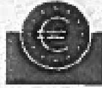

EUROPEAN CENTRAL BANK

BANKING SUPERVISION

ECB-CONFIDENTIAL

DIRECTORATE GENERAL MICRO-PRUDENTIAL SUPERVISION I

Mr Fabrizio Viola
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9 December 2014
Ref: DGMS1-3/MPS001

Findings of the Asset Quality Review – Banca Monte dei Paschi di Siena

Dear Mr. Viola

From November 2013 to October 2014 Banca Monte dei Paschi di Siena (BMPS) has been subject to a Comprehensive Assessment (CA) which included an Asset Quality Review (AQR). The assessment was carried out according to criteria and assumptions which were carefully devised having in mind not only accounting standards but also the need to ensure consistency across the SSM and - in light of the recent experience of national supervisors and of the challenges posed by the current economic scenario - a rigorous approach to classification and valuation of assets.

Therefore, the CA centrally led by the ECB is fundamentally a prudential exercise and the SSM acknowledges that the responsibility of preparing financial statements, selecting and applying appropriate accounting policies and developing accounting estimates rests with management.

Nevertheless, in light of the AQR results, BMPS management shall pay close attention to the findings, which can be highly valuable when establishing accounting estimates. To this end, on November 17th, the Joint Supervisory Team (JST) sent to the CFO of BMPS a number of key files used in the AQR. In

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addition to those templates, this letter summarizes the key quantitative and qualitative findings emerging from the AQR for BMPS. Although there is no mechanistic way of deriving the accounting implications of the AQR exercise, BMPS should critically assess all issues and related underlying reasons. The contents of this letter shall be brought to the attention of the external/statutory auditors and of the relevant governance bodies without delay. The JSTC will contact you at some point in December to obtain your preliminary feedback and discuss instances in which it is not possible to reflect the AQR findings in a more prudent approach to financial statements.

The implementation of remedial actions and prudential and/or accounting adjustments will be closely monitored by the JST in charge of the supervision of BMPS. For all required remedial actions BMPS is expected to provide a written answer **by 31st January 2015**, indicating the way it intends to comply and providing any supporting documentation if need be. In the course of January the JST might also contact the external/statutory auditor to obtain an independent view on issues and proposed actions.

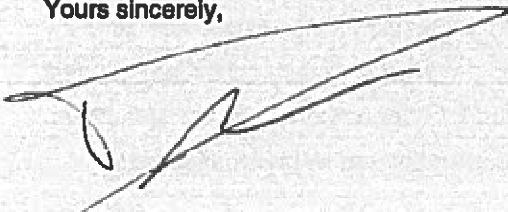
Should you have any further questions or requests, please contact the JST Coordinator in charge of the supervision of BMPS:

Maria José Romero Rico
E-mail: maria_jose.romero_rico@ecb.europa.eu
Tel.: +49 69 1344 4761

Please provide your reply, preferably by e-mail, to the following address: JST.ITMPS@ecb.europa.eu

Any postal communication should be addressed to: European Central Bank, [], [JST Coordinator / Director General DG/MS I], Sonnemannstrasse 20, 60314 Frankfurt am Main, Germany.

Yours sincerely,



Patrick Amis
Deputy Director General
DG Micro-Prudential Supervision I

Encl.

1. High level summary

Regarding the Credit file review performed under the AQR, it should be noted that the quality of loans portfolio is still idiosyncratically affected by:

- Expansive loan policy in the triennium 2008- 2010 (increase of stock loans to clients by 4,6% vs. a reduction of overall italian banking system by 4,5%);
- Below-average quality of the ex Banca Antonveneta portfolio, acquired in 2007 (55% of counterparties were found out misclassified);
- Past low credit standards in origination of loans granted to related parties and local economy (respectively 50% of exposures to related parties and 54% to counterparties located in Tuscany were found out misclassified).

Against this background, 31% of the performing (PEs) sample exposure was reclassified to non performing exposures (NPEs) and the coverage of NPEs sample was increased from 27.95% to 38.85%. Considering also the projections and adjustments to collective provisions, the total AQR impact on available capital has been of EUR 2,807 mln.

In addition, other minor CET1% adjustments for fair value assets have been applied (EUR 44 mln) in order to align across the group the LGD parameter in CVA calculation and as a consequence of Level 3 asset revaluation.

Regarding processes and procedures, it was found out that in most areas the guidelines are not adequately detailed: as a consequence, a relevant degree of variability in credit quality standards and practices was observed during credit file reviews.

Eventually, the trading book core processes review found out misalignments to ECB best practices and needs of remedial actions in some areas (e. g. model validation, independent price verification, new product approval) whose priority however is less stringent, taking into account that BMPS has a low risk appetite in this business segment according to the constraints embedded in the restructuring plan approved by European Commission.

Additionally, regarding the so called Nomura transaction[1], in order to eliminate potential linked accountancy arbitrage, it was deemed appropriate to take a prudential measure for the purposes of the AQR ("total phasing in" of 100% instead of 20% of the unrealized losses on Italian sovereign bonds, included in the transaction and booked in AFS portfolios). As a result the bank starting CET1% ratio has been lowered from 10.6% to 10.2%. In addition, the vehicle Patagonia has been consolidated

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[1] Series of transactions conducted in 2009 with Nomura, including a purchase of Italian BTP 2034, an interest rate swap, a long term repo and a repo facility, that are booked separately in the financial accounts of the bank.

in the prudential perimeter with very marginal effects on the reported CET1% (the main effect is the exclusion of about EUR 149 mln of lower tier 2 liabilities from the regulatory capital).

Based on the conclusions obtained in the AQR exercise for these two transactions, the ECB considers appropriate to maintain the prudential measures in the aforementioned paragraph going forward.

2. Key figures resulting from the AQR

Figure 1: Overview of AQR adjustment to Significant Bank CET1% ratio

	Phase in period for CRR/CRD IV deductions		
	2014	2015	2016
Bank-reported CET1% ratio (with static balance sheet)	10.6%	9.9%	9.1%
Bank-reported CET1% ratio (with static balance sheet) after bank team II pillar measure	10.2%	9.6%	8.9%
AQR adjusted CET1% ratio	6.8%	6.2%	5.5%

Figure 2: Summary of impacts on bank available capital as identified during the AQR[2]

	Impact on available capital		
Basis for adjustment	2014	2015	2016
Total impact of AQR adjustments on available capital for fair value assets	44.0	44.0	44.0
Adjustment for reclassification of exposures to AFS			
Adjustment for reclassification of exposures to Fair Value			
Adjustment due to CVA challenger model analysis	6.7	6.7	6.7
Adjustments to level 3 assets in the banking book (AFS)	1.8	1.8	1.8
Adjustments to level 3 assets in the banking book (Fair Value)			
Adjustments to level 3 assets in the Trading book (Fair Value)	6.9	6.9	6.9
Adjustments to other level 3 assets analysed (all other accounting classifications) *Real estate held at cost*	28.6	28.6	28.6

[2] All figures include offsetting impact of tax (after rules on limitations on DTAs) and risk protection

Total impact of AQR adjustments to provisioning on available capital	2807.1	2807.1	2807.1
Adjustment to provisions on Credit File sample	758.8	758.8	758.8
Projection of Credit File findings to wider portfolio	1474.8	1474.8	1474.8
Adjustment to provisions due to collective provisions analysis	573.5	573.5	573.5

Total AQR impact on available capital	2851.1	2851.1	2851.1

Figure 3: Adjustment to RWA for IRB banks benefitting from risk protection via Supervisory Formula Approach (SFA) - where material

	2014	2015	2016
Total adjustments made to RWA			

3. Key findings emerging from the AQR

In this paragraph the findings and remedial actions are listed according to the work-blocks of the AQR manual.

Associated AQR work block	Description of issue	Remedial action required	Required Deadline
4	The process of default detection has the following shortcomings: The guidelines are not enough detailed neither in setting the assessment criteria neither in setting actions to be undertaken in case of debtor difficulty in servicing the debt. The control system does not assure the full alignment of credit staff's operational behaviour to the internal guidelines and does not guaranty uniformity in the credit assessment of the exposures. The re - aging process, especially with reference to real estate initiatives,	[Action (1)] Significant bank is required to perform a comprehensive review of the portfolio especially with reference to the bucket high risk cured. [Action (2)] The credit monitoring and default detection processes have to be reinforced, extending the panel of early warning signals to be considered and issuing more analytical guidelines for the assessment of debts potentially impaired; moreover coherent checks have to be implemented to align credit staff operational behaviour to guidelines [Action (3)] The re - aging process has to be	[Action (1)] 31th July 2015 [Action (2)] 30th April 2015 [Action (3)] 31st March 2015 [Action (4)] 31st March 2015 [Action (5)] 30th April 2015

	does not set either a maximum number of re - aging that can be granted or ad hoc escalation procedures; IT issues do not permit a proper accounting of NPE that are granted forbearance measure. As a result: The early warning signals do not trigger systematically a comprehensive reassessment of the exposures that should take into account all the relevant elements; Exposures have been re – aged more times without adequate re – assessment of the debtors' creditworthiness. There is too room for discretional assessment by the single operators The exposures moved from original manager to restructuring function manager are not timely properly classified when the debtor keeps having difficulties to regularly service the debt while there are delays in reaching a debt restructuring agreement . NPE that are granted some kind of forbearance measures are automatically accounted as Performing (even if from a prudential point of view they keep to be risk weighted at 100%)	better regulated defining guidelines that entail maximum number of re - aging that can be granted, escalation rules, ad hoc assessment criteria, especially with reference to real estate portfolio. The Bank should assess all positions subject to re-aging to ensure that all rescheduling granted because of financial trouble of the debtor trigger the classification of the debtor as restructured. [Action (4)] The restructuring function, independently from managerial actions undertaken or to be undertaken, has to perform a timely impairment test of exposures. For this purpose, specific deadlines should be established, ensuring a binding application of the guidelines throughout the Bank. [Action (5)] Actions have to be taken to overcome IT issue that determines the reclassification as PE of NPE subject to forbearance measures.	
4	The provisioning process has the following shortcomings: Provision process of bad loans is not always supported by complete and/or	[Action (6)] to define more analytical impairment guidelines, setting conservative and consistent haircuts to be applied to the collateral, whose value must be yearly	[Action (6)] 31st March 2015 [Action (7)] 31st March 2015

	updated information. Specifically the appraisals are not systematically updated (n. 43 debtors required revaluation of collateral); The haircuts to be applied to collateral are not detailed in guidelines. There are not clear criteria to quantify provision of NPE without collateral. Shortcomings in procedures and excessive number of files managed by single operators affect the assessment process and cause delays in updating the assessment of provision needed. As a result: The provision process of bad loans is not always supported by complete and/or updated information. Specifically the appraisals are not systematically updated. There is too room for judgement in applying haircut to collateral and in assessing NPE without collateral. Additionally, the Bank does not perform systematically a cash flow analysis with reference to past due, substandard and restructured exposures which are generally evaluated with an approach based on historical data, taking into account the observed cure rate. Regarding CFR sampling, counterparties for EUR 3.17 billion have been reviewed increasing coverage from 9.6% to 18%.	updated, together with the provision assigned to the respective exposure when needed. [Action (7)] to set clear criteria to calculate provisions related to uncollateralized NPE. [Action (8)] To reinforce the process of provision, updating IT procedures and better calibrating the number of files managed by each portfolio manager; [Action (9)] to establish and put in place processes to update systematically the recovery plan on which the provisions are based. [Action (10)] Provisioning should be updated as soon as additional impairment is identified. For this purpose, clear guidelines and deadlines should be established and bindingly applied throughout the Bank. [Action (11)] The Bank is required to update the approach in calculating provisioning for past due, substandard and restructured exposures considering idiosyncratic issues especially for exposures greater than a certain threshold.	[Action (8)] 31st March 2015 [Action (9)] 31st March 2015 [Action (10)] 31st March 2015 [Action (11)] 31st July 2015

7	Collective provisioning for corporate exposure does not properly reflect the current economic conditions since the PDs are calibrated on a time series of 7 years without any adjustments (see IAS 39, Para AG89).	[Action (12)] Effective adjustments have to be introduced to take into account the evolution of economic cycle, for instance aligning the calibration timeframe of corporate PDs to retail ones, set in 5 years, considering their potential impact on IRB prudential models.	[Action (11)] 30th June 2015
8	The LGD parameter for CVA calculation used by legal entity BMPS Capital service (32%) was misaligned from the one - in line with market practices - used by the parent company BMPS (about 60%) : the alignment of the parameter across the group would have increased the accounting CVA of EUR 10,6 mln as of December 2013 (from EUR 118,6 mln to EUR 129,2 mln)	[Action (13)] The bank is required to align the LGD parameter across the group setting a floor of 60%.	[Action (12)] 30th June 2015

The **Nomura transaction** was analysed as a special case in the context of policy and processes review in order to assess if the relevant bank accounting treatment of the transactions on a gross basis versus a net basis (as a CDS) was adequately supported.

The IFRS IC Staff Paper issued in March 2014 (summarized in the paragraph "IAS 39 Financial Instruments - accounting for term-structured repo transactions" in the document "IFRIC Update – March 2014") was taken into account. The main conclusions of the analysis were:

- Due to the complexity and opaqueness of the transaction, from an accountancy perspective the interpretation of the interlinks between each financial instrument making the deal as a whole needs a considerable level of judgment as confirmed also by the last document "IFRIC Update-March 2014";
- Transactions with opaque close-out clauses, widespread in the post crisis capital markets, may result in accounting arbitrage for all the counterparties involved with consequent asymmetric prudential capital requirements calculation.

Moreover, a pro-forma accounting treatment for this transaction as a CDS is being disclosed quarterly since December 2013.

Against this background, it was deemed appropriate to assume a Second Pillar measure for the purposes of the Comprehensive Assessment, including in the calculation of CET1 the 100% of unrealized losses on

Italian government bonds encompassed, so anticipating the full phase in of the CRR (art 35 and art 467) in order to eliminate any potential arbitrage incentive from a prudential point of view.

Regarding **level 3 assets revaluation**, the model of valuation of the bond EIRLES II Limited series n. 195 - perpetual bond formula assuming a risk profile equal to a first-to-default basket CLN on two entities (Deutsche Bank and France Telecom) – was found out not appropriate to the bond characteristics that sum up the risk of two different instruments: a perpetual bond with Deutsche Bank risk plus a CDS whose reference entity is France Telecom. Summing up the two risks, the valuation is lower of EUR 10.4 mln from EUR 62.7 mln to EUR 52.2 mln. In this regard, BMPS has modified the model of valuation of the bond adopting a summing up approach and accounting a loss of about EUR 10 mln.