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FINANCIAL SYSTEM REFORM: ROYAL DECREE-LAW 2/2012

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The Spanish Government enacted on 3rd February 2012 the Royal Decree-Law 2/2012 (the "**RDL**") for the rationalization of the Spanish financial system. The main purposes of the RDL are the cleaning up of real estate exposures from the financial institutions' balance sheets and the promotion of further concentration among them, with the aims to strengthen markets' confidence and, ultimately, reestablish their function of channeling funds into the economy.

The main new measures implemented by the RDL focus on the followings areas:

(i) new provisioning and capital requirements in relation to real estate exposures;

(ii) changes in the types of support investments to be made by the Fund for Orderly Restructuring of Financial Entities ("**FROB**"); and

(iii) additional corporate governance requirements for savings banks and remuneration limitations for financial institutions that have received FROB support.

I. REAL ESTATE EXPOSURES

The RDL sets out new provisioning and capital requirements for real estate exposures of financial institutions as of 31 December 2011, affecting those exposure that are classified in their balance sheets as foreclosed (i.e. assets foreclosed or received in payment of debts), problematic (doubtful or substandard[1]) or normal (i.e. non-problematic).

The new requirements include: (i) increased minimum levels of specific provisions, (ii) new generic provision, and (iii) capital add-on. The main difference between these requirements is that specific provisions respond to an incurred losses rationale, while the generic provision and the capital add-on work more as capital buffers in contemplation of potential future losses.

1 Doubtful loans are loans in which some installment has not been paid and remains unpaid for a period of more than 90 days, and those exposures in which there are reasonable doubts as to total repayment under the terms agreed.

Substandard loans are loans showing some general weakness associated with the fact they are related to a specific troubled group or sector or if weaknesses are apparent in certain operations, even if these operations do not qualify individually for classification as doubtful or write-off.

1.1 Specific provision

The increased minimum levels of specific provisions apply to such real-estate exposures that as of 31 December 2011 were classified as foreclosed, doubtful or substandard, even if they are refinanced after such date.

With respect to assets related to land and real estate under development, the main difference with respect to the existing provisioning requirements is that fixed percentages of minimum provisioning levels are established that will be applied over the value of the loan, without deducting any of the collateral. Such percentage is 60% for land and 50% for real estate under development (which can be brought down to 24% if the development is on-going).

Additionally, the provisioning requirements for completed real estate (including first residence) have been enhanced. Mainly, the provision percentages for foreclosed completed real estate are increased and a fourth year of provision is added (40% for fist residence and 50% for others); also, the minimum provisioning levels for doubtful and substandard loans are required without exceptions.

In principle, any additional provisions that have to be created pursuant to these new requirements will be charged against P&L.

1.2 Generic Provision

Financial institutions shall create a new generic provision amounting to 7% of real estate financial exposures that as of 31 December 2012 were classified as normal. This generic provision may only be used going forward to cover future migration of such exposures to the problematic or foreclosed portfolios.
It should be noted that this generic provision is a one-time provision and differs from the dynamic generic provision that was already contemplated by the accounting regulations. Actually, the Bank of Spain has indicated that those financial institutions that have any remaining dynamic generic provision may use it to create this new one-time generic provision.

In principle, this new provision will be charged against P&L.

1.3 Capital Add-on

The capital add-on applies to such real-estate exposures related to land and real estate under development that as of 31 December 2011 were classified as foreclosed, doubtful or substandard, even if they are refinanced after such date.

Such capital add-on is calculated as a percentage (80% for land and 65% for real estate under development) over the value of the exposures, after deduction of any provisions created over them[2]. Only one exception applies to substandard loans related to on going real estate developments.

This capital add-on is added to the core capital (*capital principal*) requirements of 8% (10% for non-listed) established by Royal Decree-Law 2/2011. It will have no impact on P&L.

2 Given that the new required provisions levels for land and real estate under development are 60% and 50%, respectively, the actual impact on equity of this capital add-on is 20% for land and 15% for real estate under development.

Following is a summary chart of the impact on equity of the new provisioning and capital requirements established by the RDL with respect to real estate exposures:

<table>
<tr><th></th><th></th><th>FORECLOSED</th><th>DOUBTFUL</th><th>SUBSTANDAR</th><th>NORMAL</th></tr>
<tr><td rowspan="3">LAND</td><td>Provisions</td><td colspan="3">60%</td><td rowspan="7">One-time generic provision: 7%</td></tr>
<tr><td>Capital Add-On</td><td colspan="3">20%</td></tr>
<tr><td>Total</td><td colspan="3">80%</td></tr>
<tr><td rowspan="3">REAL ESTATE UNDER DEVELOPMENT</td><td>Provisions</td><td colspan="2">50%</td><td>Stopped: 50%
On going: 24%</td></tr>
<tr><td>Capital Add-On</td><td colspan="2">15%</td><td>Stopped: 15%
On going: 0%</td></tr>
<tr><td>Total</td><td colspan="2">65%</td><td>Stopped: 65%
On going: 24%</td></tr>
<tr><td>COMPLETED REAL ESTATE NOT INCLUDING FIRT RESIDENCE</td><td>Provisions</td><td><12 months: 25%
+12 months: 30%
+24 months: 40%
+36 months: 50%</td><td>25%</td><td>20%

(24% without in rem guarantee)</td></tr>
<tr><td>FIRST RESIDENCE</td><td>Provisions</td><td><12 months: 10%
+12 months: 20%
+24 months: 30%
+36 months: 40%</td><td></td><td></td><td></td></tr>
</table>

Although not clear from the RDL, it seems that it will be possible to release provisions as an asset moves from land to real estate under development and finally to completed real estate.

As to timing, the foregoing measures need to be complied with by financial institutions by 31 December 2012. For such purposes, by 31 March 2012 they shall deliver to the Bank of Spain a plan to comply with new measures, which shall be approved by the Bank of Spain within fifteen working days.

However, such financial institutions that undergo an integration process during 2012 will be given some extra time to comply with the measures, provided certain requirements are met. For such purposes, these institutions shall present an integration plan by 31 May 2012, which shall be approved by the Ministry of Economy within one month. Such institutions will then have 12 months as from such approval to comply with the measures. Another advantage of undergoing an integration process is that the new provisions of

the acquired entities will not be charged against P&L.

In order to benefit from this extended timing, the integration process shall comply with the following requirements:

- resulting entity's balance sheet shall be at least 20% bigger than that of the largest institution participating in the integration;
- integration shall be done through a merger or corporate restructuring (not through simple contractual arrangements, IPS type);
- improvements in corporate governance shall be made and a remuneration plan for directors and senior management shall be presented;
- objectives to increase credit to households and SMEs and to reduce real estate exposures during three years following integration shall be set;
- resulting entity shall be economically viable; and
- integration shall be approved by corporate bodies of relevant entities by 30 September 2012 and shall be concluded by 1 January 2013.

II. FROB INVESTMENTS

In addition to increasing the FROB by 6 billion euro, the RDL sets forth that the FROB may provide support to financial institutions in the following forms:

(i) By subscribing shares at market value determined by independent experts, to be sold through competitive procedures within a maximum period of 3 years. The financial institution will have to present a recapitalization plan and the FROB will have Board presence.

(ii) By subscribing convertible bonds of those financial institutions that have decided to undergo integration processes. The bonds will be converted into shares after 5 years, or before if the Bank of Spain considers improbable the repurchase or amortization of the bonds by the issuer. Conversion into shares will be done at market conditions. The bonds will compute as basic equity and core capital with no limitations.

Therefore, the RDL provides the following incentives for the financial institutions to undergo further integration processes:

1. Extend the term to comply with new provisioning and capital requirements by 6 months;
2. Ability to charge additional provisions directly to equity, with no P&L impact; and
3. Ability to receive funds from FROB in the form of convertible bonds (as opposed to shares) during a 5-year period (as compared to only 3 years).

III. CORPORATE GOVERNANCE AND REMUNERATION

The RDL establishes additional corporate governance requirements for savings banks (*cajas de ahorros*) and remuneration limitations for financial institutions that have received FROB support, which can be summarized as follows:

3.1 Savings Banks

(i) The structure and operational requirements of saving banks that develop its activity indirectly (due

to the assignment of the banking business to a new bank) are simplified. Managing bodies are reduced to General Assembly, Board of Directors and, optionally, the Control Commission and their composition and operation is simplified.

(ii) Savings banks may not allocate more that 10% of their freely available surplus to expenses other than Social Work.

(iii) Saving banks that either cease to control, or reduce voting rights below 25% in, the bank through which they develop indirectly their banking activity shall renounce to authorization as bank and be transformed into special foundations. The Ministry of Economy will supervise those special foundations whose geographical scope exceeds one region (which are most, if not all, savings banks).

3.2. Remuneration limitations

The following limitations will apply to remuneration received by directors and senior management of financial institutions that have received FROB support, until payment, amortization, redemption or sale of securities held by FROB:

(i) If majority shareholding held by FROB: (a) no bonus shall be payable; (b) maximum remuneration for directors shall be 50,000 euro per year; and (c) maximum remuneration for senior management shall be 300,000 euro per year.

(ii) Other type of FROB support: (a) bonus shall be deferred 3 years and be conditioned to achieving certain results; (b) maximum remuneration for directors shall be 100,000 euro per year; and (c) maximum remuneration for senior management shall be 600,000 euro per year.