of the shares of CX, including its own shares and those held by minority shareholders.

4.2 Basic guarantees

In accordance with the draft agreement provided to potential buyers, the FROB undertakes to compensate CX, subject to certain quantitative and time limits, for any amounts payable by CX as a result of:

- The adjustments envisaged in certain clauses of the agreement for the transfer of assets from CX to SAREB (net of adjustments in favour of the bank).
- Tax risks arising from the transfer of assets to SAREB, as a consequence of the removal of transactions from the VAT regime.
- 85% of CX's liability arising from the mis-selling of hybrid instruments, as determined in a final court judgment.
- 85% of CX's liability arising from claims relating to the mis-selling of mortgage loans containing floor clauses.
- 85% of CX's liability arising from significant litigation identified in the agreement.
- 85% of CX's liability arising from interest rate swaps linked to mortgage loans to SMEs and self-employed persons.
- 85% of any amounts that CX may have to pay to the insurance company with which it has a bancassurance agreement, relating to certain contingencies arising from the sale of CX.

The addendum to the process letter established that potential buyers could waive some of these guarantees (hybrid instruments, floor clauses and interest rate swaps) and could change the terms of the guarantee relating to bancassurance.

5. Main changes

Under the process letter and its subsequent addendum, potential buyers were allowed to propose changes to the basic agreement, identifying the impact those changes would have on the basic price. Specifically, the changes could consist in requesting guarantees in addition to those envisaged in the agreement, or in amending or waiving any of those guarantees.

In this respect, the process letter sent on 3 June included the possibility of changes being requested that entailed the FROB providing guarantees of some sort or assuming a payment obligation, with potential buyers specifying in each case the amount by which they would be prepared to raise the basic price if such changes were accepted. These changes specifically excluded waiver of the unused tax losses on CX's balance sheet, requests for guarantees or any significant change affecting the bonds issued by SAREB or by the ESM on CX's balance sheet. In addition, and in contrast to the NCG sale process, requests for an asset protection scheme (APS) were also excluded. In this first process letter, no changes to or waiver of the basic guarantees envisaged in the draft agreement were permitted. However, so as to provide potential buyers with greater flexibility to allow contingencies covered by the guarantees to be settled other than through the courts, in the addendum to the process letter sent on 14 July the FROB permitted changes to or waiver of the basic guarantees proposed, provided that any waivers proposed included a change in the corresponding price.

For the assessment of significant changes, the FROB would deduct from the price change proposed the fair value established in accordance with Law 9/2012, multiplied by 150% as penalisation, in order to reward bids that included fewer changes to the original agreement. In the sale of NCG this figure was 125%; it was raised in this case to discourage requests for more assistance.

6. Assessment criteria

The process letter and its subsequent addendum laid down the assessment criteria for the binding bids:

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1. With a view to selecting the bid that maximised the sale price and, in consequence, helped minimise the public funds invested in the process, the binding bids would be assessed taking into consideration the economic terms offered by the potential buyer.

2. Moreover, any significant changes to the sale agreement should reflect, individually, the price adjustments (increases or decreases) corresponding to each significant change. In any event, significant changes that were not substantial or were not acceptable to the FROB would not be admitted.

3. In the assessment of each significant change proposed and not rejected, the price adjustment offered would be taken into consideration, provided the change was accepted, deducting from that price the fair value assigned by the FROB to that significant change multiplied by 150%.

4. A similar assessment process was established in the case of waiver of any basic guarantees: the effect of the waiver on the price would be corrected by the fair value of the guarantees multiplied by 150%.

Under the process letter, the potential buyer would be selected in accordance with the above conditions and, if there were two equal bids, the best bid would be understood to be that which represented the highest and the most immediate revenue for the FROB. The award process would have two rounds: there would be a second round of binding bids if the difference between the first- and second-placed bids was less than €200 million or less than 50% of the first-placed bid.

If a second round were necessary, a maximum of three institutions would be chosen to be asked to submit an improved bid, within the perimeter defined by the best of the three institutions in the first round.

In short, the FROB designed a competitive, transparent and non-discriminatory sale process whose ultimate aim was to maximise the sale price and, therefore, to reduce the impact on the taxpayer. The sale process met the objective of maximising the price and fostering transparency and neutrality, as all the potential buyers had the same opportunities, tools and access to information to assess the investment. Each of the bids was assessed purely on economic criteria, without considering other aspects that are more difficult to quantify.

7. Winning bid

At its meeting on 21 July and after studying the three binding bids received in the sale process of Catalunya Banc S.A., the FROB Governing Committee agreed to award CX to Banco Bilbao Vizcaya Argentaria, S.A. (BBVA). The bid made by BBVA amounted to €1,187 million for 100% of the capital, to be paid upon completion of the sale process, once the relevant conditions precedent have been met. The bid envisages the possibility of BBVA acquiring just 98.4% of the shares, i.e. the holdings of the FROB and the Deposit Guarantee Fund, with the corresponding price adjustment. The decision as to whether it acquires 98.4% or 100% of the shares shall be taken once the terms of the sale have been reviewed by the European Commission.

The agreed sale price will be lowered by €267 million if, before the date of final completion of the transaction, neither the FROB nor Catalunya Banc has obtained confirmation from the tax authorities that certain losses recognised in the consolidated annual accounts of Catalunya Banc for 2013, arising from the transfer of assets to SAREB, qualify for the deferred tax assets regime (established in Royal Decree-Law 14/2013).

The terms of the sale agreement observe, in essence, the package of basic guarantees provided by the FROB in the process.

Given that the bid submitted by BBVA was higher than the threshold established by the FROB for this process, a second round of bids was not necessary.

The effectiveness of the award to BBVA is conditional upon the requirements established by law being met and on the corresponding approval being obtained from the competent Spanish and European authorities.

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