BANCA D'ITALIA
EUROSISTEMA

MAIN SUPERVISORY ACTIVITIES WITH REGARD TO THE MONTE DEI PASCHI DI SIENA GROUP

The supervisory activities conducted by the Banca d'Italia in recent years with regard to Monte dei Paschi di Siena (MPS) have been continuous and of growing intensity, with a focus on the main areas important for its management: capital adequacy, the prudent management of the liquidity position, financial risks and, in particular, interest rate risk, the dynamics of the large holdings of mainly long-term Italian government bonds, credit quality, the verification of internal models for measuring credit and operational risk, and the adequacy of management and of the system of internal controls. The following pages provide a brief description of the main supervisory actions with regard to MPS, in chronological order:

- In January 2008 MPS submitted to the Banca d'Italia its application to acquire ABN AMRO's Antonveneta group (BAV) as part of an agreement with Santander. The cost of the operation was around 9 billion (6 billion of which was for goodwill). A liquidity commitment – of an estimated amount of around 9.5 billion – was foreseen for MPS, for the purpose of repaying (within 12 months of the conclusion of the contract) the credit lines previously committed by AMRO to BAV. In line with the applicable legislation, the cost was evaluated in relation to the capital adequacy and on the basis of its financial sustainability for MPS.
- The application contained a plan for a capital increase, which was required in order to remain compliant with capital ratios. A capital increase of 6 billion was foreseen, 5 billion of which was earmarked for shareholders and 1 billion for JP Morgan for the issuance of convertible bonds in MPS shares (known as "FRESH"); a further 2 billion was obtained via bond issuance.
- In March 2008 the Banca d'Italia informed MPS that the conclusion of the operation was dependent on the achievement of the above-mentioned capital strengthening measures. With reference to the capital increase earmarked for JP Morgan and the planned issuance of FRESH bonds, the supervisor (Banca d'Italia) asked MPS to ensure that the relevant contractual arrangements were consistent with the core capital status assigned to the instrument and to guarantee the complete transfer of enterprise risk to third parties.
- In May 2008 MPS reported that it had completed its plan to increase its capital, as requested by the Banca d'Italia. On the basis of the documentation provided, the Banca d'Italia began an in-depth analysis of the draft contracts relating to the FRESH operation in order to verify the compliance of the asset in question with supervisory requirements.
- Technical discussions with MPS continued until September 2008, when the Banca d'Italia formally informed MPS of the elements preventing the full inclusion in the bank's core capital of the shares used for FRESH.
- MPS provided the Banca d'Italia with new contractual arrangements for the FRESH operation, in line with the provisions of the Banca d'Italia. The Banca d'Italia took note of this in October 2008. Further details were subsequently to emerge in this regard (see below).

- In the second half of 2009 the supervisor intensified its close examination of the liquidity conditions of the MPS group. At the beginning of 2010 the bank was summoned by the supervisor on three occasions in quick succession, on 5 March, 30 March and 21 April 2010. From 3 to 7 May the supervisor visited the bank for a series of informative meetings. It emerged that there was a high incidence of repo operations backed by long-term Italian Government bonds, resulting in the absorption of high liquidity margins (owing to growing demands for margin-setting[1]) in the context of worsening market conditions. The situation of the bank was considered to be unclear and potentially critical.
- Banca d'Italia's supervisory rules are strict as regards the necessary safeguards for complex financial activities. The rules, laid down in 2004, state that banks dealing in credit derivatives – as with the transactions carried out by MPS – must be able to evaluate on a daily basis developments in the prices of individual products and in the overall risk profile of their portfolios. More generally, the rules state that banks unable to correctly measure and manage risks associated with complex financial instruments must abstain from trading in such instruments.
- In order to gain further necessary information in situ, a supervisory inspection was launched immediately, looking at the MPS group's liquidity management and its financial risk division.
- The supervisory inspection was carried out between 11 May and 6 August and highlighted tensions in the liquidity situation and a high level of exposure – not measured precisely – to rate risk. The inspection also highlighted the rigidity of the investment strategies for Government bonds, the value of which was quite large (around 25 billion). In particular, the liquidity position, characterised by high volatility, had been mainly affected by two structured repurchase agreements relating to government securities carried out with Deutsche Bank and Nomura respectively, with a total nominal value of around 5 billion euro, with risk profiles that were not adequately monitored or measured by MPS, nor fully reported to the MPS board.
- With reference to the assets of the Santorini vehicle, the inspection did not reveal any information to support the launch of a sanctions procedure or an alerting of the judicial authorities. In addition to the significant effect on liquidity, a problem came to light in relation to the accounting criteria (cost evaluation) adopted by MPS and approved by the auditing company. These procedures gave rise to reservations on the part of the supervisor as regards the operation's representation on the balance sheet, which did not show its fair value. Given that Banca d'Italia does not have powers as regards accounting, considering the complexity of the operation and the possible room for interpretation created by the IAS accounting rules, the Banca d'Italia decided in November 2011 to conduct a more in-depth specific accounting review of this issue, in collaboration with the other authorities, in part so that an explanation could be provided to the entire banking system. Given the particularly complex nature of the operations, a discussion was opened that has not yet been concluded.
- In the second half of 2010, in part owing to the initial findings of the supervisory inspection, it was clear that the capital of the bank needed to be strengthened as soon as possible. A formal request for this was made in late August 2010. In subsequent meetings held in the autumn of 2010, the amount of the necessary capital increase was discussed. In particular, the supervisor requested that the level of increase initially envisaged by the bank be made higher to take into account the exposure to sovereign risk and the need to

[1] These contracts call for the continuous adjustment of the volume of collateral assets provided as their price varies.

strengthen the bank's reserves in light of the stress tests to be carried out at European level.

- The supervisory report was presented to MPS during a meeting of the Board of Directors in the presence of the Statutory Board of Auditors on 29 October 2010. On that occasion the supervisor, among other things, reaffirmed the urgent need to ensure, as soon as possible, a substantial increase in capital and to strengthen the internal controls. The increase in capital was then to effectively take place between April and July 2011 with a total increase in core capital of 3.2 billion, 2 billion of which was to be paid in cash by the shareholders.

- In the face of requests for intervention and formal objections, the corporate bodies of the banks must respond to the findings of the inspection by Banca d'Italia and report to it on the measures already taken in order to rectify the shortcomings identified by the inspection and measures planned for the future. In this context, MPS indicated: the adoption of a organisational model for the finance division which is uniform for the entire MPS group; new supervisory and control tasks for the Finance Committee with regard to the investment choices of entities within the MPS Group (overseas subsidiaries were asked to suspend all trading activity); and changes to the risk-management strategy, with the aim of improving the measurement of financial risk and achieving more rigorous financial risk management. MPS stated that structured repurchase agreements relating to Government securities were economically rational in support of carry trade strategies and the intention to take on reduced risk-return profiles in the context of the overall position of the bank. For those reasons, and taking into account adherence to operational limits in place, these measures were not submitted to the board, but approved by the Finance Committee and the Director General.

- The supervisor further intensified its scrutiny of the three main areas which emerged as particularly problematic in the course of the 2010 inspection:

    - <u>Liquidity risks</u>: the submission to the supervisor of a <u>daily</u> report on liquidity risk was imposed; strengthened governing procedures and an internal survey on liquidity risks were requested; and a continuous verification of funding plans with the involvement of management began. These exercises revealed dysfunctions and shortcomings which sometimes seriously compromised the reliability of the data: on 22 September 2010, during a conference call, the supervisor asked Mr Vigni, the Director General of MPS, to personally sign all information on the bank's liquidity position to be sent to Banca d'Italia in its supervisory capacity on a daily basis;

    - <u>Interest rate risks:</u> the supervisor requested that a report on risk management be sent to it periodically; the bank was also asked to include its specific interest-rate risk profile in its capital adequacy assessment;

    - <u>Sovereign risk:</u> the evolution of the Government securities portfolio became subject to constant monitoring. Continuous checks on the quality of data revealed organisational and procedural shortcomings which became the subject of a formal intervention in March 2011; in the absence of tangible results, the bank was again sent a formal letter of intervention in May 2012; the unsatisfactory response on the part of the bank necessitated the opening of a sanctions procedure in respect of the former managers;

    - The Banca d'Italia collaborated closely with the authorities of the United Kingdom (FSA), the United States (Federal Reserve) and Hong Kong (the Hong Kong

Monetary Authority) in the monitoring of the liquidity positions of the MPS branches in London, New York and Hong Kong.

Seven meetings with the bank were held in the period between the end of the inspection and the beginning of the following inspection to discuss the specific areas of focus of the supervisory report. A formal intervention letter was sent to the corporate bodies of the bank.

- As of summer 2011 the rapid deterioration in market conditions (the sovereign debt crisis spread to Italy) caused a further severe weakening of the liquidity position of MPS, especially following the widening of the margins on the two above-mentioned repo agreements. The supervisor, through both formal and informal interventions, called for the top management of the bank to focus on the absolute urgent need to adopt all the necessary measures to re-establish appropriate liquidity margins.
- In September 2011, the supervisor launched an urgent second inspection of the bank, in order to carefully assess the suitability of the measures adopted by MPS. The assessment, which began at the end of September, also provides – in tense market conditions – for a direct control of the MPS group's liquidity management, essential to monitoring the situation in close connection with the Banca d'Italia.
- The supervisory inspection indicated, in the initial phases, that the issues previously highlighted by the Banca d'Italia in its supervisory capacity had not, in fact, been overcome and confirmed that the MPS group continued to have significant organisational problems and an inadequate managerial structure.
- The bank's liquidity position became increasingly fragile. In autumn 2011, the Banca d'Italia was obliged to conduct securities lending operations in order to enable the bank to increase its recourse to refinancing from the European Central Bank.
- Given the difficult situation uncovered as a result of the latest inspection, on 15 November 2011 the Governing Board of the Banca d'Italia summoned the top management of MPS and of the MPS Foundation to Rome in order to make them face up to their responsibilities and ask MPS to quickly and definitively turn around the way it conducts its business.
- MPS later terminated the contract of its Director General, Dr Vigni. On 12 January 2012, Dr Viola was appointed as Director General. Upon termination of his contract, Dr Vigni received a payoff of approximately €4 million. In July 2012, the Banca d'Italia, deeming the payoff was not justifiable given the circumstances, delved further into specific aspects of the matter which then led to a formal intervention letter being written and a sanctioning procedure being started on the administrative and control bodies in office at the time, who were responsible for the decision.
- On 19 January 2012, the Governor of the Banca d'Italia sent a letter to MPS repeating the objections raised by the Governing Board of the Banca d'Italia during the meeting of 15 November. In the light of the revealed shortcomings and tensions, MPS was asked for an extraordinary intervention plan.
- The on-site inspection of MPS was completed on 9 March 2012, after the MPS group's liquidity position was normalised, following, among other things, MPS' participation in the two three-year refinancing operations conducted by the ECB. The inspection report was highly critical, emphasising the bank's serious shortcomings in its liquidity management. A sanctioning procedure was started on MPS board members, the former Director General, the auditors and the members of the management committee for shortcomings in organisation, internal controls and breach of the regulations on containing financial risk. These proceedings are in their final stages.

- In the inspection report, the structured repo agreements mentioned previously were re-examined. MPS is criticised for not critically reviewing these operations in terms of their cost and benefits, even following the findings of the Banca d'Italia on the occasion of the previous inspection. The bank was also questioned as to data filing irregularities which led to the exposure deriving from these repos being underestimated. Information providing further details on the transaction with Nomura, highlighting the Alexandria restructuring operation carried out with Nomura, and on the accounting criteria followed in the transactions was submitted to the CONSOB (Commissione Nazionale per le Società e la Borsa, the public authority responsible for regulating the Italian securities market). At the same time, the supervisory report was communicated to the judicial authorities.
- At a meeting on 27 April 2012 the majority of the members of the Board of Directors and of the Board of Statutory Auditors were replaced. Mr Mussari did not renew his candidature for the role of President.
- In June 2012 the new corporate bodies approved the new business plan, which contained the extraordinary initiatives requested by the Banca d'Italia on 19 January.
- The plan, among other matters, confirmed the commitment to achieve by 30/06/2012 the capital target (9% of core tier 1 plus an exceptional temporary buffer for the holding of state securities) set by the EBA in the recommendation of December 2011, aimed at increasing market confidence in the capacity of the banking system to withstand adverse shocks. Although its capital was well above the amount provided for in the prevailing regulations, Banca Monte dei Paschi di Siena recorded a shortfall of €3.3 billion as at 30/09/2011 compared with the target set in the EBA recommendation. The shortfall was entirely attributable to the valuation at market prices of Italian Government bonds held in its portfolio (about €25 billion); leaving aside the sovereign risk buffer required by the EBA (€3.5 billion), the bank's core tier 1 ratio as at 30/09/2011 was equal to 9.2%. The plan put in place by MPS to strengthen its capital did not enable it to make up the shortfall entirely. The Banca d'Italia therefore asked the Ministry of Economy to adopt a public backstop measure, as provided for in the decision of the European Council of Heads of State or Government of 26 October 2011. In November 2012 MPS put the amount of the intervention at the maximum amount provided for under the law, equal to €2 billion; the Banca d'Italia gave a favourable opinion.
- In the ensuing months many senior managers with key roles were replaced.
- On 17 July 2012 MPS provided its response to the inspection findings . In general, having regard to the entire contents of the inspection findings (weakness of the financial balance, failings in organisation and controls), MPS cited the objectives in the recently approved corporate plan for 2012-2015, in which the central components were the financial rebalancing of the group and the initiatives specified in the plan to strengthen the liquidity position and the organisational and control structure. With regard to the Deutsche Bank and Nomura operations, MPS stated that, in order to reduce the absorption of liquidity by such financial investments, it had tried to mitigate the collateral obligations by negotiating with the counterparties possible amendments to the relevant contractual clauses. While some amendments to the contracts were agreed with Deutsche Bank, the negotiations with Nomura were abandoned by MPS owing to the heavy impact it would have had on the profit and loss account.
- In a letter of 15 October 2012, MPS notified the supervisor that on 10 October MPS's new directors found a contract dated 31 July 2009 between Banca Monte dei Paschi di Siena and Nomura, related to the restructuring of the Alexandria security transaction. This is a "framework" contract that provided evidence of the link between the restructuring of the

Alexandria security transaction and the subsequent repo operations carried out with Nomura, and clarified the real purposes of these operations. The contract had not been disclosed to the Banca d'Italia's inspectors who were responsible for inspections conducted on MPS's finance division in 2010 and 2011. In the absence of these documents, the supervisor was not previously able to identify with certainty the real purpose of the various components of the operation. The new information also contributed to strengthening reservations previously expressed by the Banca d'Italia regarding the Santorini operation.

- In the light of the above, the Banca d'Italia requested that MPS provide it with an analytical and detailed reconstruction of the real nature of the transaction as described in the contract provided. In addition, the Banca d'Italia asked MPS for an assessment of the current and future impact of the operation on the economic and patrimonial situation of both the bank and the group as a whole, as well as of the accounting practices used for the said operations, including those of previous years.
- In this case, too, the Banca d'Italia immediately informed the Public Prosecutor's Office that the contract had been kept hidden from the supervisory authorities at the time of the inspections carried out in both 2010 and 2011.
- In an e-mail dated 28 December, before it provided the formal response to the request for information issued by the Banca d'Italia, MPS sent to the supervisory authorities a draft report addressed to the board of directors containing the initial references to the Nomura/Alexandria, Deutsche Bank/Santorini transactions. Mention was also made of a low impact transaction entitled "Nota Italia", in relation to which mistakes were made in assessing the risk stemming from the operation.
- The e-mail in question also included the transcription of a conference call that took place in July 2009 between representatives of MPS and Nomura concerning the transaction with the latter counterparty. It was also specified that the framework agreement for the Alexandria transaction had not been sent to the auditors. In various press releases (dated 28 November 2012, 17 January 2013, 22 January 2013 and 23 January 2013), MPS informed the market that it was carefully examining the aforementioned structured repo agreements that it had stipulated in the preceding years.
- From the end of 2011 the Banca d'Italia was kept informed by Siena's Public Prosecutor's Office about the ongoing investigation and was in constant contact with the judges dealing with the enquiry, who received every possible assistance and had access to all documentation, in collaboration with the CONSOB and the Guardia di Finanza. The Banca d'Italia assessment of the true nature of the transactions carried out by MPS was therefore also based on developments in the criminal inquiries, which had brought to light facts that would have otherwise been impossible to ascertain.
- In this regard, both the Banca d'Italia and the competent judicial authorities worked in close cooperation to also determine whether the contractual structures used for the FRESH operation were in line with the regulations of the Banca d'Italia and the information communicated at that time by MPS to the supervisory authority. In response, in December 2012 the Banca d'Italia initiated a sanctioning procedure.

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- To conclude, MPS has been subject to detailed supervisory scrutiny, which has made it possible to identify and put a stop to high-risk activity, leading the bank to strengthen its administrative and control procedures. Its business is being closely monitored by the Banca d'Italia, in close cooperation with the new management, which is currently implementing a comprehensive restructuring with a view to boosting efficiency and restoring adequate profit levels.

- Following the action taken to date, the liquidity situation has improved. Capital levels are more than adequate with respect to the current regulatory limits: the supervisory measures have led to an increase in the total capital ratio of the MPS group from 9.3% at the end of 2008 to 15.4% in September 2012 (compared with a minimum regulatory limit of 8%). The public support that is now required relates to the pursuit of the higher capital targets set by the EBA in its Recommendation of December 2011 and the implementation of the restructuring plan.

Rome, 28 January 2013