MONTE DEI PASCHI DI SIENA
BANCA DAL 1472

Protocollo Sisifo: **3A0BD7EA53**

Siena, 15/03/2018

FUNZIONI COMPILATRICI:
Servizio Gestione Portafoglio Creditizio - MPS

Comunicazione per:

Consiglio Di Amministrazione - MPS

OGGETTO:

OSI 1238: Final Follow-up letter e risposta della Banca

Indice degli allegati:
1) *Allegato 1 – Follow-up letter On-site Inspection*
2) *Allegato 2 – Risposta alla Follow-up letter*

MOTIVAZIONE

- Informare il Consiglio di Amministrazione riguardo:
  - La Follow-up letter pervenuta in data 13 febbraio 2018 contenente i Finding connessi all'ispezione On-Site (OSI) 1238 inerente il sistema di gestione e di controllo dei rischi di credito e di controparte che si è svolta nel periodo dal 17 maggio 2016 al 17 febbraio 2017
  - La risposta della Banca alla Follow-up letter inviata al JST in data 15 Marzo 2018.

ELEMENTI CHIAVE DELL'INFORMATIVA

- Il documento ricevuto dal JST in data 13 febbraio 2017 (confronta Allegato 1, che costituisce parte integrante della presente memoria) individua gli elementi di debolezza (Findings) emersi nel corso dell'ispezione e le relative raccomandazioni finalizzate a superare i Findings stessi.
- Il documento nella sua versione finale ricalca i contenuti di quello in bozza ricevuto dalla Banca il 30 Novembre 2017 e già portato alla Vostra attenzione nella seduta del 12 Dicembre 2017. A livello complessivo, infatti, gli aspetti individuati sono 9 e attengono ai processi di gestione e controllo dei crediti.
- Il Gruppo ha già avviato e progressivamente implementato le attività necessarie a superare in modo integrale le criticità indicate in 2 dei Findings e in modo parziale le criticità rilevate in altri 2 Findings. Ulteriori azioni sono comunque già in corso relativamente al complesso delle rimanenti raccomandazioni.
- Allo scopo di garantire uno stretto monitoraggio delle iniziative è stata avviata una nuova progettualità denominata ARGO 3, guidata dalla Direzione CLO, nell'ambito del Programma Credito. In tale ambito, verrà attivata una gestione dedicata con monitoraggio puntuale che prevede un reporting indirizzato al Consiglio di Amministrazione, al Comitato Rischi e al Collegio Sindacale, nonché una rendicontazione periodica degli stati di avanzamento da trasmettere al JST. I report periodici saranno accompagnati anche dall'*assessment* effettuato dalla Funzione di Revisione Interna avente ad oggetto l'adeguatezza delle misure adottate.

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INFORMAZIONI RILEVANTI

Findings risolti

- Come sopra descritto, il Gruppo ha già dichiarato come integralmente risolti 2 Findings e parzialmente risolti altri 2 Findings:
    - Finding #2, relativo al corretto calcolo dell'EAD. Tale Finding è stato dichiarato chiuso in quanto a partire dall'1/1/2018 l'EAD viene calcolata, come richiesto dal team ispettivo, a partire dall'esposizione di bilancio che già include gli interessi maturati durante il periodo della moratoria.
    - Finding #5, relativo al conteggio dei giorni di scaduto per le moratorie e per gli Extra Fido. La raccomandazione viene ritenuta chiusa alla luce delle diverse azioni realizzate nel tempo, comprese quelle mirate alla risoluzione dei gap aperti dalla Funzione di Revisione Interna, volte a correggere proprio il calcolo dei giorni di past due.
    - Finding #4, relativo alla watch-list. Tale aspetto viene ritenuto superato per la sola Capogruppo a seguito della creazione della filiera High Risk e della relativa targatura delle controparti più rischiose, unitamente all'implementazione della reportistica trimestrale al Consiglio di Amministrazione sull'andamento del portafoglio crediti.
    - Finding #6, inerente il processo di identificazione delle forbearance. Tale aspetto viene ritenuto chiuso con riferimento alla sola parte dei controlli grazie al rafforzamento del processo di classificazione delle posizioni e dei relativi controlli finalizzato successivamente alla conclusione dell'On Site Inspection.

Findings che coinvolgono le società controllate

- Con riferimento ai Findings #1, #3 e #4, che coinvolgono anche le Società del Gruppo, il JST ha assegnato come scadenza delle remedial action il 31 Dicembre 2018.
- A tale riguardo nella risposta è stato segnalato al JST che la Banca sta valutando il processo di integrazione nella Capogruppo delle due società controllate MPS Capital Services e MPS Leasing and Factoring (Pelican Project). In particolare, è stato assicurato al JST che, in costanza della definizione della strategia, entro la scadenza assegnata verranno adottate delle iniziative volte a mitigare i rischi segnalati nelle specifiche raccomandazioni.

Scadenze e organizzazione progettuale

- Come sopradescritto, allo scopo di garantire uno stretto monitoraggio delle iniziative è stata avviata una nuova progettualità denominata ARGO 3, guidata dalla Direzione CLO.

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- Nell'ambito di tale progetto sono stati individuati 4 moduli all'interno dei quali sono stati allocati i diversi Findings, raggruppandoli per ambito di intervento.
- Sotto una tabella che riassume l'organizzazione progettuale e le scadenze assegnate da JST per ciascun Finding.

Findings	Descrizione	Delivery	Scadenza	Stato
#1	Qualità e disponibilità delle informazioni sottostanti il processo di default detection	Predisposizione database con informazioni sottostanti ai parametri di classificazione per i controlli di data quality	31/12/2018	APERTA
#2	Calcolo dell'EAD		30/06/2018	CHIUSA
#3	Duplicazione dei beni a garanzia di finanziamenti erogati da diverse società del Gruppo	Aggiornamento della stima di impatto della problematica segnalata, in attesa dell'integrazione di MPS CS, che risolverà in modo definitivo e strutturale la problematica	31/12/2018	APERTA
#4	Watch-list: omogeneizzazione all'interno del Gruppo e reportistica agli organi apicali	Estensione alle società controllate del perimetro High Risk e conseguente inclusione delle relative informazioni nella reportistica per il CdA	30/06/2018 per MPS 31/12/2018 per il Gruppo	PARZIALMENTE CHIUSA
#5	Conteggio dei giorni di scaduto per le moratorie e gli Extra Fido		30/06/2018	CHIUSA
#6	Efficacia e tempestività del processo di classificazione a maggior rischio delle posizioni oggetto di forborne	Automatizzazione della classificazione delle posizioni forborne Performing con parametri vincolanti accesi	30/06/2018 per le Policy 31/12/2018 per l'IT	PARZIALMENTE CHIUSA
#7	Adeguatezza dei parametri di classificazione per la default detection	Rivisitazione critica, insieme ai revisori esterni, del framwork di default detection e automatizzazione della classificazione a Inadempienza Probabile delle posizioni con parametri vincolanti accesi	30/06/2018	APERTA
#8	Adeguatezza delle metriche sottostanti la valutazione analitica dei crediti deteriorati (Haircut, tempi di recupero, cure rate)	Revisione, anche in ottica IFRS 9, del calcolo delle metriche sottostanti la valutazione dei NPE con conseguente aggiornamento delle Policy di valutazione.	30/06/2018	APERTA
#9	Tempestività aggiornamento Business Plan e adeguatezza accantonamenti sulle posizioni con Business Plan scaduto	Report sullo stato di avanzamento della lavorazione dei Business Plan e sulla copertura media delle posizioni con Business Plan scaduto	30/06/2018	APERTA

CONDIVISIONI/PARERI PREVENTIVI

- La presente memoria è stata preventivamente condivisa con le seguenti funzioni:
  - Direzione Chief Risk Officer
  - Direzione Chief Financial Officer
  - Direzione Chief Operating Officer
  - Direzione Chief Audit Executive
- La presente memoria è stata sottoposta all'attenzione del Comitato Rischi.

Valutazione impatti contabili/ fiscali/ segnaletici/ di compliance L.262 (SI-NO):
☑ NO: Non esistono impatti contabili/ fiscali/ segnaletici/ di compliance L.262 che richiedano una preventiva analisi da parte delle funzioni preposte.

Parte Correlata o Soggetto Collegato (SI-NO):
☑ NO: La controparte non è individuata come parte correlata/soggetto collegato, a seguito degli opportuni controlli previsti dalla normativa interna in materia.

Allegato File: Allegato 1_ Follow-up letter On-site Inspection.pdf
Allegato File: Allegato 2_Risposta alla Follow-up Letter.pdf

EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Significant Bank Supervision III
DGMS1/3

ECB-RESTRICTED

Mr Marco Morelli
Chief Executive Officer
Banca Monte dei Paschi di Siena S.p.A.
Piazza Salimbeni 3
53100 Siena
Italy

13 February 2018
OSI-2016-1-ITMPS-1238

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Follow - up letter On-site Inspection: credit and counterparty risk management and risk control system

Dear Mr Morelli,

In accordance with Article 12 of the Council Regulation (EU) No 1024/2013[1], and Articles 143 to 146 of the Regulation (EU) No 468/2014 of the ECB[2], and according to the 2016 supervisory examination programme adopted by the ECB on 7 January 2016, the group of Banca Monte dei Paschi di Siena S.p.A. ('the Bank'), particularly the entities Banca Monte dei Paschi di Siena S.p.A. ('BMPS'), MPS Capital Services Banca per le Imprese S.p.A. ('MPSCS') and MPS Leasing & Factoring S.p.A. ('MPSLF'), has been subject to an on-site inspection from 17 May 2016 to 17 February 2017 with the purpose of assessing the Bank's credit and counterparty risk management and risk control system.

Covering the retail, small and medium enterprise ('SME') and corporate portfolios of the Bank, the main objectives of the mission were to:

- ascertain the risk classification for the performing exposures;
- ascertain the level of provisions for non-performing exposures;
- carry out, for that purpose, a review of the collateral values;

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[1] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

[2] Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation).

- verify the quality of credit risk-related data;
- measure the impact of the Credit File Review on the capital position of the Bank, and analyse the clean-up process and its implications for the viability of the Bank;
- place a specific focus on the review of *"sofferenze rettificate"* files.

This letter and the Annex hereto, as part of the on-going supervision, aim at explaining the expectations of the supervisor in order to remediate the weaknesses and shortcomings detected during the on-site inspection as described in the on-site report dated 2 June 2017 and submitted to the Bank on 7 June 2017. On 30 November 2017 the Bank was given the opportunity to comment on a draft of this letter. The Bank provided comments during the closing meeting held on 12 December 2017 and by e-mail on 19 December 2017. The comments received from the Bank were evaluated and are taken into consideration in the final version of this letter.

Summary of the JST's recommendations aimed at addressing the identified weaknesses

The detected weaknesses are related to inadequate processes, systems or metrics in place, inadequate control procedures and other aspects that led to the non-adherence to the policies and processes in place, and/or flaws in relation to the Bank's internal governance arrangements. To address these shortcomings, summarised in 9 findings, the JST has defined specific recommendations. Both findings and recommendations are detailed in the Annex.

Based on the results of the review of the sampled credit files (Credit file review – CFR) and their projection to the un-sampled part of the in-scope portfolios, the inspection identified the need of additional provisions amounting to EUR 7.55bn, of which EUR 953 mln stemming directly from the CFR and the remaining amount from projections. The JST addressed to the Bank – amongst others – the quantitative findings of the on-site inspection (Findings #1 and #8) within the SREP decision dated 19 June 2017 ('2017 SREP decision', reference ECB/SSM/2017 - J4CP7MHCXR8DAQMKIL78/35). The Bank assessed the quantitative impacts of the credit risk on-site inspection and provided evidence, supported by its external auditors, to the JST that additional provisions for an amount of EUR 7.29bn have either already been booked ahead of the Precautionary Recapitalisation or will be booked over the horizon of the restructuring plan that was approved by the European Commission on 4 July 2017 (reference SA.47677). Based on the 2017 SREP decision, the ECB expected the booking of the remaining CFR in the Bank's financial statements by the end of 2017 (ca. EUR 250 million). The compliance with the SREP requirements related to the quantitative findings of the on-site inspection will be monitored exclusively via the implementation reports required as per para 1.1.3 of the 2017 SREP decision and are not in the scope of this letter.

As a consequence of the abovementioned findings and weaknesses and as further evidenced by the results of the CFR, the JST highlights that the classification and provisioning processes of the Bank must be further improved: in a total of 154 cases, the CFR revealed the necessity of reclassifications from Performing Exposure ('PE') to Non Performing Exposure ('NPE') categories (76 cases) and – within the NPE categories – from NPE "living" (unlikely to pay) to NPE Sofferenze (78 cases). In the vast majority of cases, the reclassifications concerned the SME and corporate portfolios. It cannot be excluded that also capital requirements have been underestimated (e.g. calculation of the probability of default, exposure at default or loss given default).

Several of the identified shortcomings relate to the wrong application of and/or non-adherence to existing policies and procedures. To address such weaknesses the JST requires the Bank to update and refine some of its existing policies, amongst others the accounting and provisioning policies. Particular importance should be placed on the review of the key metrics for calculation of loan loss provisioning and on the set of binding and non-binding parameters included in "Allegato 1" of policy 1991. The latter is needed in order to clarify both the scope of application of all the parameters and any possible exception to their use. To ensure that policies are consistently applied throughout the organisation going forward, the JST also requests the Bank to establish structured reporting, both to the management and the Board of Directors, to monitor the areas where criticalities were identified by the on-site inspection.

Detection and management of forbearance were also identified as areas to be improved by the Bank. Consequently, the JST requires the Bank to solve specific issues identified around the classification of forborne exposures under probation, reinforcing first and second level controls.

Additional improvements are requested concerning the internal watch-list of the Bank, with a strong focus on ensuring that a unified group-wide process is established for watch-list exposures.

The comprehensive implementation of the JST recommendations includes IT components that the Bank is requested to consider in its action plan. More precisely, data quality and data availability must be upgraded at least for default triggers, impairment triggers and early warning signals. The Bank is also requested to improve its data accessibility, making it simpler and more immediate, in particular for the relationship managers.

Next steps

The Bank is requested to submit an Action Plan within 30 days after receipt of the final version of this letter indicating the way it intends to comply and providing any necessary supporting documentation (as per the scheme reported in the Annex). The actions outlined in the Plan, once agreed with the JST including any necessary amendments, are expected to be adhered to and these will be closely monitored by the JST.

The Action Plan should detail, where applicable, the quantitative effects of the remediation actions engaged with regard to the findings that have not yet been addressed by the additional provisions stemming from the CFR. The quantitative effects shall be detailed in terms of Profit and Loss and CET1.

The ECB expects the content of this letter, including the Annex hereto, to be discussed in the Board of Directors, which is expected to be closely involved in the implementation and monitoring of the remedial actions requested. The ECB also expects the Bank's Collegio Sindacale to be involved in the supervision of the Action Plan's implementation. The Bank is requested to provide the JST with the minutes of the respective Board of Directors and Collegio Sindacale meetings in which the content of this letter and the Action Plan is discussed.

Additionally, this letter, including the Annex, should be brought to the attention of the external auditors of the Bank.

Finally, the Bank is required to provide the JST with quarterly update reports starting from the status and impacts as of 31 March 2018 until completion of the implementation of the remedial actions. These status updates should be accompanied by reports of the Internal Audit function assessing the appropriateness of the implemented measures.

Should you have any further question or request, please contact the JST Coordinator in charge of the supervision of Banca Monte dei Paschi di Siena S.p.A..

Yours sincerely,

Patrick Amis
Deputy Director General
DG-Microprudential Supervision I

Encl.

EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Annex to the Follow - Up letter (Final Recommendations)

For more details regarding the findings, please check the full report on the respective On-site inspection

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Finding #1	**Finding Description:** **Identification of impaired credit risk exposures** The process to identify impaired credit risk exposures is not functioning properly. The Credit File Review led to a significant number of reclassifications from PE to NPE categories, in particular for the non-retail portfolios and to a lesser extent for the retail portfolio: • 6.6% reclassification for SME, • 8.0% for top 50 corporate, • 16.0% for the statistical corporate portfolio hit by impairment triggers, • 2.7% reclassification for retail. As a consequence, the probability of default is not correctly estimated, especially for corporates hit by regulatory impairment triggers, which represent an EAD of EUR 20.3bn or 33.5 % of the corporate exposures. For this population, the Bank assigned on average a PD of 4.5 %, whereas the one-year default rate following the reclassification is estimated to be is 16 %. The quantitative impact of the reclassifications (PE-NPE and NPE "living" to bad loans) has been estimated at EUR 1.68 bn, without taking into account the need of recalibrating the PD. Root causes The Bank default / impairment triggers are incomplete to assess a significant financial difficulty of an obligor (DSCR is deactivated). Certain bank-defined binding impairment triggers do not lead to an automatic reclassification. Due to significant deficiencies and shortcomings in Bank's IT systems, the majority of risk data needed to appropriately assess the debtor's ability and likeliness to pay is neither available on automated basis nor otherwise This especially relates to data needed in order to calculate regulatory default triggers (negative EBITDA, material postponement of interest, principal and fees, etc.). JST observations In the on-site 34-35 follow-up letter dated 30 November 2015 the Bank was already requested to "upgrade and update data bases to ensure that all relevant information is taken into account in the monitoring of credit and allow a prompt identification of

impairment" (Recommendation 16). Despite the improvements reported by the Bank in the past years, the on-site 1238 report still highlights significant deficiencies and shortcomings in the availability and quality of the Bank's data. These issues mostly relate to the availability of significant risk information in the databases of the Bank.

Recommendation

The Bank is requested to improve the quality of the data of its IT databases at minimum for the following information:

- Data underlying the regulatory default triggers,
- Data underlying the Bank's own default/impairment triggers, with a priority for the binding ones,
- The Bank's own early warning signals.

The Bank is also requested to improve its data accessibility, making it more simple and immediate, in particular for the relationship managers.

The Bank is requested to report to the JST all the cases where it believes that it is impossible to upload or improve the requested information into its IT databases, with supporting evidence. In particular, the Bank is requested to:

- communicate, on a quarterly basis, the part of the corporate and SME debtors, in terms of EAD, for which no DSCR or EBITDA is available, and the actions engaged to manage this data deficiency,
- detail the early warning monitoring associated to the debtors for which these data are not available.

N.B.

The quantitative component of Finding #1 – as described above without taking into account the need of recalibrating the PD – has already been addressed to the Bank via SREP decision dated 19 June 2017 (reference ECB/SSM/2017 - J4CP7MHCXR8DAQMKIL78/35).

The shortcomings related to processes are addressed in the recommendation related to the Finding #7.

The shortcomings related to the IT part of the Finding #7 are addressed in this recommendation (related to Finding #1).

Deadline

31/12/2018

Finding # 2

Finding Description:

Flaws in estimating the EAD on single debtor level

Before December 2015, the Bank booked the amount of interests calculated during moratoria period in one account for diverse debtors, without possibility to allocate the correct amount on a single debtor level. The mentioned issue has been corrected at 31.12.2015. However, the accrued amount has not yet been integrated in the EAD.

Recommendation

The Bank is requested to estimate EAD on single debtor level in a consistent way by integrating all exposures relating to each debtor. Specifically, the EAD shall also include interests calculated during moratoria period and any other accrued amount.

Deadline
30/06/2018

Finding # 3

Finding Description:

Double and multi-counting of collaterals

- For a significant number of properties the cadastral data are partially or totally missing.
- The same collateral can be identified with different IDs in different companies of the group.
- The same collateral can be assigned different values in different companies of the group. As a consequence, for the collaterals that are double or even multi-counted, the exposures they related to are assigned to preferential LGD buckets.

This leads to an underestimation of capital requirements, which cannot be quantified due to the lack of cadastral data.

At the moment of the registration of a collateral in the IT systems of the Bank, the correct recognition of a collateral already registered in at least one of these systems is hindered by:

- the lack of the cadastral data of a significant number of collaterals in the database of the parent company,
- the lack of the cadastral data of the collaterals in the database of the subsidiary MPS Capital Services.

The aforementioned lack of cadastral data in the databases of the group in turn hinders the integration of the collaterals' information at group level.

	Recommendation	Deadline
	Recommendation The JST requires the Bank to put in place reports and/or processes and/or the necessary IT infrastructure to assure that, both with reference to existing exposures and new ones: • a collateral cannot have different ID numbers in different companies of the group or in the same company with reference to different debtors, avoiding any double counting. • if the value of a collateral is updated in any company of the group, the most updated value is consistently used in all the IT systems throughout the group (parent company and subsidiaries).	**Deadline** 30/06/2018 (In case of incorporation of MPSCS and MPSLF into BMPS, 31/12/2018)

Finding # 4	**Finding Description:** **Flaws in relation to the watch-list** The on-site inspection revealed that the internal watch-list in place is not reported to the management board. The latter is therefore not deemed to be sufficiently informed about the deterioration of the Bank's credit risk quality as required according to Article 74 CRD and the respective implementation in Bank of Italy's Circular 285. It has furthermore been detected that the internal watch-list lacks any inclusion of the subsidiaries and that there is no group-wide unified process in place on how to treat watch-list exposures (e.g. restructuring or workout processes). In addition, during the time of the inspection, the watch-list has not been considered to be fully aligned with the internal rating system. Given that the internal watch-list has only been introduced during the time of the on-site inspection, no back-testing had been in place allowing for a comparison of the probability of default of watch-list exposures with the actual default rates. The data requested in this context during the on-site inspection showed an underestimation of the probability of default and a need to recalibrate the PD.	
	Recommendation The Bank is requested to: • Implement a regular reporting containing an overview of the watch-list developments to the management board, • Extent the scope of the watch-list to the subsidiaries Banca Widiba S.p.A. ('Widiba'), MPSLF and MPSCS (just applicable to Widiba in case MPSCS and MPSLF are incorporated into BMPS),	**Deadline** 30/06/2018 (In case of incorporation of MPSCS and MPSLF into BMPS,

<table>
<tr><td></td><td>• Define and formalise a unified group-wide process regarding the treatment of watch-list exposures,
• Ensure that the Internal Validation function, at its next annual review of the internal rating system, places additional focus on watch list exposures, at least by backtesting the probability of default and the observed default rate of the watch-list files.</td><td>30/06/2018 for BMPS alone and 31/12/2018 for the new merged entity)</td></tr>
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<table>
<tr><td rowspan="2">Finding # 5</td><td colspan="2">Finding Description:

Counting of days past due for restructured “moratoria” and “extra fido” exposures

• In case of concession of a moratorium programme the counting of days past due is not frozen but it is reset erasing the history of past due amounts. Consequently, those loans are classified as performing instead of non-performing past due. The number of days past due erased is especially high whenever the suspension period starts before the granting of a moratorium. This problem was signalled by the Internal Audit function in the report no. 199/2015. The Bank formally considered the Audit finding as closed, only because the process of identification of forbearance measures was put in practice at the end of 2015 (and controls/actions are required in case of 30 days past due) without resolving the problem. However, the on-site team has found a lack in the process of identification of forbearance measures (see Finding #6).
• In case of granting an additional loan to debtors that have already past due exposures (called concession of an “extra-fido”), the counting of number of day past-due is not correct: it does not start from the date of concession of the extra-loan as required by the Italian regulation but from the date it produces past due amounts. The Internal Audit reported also this issue, which has not been solved yet.</td></tr>
<tr><td>Recommendation

The Bank is requested to put in place and/or complete all actions needed to definitively solve the issue regarding the counting of days past due on all the exposures.
With reference to “moratoria” exposures, the Bank is requested to avoid any reset of the history of past due amounts, in order to allow a proper classification of the exposures.
Moreover, as far as the “extra fido” exposures are concerned, the Bank shall ensure that the counting of the days past-due is compliant with Circular 272 and other applicable regulations.</td><td>Deadline
30/06/2018</td></tr>
</table>

Finding # 6	**Finding Description:** **Effectiveness and timing of the process of identification of forbearance** The process of identification of forbearance shows weaknesses: • when detection is not automatic, but based on the expert judgment of relationship managers, consequently affecting the start date of probation and cure period. As an example, there is no automatic reclassification into non-performing of cured forborne exposures under probation period that become more than 30 days past due, even though the Bank has introduced a binding parameter to monitor this phenomenon. • concerning the detection of re-aged facilities, hindered by the fact that the initial granting date is not available at facility level in the IT-systems of the Bank (DWHC).	
	Recommendation In order to comply with the definition of Forbearance provided by the Commission Implementing Regulation (EU) 2015/227, the Bank is requested to: • solve the weaknesses found during the investigation and, in particular, to automatically classify to non-performing the forborne exposures under probation period that meet the criteria of reclassification. To this extent, the Bank is requested to implement the necessary IT system in order to comply with this recommendation. Pending the completion of the IT developments, the Bank shall establish a dedicated monitoring of forborne exposures under probation, • reinforce first and second level controls, at least, on clients subject to credit decisions while showing signs of potential financial difficulties (e.g. inclusion in watch-list or flagged as high risk). In addition, considering that the financial difficulty of a debtor cannot be automatically detected in every case, the Bank is required to establish specific internal control procedures in order to avoid or at least limit the potential misclassification of forborne exposures by the commercial network.	**Deadline** 30/06/2018 for the policies 31/12/2018 for the IT component

Finding #7

Finding Description:

Flaws in the processes of identifying and managing problem credits

The process is not (consistently) applied:

- Two binding impairment triggers defined by the relevant internal procedure of the Bank's (policy D 01991) are not applied […].

The process is not effective.

- The default identification process requires two levels of analyses and decisions and the participation of many actors, a process causing delays in practice. As an example, out of 53.222 exposures identified hit by triggers […], some parameters (binding or non-binding reclassification triggers) switched on (generally triggered) were not checked because they were switched off (not struck) at the date of analysis, very delayed in comparison to the extraction date, or because relationship managers were still working on them […]. Finally, only 44% of them (23.726 cases) were analysed, mainly Small Business and Retail debtors.
- The connection between two main internal indicators of early warning signals – IRA and ISA – is not clear: these two indicators are used for same purposes that is the measurement of the deterioration of credit-worthiness of debtors (ISA - "Indicatore Sintetico di Anomalia" - and ISA_P - ISA Evoluto -, the first one influences the rating system determining a possible early rating review while the second one represents an input for the IRA.
- The ISA indicator is not visible in the IT system used for credit monitoring ("Mocre").

JST observations

- According to the current definition of policy 1991 (para. 2.5.1) counterparties with binding parameters must be reclassified to the status foreseen by the policy. However, the process of default detection currently gives the possibility to the relationship manager, in agreement with the Credit Department, to not reclassify counterparties which have binding parameters activated.
- Currently low priority non-binding parameters have a limited role in the default detection process, which questions either the setting of policy 1991 or the implementation process.

Recommendation	Deadline
The shortcomings related to processes and policies of Finding #1 are addressed in this recommendation. The shortcomings of Finding #7 related to IT are addressed in the recommendation related to Finding #1.	30/06/2018

The Bank is requested to review, together with its external auditors, the list of parameters included in "Allegato 1" of the internal policy 1991 in order to ensure that each parameter:

- is clearly defined,
- is meaningful for default and impairment detection,
- can be obtained or calculated within a reasonable timeframe.

The Bank shall demonstrate that any change to the list of parameters does not weaken the default detection process and the recognition of impairments,

In addition, the Bank is requested to clearly define in its policies any possible exception to reclassifications required by the binding parameters. The new policy and process must not allow exceptions to reclassification when binding parameters are activated, unless the exception is clearly defined in the policy.

The Bank is also requested to improve its processes to ensure that also low priority non-binding parameters are promptly assessed.

Concerning the timely processing of binding parameters, the Bank is requested to ensure that, for binding parameters derived from the regulation (e.g. material 90 days past due or 30 days past due forborne performing exposures in the cases specified in para. 2.6.4 of policy 1991), their activation must necessarily lead to reclassification regardless of the status of the parameter at the time of the analysis.

In order to assess the timely analysis of the binding parameters, the Bank is requested to submit to the ECB, on quarterly basis, a report highlighting the timing for the assessment of binding parameters. The report must contain, at minimum:

- the minimum, median and maximum days to process binding parameters per month of activation,
- the actions taken to reduce delays, if any.

In addition, the Bank is requested to communicate the annual reclassification rate, at debtor level, of debtors hit by at least one non-binding impairment trigger. Furthermore, internal audit shall conduct a yearly examination of a representative sample of the latter population, and communicate the results to the ECB.

The quarterly report must be submitted also to the Risk Committee of the Board of Directors. The relevant extract of the minutes where the report is discussed shall be submitted to the ECB.

Furthermore, the Bank is requested to assess how to align ISA - "Indicatore Sintetico di Anomalia" - and ISA_P - ISA Evoluto – to incorporate all the changes driven by the recommendation contained in this letter.

Finding #8

Finding Description:

Underestimation of key metrics for calculating loan loss provisions

Regarding the collateral haircuts:

- External costs of recovery have not been taken into account (representing 5 to 7 percentage points).
- Options have been chosen that underestimate the haircuts: removal of outliers, shorter time horizon applied, individual updates of collateral values for the biggest tickets.

Regarding the time to recovery:

- Due to data shortcomings (NPL Unlikely to Pay Exposures are registered in a different database when entering in bad loan status, and change their ID, without track of this change), the Bank can only estimate the time from the entry date in bad loan status to the end of the recovery period.
- The restructured exposures are excluded from the database estimating the time to recovery.

Regarding the cure rates:

- The Bank is overestimating the cure rates applied, due to a longer reference period applied than corresponding to AQR-standards (7 years vs. 1 year) and due to the fact that, in economic substance, the calculated cure rate corresponds to the application of a matrix with infinite iterations, corresponding to an expected workout period of more than 20 years.

Impact: The application of these key metrics – together with the challenge of too optimistic assumptions in business – led to additional provisioning need that can be quantified as EUR 5.9bn.

Recommendation

The quantitative component of Finding #8 has already been addressed to the Bank via SREP decision dated 19 June 2017 (reference ECB/SSM/2017 - J4CP7MHCXR8DAQMKIL78/35).

The Bank is requested to update its accounting and provisioning policy in order to address the issues highlighted during the on-site inspection and reported in Finding #8.

The Bank is also requested to highlight any changes already implemented to the abovementioned policy compared to the version of the policy as of year-end 2015 which was provided to the on-site team. Such changes should also be mapped against the shortcomings identified by the on-site team and reported in the on-site report, highlighting areas where the Bank believes to have completely solved the identified issues. For issues which have not yet been addressed, the Bank is requested to amend its policies by the set deadline.

Deadline
30/06/2018

<table>
<tr><td rowspan="2">Finding # 9</td><td colspan="2">Finding Description:

Flaws around the use of debtor's business plans

The inspection revealed that out of 147 debtors classified as sofferenze by the banking group the files of only 88 debtors had an updated business plan. It has furthermore been detected that for the calculation of the time to recovery, the business plans are not consistently used within the Monte Paschi Group.</td></tr>
<tr><td>Recommendation

The Bank is requested to:
• ensure that business plans are updated on a timely basis;
• implement conservative provisioning rates for debtors with an expired business plan,
• Develop specific procedures in order to ensure that, when a business plan is expired, the conservative provisioning rate is applied.</td><td>Deadline
30/06/2018</td></tr>
</table>

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Siena, 15 marzo 2018

European Central Bank
JST Coordinator/Director General DG/MS I
Sonnemannstrasse 20
60314 Frankfurt am Main
Germany

Answer to the February 13th 2018 "Follow-up letter On-site Inspection: credit and counterparty risk management and risk control system"

With reference to your letter sent on February 13th 2018 "Follow up letter On-site Inspection [OSI-2016-1-ITMPS-1238] (hereinafter "Follow up letter"), relating to the results of the On Site inspection held from May 17th 2016 to February 17th 2017, following our answers to each "finding" and the summary of the remediation activities we intend to implement within the set deadline.

First we confirm that the Group has already been started and gradually implemented the necessary activities to address the Recommendations contained in the mentioned letter (hereinafter, the "Recommendations"). In particular, we addressed and solved recommendation included in Findings # 2 and # 5, in Finding #4, with regards to the Parent Company only, and in Finding #6, with regards to the controls only. We will send you the documentation to support the resolution of these Findings as soon as possible. Further actions have already been undertaken according to the remaining Recommendations.

Finally, with reference to the Findings # 1, # 3 and # 4, which also involve the Group Companies, we would like to point out that the Bank is evaluating the integration process of MPS Capital Services and MPS Leasing and Factoring into the Parent Company. Without changing the defined strategy, we confirm that within the set deadline we would adopt all the initiatives to mitigate the risks highlighted in the specified Recommendations.

As you indicate in the "Follow up letter" the impacts arising from Findings # 1 and # 8 will be monitored as part of the communication related to the SREP Decision of June 19th 2017.

No further significant impacts in terms of reclassifications and/or income statement and capital calculations are expected from the actions that will be undertaken according to the remaining Recommendations.

In order to ensure close monitoring of the initiatives, a new project called ARGO 3 has been launched.

In this context, a dedicated management will be activated with timely monitoring that provides reporting to the Board of Directors, to the Risk Committee and the Board of Statutory Auditors, as well as an account of the progress reports to be transmitted to your attention by the Regulatory Relationship Function. These reports will be accompanied by an assessment carried out by the Internal Audit Function concerning the adequacy of the measures adopted.

Moreover, we point out that the cost of credit incurred during the years 2016 and 2017 is already the consequence of more severe classification and assessment policies that have been adopted by the bank during the mentioned years.

The draft Consolidated Financial Statement as of December 31st ,2017 shows balance sheet items 130 a) and d) of approximately Euro 5.4 bn compared to Euro 4.5 bn of the previous year.

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These values, related to the Balance Sheet item 70 (Customer Loans), determine a total cost of credit of 585 bps for 2017 and 419 bps for 2016.

Following your request, the "Follow up letter" and this answer have already been brought to the attention of the external auditing firm and will be submitted to the Board of Statutory Auditors on March 21st 2018. Finally, the Board of Directors will take note of the "Follow up letter" and this answer on March 22nd 2018

° ° °

In order to comply with the additional requests of the "Follow up Letter" i) the Board of Directors will be involved in the implementation and monitoring of the activities ii) the Board of Statutory Auditors will be involved in the supervision of this action plan; and iii) the Internal Audit Function will assess the appropriateness of the implemented measures. Moreover, the Internal Audit Function has already scheduled in its 2018 Audit Plan specific audit on the issues related to Findings #3, 6, 7, 8 e 9.

Following all the necessary details for summarizing the requested activities for each Recommendation.

Kind regards

Fabrizio Leandri	Leonardo Bellucci
Chief Lending Officer	*Chief Risk Officer*
Banca Monte dei Paschi di Siena S.p.A.	Banca Monte dei Paschi di Siena S.p.A.

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Finding # 1	**Finding Description:** **Identification of impaired credit risk exposures** The process to identify impaired credit risk exposures is not functioning properly. The Credit File Review led to a significant number of reclassifications from PE to NPE categories, in particular for the non-retail portfolios and to a lesser extent for the retail portfolio: • 6.6% reclassification for SME, • 8.0% for top 50 corporate, • 16.0% for the statistical corporate portfolio hit by impairment triggers, • 2.7% reclassification for retail. As a consequence, the probability of default is not correctly estimated, especially for corporates hit by regulatory impairment triggers, which represent an EAD of EUR 20.3bn or 33.5 % of the corporate exposures. For this population, the Bank assigned on average a PD of 4.5 %, whereas the one-year default rate following the reclassification is estimated to be is 16 %. The quantitative impact of the reclassifications (PE-NPE and NPE "living" to bad loans) has been estimated at EUR 1.68 bn, without taking into account the need of recalibrating the PD. Root causes The Bank default / impairment triggers are incomplete to assess a significant financial difficulty of an obligor (DSCR is deactivated). Certain bank-defined binding impairment triggers do not lead to an automatic reclassification. Due to significant deficiencies and shortcomings in Bank's IT systems, the majority of risk data needed to appropriately assess the debtor's ability and likeliness to pay is neither available on automated basis nor otherwise This especially relates to data needed in order to calculate regulatory default triggers (negative EBITDA, material postponement of interest, principal and fees, etc.). JST observations

In the on-site 34-35 follow-up letter dated 30 November 2015 the Bank was already requested to "upgrade and update data bases to ensure that all relevant information is taken into account in the monitoring of credit and allow a prompt identification of impairment" (Recommendation 16). Despite the improvements reported by the Bank in the past years, the on-site 1238 report still highlights significant deficiencies and shortcomings in the availability and quality of the Bank's data. These issues mostly relate to the availability of significant risk information in the databases of the Bank.

Recommendation The Bank is requested to improve the quality of the data of its IT databases at minimum for the following information: • Data underlying the regulatory default triggers, • Data underlying the Bank's own default/impairment triggers, with a priority for the binding ones, • The Bank's own early warning signals. The Bank is also requested to improve its data accessibility, making it more simple and immediate, in particular for the relationship managers. The Bank is requested to report to the JST all the cases where it believes that it is impossible to upload or improve the requested information into its IT databases, with supporting evidence. In particular, the Bank is requested to: • communicate, on a quarterly basis, the part of the corporate and SME debtors, in terms of EAD, for which no DSCR or EBITDA is available, and the actions engaged to manage this data deficiency, • detail the early warning monitoring associated to the debtors for which these data are not available. N.B. The quantitative component of Finding #1 – as described above without taking into account the need of recalibrating the PD – has already been addressed to the Bank via SREP decision dated 19 June 2017 (reference ECB/SSM/2017 - J4CP7MHCXR8DAQMKIL78/35). The shortcomings related to processes are addressed in the recommendation related to the Finding #7.	**Deadline** 31/12/2018

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	The shortcomings related to the IT part of the Finding #7 are addressed in this recommendation (related to Finding #1)	
	Inspected institution's answer Within the set deadline, the Bank will assure to put in place specific instruments in order to maintain in its databases all the elementary information used to calculate binding and not binding triggers, so to improve the data quality controls. Historic binding and not binding parameters are already included in the databases developed by the Bank and are easily available for Relationship Managers through the "Monitoraggio del Credito" application. This application makes available all the essential information for a proper evaluation of the counterparties, highling the riskiest. These parameters are checked on a daily basis and are one of the criteria used for the elaboration of the high risk clients list, on which the Relationship Manager has to focus on, in order to avoid the deterioration of the position. After the first adoption, new search functions were implemented in order to allow the Relationship Manager to identify, in a more timely manner, the critical counterparties, on which to start a dedicated activity and/or classification to worse status. As requested, starting from December 2018, we will quarterly send you a report with counterparties with revenues >€ 2.5 mln (SME and Corporate), for which EBITDA and/or DSCR could not be calculated..	

Finding # 2	**Finding Description:** **Flaws in estimating the EAD on single debtor level** Before December 2015, the Bank booked the amount of interests calculated during moratoria period in one account for diverse

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debtors, without possibility to allocate the correct amount on a single debtor level. The mentioned issue has been corrected at 31.12.2015. However, the accrued amount has not yet been integrated in the EAD.

Recommendation	Deadline
The Bank is requested to estimate EAD on single debtor level in a consistent way by integrating all exposures relating to each debtor. Specifically, the EAD shall also include interests calculated during moratoria period and any other accrued amount.	30/06/2018

Inspected institution's answer

During the 2017 the Bank updated its EAD parameters models, including the evaluation on a single borrower basis and considering all the underlying exposures. These new models have been subjected to the validation of Validation and Internal Audit functions, to the approval of the dedicated internal Committee, the Risk Management Committee and the Board of Directors. On 10th November 2017 we submit an application to the ECB for the validation of the models and, after the approval, we will use them for the calculation of capital requirements.

The finding is considered addressed as from 1 January 2018 EAD is already used for the valuation of IFRS9 provisions and it is calculated starting from the balance sheet exposures, including both overdue interests and any other accrued amount, on which the expected utilization of the credit line is added.

Finding # 3	
	Finding Description: **Double and multi-counting of collaterals**

- For a significant number of properties the cadastral data are partially or totally missing.
- The same collateral can be identified with different IDs in different companies of the group.
- The same collateral can be assigned different values in different companies of the group. As a consequence, for the collaterals that are double or even multi-counted, the exposures they related to are assigned to preferential LGD buckets.

This leads to an underestimation of capital requirements, which cannot be quantified due to the lack of cadastral data.

At the moment of the registration of a collateral in the IT systems of the Bank, the correct recognition of a collateral already registered in at least one of these systems is hindered by:

- the lack of the cadastral data of a significant number of collaterals in the database of the parent company,
- the lack of the cadastral data of the collaterals in the database of the subsidiary MPS Capital Services.

The aforementioned lack of cadastral data in the databases of the group in turn hinders the integration of the collaterals' information at group level.

Recommendation	Deadline
The JST requires the Bank to put in place reports and/or processes and/or the necessary IT infrastructure to assure that, both with reference to existing exposures and new ones: • a collateral cannot have different ID numbers in different companies of the group or in the same company with reference to different debtors, avoiding any double counting. • if the value of a collateral is updated in any company of the group, the most updated value is consistently used in all the IT systems throughout the group (parent company and subsidiaries)	30/06/2018 (In case of incorporation of MPSCS and MPSLF into BMPS, 31/12/2018)

Inspected institution's answer

The attribution of different identification codes (ID) to the same asset from different Group's companies doesn't constitute an anomaly, but it depends on the coexistence of different information systems. Through the project of incorporation of the subsidiaries in MPS Group's and the consequent integration of the IT systems, a single database of guarantees and assets will be created, completely addressing the finding.

Nevertheless,in the reply sent to you on 7th April 2017 we highlighted:

Although a single entity or different legal entities of the Group assign different IDs to the same asset, this does not generally imply double or multi-counting of collaterals considered for the calculation of LGD and RWAs. Moreover, the assignment to LGD bucket is related to LTV which in turn is connected with collateral value compared with residual exposure at the reference date. Exposures are normally assigned to correct LGD buckets and specific deviations have negligible effects on LGD and capital requirements.

For loans granted by different entities of the Group, previous encumbrance on the asset is discounted from the collateral value. As a consequence, exposures are normally assigned to correct LGD buckets. It should be noted that the value of collateral is generally significantly higher than the residual exposure, and consequently, even where specific deviations from the normal process occurred, a significant effect on capital requirements would be unlikely.

However, as far as loans granted by different entities of the Group with the same asset as collateral are concerned, in order to assess the risk of impacts on capital requirements connected with the described issue, we considered the extreme unrealistic scenario in which the exposures of only one of the entities are considered as secured (thus fully excluding the value of collateral on the exposures of the other entities). In this scenario we estimated that an increase of RWAs not exceeding 60 million euro would result as at 31 December 2016 with negligible effects on collective provisions and no effect on shortfall to be included in own funds. This assessment allows to conclude that specific deviations (if any) from the normal process would have determined a negligible effect on capital requirements as at 31 December 2016.
On the other hand, as regards different loans granted by the Parent Company with the same asset as collateral, starting from February 2017 a new algorithm has been applied to split the collateral value on different exposures.

Ultimatly:

- Through the integration of the different IT systems of the Group's Companies, a single ID will be assigned to each asset, completely addressing the finding;
- Waiting for the conclusion of the integration process (Pelican Project), from 30th June 2018 and on a six-month basis, the Bank will update the analysis related to the exposures shared by the Group's companies and collateralized by the same asset, in order to assess the potential impacts on the capital requirements;
- Whereas from the above evaluation potential impacts higher than 0,2% of the consolidated RWA were to emerge, the Bank will implement specific remediation actions.

The Internal Audit Function has already scheduled in its 2018 Audit Plan specific audit on collateral.

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<table>
<tr><td rowspan="2">Finding # 4</td><td colspan="2">Finding Description:

Flaws in relation to the watch-list

The on-site inspection revealed that the internal watch-list in place is not reported to the management board. The latter is therefore not deemed to be sufficiently informed about the deterioration of the Bank's credit risk quality as required according to Article 74 CRD and the respective implementation in Bank of Italy's Circular 285. It has furthermore been detected that the internal watch-list lacks any inclusion of the subsidiaries and that there is no group-wide unified process in place on how to treat watch-list exposures (e.g. restructuring or workout processes). In addition, during the time of the inspection, the watch-list has not been considered to be fully aligned with the internal rating system.
Given that the internal watch-list has only been introduced during the time of the on-site inspection, no back-testing had been in place allowing for a comparison of the probability of default of watch-list exposures with the actual default rates. The data requested in this context during the on-site inspection showed an underestimation of the probability of default and a need to recalibrate the PD.</td></tr>
<tr><td>Recommendation

The Bank is requested to:
Implement a regular reporting containing an overview of the watch-list developments to the management board,
Extent the scope of the watch-list to the subsidiaries Banca Widiba S.p.A. ('Widiba'), MPSLF and MPSCS (just applicable to Widiba in case MPSCS and MPSLF are incorporated into BMPS),
Define and formalise a unified group-wide process regarding the treatment of watch-list exposures,
Ensure that the Internal Validation function, at its next annual review of the internal rating system, places additional focus on watch list exposures, at least by backtesting the probability of default and the observed default rate of the watch-list files.</td><td>Deadline
30/06/2018
(In case of incorporation of MPSCS and MPSLF into BMPS, 30/06/2018 for BMPS alone and 31/12/2018 for the new</td></tr>
</table>

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	merged entity)

Inspected institution's answer

In July 2017 the project for the identification, within the bank's Performing portfolio, of positions characterized by high risk elements was completed (High Risk). The identification of these positions was carried out together with the creation of a dedicated decision-making process different from the one related to the standard risk (Low Risk) positions, to allow a more effective and specialized follow-up of the positions.

The criteria to classify the performing positions as High Risk are:

- Binding/non-binding parameters with high relevance
- Forborne exposures
- Rating worse than D3 for more than 3 months
- >45 days past due (max between client days and exposure days)
- High IRA (MPS early warning indicator)
- Shared positions: which have a Group's status worse than Performing state in MPS.

Positions with A or B ratings, positions monitored by the Restructuring area, Banks and foreign counterparties are always excluded from the High Risk classification.

The High Risk positions are identified in the Credit Monitoring application, with the aim of activating a timely intervention by the dedicated supply chain aimed at avoiding the deterioration of the position and its correct classification.

Starting from the first quarter 2017, a specific section illustrating the stock of the High Risk positions and the changes with respect to the previous quarter for Banca MPS is presented as part of the quarterly reports to the Board of Directors.

Pending the conclusion of the integration process of MPS Leasing & Factoring and MPS Capital Services, within the deadline set, the Bank will, in any case, extend the High Risk to the subsidiaries through a dedicated process.

The Risk Validation Systems Department will provide, once a year, the validation of the High Risk portfolio, verifying the consistency between the risk parameters (average PD) and the risk actually observed (default rate).

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Finding # 5

Finding Description:

Counting of days past due for restructured "moratoria" and "extra fido" exposures

- In case of concession of a moratorium programme the counting of days past due is not frozen but it is reset erasing the history of past due amounts. Consequently, those loans are classified as performing instead of non-performing past due. The number of days past due erased is especially high whenever the suspension period starts before the granting of a moratorium. This problem was signalled by the Internal Audit function in the report no. 199/2015. The Bank formally considered the Audit finding as closed, only because the process of identification of forbearance measures was put in practice at the end of 2015 (and controls/actions are required in case of 30 days past due) without resolving the problem. However, the on-site team has found a lack in the process of identification of forbearance measures (see Finding #6).
- In case of granting an additional loan to debtors that have already past due exposures (called concession of an "extra-fido"), the counting of number of day past-due is not correct: it does not start from the date of concession of the extra-loan as required by the Italian regulation but from the date it produces past due amounts. The Internal Audit reported also this issue, which has not been solved yet.

Recommendation

The Bank is requested to put in place and/or complete all actions needed to definitively solve the issue regarding the counting of days past due on all the exposures.

With reference to "moratoria" exposures, the Bank is requested to avoid any reset of the history of past due amounts, in order to allow a proper classification of the exposures.

Moreover, as far as the "extra fido" exposures are concerned, the Bank shall ensure that the counting of the days past-due is compliant with Circular 272 and other applicable regulations.

Deadline
30/06/2018

Inspected institution's answer

The finding is considered addressed taking into account all the actions implemented at this regards over time, in particular the actions aimed at resolving the Internal Audit gap related to the correct calculation of days past due.

The freezing of the days past due at the time of the granting of the "moratoria", is no longer necessary as managed through the new rules for monitoring the forborne exposures. Positions with "moratoria" are in fact classified as forborne exposures and, as such, for them a reduction from 90 to 30 of days past due is applied in order to activate actions for evaluating the classification. For such cases, it appears coherent not to freeze the days past due at the time of the grant.

For the cases of "Extra Fido" granting, the days past due counting rule has been modified in compliance with the Bank of Italy rules (Circolare 272). Starting from February 2017 the counting of days past due starts from the date of "Extra Fido" granting and not from the effective date of the past due.

Finding # 6

Finding Description:

Effectiveness and timing of the process of identification of forbearance

The process of identification of forbearance shows weaknesses:

- when detection is not automatic, but based on the expert judgment of relationship managers, consequently affecting the start date of probation and cure period. As an example, there is no automatic reclassification into non-performing of cured forborne exposures under probation period that become more than 30 days past due, even though the Bank has introduced a binding parameter to monitor this phenomenon.
- concerning the detection of re-aged facilities, hindered by the fact that the initial granting date is not available at facility level in the IT-systems of the Bank (DWHC).

Recommendation	Deadline
In order to comply with the definition of Forbearance provided by the Commission Implementing Regulation (EU) 2015/227, the Bank is requested to: • solve the weaknesses found during the investigation and, in particular, to automatically classify to non-performing the forborne exposures under probation period that meet the criteria of reclassification. To this extent, the Bank is requested to implement the necessary IT system in order to comply with this recommendation. Pending the completion of the IT developments, the Bank shall establish a dedicated monitoring of forborne exposures under probation, • reinforce first and second level controls, at least, on clients subject to credit decisions while showing signs of potential financial difficulties (e.g. inclusion in watch-list or flagged as high risk). In addition, considering that the financial difficulty of a debtor cannot be automatically detected in every case, the Bank is required to establish specific internal control procedures in order to avoid or at least limit the potential misclassification of forborne exposures by the commercial network.	30/06/2018 for the policies 31/12/2018 for the IT component

Inspected institution's answer

The classification of positions with Forborne under probation exposures for which one of two conditions, "past due beyond 30 days on forborne NPE" or "regulatory past due on position with forborne performing at the previous month", are met, will be automatic as described in Finding #7.

Referring to this aspect, we report that, after the conclusion of the On site inspection, measures to strengthen the process of classification of positions with binding parameters and related controls have been implemented.

In fact, starting from August 2016, the decision to keep a position which meets a binding parameter as performing is no longer in the hand of the relationship manager, but the involvement of a credit specialist is requested; starting from July 2017, the decision of the credit specialist to keep the position as performing should be authorized by a specific Committee (known as the "Tavolo On

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	Boarding "). Finally, again during 2017, a weekly report for the Chief Lending Officer was implemented with a summary of the results of the processing of positions for which binding parameters were taken. Furthermore, in order to improve the early detection process and to supervise the correct classification of exposures, in particular the Forborne ones, in July 2017 the implementation of the High Risk dedicated function has been completed (see Finding #4) for the management of riskiest positions. In particular, this dedicated function evaluates the financial difficulty of a borrower during Forbearance measure granting and, therefore, the consequent correct classification of the position. Regarding controls, the Credit Process Quality Department and the Regional Areas specific offices (CLO) already performs a series of controls starting from August 2017 in compliance with the internal rule D2284 "Monitoring the quality of the credit process on positions under ordinary management" issued on 29/12/2017, aimed at checking the correct classification of the positions and more in detail: - monitoring activities on processing of parameters and checking of the of the quality of the process - monitoring activities on the management of past due positions - monitoring activities on positions in Forborne status, in order to identify any situations of failure and / or non-timely classification in the presence of highly critical elements that suggest a change in status. The Credit Exposure Control Department (CRO), in accordance with the provisions of the D1591 "Credit granting and review", carries out controls on a sample basis concerning the compliance with the purpose of verifying the correct detection during the underwriting decision process. Furthermore, checks are carried out on the consistency of the classification related to the processing of the parameters. These controls are scheduled on a half-yearly basis for BMPS and on annual basis for MPS Leasing & Factoring and MPS Capital Services. Pending the implementation of the IT procedures that guarantee automatic classification, a dedicated activity will be set up that provides for the periodic extraction of positions with unconfirmed binding parameters that have not yet been classified and their "massive" classification. The Internal Audit Function has already scheduled in its 2018 Audit Plan specific audit on forborne identification

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Finding # 7

Finding Description:

Flaws in the processes of identifying and managing problem credits

The process is not (consistently) applied:

- Two binding impairment triggers defined by the relevant internal procedure of the Bank's (policy D 01991) are not applied […].

The process is not effective:

- The default identification process requires two levels of analyses and decisions and the participation of many actors, a process causing delays in practice. As an example, out of 53.222 exposures identified hit by triggers […], some parameters (binding or non-binding reclassification triggers) switched on (generally triggered) were not checked because they were switched off (not struck) at the date of analysis, very delayed in comparison to the extraction date, or because relationship managers were still working on them […]. Finally, only 44% of them (23.726 cases) were analysed, mainly Small Business and Retail debtors.
- The connection between two main internal indicators of early warning signals – IRA and ISA – is not clear: these two indicators are used for same purposes that is the measurement of the deterioration of credit-worthiness of debtors (ISA - "Indicatore Sintetico di Anomalia" - and ISA_P - ISA Evoluto -, the first one influences the rating system determining a possible early rating review while the second one represents an input for the IRA.
- The ISA indicator is not visible in the IT system used for credit monitoring ("Mocre").

JST observations

- According to the current definition of policy 1991 (para. 2.5.1) counterparties with binding parameters must be reclassified to the status foreseen by the policy. However, the process of default detection currently gives the possibility to the relationship manager, in agreement with the Credit Department, to not reclassify counterparties which have binding parameters activated.
- Currently low priority non-binding parameters have a limited role in the default detection process, which questions either the setting of policy 1991 or the implementation process.

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Recommendation

The shortcomings related to processes and policies of Finding #1 are addressed in this recommendation.
The shortcomings of Finding #7 related to IT are addressed in the recommendation related to Finding #1.

The Bank is requested to review, together with its external auditors, the list of parameters included in "Allegato 1" of the internal policy 1991 in order to ensure that each parameter:

- is clearly defined,
- is meaningful for default and impairment detection,
- can be obtained or calculated within a reasonable timeframe.

The Bank shall demonstrate that any change to the list of parameters does not weaken the default detection process and the recognition of impairments.

In addition, the Bank is requested to clearly define in its policies any possible exception to reclassifications required by the binding parameters. The new policy and process must not allow exceptions to reclassification when binding parameters are activated, unless the exception is clearly defined in the policy.

The Bank is also requested to improve its processes to ensure that also low priority non-binding parameters are promptly assessed.

Concerning the timely processing of binding parameters, the Bank is requested to ensure that, for binding parameters derived from the regulation (e.g. material 90 days past due or 30 days past due forborne performing exposures in the cases specified in para. 2.6.4 of policy 1991), their activation must necessarily lead to reclassification regardless of the status of the parameter at the time of the analysis.

In order to assess the timely analysis of the binding parameters, the Bank is requested to submit to the ECB, on quarterly basis, a report highlighting the timing for the assessment of binding parameters. The report must contain, at minimum:

- the minimum, median and maximum days to process binding parameters per month of activation,
- the actions taken to reduce delays, if any.

In addition, the Bank is requested to communicate the annual reclassification rate, at debtor level, of debtors hit by at least one non-binding impairment trigger. Furthermore, internal audit shall conduct a yearly examination of

Deadline
30/06/2018

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a representative sample of the latter population, and communicate the results to the ECB.

The quarterly report must be submitted also to the Risk Committee of the Board of Directors. The relevant extract of the minutes where the report is discussed shall be submitted to the ECB.

Furthermore, the Bank is requested to assess how to align ISA - "Indicatore Sintetico di Anomalia" - and ISA_P - ISA Evoluto – to incorporate all the changes driven by the recommendation contained in this letter.

Inspected institution's answer

In a perspective of continuous refining of the default detection system of the Bank and in line with the regular analysis normally conducted, some fine tuning actions on parameters have been considered necessary:

- "Reduction of number of companies in CR": the low materiality non-binding parameter is turned into "operational event" because of it low predictability of the default
- "EBITDA<0 for two consecutive years": in accordance with IFRS9, the parameter is changed in "negative EBITDA" (one year only) maintaining the classification as "non-binding parameter with high relevance"
- "DSCR<1.1": a new method of calculation is identified, consistent with that of recent inspection, and it is replaced as non-binding parameter with low relevance, limited to counterparts with Multiannual Balance Sheet Structure for which it prove to be more discriminatory.
- "Past-due more than 90 days not material": the default rate on the positions with this parameter (above the average of low relevance parameters) made the decision of changing the relevance of non- binding parameter from Low to High.

The activities to integrate the decisions into processes and systems of the Bank are under way.

A further audit activity of binding and non-binding parameters will be started with the support of the external auditor (Ernst&Young) that will validate:

- clarification in parameters definition
- significance in the default detection and impairment detection
- possibility for computing in a reasonable time

The classification of positions that show binding parameters will be rendered automatic. Exceptions are represented exclusively by parameters that lead to the classification as "sofferenze" as provided for by the Italian legislation (Bank of Italy Circular no. 1939/1991) for a subjective assessment of the client's overall financial situation by the bank or financial intermediary aimed at assessing the customer's "insolvency status". Having taken note of the state of insolvency and before proceeding with the

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notification, the intermediary is also required to fulfil an informative obligation towards the customer. The exceptions to the automatic classification of binding parameters will be defined in the D1991 "Group Policy on credit classification and valuation".

A monthly report has been implemented to summarize the processing status of the binding and non-binding parameters (with high / low relevance) which includes, among other things, processing times and classification rates in order to constantly monitor the default process detection.

This monthly report, already implemented for internal purposes, will be sent on a quarterly basis to the ECB, with details of the required data regarding the processing times of the parameters. On an annual basis, the same report will also include the reclassification rate of debtors who presented, during the year, at least one not binding parameter.

The internal audit function will perform an annual check on a representative sample of debtors; the outcome will be communicated to the ECB.

The Internal Audit Function has already scheduled in its 2018 Audit Plan a specific audit on the correct exposures classification. For the year 2018 we considered the requested examination of a representative sample of debtors hit by impairment trigger already included in this activity. On the basis of the results of this first audit we will define the yearly activities to be included in the subsequent audit plan.

In order to make the detection mechanisms more accurate, we will proceed with the definitive replacement of the ISA (indicator of an anomaly that has now been replaced and used only in the rating review process) with ISA P in all the bank's monitoring processes. The information used by ISA P will be re-evaluated and revalued in the light of the evidence contained in this letter.

Finding # 8

Finding Description:

Underestimation of key metrics for calculating loan loss provisions

Regarding the collateral haircuts:

- External costs of recovery have not been taken into account (representing 5 to 7 percentage points).
- Options have been chosen that underestimate the haircuts: removal of outliers, shorter time horizon applied, individual updates of collateral values for the biggest tickets.

Regarding the time to recovery:

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- Due to data shortcomings (NPL Unlikely to Pay Exposures are registered in a different database when entering in bad loan status, and change their ID, without track of this change), the Bank can only estimate the time from the entry date in bad loan status to the end of the recovery period.
- The restructured exposures are excluded from the database estimating the time to recovery.

Regarding the cure rates:

- The Bank is overestimating the cure rates applied, due to a longer reference period applied than corresponding to AQR-standards (7 years vs. 1 year) and due to the fact that, in economic substance, the calculated cure rate corresponds to the application of a matrix with infinite iterations, corresponding to an expected workout period of more than 20 years.

Impact: The application of these key metrics – together with the challenge of too optimistic assumptions in business – led to additional provisioning need that can be quantified as EUR 5.9bn.

Recommendation	
The quantitative component of Finding #8 has already been addressed to the Bank via SREP decision dated 19 June 2017 (reference ECB/SSM/2017 - J4CP7MHCXR8DAQMKIL78/35). The Bank is requested to update its accounting and provisioning policy in order to address the issues highlighted during the on-site inspection and reported in Finding #8. The Bank is also requested to highlight any changes already implemented to the abovementioned policy compared to the version of the policy as of year-end 2015 which was provided to the on-site team. Such changes should also be mapped against the shortcomings identified by the on-site team and reported in the on-site report, highlighting areas where the Bank believes to have completely solved the identified issues. For issues which have not yet been addressed, the Bank is requested to amend its policies by the set deadline.	**Deadline** 30/06/2018

Inspected institution's answer

Changes already implemented to the policy compared to the version of the policy as of year-end 2015:

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During 2016 and 2017, the Bank has modified its valuation policies (D1991) by:

1) Increasing the **threshold below which statistical provisioning is applied:**
   - from €70k to €150k for Bad Loans – implemented in 2Q 2016
   - from €20k to €150k for Unlikely To Pay (UToP), neither restructured nor under restructuring – implemented in 3Q 2016
   - from €150k to €500k for Bad Loans and Unlikely To Pay (UToP), neither restructured nor under restructuring – implemented in 4Q 2016

2) Reviewing the **actualization algorithm** underlying the analytical evaluation approach for exposures classified as UToP (not applied to closed restructuring deal) – implemented in 3Q 2016
   The level of provision in case of analytical approach is composed by Expected Loss value and the effect of time on the value of recovery, representing the discounting effect on the recoverable amount given the time necessary for recovery.
   The methodology adopted, until 30/09/2016 to estimate the discounting effect for UToP took into account an average historical recovery period estimated by the Risk Management function on the basis of:
   - Historically observed migration to different default statuses
   - Average time to default observed for different statuses

   In particular, the discounting effects applied were the following:
   - Almost 0 to cured exposures
   - Average time spent in the status to exposures remaining UToP, only for the expired amount
   - 6 months plus the average recovery period of Bad Loans to exposures classified to Bad Loan

   In order to align the methodology to the best practices, it has been decided to change the methodology used for UToP discounting calculation, with the introduction of new discounting effects applied as follow:
   - Removal of exposures remaining UToP through a polarization approach towards Performing and Bad Loan statuses
   - 0 discounting effect applied to cured exposures
   - Average recovery period of Bad Loans plus the average time observed to migrate from UToP to Bad Loan

   Based on the above mentioned changes the average discount time increased from 2 - 2.5 years to 4 - 4.5 years

3) Reviewing the **haircuts used on real estate collaterals** underlying the analytical evaluation approach for exposures classified as UToP and Bad Loan – implemented in 4Q 2016

In order to increase the coherence between haircut adopted and evidences from recovery process, new haircut have been determined based on the analysis of a statistically significant sample having the following features:

- Positions with real estate collaterals sold via auction in the last 3 years (October 2013 – December 2017)
- Positions classified as Bad Loan after 2001,
- Positions on which the reduction of value between latest appraisal and «CTU» was not higher than 50%

The obtained haircuts are used also for UToP but considering a correction effect based on the average cure rates historically observed during the last 7 years.

4) Setting a **minimum floor for coverage** of positions evaluated under analytical approach, classified as UToP, unsecured (absence of real estate or financial collateral) and classified as Bad Loans at banking system level on more than 5% of total exposure (External Credit Bureau – Centrale Rischi) – implemented in 4Q 2016
On positions classified as UToP, object of analytical approach, and classified as Bad Loan by other banks on more than 5% of total exposure, a floor on the level of coverage has been introduced – only for unsecured positions (secured exposures have been treated according to the previously described intervention on collateral).
The floor is applied in case of absence of idiosyncratic elements related to individual credits that could lead the relationship manager to consider inappropriate the level of coverage.
The floor was determined taking into account also the cure rate historically observed on these exposures, calculated as average of the last 7 years (2009-2016), to the observed loss rates on Bad Loans, closed in the last 10 years.

By the set deadline the Bank will update the key metrics calculation taking into account the content of your recommendation as well as the forward looking elements required by the IFRS 9 and will update the valuation policy consistently.

The Internal Audit Function has already scheduled in its 2018 Audit Plan a specific audit on the haircut and underestimation of loan loss provisions.

Finding # 9	**Finding Description:**

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Flaws around the use of debtor's business plans

The inspection revealed that out of 147 debtors classified as sofferenze by the banking group the files of only 88 debtors had an updated business plan. It has furthermore been detected that for the calculation of the time to recovery, the business plans are not consistently used within the Monte Paschi Group.

Recommendation	Deadline
The Bank is requested to: • ensure that business plans are updated on a timely basis; • implement conservative provisioning rates for debtors with an expired business plan, • Develop specific procedures in order to ensure that, when a business plan is expired, the conservative provisioning rate is applied.	30/06/2018

Inspected institution's answer

With regards to the Business Plan timely update, please note the following:

- In the last quarter 2017 the threshold below which statistical provisioning is applied for positions classified to bad loans ("sofferenze") was increased from Euro 150 thousand to Euro 500 thousand. As a consequence, the number of business plan to be monitored and updated will be reduced significantly. As a matter of fact, Bad Loans with analytical valuation were about 5.300 at the end of October 2017 and about 1.580 at the end of December 2017.
- In the servicing agreement agreed with Cerved/Quaestio in connection with the project Valentine, it is envisaged the duty of the Servicer and specific Servicing Level Agreement to update and maintain updated the business plan.
- In order to check the business plan status an automated report is available on line for Loan Managers and a fortnightly report for the Chief Lending Officer have been implemented during 2017.

Same considerations are applicable for the expired Business Plan. As a matter of fact, in order to check the number of expired business plan, an automated report is available on line for Loan Managers and a fortnightly report for the Chief Lending Officer have been implemented during 2017. Moreover, in order to monitor the issue of expired business plan, an alerting message is automatically sent to the Loan Manager once the business plan expired.

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	With regards to the provisioning rate applied to expired business plan, please note that when a business plan expires the recoverable amount remain the same but the statistical time to recovery starts to be applied for the discounting effect calculation. At this regards, starting from 1 January 2018 the statistical time to recovery is calculated taking into account the rescheduling of the recoveries expected but not yet achieved on the basis of the Bad Loans duration. By the set deadline the Bank will send you a report showing the Business Plan status and the coverage of the expired business Plan. The Internal Audit Function has already scheduled in its 2018 Audit Plan a specific audit on debtors Business Plan.