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MONTE DEI PASCHI DI SIENA
BANCA DAL 1472

OSI 1238 –ARGO 3 Project
OSI 34-35 –ARGO 2 Project

ECB Remedial Action Report (ARGO 3 & ARGO 2)
Progress status as at 30.06.2018 with update of activities as at 30.09.2018

Siena, 18 October 2018

This document reports the results of the audits carried out by the Chief Audit Executive Division on the Recommendations set out by the ECB following the On Site Inspection OSI-2016-ITMPS-1238.

Both the mitigation actions implemented and their effectiveness in terms of results achieved were reviewed (with on and off-site activities).

For each recommendation, information is provided on the status of completion of the activity identified and the results of any related audit exercises. A rating on the solution's effectiveness is also given according to the function's rating scale (four levels).

The report also provides an update on the ARGO 2 Project, relating to OSI-2015-ITMPS-34-35.

Agenda

1. Executive Summary
2. Argo 3: Summary of the 9 Findings from OSI 1238 and related audit exercises planned
3. Remedial Action – ECB OSI 1238 #2
4. Remedial Action – ECB OSI 1238 #3
5. Remedial Action – ECB OSI 1238 #5
6. Remedial Action – ECB OSI 1238 #6
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8. Remedial Action – ECB OSI 1238 #8
9. Remedial Action – ECB OSI 1238 #9
10. Overview of ECB Remedial Actions OSI 34-35 and correlation with ECB Findings OSI 1238
11. Remedial Action – ECB OSI 34-35 #12
12. Remedial Action – ECB OSI 34-35 #21
13. Remedial Action – ECB OSI 34-35 #31

1 Executive summary

OVERVIEW ARGO 3	Our analysis confirmed stronger credit risk controls, achieved through the updating of regulations, rules, processes and specific monitoring exercises aimed at enhancing the effectiveness of operations. Overall, just two of the actions underway (Findings 2 and 9) have been rated “Yellow”, the Audit activities related to Findings 3 will be carried out in the 4Q 2018 while those related to the Finding 1 have been planned in 2019. Relatively to Finding 4 the High Risk implementation activities were completed including the quarterly information flows for the Board of Directors. Remedial Actions currently “Open” relate to Findings 1 and 3 (concerning just the MPS Group subsidiaries) and 6 (relating to the IT component). For the Finding 4 the activities relating to the Group's subsidiaries remain to be finalized.
NPL	The method used to calculate the haircuts applied to the value of real estate collateral has been integrated with an update to the time series, the application of the new threshold set for individual assessments, the inclusion of recovery costs in order to net the realisable value of real estate assets, update of the cure rate and inclusion of the “forward-looking” elements required by the new IFRS 9. The new haircuts were approved by the BoD on 12/07/2018 and included in Annex 2 of the new D.1991. Regarding the timely update of Business Plans, policies have been updated and integrated to take account of the recently revised organisational model of the CLO Division. As at 05/07/2018, the Business Plan updating process had been successfully completed for 90.2% of the portfolio under Direct Management and for 92.6% of the portfolio assigned to Juliet. As for the portfolio with expired Business Plans, the procedure/methodology used by the relevant functions and control units were not adequately set out in a specific document. It was therefore agreed that the Group’s Loan Classification and Provisioning Policy required updating. Areas of improvement were also identified in the quality of data entered in the IT systems.
CALCULATION OF EAD	The Risk Management Function produced summary data to demonstrate the equality between the balance sheet exposure and the EAD amount, net of the off-balance sheet exposure, used in the calculation of Expected Credit Loss according to the new IFRS9. The analysis of the procedure used to construct data for the EAD and the balance sheet value (included in the material sent to support the resolution of Finding #2 did not point to any factors of concern. The Findings from the sample analysed confirm the inclusion of interests calculated during the moratoria period and accrued interest in the calculation of EAD at single borrower level. The process was replicated and it is confirmed a marginal misalignment of € 47 million between the balance sheet exposure and total EAD. This difference was also confirmed in the processing of 30 June 2018. The corrective actions were directed to the competent function (COG) for the appropriate solutions.
CREDIT DEFAULT DETECTION	A detailed description for each parameter has been included in Annex 1 of D1991 along with a reference to the specific data sources. The list of parameters has been updated as reported in the bank’s letter to the ECB dated 15/03/2018. In compliance with the request of the Supervisor, the D1991 establishes that the Position Manager must necessarily reclassify the position with an activated binding parameter. In the event of no classification, a specific process will be initiated leading to a forced classification. Only two situations are exempt from this and are expressly detailed in the Policy. At the level of non-binding parameters, the average reclassification rate per parameter stands at 12% for high-priority and 2% for low-priority, in line with what emerges from the document and the back-testing performed by the independent auditors. The 1st and 2nd level controls system, particularly with forborne positions, has been strengthened with the creation of a specialist High Risk Credit Unit, whose areas of competence include that of assessing the financial difficulties of borrowers when granting forbearance measures and the consequent correct classification; the 1st level control function (the Credit Process and Quality Service Unit), performs a set of controls aimed at monitoring the quality of the credit process in compliance with D2284 and, in particular, the implementation of monitoring activities as per the Bank’s reply to the ECB on 15/03/2018; the monitoring activities conducted by the 2nd level control function (SCEC) are aimed at ensuring proper detection during the credit decision process as well as the consistency of classification assessments relating to the processing of parameters.
ARGO 2	Compared to the last report on Argo 2, the RA #31 is the only recommendation still to complete. For the RA #12 the centralization campaign of the mortgages of the perimeter (January 2002 – July 2016) has been finalized and all the retrieved documentation has been sent to the outsourcer for the digitalization, the data quality and archiving. For the RA #12 the group regulation on credit processes has been transposed to da MPS CS and MPS L&F, the credit monitoring process and the analysis of classification parameters are effective. The extension of the IT applications for accounting management of litigation (AMCZ) of the Parent Company to MPSCS has not been started pending the definition of strategic options on the company. The IT impact on the procedures of the subsidiaries MPS CS and MPS L & F falls in the program of releases of RA 31 instead.

Argo 3: Summary of Findings

#	Finding Description	Deadline	Status	Audit Exercise	Audit Rating
1	Quality and availability of data underlying the default detection process	31/12/2018	Open	To be included in the 2019 Audit Plan	-
2	Estimation of EAD	30/06/2018	Closed	Report n.2018_40	Rating 2 (Yellow)
3	Double-counting of collaterals on loans issued by different companies of the Group	30/06/2018 (in case of merger of MPSCS and MPSLF into BMPS 31/12/2018)	Open	Scheduled for completion in 2018	-
4	Watch-list: unified process within the Group and reporting to the management board	30/06/2018 (in case of merger of MPSCS and MPSLF into BMPS, 30/06/2018 for BMPS and 31/12/2018 for the new entity)	Closed for MPS Open for subsidiaries	Verification of the quarterly information flows for the BoD	
5	Counting of days past due for "moratoria" and "Extra Fido" exposures	30/06/2018	Closed	Report n.2015_199 (follow up completed)	Rating 1 (Green)
6	Effectiveness and timing of the process of classification of forborne positions to higher risk	30/06/2018 for policies, 31/12/2018 for the IT components	Closed for policies Open for IT components	Report n.2018_226	Rating 1 (Green)
7	Adequacy of classification parameters for default detection	30/06/2018	Closed	Report n.2018_067	Rating 1 (Green)
8	Adequacy of key metrics for calculating loan loss provisions (Haircuts, time to recovery, cure rate)	30/06/2018	Closed	Report n.2018_93	Rating 1 (Green)
9	Timely update of Business Plan and adequate provisioning for debtors with an expired Business Plan	30/06/2018	Closed	Report n.2018_068	Rating 2 (Yellow)

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Finding # 2: Estimation of EAD (1/2)

deadline 30/06/2018

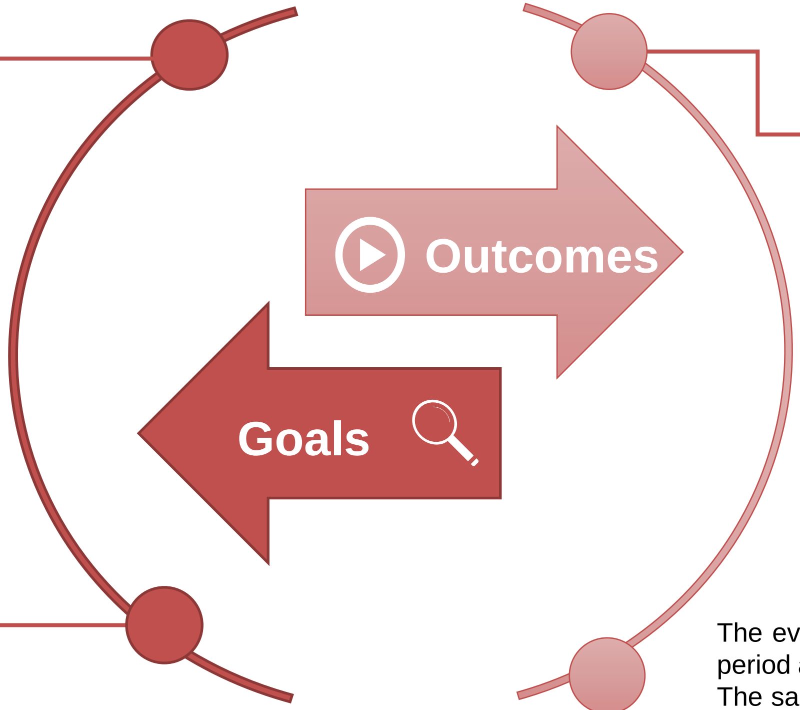
Recommendation	*The Bank is requested to estimate EAD on single debtor level in a consistent way by integrating all exposures relating to each debtor. Specifically, the EAD shall also include interests calculated during moratoria period and any other accrued amount.*
Deliverables	• Update EAD triggers with the latest information and with all data available on a single borrower level • Use the balance sheet value as input for the loan loss provisions calculation engine
Results	As of 1 January 2018, use of new triggers for the estimation of EAD and the new ERMAS platform which is fully aligned with the Balance Sheet

3 Finding # 2: Estimation of EAD (2/2)

Rating 2 (Yellow)

Related Audit activities

Recalculation of data as at 31/05/2018:
Verify the validity of the information provided to the Supervisory Authority by the Risk Management Function to support the proposal to close Finding #2 OSI-1238.



EAD sample check:
Verify that interest on suspended instalments (moratoria) and accruals is correctly included in the EAD, as required by the Supervisory Authority

The Risk Management Function produced summary data to demonstrate the equality between the balance sheet exposure and the EAD amount, net of the off-balance sheet exposure, used in the calculation of Expected Credit Loss according to the new IFRS9.
Our analysis of the procedure used to construct data for the EAD and the balance sheet value (included in the material sent to support the resolution of Finding #2) did not point to any factors of concern.
The process was replicated and the results are in line with the data supplied by Risk Management, as summarised in the table below:

Loan Portfolio statistical evaluation			
Typology	Balance sheet exposure	EAD	Difference
Cash Exposures	91.898	91.945	47
Off-balance sheet Exposures	0	3.315	3.315
Total	91.898	95.26	3.362

Group data at 31.05.2018 (€/mln)

The difference of € 47 million between the balance sheet exposure and total EAD is confirmed. This difference was also confirmed in the processing of 30 June 2018. The process has been addressed to the relevant function (COG). The solution identified is going in progress.
Note also the marginal presence of mortgages with a GBV higher than the EAD (total difference of 750,000€). In particular, these are mortgages that were suspended by law following the earthquake in Central Italy in August and October 2016 (Legislative Decree 189/2016 and subsequent provisions) as well as mortgages with changes to interest rates or loan maturity in the month of reference (May 2018). The solution has yet to be completed in this case also (expected date of completion 31/12/2018).

The evidences from the sample analysed confirm the inclusion of interests calculated during the moratoria period and accrued interest in the calculation of EAD at single borrower level.
The sample was selected through discretionary sampling among loans on performing counterparties valued at amortised cost falling with the scope used by the Risk Management Function in response to the Finding.
The selection particularly concerned loans that benefitted from one or more moratoria with suspension of the portion of interest. The sample coverage is 3% of the total EAD (roughly € 3.7 billion) of the loans forming part of the analyses.
The construction of the EAD data was carried out by adding together the:

- value of residual date at the date of reference,
- moratoria interest net of the portion already repaid,
- accrued interest recalculated by proxy,
- any early repayments, cancelled amounts or adjustments,
- the exposure adjustment due to the calculation of amortised cost.

Finding # 3: Double-counting of collaterals on loans issued by different companies of the Group

deadline 30/06/2018, In case of incorporation of MPSCS and MPSLF into BMPS, 31/12/2018)

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).

Deliverables

Update the estimated impact of double-counting collaterals on loans issued by the different companies of the Group, pending the integration of MPS CS, which will be a definitive and structural solution to the problem.

Results

Activities aimed at implementing the actions relating to this recommendation have not yet started.

Related Audit activities

The Audit exercises is planned in the 4Q 2018

5

Finding # 5: Counting of days past due for “moratoria” and “Extra Fido” exposures (1/2)

deadline
30/06/2018

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.
Deliverables	Implement all actions necessary to correct the counting of past due days: • For “extra fido” exposures, the counting of days will have to start from the date the additional loan was granted; • For “moratoria” exposures, the freezing of the days past due at the time the moratorium is granted is no longer necessary since it is managed through Forborne rules.
Results	• Use of the correct method for calculating the days past due in the Bank’s procedures; • Identification of “moratoria” exposures as Forborne exposures.

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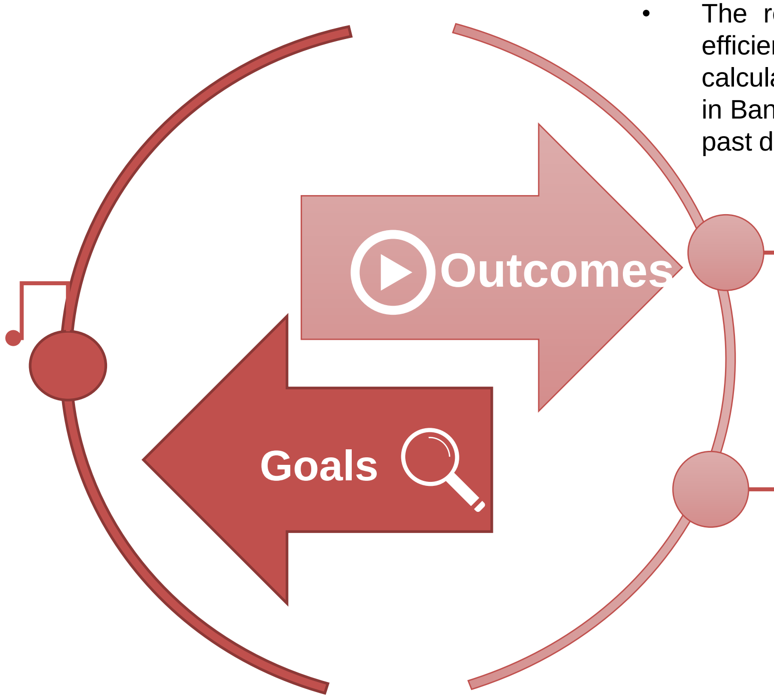
Finding # 5: Counting of days past due for “moratoria” and “Extra Fido” exposures (2/2)

Rating 1 (Green)

Related Audit activities

Assess the effectiveness and efficiency of rules currently in use to identify past due counterparties and the calculation procedure implemented in the information systems in use, by verifying the:

- compliance of processes with internal and external regulations;
- formalisation of operating practices within appropriate methodological frameworks;
- monitoring of the correct application of operating rules and processes for the classification of past due positions;
- analysis of information flows and inter-functional connections among the units involved in the process;
- data quality and performance controls on the information used/produced within the process in question;
- process of monitoring and managing past due positions for the purpose of Supervisory reporting.



- The results of the audit, which focused mainly on examining the efficiency of rules used to identify past due counterparties and the calculation procedure implemented in the information systems in use in Banca MPS, confirmed that the algorithm currently used to calculate past dues as at 28.02.2015 was functioning correctly.

- As for certain types of loans and certain technical forms of use (*see* moratoria and extra-fido exposures in particular), some areas of concern were identified regarding the correct counting of days past due for customers with past due loans and the calculation of the customer’s debt exposure.

FindingS:

n. 1 - Moratoria: failure to “freeze ” the days past due in cases of instalment suspensions being activated, as provided for by Supervisory Regulations (Roneata Banca d’Italia 2011 – NPL past due and/or overdrawn exposures).

CLOSED : The freezing of days past due, originally provided in the Bank of Italy’s letter of 31/05//2012, has been replaced with the Bank of Italy’s 7th update of 20/01/2015, Circular 272. The update incorporates the new classification rules for exposures, as provided for by the Implementing Technical Standards (ITS) and has introduced the category of forborne exposures to which specific rules apply for the classification of exposures as performing/non performing. The Bank has correctly applied the rules in force for the classification of forborne exposures, which do not require the freezing of days past due

n. 2 - Extra-fido: failure to calculate the days past due from the date the extra-fido is granted, when past due amounts are produced in the additional loan (Bank of Italy Circ. 272– Section. B – Par. 2 Credit Quality – nota 2 - pg. B 8)- .

CLOSED : in February 2017 the rule for calculating past dues was upgraded, establishing that the days past due on an extra-fido exposure are to be counted starting from the date the extra-fido is granted and not from the date the customer begins to produce the past due amount, as required by Circular 272. This rules also applies in the case of a past due being produced in the extra-fido with a customer who is past due in the previous loan.

n. 3 – Calculation of Minimum Balance Available: incorrect calculation of the past due amount for the calculation of items not yet “certain/available” under “Cash Exposures” (bank checks presented and not paid at the same time).

CLOSED: the qualitative analysis carried out by the credit function highlighted the limited impact of this situation which was subject to monitoring, finalising the recommendation without an IT intervention.

6 Finding # 6: Effectiveness and timing of the process of classification of forborne positions to higher risk (1/2)

deadline:
30/06/2018 per le Policy
31/12/2018 per l'IT

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.
Deliverables	• Definition of "bridge" process for forced classification pending the introduction of automatic classification procedure in the Bank's systems, scheduled for December 2018 • Update of Classification Policy (D1991) • Reinforcement of 1st and 2nd level controls in order to monitor the proper classification of exposures.
Results	• Application of forced classification process • Publication of Policy D1991 • Re-organise 1st and 2nd level units in order to optimise the process used to classify exposures subject to forbearance by the Commercial Network. • Regulatory update.

6 Finding # 6: Effectiveness and timing of the process of classification of forborne positions to higher risk (2/2)

Rating 1 (Green)

Related Audit activities

- Provide assurance on the progress of the implementing actions for Finding 6 regarding policies; assess the compliance of the changes to D1991 and with the Supervisory Authority's recommendations in the follow-up letter of 13/02/2018;
- Analysis of the forced classification processes pending the integration of IT procedures which will make the classification of the positions automatic.
- Assess the activities put in place to strengthen 1st and 2nd level controls for the identification and proper classification of forborne positions

- D1991 was updated on 20/07/2018 with the introduction of an *automatic classification process*, which involves a 10-day suspension period, if the classification questionnaire or PEF are absent, or a 30-day suspension if the classification questionnaire or PEF are in progress; the related IT implementations which will be released at the end of 2018 are under way.

  The Policy establishes two situations that may be exempt from the application of automatic classification:
  - presence of parameters that lead to classification as "*sofferenza*" since Italian legislation (Bank of Italy Circular n.139/1991) provides for a subjective assessment of the client's overall financial situation;
  - counterparties for which an external recovery process has been initiated for the duration of the mandate (PRI, PMR). At the end of this, the position must be classified appropriately, taking also account of the debt recovery outcome. (*)

- D2284 was updated on 24/07/2018 and, among other things, governs the *forced classification process,* which is a temporary solution pending the IT implementations required by the ECB to automate the classification of positions with activated binding parameters to high risk; the owner function of the process is SQPC.

- The 1st and 2nd level controls system has been strengthened with:
  - the creation of a specialist *High Risk Credit Unit* that oversees the proper classification of forborne exposures by the network. Its areas of competence include that of assessing the financial difficulties of borrowers when granting forbearance measures and the consequent correct classification;
  - a set of credit quality monitoring checks performed by the 1st level control function (the Credit Process and Quality Service Unit) in compliance with D2284 and, in particular, with the implementation of monitoring activities as per the Bank's reply to the ECB on15/03/2018;
  - the monitoring activities carried out by the 2nd level control function (SCEC), aimed at ensuring proper detection during the credit decision process as well as the consistency of classification assessments relating to the processing of parameters.

(*) N.B. During the Audit engagement the owner function has harmonised the D2226 «General Credit Monitoring Guidelines» with Policy D1991 regarding exemptions from automatic procedures.

At the date of analysis, the D2226 also made reference to general situations of technical/operational adjustments to justify the further granting of an exemption to classification times of up to 6 months. Consequently, a request was made to reduce the maximum duration of the exemption with the preparation of a suitable report. The updated document reports a maximum exemption time of 3 months.

7 Finding # 7: Adequacy of classification parameters for default detection (1/3)

deadline 30/06/2018

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 (…), 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.

Deliverables

- *Self Assessment* on Parameters used for Default Detection;
- Accounting Note by budget and Planning;
- Analysis of the processing of low priority non-binding parameters;
- Report on processing times for binding parameters;
- Analysis of reclassification times for non-binding parameters.

Results

- Opinion letter by independent auditors EY;
- Ensure the processing of low priority non-binding parameters;
- Prepare a report summarising the status of processing of parameters, processing times and reclassification rates so as to constantly monitor the Default Detection process.

7 Finding # 7: Adequacy of classification parameters for default detection (3/3)

Rating 1 (Green)

Related Audit activities

Goals

- Assess the effectiveness and efficiency of the Credit Default Detection process regarding both low and high priority non-binding parameters processed in 2017 in relation to:
  - Reclassification rate for non-binding parameters;
  - Reclassification rate for positions with non-binding parameters (high and low priority);
- Proper management and classification of the sample of positions extracted
- Evaluate the compliance of the changes made to D1991 with the recommendations of the ECB in its follow-up letter to On Site Inspection 1238 («OSI 1238»).

Outcomes

- Regarding the high priority non-binding parameters:

  The average reclassification rate per parameter stood at 12%, in line with what emerges from the document prepared by the independent auditors.
  The average reclassification rate per customer number, after 4 months of processing and compared to 31/12/2017, stood at 9.71% per head and 11.95% per exposure;
- Regarding the low priority non-binding parameters:

  The average reclassification rate per parameters stood at 2%,
  The average reclassification rate per customer number, after 4 months of processing and compared to 31/12/2017, stood at 2.67% per head and 1% per exposure;

- In a sample (extracted with the application of judgmental criteria) of 130 customer numbers taken from among counterparties under a Performing administrative status as at 31/12/2017 and having activated non-binding parameters deemed most significant for Default Detection purposes, out of 24 customer numbers with criticalities considered appropriate for reclassification at the date of the analysis (19/07/2018), the number of positions actually reclassified to *IPRA* and *Sofferenze* was 15, accounting for 11.54% of the total sample. For the other 9 cases where it was believed that a change in administrative status was to be evaluated, 2 were reclassified in the course of the inspection, while for the remaining 7 the reference Units have been involved.

- In compliance with ECB requirements, D1991 establishes that the Position Manager must take immediate steps to reclassify positions with activated binding parameters; failing this, a specific process will be initiated that will lead to forced classification. Only two situations may be exempt from this and are detailed in the regulations.

8 Finding # 8: Adequacy of key metrics for calculating loan loss provisions (1/3)

deadline 30/06/2018

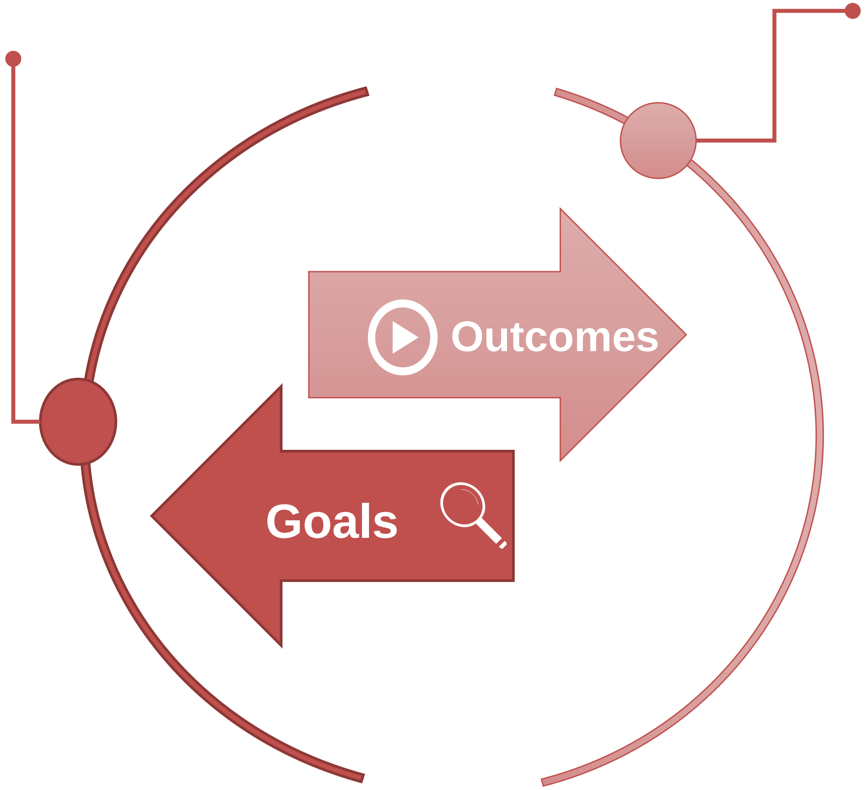
Recommendation	The quantitative component of Finding #8 has already been addressed to the Bank via SREP decision dated 19 June 2017 (reference ECB/SSM/2017 - J4CP7MHCXR8DAQMKIL78/35). The Bank is requested to update its accounting and provisioning policy in order to address the issues highlighted during 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
Deliverables	• Refinement of the methodology for calculating haircuts applied to real estate guarantees • Updating gof the Accounting Policy (D1965) • Updating of the Policy D1991 • Updating of the Gone Concern Tool • Updating of the Guidance in the use of the Gone Concern Tool
Results	Updating of the evaluations with the use of the new metrics underlying the analytical evaluation (the new haircuts will be applied on the first occasion useful for the analytical evaluation of the individual positions; recovery times and cure rates are, however, immediately appliedi).

8 Finding # 8: Adequacy of key metrics for calculating loan loss provisions (2/3)

Rating 1 (Green)

Related Audit activities

➢ Assess the adequacy of the remedial actions relating to the calculation of haircuts to be applied to values of real estate collateral.



The method used to calculate the haircuts to be applied to the values of real estate collateral for positions classified as Bad Loans was defined by the Bank in 4Q 2016 and was consolidated in the early months of 2017, coinciding with the end of ECB inspection OSI-1238 di BCE. As reported in the methodological notes prepared by the Credit Portfolio Management Service Unit (SGPC), the new calculation of haircuts has fully acquired the information regarding earlier processing (2016) and has proceeded to integrate the data base with the following:

- Update of time series (including all positions classified to Bad Loan status as of 2001, with a real estate asset collateral sold via auction from October 2013 to October 2017) and the application of the new threshold established for individual provisioning (exposure > € 500,000). Determining whether an exposure is “above threshold” or “below threshold” was the task of the Lending Risk Officer Area (ALRO). It was ascertained that the data base used did not include positions that complied with the aforementioned drivers.
- Inclusion of recovery costs in order to discount the realisable value of the real estate assets; the costs (both invoiced and to be invoiced) for the procedures connected to the sale of the real estate assets included in the data base were identified. In the event of more than one property being present within an execution procedure, the amounts are allocated pro-rata using the auction sale value of each property as driver. Information regarding expenses was extracted from the Corporate DWH tables containing the receipts registered in EPC. It was not possible to acquire and integrate the data base with the F23 amounts paid in the course of the procedure, which, although contained in AMCZ, are not attributable to sales procedures. As for the sample analysis, 4 positions inserted in the data base were selected and a check was conducted on the recovery costs allocated with what resulted in EPC. The results confirmed that the external costs calculated for the recovery of the collateral can be identified in the EPC application . The interviews conducted revealed that additional fine-tuning of the data bases used is also possible.
- Update of cure rate: for positions classified as UTP, the same haircuts estimated for bad loans are used, discounted of the cure rate. To this end, the ALRO has updated the estimated cure rate for 2018, which has been correctly entered in the haircut calculation data base.
- Inclusion of «forward looking» elements as required by the new IFRS 9 (in force as of 01/01/2018): the ALRO has provided the SGPC with the real estate market price index from 3Q 2015 to 4Q 2022, taking account of three macroeconomic scenarios: i) baseline scenario, ii) negative scenario, iii) positive scenario. These scenarios, provided by Prometeia, have been matched with the following weighting factors: 60% for the baseline scenario and 20% for the other two scenarios in order to determine a univocal parameter for the various time horizons (in alignment with what was done in the calculation of PD and LGD in IFRS9).

The new haircuts were approved by the BoD on 12/07/2018 and included in Annex 2 of the new D.1991, published on 20/07/2018.

8 Finding # 8: Adequacy of key metrics for calculating loan loss provisions (3/3)

Rating 1 (Green)

Related Audit activities

Goals

- Assess the adequacy of remedial actions regarding the method used to calculate the cure rate and time to recovery.
- Update the main regulatory documents (D1991 and D1695) and assess the application of new haircuts on a sample of positions classified as «unlikely to pay».

Outcomes

- In the course of 4Q 2017, the Credit Risk Models Service Unit (SCRM) communicated the latest estimate of the cure rate and time to recovery currently in force. It should be noted that as at 31/12/2017 MetrIas was still being used, replaced by ERMAS in 1H 2018. The methodological note prepared by the SCRM was acquired and showed that the models for calculating time to recovery and cure rates, subject to validation by the Bank's delegated functions, had not undergone any changes; in particular, it was shown that the time to recovery of UTPs is given by the sum of the average time spent in the UTP status and the average financial duration of bad loans, with the inclusion of positions classified as Restructured. The processing data base has been updated by one year and encompasses the higher threshold established for individual provisioning. Pending the ECB's reply to Finding#8, the SCRM went ahead and calculated the cure rate for BMPS using the method provided for in the AQR Manual, applying a value of 11.1%, which is higher than the one used in the current method and entered in the systems (9.7%).

Together with the Credit Control Unit Service (SCCU) , a new control query was created and it was possible to to verify the compliance of deadlines for the purposes of discounting in ERMAS with internal regulations regarding UTPs in BMPS and MPS CS as at 30/06/2018, with no exceptions being recognised. A sample analysis was also carried out to verify the correct application of the cure rate when calculating the performing polarised gross exposure as well as compliance with deadlines (average length of time spent in UTP status + Average Financial Duration under Bad Loans) for discounting purposes. The audits conducted did not reveal any anomalies. However, note that for movable and vehicle leasing, the deadlines in ERMAS are not compliant with Annex 2 of D.1991, which continues to report a single data linked to a generic leasing product (real estate leasing parameter). The functions involved have agreed on the need to align the regulations in question with the systems when the D.1991 is next updated, which will coincide with the 2018 re-estimation of parameters for individual provisioning.

The following documents were updated in July 2018: Group Accounting Rules (D.1695) Group Loan Classification and Provisioning Policy (D.1991). The audits confirm that the updates to the metrics used for individual provisioning and the changes introduced by the entry into force of the new IFRS9 have been implemented.

Subsequent to the audits carried out, it was agreed together with the audited units, that the AFD for movable and vehicle leasing will be specifically included in the internal regulations, as will the controls conducted by the SCCU regarding the update/annual application of the parameters subject to this audit.

The audits conducted on a sample of UTP positions with the assessment tools prepared after the publication of the new D.1991, showed that the assessment tools updated with the new metrics are available in the systems, though there are still areas of improvement as to their use. The consequent mitigation actions are already being monitored as a result of the follow up to report 206_2017 "Credit Accounting Policy".

9 Finding # 9: Timely update of Business Plan and adequate provisioning for debtors with an expired Business Plan (1/2)

deadline
30/06/2018

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.

Deliverables

- Activation of Platform and signing of Servicing agreement which requires the Servicer to update the Business Plans and keep them updated, with specific SLAs.
- Work plan for updating the Business Plans

Results

- Update of Business Plans
- Report on the update of the Business Plans

9

Finding # 9: Timely update of Business Plan and adequate provisioning for debtors with an expired Business Plan (2/2)

Rating 2 (Yellow)

Related Audit activities

Goals

Verify update of policies to ensure the consistent application of time to recovery to all NPL exposures.

Provide Top Management with assurance on the objectives of the "ARGO 3" Project and the remedial actions put in place to complete, by 30/06/2018, the expected recoveries - calculated individually – for the portfolio under Direct Management and the portfolio assigned to the External Servicer.

Assess the SREP control objectives associated with the processes examined. RC.1.24 - Credit & Counterparty Risk – Method for calculating loan loss provisions.

Outcomes

The regulations have been updated and integrated to take account of the recently revised organisational model of the CLO Division, which has had significant impacts on the Credit Recovery Area.

As at 03/07/2018, the number of total positions managed, classified as "Operational", stood at 20,269 for the amount of €M 5,282, of which 11,744 allocated to «Juliet» (*Outsourced management platform*) and 8,525 under «Direct Management».
Positions with an accounting value of > €K 500 came to 1,809 for the amount of €M 3,492, of which 1,470 «Juliet» and 339 under «Direct Management». As at 05/07/2018, the Business Plan updating process had been successfully completed for 90.2% of the portfolio under Direct Management and for 92.6% of the portfolio assigned to Juliet.
Portfolio with expired Business Plans: although from a substantial point of view, it was shown that in the presence of expired recovery forecasts, more prudent coverage rates were applied, the procedure/methodology used by the relevant functions and control units were not adequately set out in a specific document. It was therefore agreed that the Group's Loan Classification and Provisioning Policy required updating.

Areas of improvement were also identified in the quality of data entered in the IT systems.
Through specific queries in the same information systems and EPC application (tool for managing bad loans), the alignment between the data present in practice with that used to prepare recovery forecasts and make credit decisions has been reconciled and verified. The representation of the data and information has revealed some gaps which are attributable to the registration of guarantees by Guarantee Entities, registration of real estate collateral and the failure to update the recovery strategies described in the Business Plans of the 20 positions audited.

10

Overview of ECB Remedial Actions OSI 34-35 and correlation with ECB Findings OSI 1238 status as at 31.08.2018 vs. status as at 31.03.2018

RA#1	Rating 1 (Green)			
RA#2, #6, #9	Rating 1 (Green)			**Finding 1, 6 e 7 OSI–ITMPS–12–38**
RA#3	Rating 1 (Green)			
RA#4	Rating 1 (Green)			
RA#7	Rating 1 (Green)			
RA#8	Rating 1 (Green)			
RA#10	Rating 1 (Green)			
RA#11	Rating 1 (Green)			
RA#12	Rating 2 (Yellow)	⇨	Rating 1 (Green)	
RA#13	Rating 1 (Green)			
RA#14	Rating 1 (Green)			
RA#15	Rating 1 (Green)			
RA#16	Rating 1 (Green)			
RA#17	Rating 1 (Green)			

RA#18	Rating 1 (Green)			
RA#19	Rating 1 (Green)			
RA#20	Rating 1 (Green)			
RA#21	Rating 2 (Yellow)	⇨	Rating 1 (Green)	**Finding 4 OSI–ITMPS–1238**
RA#22	Rating 1 (Green)			
RA#23	Rating 1 (Green)			
RA#24	Rating 1 (Green)			
RA#25	Rating 1 (Green)			
RA#26	Rating 1 (Green)			
RA#27	Rating 1 (Green)			
RA#28	Rating 1 (Green)			
RA#29	Rating 1 (Green)	⇨		**Finding 9 OSI–ITMPS–1238**
RA#30	n.a.			
RA#31	Work in progress			

[1] *RA 30 is not reported since it is summarised in all the IT releases relating to the ECB RAs included in the ARGO IT project, which were rescheduled following the changes resulting from the implementation of the 2017-2021 Business Plan*

Remedial Action – ECB OSI 34-35 12

Remedial Action ECB

Upgrade and update data bases to include all relevant information about collaterals.

Deadline
31.12.2016

Related Audit exercises

INFORMATION AND DOCUMENTS SUPPORTING COLLATERAL: Ascertain the definition and implementation of relevant information about real estate collaterals and the digital acquisition of documents relating to a mortgage position (appraisal, notary deed, etc.). Check progress of the dematerialisation plan, which includes the digitisation/data completion of documents/information on previous loans issued (loans issued by the Bank between 2002- 2015).

Rating 1
(Green)

Audits conducted in relation to Remedial Action ECB OSI 34-35

Information on real estate	The completeness of information on real estate assets has been improved. The automatic processes implemented in On Line Appraisals allow the Real Estate Assets procedure to be fed with the data already acquired, checks and certified during the phase of appraisal by an accredited expert.
Digitisation of documents for new mortgage loan transactions	A new type of practice referring to mortgage loans has been introduced in the Document Checking procedure. This implementation allows operators to be guided in the acquisition, digitisation and centralisation of supporting documents.
Dematerialisation Plan for previous Mortgages	All the documents stored in the branches have been transferred to the outsourcer for digitisation, data acquisition and centralised storage. Digitisation has been completed for 363,000 mortgage positions out of a total of 380,000 mortgages issued between 2002-2016 (965 of the total). Integration of data for 363,000 mortgages in the Bank’s information system has been completed.

Remedial Action – ECB OSI 34-35

21

Remedial Action ECB

Integrate MPSCS and MPSL&F in the processes of BMPS (granting, monitoring and work-out) including IT tools, assuring the correct application of the policies throughout the Group.	Deadline 31.12.2016

Related Audit exercises

As a result of project delays in implementing the remedial actions linked to RA #21, the Audit Function provided for specific audit exercises in the course of 2017.

Rating 1 (Green)

AUDIT EXERCISE CARRIED OUT: Review the integration of the credit-granting, monitoring and work-out processes used by Banca MPS in the companies MPS L&F and MPS CS.

Audits conducted in relation to Remedial Action ECB OSI 34-35

Credit Processes Policy	The effective implementation of the Group's Policies and Procedures on Credit Processes was verified
Credit Default Detection	The effectiveness of the Credit Default Detection process, introduction of the application MO.CRE and Forborne management procedure were all confirmed. Positive results from the parameters backlog processing plan.
Second-line controls on credit exposures	Our analysis of the relationship with the Group's Credit Exposure Monitoring Unit showed there is a constant exchange of information and good coordination.
Integration of Group IT procedures	The extension of the IT applications for accounting management of litigation (AMCZ) of the Parent Company to MPSCS has not been started pending the definition of strategic options on the company. The IT impact on the procedures of the subsidiaries MPS CS and MPS L & F is part of the RA 31 release program

Audits relating to ARGO 3 Findings

Finding 4 of ECB OSI 1238 ECB provides for activities relating to the credit management process that also impact the subsidiaries MPS Capital Services and MPS Leasing & Factoring.
Specifically, the Credit management criteria envisaged for the BMPS High Risk Unit are in the process of being extended to the Subsidiary Banks also

Remedial Action – ECB OSI 34-35 31

Remedial Action ECB

Review the capacity of the Bank's IT system to support the Credit and Risk Management processes, defining and implementing an appropriate structural solution accordingly

Attività di audit correlate

The conclusion of all remedial action activities has been postponed to 2018. The CAE Direction has therefore decided to postpone the planned revision for 2017, and drown up a note for the Board of Statutory Auditors in which, on the basis of the "work in progress" of Argo IT discussed in the Steering Committee and of what was affirmed by the Consorzio Operativo representatives, the macro areas related to the following IT developments were presented:

- instalment financing applications
- credit management applications,
- Subsidiaries applications(MPS Capital Services e MPS Leasing & Factoring).
- Data – Governance , reporting and monitoring

Work in progress

Attività Svolte per la finalizzazione della Remedial Action

instalment financing applications	the procedures for financing have been rationalized ; the current Plan provides that the Platform will be distributed by the end of 2018 over the entire network for the management of mortgages unsecured.
credit management applications	Identified a market solution for the PEF; the following waves di User Acceptance Testing have been planned: 1-Corporate (02/2019), 2-Small Business (04/2019), 3-Retail (06/2019);
Subsidiaries applications(MPS Capital Services e MPS Leasing & Factoring).	MPS Leasing & Factoring – activities for the automation of Factoring procedures (mitigation of operational risks)

Attività da svolgere per la finalizzazione della Remedial Action

instalment financing applications (Progetto ELISE)	Completion of the roll-out by the end of 2018 for unsecured loans; the progressive extension to other products will follow in 1Q and 2Q 2019
credit management applications (Progetto PEF)	PEF e Fidi: Technological evolution leading to optimizing and increasing flexibility, completition of the Roll-Out: planned for the end of 2019 Bad loans management application (EPC) - Functional developments
Subsidiaries applications (MPS Capital Services e MPS Leasing & Factoring).	MPS Capital Services (MPSCS) – Extension to MPSCS of the standard group application s for credit management MPS Leasing & Factoring - Implementation of integrated administrative management with EPC for bad loans
Data – Governance , reporting and monitoring	Release of the Loan Data Tape – Unique Database del Credito / Non Perfoming Loans

MONTE DEI PASCHI DI SIENA
BANCA DAL 1472