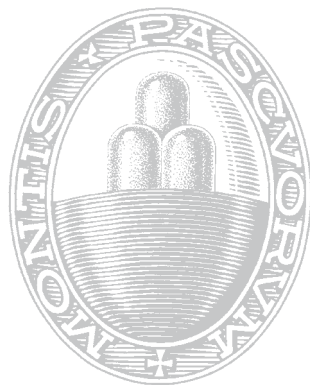


Pillar 3 Disclosure

31 December 2010



**MONTE
DEI PASCHI
DI SIENA**
BANK SINCE 1472



Pillar 3 Disclosure

31 December 2010

**Banca Monte dei Paschi di Siena SpA**

Company Head Office in Siena, Piazza Salimbeni 3, www.mps.it

Registered with the Companies Register of Siena - registration number and tax code 00884060526

Member of the Italian Interbank Deposit Protection Fund and of the National Guarantee Fund.

Register of Banks no. 5274.

Parent Company of the Monte dei Paschi di Siena Banking Group registered in the Roll of Banking Groups



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Introduction

The existing prudential supervisory framework, commonly referred to as “Basel 2”, was developed by the Basel Committee and transposed into European Union Directives 2006/48 and 2006/49. The Basel 2 framework is based on three mutually underpinning concepts (so called “Pillars”).

More specifically, Pillar 3 was designed on the notion that Market Discipline can be harnessed to reinforce capital regulation and therefore promote stability and soundness in banks and financial systems.

The purpose of Pillar 3 therefore is to complement the operation of minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2) by developing a set of disclosure recommendations and requirements which will allow market participants to assess key, fully comprehensive and reliable information on capital adequacy, risk exposures and risk identification assessment and management processes.

In Italy, Pillar 3 disclosure is pursuant to Title IV, Chapter 1 of Bank of Italy Circular no. 263 of 27.12.2006 (“New Regulations for the Prudential Supervision of Banks”, hereafter “Circular”).

Under the Circular, banks that are authorised to use internal methodologies in their assessment of capital requirements for credit or operational risk – as is the case with the Montepaschi Group – are required to publish a quarterly report setting out the specific criteria and methodologies adopted.

The information provided is both qualitative and quantitative and is presented under four synoptic tables as defined in Appendix A, Title IV, Chapter 1 of the aforementioned Circular.

The Pillar 3 disclosure is structured in such a way as to provide as full a picture as possible of the risks assumed, the characteristics of the management and control systems used and the capital adequacy of the Montepaschi Group.

The disclosure is prepared at consolidated level by the Parent Company.

In accordance with the Bank of Italy’s Circular Letter 263, calling upon banks to avoid publishing tables without information if not applicable, Table 11 on internal models for Market Risk has not been published since it is non-applicable to the Montepaschi Group at present. Unless otherwise indicated, all the amounts in this report are stated in TEUR (thousands of Euro).

In order to facilitate reading and better clarify certain terminology and abbreviations used in the text, a Glossary can be found at the end of the current document. The Montepaschi Group regularly publishes its Pillar 3 disclosure on its website at:

www.mps.it/Investor+Relations



Table 1 - General requirements

Qualitative disclosure

1.1 The Risk Management process in the Montepaschi Group

The Montepaschi Group attaches the utmost importance to the process of identifying, monitoring measuring and controlling risk. The risk management process within the Group was further strengthened in 2009. This was made possible with the gradual extension of the advanced management and reporting models to the various entities of the Montepaschi Group. Furthermore, following the international financial crisis which gave rise to a further impetus for improving the efficiency of risk management and control systems worldwide, the Montepaschi Group also developed its risk management methods, models and processes.

The fundamental principles of the Montepaschi Group's Risk Management process are based on a clear-cut distinction of the roles and responsibilities of the different functions at first, second and third-levels of control.

The Board of Directors of the Parent Company is responsible for defining strategic guidelines and risk management policies at least on a yearly basis and setting the overall level of risk appetite for the Group also quantitatively in terms of Economic Capital. The Board of Statutory Auditors and the Internal Controls Committee are responsible for evaluating the level of efficiency and adequacy of the Internal Controls Systems with particular regard to risk control. Top Management is responsible for ensuring compliance with risk policies and procedures. The Risk Committee of the Parent Company establishes Risk Management policies and ensures overall compliance with the limits defined for the various operating levels. The Risk Committee is also responsible for assessing initiatives for capital allocation and submitting them to the Board of Directors and assessing risk profile and capital consumption as well as the trends of risk-adjusted performance indicators at Group level and for each company of the Group. The Finance Committee of the Parent Company has the task of setting the principles of – and providing strategic guidance for – Proprietary Finance for both the Trading Book and the Banking Book. Furthermore, it deliberates and submits proposals concerning the interest rate and liquidity risk exposure of the Banking Book



and defines Capital Management actions required.

The Internal Controls Area operates through an independent and objective activity of assurance and advice aimed, on the one hand, at controlling - also through on-site inspections - regular operations and risk trends and, on the other, at assessing the functional efficiency of the Internal Control Systems in order to improve the effectiveness and efficiency of the organisation.

The Risk Management Area of the Parent Company defines integrated analysis methodologies needed to measure overall risks so as to guarantee they are accurately measured and constantly monitored.

It also quantifies Economic Capital consumption as well as the minimum amount of capital to be held to cover all existing risks.

The Area produces control reports and ensures compliance with the operational limits set by the Board of Directors on the basis of internally-developed models.

The Risk Management Area is also responsible for measuring, monitoring and controlling risk and performance of investment services/products offered to or held by the customers.

The Business Control Units (BCUs), which are internal to the business and operating units of the Parent Company and Group subsidiaries, carry out conformity checks on the transactions they are responsible for and are the first level of organisational supervision of operations within the more general system of Internal Controls.

From an overall organisational and governance point of view with regard to Group risk, it should be noted that in the first half of 2009, the Risk Management Area was made to report directly to the General Manager while maintaining a functional connection with the Board of Directors and the CFO.

This setup, in alignment with regulatory provisions and international best practices, aims at guaranteeing greater autonomy and forcefulness to risk management actions and to the effectiveness of the entire risk management and control process.

As a consequence of the re-allocation, new risk information flows were designed for the Group's governing bodies (Chairman, General Manager and Internal Controls Committee) and for the Board of Directors in addition to the already-existing reporting flows.

The main types of risk incurred by the Montepaschi Group in its day-to-day operations can schematically be presented as follows:



- credit risk,
- counterparty risk,
- issuer risk,
- concentration risk,
- market risk (price, interest rate and foreign exchange) in relation to the Trading Book,
- interest rate risk for the Banking Book (Asset & Liability Management - ALM),
- liquidity risk,
- equity investments risk,
- UCITs risk (alternative funds),
- operational risk,
- business risk,
- real-estate risk,
- reputational risk.

Internal Rating Based) and operational risk (AMA – Advanced Measurement Approach) as of the first consolidated report at 30-06-2008.

Throughout the year work continued on the completion and extension of these models to those entities not included in the initial scope of validation as did the activities aimed at improving the internal market and counterparty risk models. With a more specific regard to credit risk, the use of the AIRB model was extended to Banca Antonveneta and Banca Antonveneta branches merged into Banca MPS, leading to significant improvements in efficiency in terms of economic and regulatory capital.

Risk relating to investment products/ services for the Group's customers are also monitored with a view to protecting the customer and preventing any potential reputational impact. In accordance with the principles contained in the New Accord on Capital Adequacy (Basel 2) in relation to First Pillar risks, in the first half of 2008, the Montepaschi Group completed its work on the internal models for credit and operational risks. Pursuant to Circular Letter 263/2006

Furthermore, activities continued in relation to Second Pillar compliance and the optimisation of processes relating to the self-assessment of the Group's Internal Capital Adequacy Assessment Process (ICAAP). As per regulations, a comprehensive report (ICAAP document) has been prepared by the Group and submitted to the Supervisory Authority.

of the Bank of Italy, on 12 June 2008 the Montepaschi Group was officially authorised under regulation no. 647555 to use the advanced models for the measurement and management of credit risk (AIRB - Advanced

With regard to the Third Pillar, the Montepaschi Group, as a class 1 bank under Supervisory classifications, fulfilled the obligation of quarterly disclosure as instructed in Supervisory regulations.



In order to ensure compliance with the disclosure obligations set forth in the regulations, specific planning initiatives were put forth with the objective of optimizing the drafting and timely publication of the document as well as the relevant organisational and control processes. The work group, coordinated by the Risk Management Area, under the responsibility of the relevant manager in charge, has seen the cooperation of all the Group's main functions.

The report is published on the Montepaschi Group website and is regularly updated on the basis of the currently regulatory framework.

1.2 Organisation of the Risk Management Area

The Risk Management Area (ARM) is responsible for centralised operation of the Group's risk management system and verifies the overall risk profile as well as compliance with - and the adequacy of - the mitigation measures adopted. It carries out controls according to the "Bank of Italy – Consob regulations" regarding the organisation of intermediaries and compliance with the prudential supervisory regulations of the Bank of Italy. Moreover, the Risk Management Area develops and implements the risk measurement and control system to determine the economic and regulatory capital (in relation to validated internal models) by different types of risk and supplies information to the business units, the Board of Directors and Top Management

through appropriate reporting systems. The Risk Management Area reports directly to the General Manager and has a functional connection with the Board of Directors and the CFO. Autonomy and independence are assured through relational mechanisms and functional connections with the corporate bodies having functions of strategic supervision, management and control, in particular through:

- the appointment/revocation of the Head of Risk Management of the Parent Company and the Heads of the relative Services by the Board of Directors against proposal of the Chairman who is advised by the Areas of Human Resources, Organisation, Property and Facility Management, upon prior opinion obtained from the Internal



Controls Committee;

- definition of the remuneration structure for the Head of Risk Management and the Heads of the related units by the Board of Directors against the proposal of the Chairman, who is advised by the Areas of Human Resources, Organisation, Property and Facility Management, upon prior opinion obtained from the Internal Controls Committee.

In addition to a Technical Secretariat for support and general coordination, a Risk Disclosure function (under the responsibility of the Area Manager), a Credit Risk, ALM and Liquidity Management function, a Market Risk Management function, an Operational Risk Management function and a Wealth Risk Management function all report directly to the **Risk Management Area of the Parent Company** (hereinafter RMA) in the form of four separate “Services”.

- **Risk disclosure** has the task of:
 - compiling and coordinating the Group’s Basel 2, Pillar 3 disclosure as required by Supervisory regulations, with the support of Financial Accounting, Planning and other related functions of the Group;
 - compiling and submitting the sections relating to overall internal capital and risk management for the preparation

of the Quarterly, Mid-year and Annual reports of both the Parent Company and the Subsidiaries;

- producing and coordinating reports on management risk for the Board of Directors, the Chairman, the General Manager, the CFO, the Internal Controls Committee, Top Management and the Risk Committee of the Parent Company;
- preparing, within its area of competence, material for meetings with rating companies and supporting Investor Relations in risk management issues;
- supervising the production of operational reporting on risk by the various ARM services to support the business of the Parent Company and Subsidiary companies.

- **Credit Risk, ALM and Liquidity Management** has the task of:

- defining, developing and updating models (PD, LGD, EAD) for the measurement of credit risk monitoring the internal model in compliance with qualitative and quantitative requirements provided for by the Supervisory Authorities;
- monitoring credit VaR measurements for each single business unit and at Group level;



- quantifying the effects on expected and unexpected loss on credit risk and therefore on absorbed economic capital of the Group portfolio and of the individual business units and proposing any corrective actions, taking into account any effects on mitigation actions;
 - determining the internal capital measure used to calculate the risk-adjusted performance measures;
 - defining, developing and updating models for the measurement of risks inherent in the interest rate and liquidity risk profile of the banks of the Group (ALM Banking Book);
 - measuring the interest rate and liquidity risk exposures, verifying the compliance with any operational threshold limit value and activating the appropriate initiatives aimed at an overall optimisation, also in consideration of adequate scenario analyses;
 - quantifying the scenario analyses and stress tests on credit, ALM and liquidity;
 - developing and maintaining the methodologies used for identifying and mapping the relevant and non-relevant risks of the Group, both by each business unit and by legal entity, for the purposes of risk integration and support to the ICAAP process;
 - defining, developing and updating the risk integration models used to quantify the overall Economic Capital;
 - developing and implementing, from an operational point of view, Pillar 2 stress and scenario testing methodologies, supporting and coordinating forecast scenario methodologies for the ICAAP process;
 - supporting the calculation of operational economic capital absorbed by legal entity, business unit and at Group level.
- **Market risk management** has the task of:
- defining, developing and updating the methodologies underlying the various internal management models inherent in the Group's market and counterparty risk profile, in coordination with the business control units (BCUs) of the individual business units for the appropriate methodologies to be shared;
 - monitoring and validating the production of market and counterparty risk measurements for each business unit, Group company and for the Group as a whole;
 - defining the structure of operating limits on market and counterparty risk in compliance with the Group's risk measurement system and for the purpose



of financial instruments holding, by verifying the methodological alignment of their overall structure with the Group's risk objectives;

- monitoring the limits established by the Board of Directors of the Parent Company in relation to market and counterparty risk at all delegated levels and verifying the application of corrective actions taken due to any mismatches or other vulnerable factors that emerge when monitoring risk;
- steering and coordinating market risk control activities relating to first level BCUs in compliance with the guidelines set out on financial controls within the Group;
- defining risk assessment and measurement methods for new financial instruments (product approval process);
- defining, determining and validating the methodologies chosen for aspects relating to the fair value of financial instruments traded by Group: valuation models, usage criteria and hierarchy of pricing sources, rules, sources and methodologies for feeding market parameters, criteria and rules of classification into the fair value hierarchy;
- controlling and validating the designation at fair value of financial

instruments contained in the supervisory trading book and in the financial assets of the banking book;

- controlling and validating the market parameters used to assess and measure risk related to the financial instruments held by the Group;
 - validating P&L data at mark-to-market on the basis of fair value control activities carried out directly and first-level control activities carried out by the BUCs of the individual business units;
 - defining, developing and updating the internal models as per regulations with regard to market risk;
 - in the Supervisory Trading Book and in the internal model of counterparty risk exposure in compliance with qualitative and quantitative requirements set out by the Supervisory Authorities;
 - quantifying market risk scenario analyses and stress tests.
- **Operational Risk Management** has the task of:
- defining, developing and updating the operational risk measurement models, monitoring the internal model in compliance with the qualitative and quantitative requirements set out by the Supervisory Authorities;
 - coordinating the data collection process for operational losses, the risk assessment process as well as the



- process used to identify the more critical operational areas on the basis of scenario analyses;
- monitoring the measurements of internal capital in relation to operational risks for each business unit and globally for the Group (Operational VaR);
 - measuring the effects of the Group's operational-risk mitigating transactions on absorbed economic capital;
 - defining, implementing, managing and updating the mathematical/statistical algorithms underlying the various measurement models and quantifying the scenario analyses and stress tests on operational risks;
 - carrying out the process for the validation and preparation of the final report for the Operational Risk internal model, to be submitted to the Risk Committee for approval;
 - identifying reputational risks inherent in Group activities overall, with specific focus on those linked to investment and lending services proposed to customers
 - monitoring the trend of reputational risk indicators.
- **Wealth Risk Management** has the task of:
- defining metrics to measure and monitor the risk/performance of investment products, portfolios and services offered to customers;
 - measuring and monitoring the risk and performances of investment products, portfolios and services;
 - defining and developing methodologies for verifying the appropriateness/adequacy of investment products, portfolios and services, so as to ensure consistency between the customer's risk profile and the risk profile of the financial instruments;
 - assigning a risk class to products on offer by the Group in addition to other parameters which are relevant for adequacy checks;
 - ensuring that all products invested in on the customer's initiative be assigned a risk class and measured against any other parameters required for adequacy checks;
 - performing checks to monitor customer operations (operating limits, concentration, "gaps", etc.);
 - validating parameters (personal data, pricing and benchmarks) which feed the applications used for assessing and measuring the risk and performances of investment products, portfolios and services;
 - monitoring changes in risk class of investment products/services for the purpose of disclosure to customers;
 - preparing the relative management and operating reports.
- The Risk Management Area of the Parent Company as at 31.12.2010 consists in 55



resources overall. Human resources have an average age of 38 and an average seniority in the banking sector of approximately 10 years. Resources show to have taken professional paths that are also outside the risk management area with significant experience gained in credit, finance, planning and sales for the Group. In terms of academic background, there is a prevalence of degrees in Economics/Banking/Business related subjects (56%), followed by degrees in Mathematics/Statistics (18%), Engineering (7%), Physics and IT (5%) and diplomas or degrees in other subjects (13%). Approximately one fourth of resources hold a post-degree qualification (Masters or PhD) or an international professional certification (e.g. FRM certification issued by GARP).

1.3 Credit risk

The Budgeting, Planning, Capital and Risk Management processes of the Montepaschi Group are based on the “Risk Adjusted Performance Management” (RAPM) logic. In the development of these management processes, the definition of adequate credit policies – under the responsibility of the Parent Company’s Credit Management Area – plays a relevant role which finds its operational expression in the implementation of the strategies (i.e. credit portfolio quality objectives), to be applied to the credit processes.

The Montepaschi Group’s strategies in risk management mainly aim at limiting the economic impact of default on the credit portfolio, exploiting, in particular, the full potential of the internal rating models and loss estimates in the case of default. Strategies are defined on a yearly basis, except otherwise provided for under exceptional circumstances due to external conditions, and are identified for two main areas:

- loan disbursement strategies (definition of quality targets for access to credit);
- credit monitoring strategies (definition of minimum quality targets for maintenance of the loan disbursed).

The definition of customer acceptance policies, based on the analysis of the customer’s prospective solvency, plays a major role in loan disbursement strategies. Only after having identified the customer



<p>with the required creditworthiness are other credit risk mitigation factors (guarantees) taken into account. The information on client quality and transaction risk is essential in identifying the decision-making body for loan granting.</p> <p>The follow-up strategies are based on systems used to detect monthly changes in the customer's risk profile.</p> <p>The identification of events likely to affect the credit risk triggers a set of obligations for the distribution network, who is assigned the key task of keeping communication channels with the customer open and obtaining all useful information needed to verify the changes in the risk profile. If changes are confirmed, the client account manager is supported by personnel specialised in credit quality management and by legal staff to define the credit risk management procedures required.</p> <p>The quantitative identification of credit risk is mainly applied, at operational level, to the measurement of the risk-adjusted return of each individual operating unit. This process is carried out with management control instruments.</p> <p>The credit risk identification and quantification instruments allow the Montepaschi Group to define hedging policies mainly consisting of defining "risk-adjusted pricing" which includes risk</p>	<p>coverage and planned 'return on capital'.</p> <p>Risk mitigation policies are defined in the Credit Risk Mitigation (CRM) process, whereby the legal, operational and organisational conditions necessary to use collateral guarantees for credit risk-mitigation purposes are identified and met.</p> <p>Three sets of guarantees complying with mitigation requirements are defined in the process: Personal securities, Financial collaterals and Mortgage collaterals. Other types of credit protection guarantees do not mitigate credit risk.</p> <p>With a specific regard to collaterals, a system has been developed to monitor the value of the collateralized asset, based on the measurement of market value (daily for securities and annually for real estate).</p> <p>Within the credit-granting process, the Montepaschi Group has adopted a risk-adjusted system for borrower identification, which is sensitive to the customer's rating and to the presence of collaterals.</p> <p>Should the value of the collateralised asset be subject to market or foreign exchange rate risk, a "safety margin" is used, i.e. a percentage of the end-of-period value of the collateral pledged, which is a function of the volatility of the collateralised asset.</p> <p>The only portion of the loan covered by the value of the assets net of the differential is considered as guaranteed during the</p>
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approval phase. In the monitoring stages, an adjustment is required on guarantees for which the market value results as being lower than the authorised value net of the safety margin; notification of this step is channelled into the implementation process of the credit monitoring strategies. Credit risk management policies and disbursement processes are governed by Group directives.

In terms of Credit risk measurement models, credit risk is analysed using the Credit Portfolio model, which was developed internally by the Risk Management Area of the Parent Company and produces detailed outputs in the form of traditional risk measures such as Expected Loss, Unexpected Loss and inter-risk diversified Economic Capital over a time horizon of one year and a confidence interval calibrated to the official rating assigned to the Montepaschi Group.

There are numerous inputs: Probability of Default (PD), Loss Given Default (LGD) rates, number and types of guarantees supporting the credit facility, internal operational Exposure at Default (EAD) and correlation matrices. The latter component, which is based on internal estimates (and which is periodically finetuned in order to introduce more advanced measurement methods), makes it possible to quantify, for individual positions, the diversification/concentration components among the positions contained in the portfolio. The economic capital calculation approach is based on Credit-VaR measurement systems and uses methods consistent with the best practices in the industry.

The portfolio model's output provides detailed measures for individual positions as well as the absorbed operating capital component and indicates the impact of diversification as compared to a building-block approach. The model reveals the change in credit risk over time based on various combinations of the variables under analysis, by legal entity, customer type, geographic area, economic sector, rating class and continental area.

Other information derived from the Credit Portfolio Model concerns "what-if" analyses produced for certain discriminating variables such as the Probability of default, LGD rates, changes in the value of collaterals and in margins available on the lines of credit in order to quantify the levels of Expected Loss and Economic Capital if the underlying (hypothetical or historical) assumptions prove to be true.

In accordance with the provisions of the Second Pillar of Basel 2, the Montepaschi Group is committed to the continuing development of methodologies and



models in order to assess the impact on the loan portfolio of stress conditions produced using sensitivity analyses with respect to individual risk factors or through scenario analyses. For further information, especially regarding the internal AIRB model, please refer to Table 7.

1.4 Operational risk

The Montepaschi Group has adopted a management system for operational risk, with the aim of guaranteeing effective risk prevention and mitigation measures. The management system consists in a structured process which identifies, assesses and monitors operational risks. This process is defined in the Group's Directive on the Management and Control of Operational Risk.

The management system adopted by the Group is divided into the following macro-processes:

- identification,
 - measurement,
 - monitoring,
 - management and control,
 - maintenance,
 - internal validation,
 - review.
- The organisational units of the various companies controlled by the Group are also involved in the processes.
- Corporate policies and procedures assign the task of operational risk control to the Risk Management Area. To this end, the Operational Risk Service has been set up within this Area and is responsible for:
- defining, developing and updating operational risk management and measurement systems;
 - coordinating data collection and storage systems;
 - the reporting system;
 - assessing the operational risk profile and measuring the relative capital adequacy requirements at both individual and consolidated levels.

The management and measurement model designed and implemented by the Montepaschi Group incorporates the following four components:



- internal data on operational loss;
- external data on operational loss;
- factors regarding the operating context and the internal controls system;
- scenario analyses.

Group has belonged since its founding in 2003. In addition to the complete utilisation of external loss data, the DIPO is also used for methodological purposes and for resolving any doubts in interpretation.

The classification of this data adopts the event and business line model established by Basel 2 and adds further classifications such as process, organisational unit, geographical area etc. The bank has defined a Loss Data Collection (LCD) process aimed at collecting and storing the data on operational risk: this includes both the information relating to the four components strictly provided for by the measurement system and other information considered significant for operating purposes.

The analysis of contextual and control factors identifies the operational vulnerabilities to which the bank is exposed. For the purpose of granularity of the analysis, which is carried out with the individual process owners through annual self assessments of operational risk control, the identification of vulnerabilities is a prospective evaluation aimed at highlighting the difficulties inherent in day-to-day operations.

The Loss Data Collection process has been designed to ensure that data is complete, reliable and up-to-date and, therefore, that the management and measurement system using it is effective. The single operational risk management application and the related database are also subject to business continuity and disaster recovery plans.

Lastly, the Montepaschi Group carries out scenario analyses for its Top Management on a yearly basis: the forward-looking analyses are aimed at measuring - in terms of capital - exposure to individual vulnerabilities with a view to capturing the developments in the business and organisational framework.

As far as the external data on operational loss is concerned, the Montepaschi Group has opted for a strongly prudential approach. External data derives from the Italian Operational Losses Database (Italian: DIPO) consortium to which the Montepaschi

To ensure the correct application of this methodology and its compliance with current regulations, the operational risk internal validation process has been allocated to the Risk Management Area. The quality of the operational risk management and measurement systems is assessed on an ongoing basis as is their compliance with



regulatory provisions, company needs and trends in the market of reference. Within this framework, it is also particularly important not only to verify the reliability of the methodology used in the calculation of capital adequacy, but also to ascertain the actual use of this system in decision-making processes as well as in the daily operational risk management systems.

Furthermore, the Risk Management Area is in charge of producing reports on the operational risk measurement and control system, both for the internal units and for the Supervisory Authorities. Each macro-process in which the system is structured produces its own report within a wider reporting framework. By defining a grid of contents, recipients and the frequency of updates, the objective of this activity is to ensure timely horizontal and vertical communication of information on operational risks among the different corporate units concerned.

Corporate regulations allocate the activity of internal review to the Internal Controls Area. This consists in periodic checks on the overall functioning of the Montepaschi Group's operational risk management and control systems, so as to achieve an independent and organic assessment in terms of efficiency and effectiveness. Once a year, the Internal Controls Area compiles a report updating the various company entities on the revision activities executed, specifically highlighting the vulnerabilities identified, the corrective measures proposed and the related findings.

For further information on Operational Risk, please refer to Table 12.

1.5 Market Risk in the Trading Book

The Montepaschi Group's Regulatory Trading Portfolio (RTP), or Trading Book, is made up of all the Regulatory Trading Books managed by the Parent Bank (BMPS), MPS Capital Services (MPSCS) and, to a smaller extent, by BiverBanca and the Irish subsidiary Monte Paschi Ireland. The addition of Banca Antonveneta to the Group in 2008 had no effect on the scope of the trading book since the management approach used called for centralising all market risks at BMPS and MPSCS. The portfolios of the other retail subsidiaries are immune to market risk since they only contain their own bonds held to service *retail* customers. Trading in derivatives, which are brokered on behalf of the same customers, also calls for risk to be centralised at, and managed by MPSCS.



The market risks of the trading book of both the Parent Company and the other Group companies (which are relevant as independent *market risk taking centres*), are monitored in terms of Value-at-Risk (VaR) for operational purposes.

The Group's Finance Committee is responsible for directing and coordinating the overall process of managing the Group's proprietary finance thereby ensuring that the management strategies of the various business units are consistent.

Market risk assumption, management and monitoring are governed Group-wide by a specific resolution approved by the Board of Directors.

The Montepaschi Group Trading Book is subject to daily monitoring and reporting by the Risk Management Area of the Parent Company on the basis of proprietary systems. VaR for management purposes is calculated independently from the trading units, using the internal model of risk measurement implemented by the Risk Management function in keeping with international best practices. The Group uses the standardised methodology in the area of market risk solely for reporting purposes.

Operating limits to trading activities, which are set by the Board of Directors of the Parent Company, are expressed by level of

delegated authority in terms of VaR, which is diversified by risk factors and portfolios, and in terms of monthly and annual Stop Loss. The limits are monitored on a daily basis.

In particular, the Trading Book's credit risk in addition to being included in VaR computations and in the respective limits for the credit spread risk component, is also subject to specific operating limits for issuer and bond concentration risk which specify maximum notional amounts by type of guarantor and rating class on all investments in debt securities (bonds and credit derivatives).

VaR is calculated with a 99% confidence interval and a holding period of 1 business day. The Group adopts the method of historical simulation with daily full revaluation of all basic positions, out of 500 historical entries of risk factors (lookback period) with daily scrolling. The VaR calculated in this manner takes account of all diversification effects of risk factors, portfolios and types of instruments traded. It is not necessary to assume, a priori, any functional form in the distribution of asset returns, and the correlations of different financial instruments are implicitly captured by the VaR model on the basis of the combined time trend of risk factors.

The daily management reporting flow on market risks is periodically transmitted to the General Manager, the Risk Committee,



the Chairman and the Board of Directors of the Parent Company within the Risk Management Report, which keeps Top Management and other senior management areas up to date on the overall risk profile of the Montepaschi Group.

The macro-categories of risk factors covered by the Internal Market Risk Model are as follows:

- interest rates on all relevant curves and relative volatilities;
- share prices, indexes, baskets and relative volatilities;
- exchange rates and relative volatilities;
- credit spread levels.

VaR (or diversified or net VaR) is calculated and broken down daily for internal management purposes, including with respect to other dimensions of analysis:

- organisational/management analysis of portfolios,
- analysis by financial instrument,
- analysis by risk family.

It is then possible to assess VaR along each combination of these dimensions in order to facilitate highly detailed analyses of events affecting the portfolios.

With particular reference to risk factors the following are identified: VaR Interest Rate,

VaR Equity, VaR Forex and VaR Credit Spread. The algebraic sum of these items gives the Gross VaR (or non-diversified VaR), which, when compared with diversified VaR, makes it possible to quantify the benefit of diversifying risk factors resulting from holding portfolios with asset class and risk factor allocations which are not perfectly correlated. This information can also be analysed along all the dimensions referenced above.

The model enables the production of diversified VaR metrics for essentially the entire Montepaschi Group in order to get an integrated overview of all the effects of diversification that can be generated among the various banks on account of the specific joint positioning of the various business units.

Moreover, scenario and stress-test analyses are regularly conducted on various risk factors with different degrees of granularity across the entire tree structure of the Group's portfolios and for all categories of instruments analysed. Stress tests are used to assess the bank's capacity to absorb large potential losses in extreme market situations, so as to identify the measures necessary to reduce the risk profile and preserve assets.

Stress tests are developed on the basis of discretionary and trend-based scenarios.



Trend-based scenarios are defined on the basis of real situations of market disruption previously recorded. Such scenarios are identified based on a timeframe in which risk factors were subjected to stress.

No particular scenarios are required with regard to the correlation among risk factors since trend-based data for the period identified is used.

Stress tests based upon discretionary scenarios assume extreme changes occurring to certain market parameters (interest rates, exchange rates, stock indices, credit spreads and volatility) and measure the corresponding impact on the value of portfolios, regardless of their actual development in the past. Simple discretionary scenarios are currently being developed (variation to a single

risk factor) as are multiple ones (variation to several risk factors simultaneously). Simple discretionary scenarios are calibrated to independently deal with one category of risk factors at a time, assuming the shocks do not spread to the other factors.

Multiple discretionary scenarios, on the other hand, aim to assess the impact of several shocks that simultaneously affect all types of risk factors.

1.6 Counterparty risk

Counterparty risk is linked to potential losses due to the default of counterparties in financial transactions prior to settlement and to financial instruments which have a positive value upon counterparty's default.

The financial instruments which point to this kind of risk:

- generate an exposure that is equal to their positive fair value;
- have a market value which evolves over time depending on underlying market variables;

- generate an exchange of payments or an exchange of financial instruments or goods against payment.

The prudential treatment of Counterparty Risk is applied to the following types of financial instruments:

- credit and financial derivative instruments traded Over The Counter (OTC derivatives);
- Securities Financing Transactions (SFTs), such as: repos and reverse repos on secu-



- rities or commodities, securities or commodities lending or borrowing transactions and borrowing on margin;
- Long Settlement Transactions (LSTs), such as: forward transactions in which a counterparty commits to delivering (receiving) a security, commodity or foreign currency against receipt (delivery) of cash payment, other financial instruments or goods with settlement upon a pre-established contractual date, later than the one determined by market practice for these types of transaction.

Book. As referred to in the Supervisory Regulations, when measuring exposure to Counterparty Risk, the Montepaschi Group adopts the regulatory current exposure method to determine the Exposure at Default (EAD) for OTC and LST transactions and the comprehensive approach to calculate EAD for SFT transactions.

For further quantitative details on Counterparty Risk, please refer to Table 9.

The scope of measurement for Counterparty Risk includes all banks and subsidiaries belonging to the Group and refers to positions held in the Banking Book and the Trading

1.7 Interest Rate risk in the Banking Book

In accordance with international best practices, the Banking Book refers to all of the commercial operations of the Parent Bank in relation to the transformation of maturities with respect to balance-sheet assets and liabilities, Treasury, foreign branches, and hedging derivatives of reference.

The scope of the Banking Book (in line with that for the regulatory book) and the ALM centralisation process are defined in a resolution by the Board of Directors of the Parent Bank which sets rules for centralised

Asset & Liability Management and operating limits for the interest rate risk of the Group Banking Book.

The Banking Book also includes active bonds held for investment purposes, classified as either AFS or L&R. The same ALM rate risk metrics of measurement used for other accounts were also applied to this aggregate.

The operational and strategic choices for the Banking Book, adopted by the Finance Committee and monitored by the Risk



Committee of the Parent Bank, are based first on exposure to interest rate risk by a variation in the economic value of the Banking Book assets and liabilities that is calculated by applying a parallel shift of 25bp, 100bp and 200bp, the latter in accordance with the requirements set out in the Second Pillar of Basel 2.

The Group adopts a rate risk governance and management system which, in accordance with the provisions of the Supervisory Authority, avails itself of:

- a quantitative model, which provides the basis for calculation of risk indicators for the interest rate risk exposure of the Group and Group companies/entities;
- risk monitoring processes, aimed at

ongoing verification of compliance with the operational limits assigned to the Group overall and to the individual business units;

- risk control and management processes, geared toward bringing about adequate initiatives for optimising the risk profile and activating any necessary corrective actions.

For further details on the methodologies developed in relation to the interest rate risk in the Banking Book (Banking Book ALM) and related quantitative findings, please refer to Table 14.

1.8 Liquidity Risk

The Montepaschi Group structurally addresses Liquidity Risk with a formal LR management policy which also complies with the Basel 2, Pillar 2 requirements.

- optimise the cost of funding in relation to current and future market conditions;
- adopt and maintain risk mitigation instruments.

The Group adopts a liquidity risk governance and management system which, in accordance with the provisions of the Supervisory Authority, pursues the following objectives:

- ensure the solvency of the Group and all its subsidiaries, both in 'business as usual' and in crisis conditions;

Within the above system, the following responsibilities are centralised in the Parent Bank:

- definition of Group policies for liquidity management and liquidity risk control;
- coordination of Group policies' implementation by the companies included in the scope;



- governance of the Group's short-, mid- and long-term liquidity position, both overall and at individual company level, through centralised operational management;
- governance and management of liquidity risk, both short- and long-term, ultimately guaranteeing the solvency of all subsidiaries.

In its steering function, the Parent Bank therefore defines criteria, policies, responsibilities, processes, limits and instruments for managing liquidity risk, both in business as usual and in liquidity stress and/or crisis conditions, formalising the Group's Liquidity Policy and Liquidity Contingency Plan.

The Group Companies included in the scope of application, to the extent that they exhibit a liquidity risk deemed significant, are responsible for abiding by the liquidity policies and limits defined by the Parent Bank and the capital requirements set by the relevant Supervisory Authorities.

The overall structural liquidity profile is monitored by quantifying the mismatches

of cash flows coming due, by maturity date. Items of an optional nature have representative models consistent with those used for interest rate risk.

The planning of the funding policies Group-wise (Funding Plan) is coordinated and directed by the Parent Company's Treasury and Capital Management Area (in cooperation with the Operational Planning Area), which:

- submits the plan of the initiatives to be taken in the financial markets to the Finance Committee for approval, with a view to achieving the objectives set by the business plan and in accordance with capital management requirements;
- coordinates access to the national and international, short- and long-term capital markets for all of the Group's banks, as well as access to ECB refinancing transactions and centralised management of mandatory reserves;
- makes projections on future liquidity on the basis of different market scenarios.

1.9 Equity investment risk

The methodology used to measure the price risk of the Montepaschi Group's equity investments portfolio is Value-at-Risk (VaR).

The VaR model used (contrary to the one used for the Trading Book) is a parametric model based on the traditional variance-



covariance matrix approach.

To estimate price volatility, the time series of market yields for listed companies and the time series of sector-based indices for unlisted ones are used.

The VaR of the equity investment portfolio is determined with a confidence interval of 99% and a holding period of 1 quarter, in line with the mid-long term holding periods of positions.

Moreover, the above-described model, developed and maintained by the Risk Management Area of the Parent Company, makes it possible to measure the marginal

risk contribution of each equity investment and to disaggregate the measurement made from the Group's perspective with respect to the investment shares held by each Legal Entity.

Risk analysis results are regularly entered in the risk reporting flow generated by the Risk Management Area and are submitted to the Parent Company's Risk Committee and Top Management.

1.10 Business Risk

Business Risk is a particular realm within Strategic Risk.

Using an internally-developed model, the Montepaschi Group constantly measures Business Risk, which is included in the calculation of the Group's Overall Internal Capital.

The main risk factors are identified in the:

- revenue volatility (particularly decreases); the item 'Net income from banking activities' is used as a proxy;
- cost volatility (particularly increases); the item 'Operating Expenses' is used as a proxy.

The algebraic sum of these two items is the Operating Income; this indicator is illustrative of the Group's earning capacity.

On the basis of these considerations, it is possible to define Business Risk as the volatility of the Operating Income, with a particular focus on the non-perfect correlation between net income and expenses. Indeed, the Economic Capital used to mitigate Business Risk is calculated as the capital required to cover the maximum mismatch between Net Income from banking activities and Operating expenses, assuming a sudden reduction in Net Income and an unexpected upturn in Expenses.



Internal Capital to face Business Risk is calculated on the basis of the Group's Operating Income (namely an indicator for the Bank's profitability) using an *Earnings at Risk* (EaR) parametric approach.

on the basis of data from the Consolidated Financial Statements.

The Economic Capital is quantified by the Risk Management Area of the Parent Company.

The time series of this indicator is provided monthly by the Operational Planning Area

1.11 Real estate risk

Real estate risk is the risk of incurring potential losses arising from unexpected changes in the value of the real estate portfolio as a result of the real estate market performance in general. The Risk Management Area believed it appropriate to adopt internal approaches for the quantification of Economic Capital for this particular type of risk. For operating purposes, the Montepaschi Group quantifies Real estate risk using a VaR type parametric approach, assuming normal distribution for the logarithmic returns of the Real estate portfolio, which can be broken down into the following stages:

- acquisition of data concerning the real estate portfolio and values of real estate indices;
- analytical correlation of each property with a suitable real estate benchmark index based upon the type of real estate, its use and its location;
- definition of annual logarithmic returns of all indices;
- calculation of the Economic Capital of the Real estate portfolio.

1.12 Risks inherent in investment products/services and Reputational Risk

The Montepaschi Group's organisational structure includes a specific unit dedicated to *wealth risk management*, to be understood as all activities for measurement and monitoring, as well as procedures for control of the risks and returns of investment services/products offered to customers. These activities particularly concern the operational procedures, tools and methods aimed at ensuring overall consistency between the customer's propensity for risk and his return expectations out of the risk



profile of the products, managed accounts and portfolios held in order to prevent and minimise the occurrence of reputational risks identifiable in the deterioration of the relationship of trust between Bank and customers.

All investment products (both Group and third-party), included in the catalogue of products offered to Group customers are subject, within a codified production-distribution supply-chain management process, to a specific multivariate qualitative risk assessment, including, market, credit and liquidity risk factors. The risk valuations are pegged to specific risk classes identified with specific legends, which are available to customers within information brochures regarding securities being placed and which therefore represent one of the guiding criteria on the basis of which the verifications of appropriateness and compliance provided for by the European MiFID regulations and by Consob Regulations. The same quantitative evaluation is also made for financial instruments purchased directly by customers and managed in portfolios under custody. Group customers are regularly informed of changes in the risk of the financial instruments held, so as to ensure timely informational transparency and facilitate possible decisions aimed at rebalancing the

risk profile of the investments held.

The interfunctional technical body, “Customer Protection”, a Montepaschi Group internal body set up in early July 2009, operates with the objective of identifying companies characterised by a particular temporary critical state, associated primarily with specific macroeconomic, corporate and/or sector-related situations or by a lack of sufficient market information, in order to assign a maximum level of risk to the financial instruments issued by them, which makes it impossible to offer them on an advisory basis and makes them inappropriate in terms of suitability.

Reputational risk, measured on the basis of the procedures outlined, is not included in the quantification of Economic Capital for the Montepaschi Group.

The charts below illustrate the treatment of risks under Pillars 1 and 2 as defined by Supervisory Regulations.

The salient features for each type of risk factor and the main as-is and to-be methodological activities, identified for self-assessment purposes are summarised below.



Pillar 1 risks

Type of risk	Current management	Present (as is) or future (to be) activities
Credit	<ul style="list-style-type: none">Internal Credit VaR Model, inclusive of inter-risk correlation.Measurement of Expected Loss and Economic Capital.	“Loss based” integrated internal model based on Montecarlo simulations.
	<ul style="list-style-type: none">Usual mitigations to reduce risk of losses.	Management of the credit portfolio
Market (Trading Book) and Counterparty	<ul style="list-style-type: none">Internal management model for Generic and Specific risks based on <i>historical simulation</i> with analytical <i>full revaluation</i>.	Evolution of risk-specific internal model.
	<ul style="list-style-type: none">Internal management model for specific risks with Credit Spread VaR	
	<ul style="list-style-type: none">Counterparty Risk: Current Value method.	Counterparty Risk: evolving towards EPE models via Montecarlo scenarios.
Operational	<ul style="list-style-type: none">Internal AMA model	Refinements
	<ul style="list-style-type: none">Mitigation and insurance allocation of risk.	



Table 1 General Requirements

Pillar 2 risks

Type of risk	Current management	Present (as is) or future (to be) activities
Concentration	<ul style="list-style-type: none"> Credit VaR internal model already includes concentration risk in the calculation of Economic Capital 	Further <i>clustering</i> refinements for concentration calculation
	<ul style="list-style-type: none"> Control and follow-up through internal policies, determination of concentration and entropy indices 	
Market (ALM Banking Book)	<ul style="list-style-type: none"> Internal Model based on the Economic Value approach, to determine the impact of interest rate variation on the bank's economic value (assets/liabilities) 	Update of behavioural models
	<ul style="list-style-type: none"> Use of maturity gap to determine the impact. Shift of 25 bp, 100 bp and 200 bp 	Refinements
	<ul style="list-style-type: none"> On demand items and <i>prepayment</i> have been modelled and are included in periodically submitted risk measures the model (prepayment rate model in particular). 	
Equity Investments	<ul style="list-style-type: none"> VaR Model based on direct observation or on <i>comparable</i> items. Variance/co-variance approach and equity VaR calculation 	Montecarlo simulation model
Liquidity	<ul style="list-style-type: none"> Cash flows mismatching model, <i>counterbalancing capacity</i> determination; setting of operational (short term) and structural (medium/long term) limits 	Model further developed
	<ul style="list-style-type: none"> Mitigation and control on the basis of liquidity policy 	Adjustment to new regulatory requirements
	<ul style="list-style-type: none"> Development of Contingency Plan 	
Business	<ul style="list-style-type: none"> Model based on internal estimates 	The model is being further developed.
Real Estate	<ul style="list-style-type: none"> Parametric VaR approach 	Refinements
	<ul style="list-style-type: none"> Normal log of yields 	
Reputation	<ul style="list-style-type: none"> Control based on specific organisational policies. 	reputational risk mitigation instruments are being issued.



1.13 An analysis of the Montepaschi Group's Economic Capital and the Risk Integration Model

The Overall Economic Capital is intended as the minimum amount of capital resources required to cover economic losses resulting from unforeseen events generated by the simultaneous exposure to different types of risk.

In order to quantify Economic Capital all types of risk come into play with the exception of liquidity and reputational risk which, instead, are mitigated through organisational policies and processes.

The Risk Management Area of the Parent Company periodically quantifies the Economic Capital for each type of risk, mainly on the basis of internally-developed models for each risk factor. The methodologies are largely developed with a Value-at-Risk (VaR) approach and are thus aimed at determining the maximum loss the Group may incur with a specific holding period and within a pre-set confidence interval.

For certain risk factors and specific portfolio categories (Credit Risk and Operational Risk in particular), the models were officially validated by the Supervisory Authorities for regulatory purposes. The outputs from the models developed internally for the different risk factors (validated and operational) constitute the main tool for

the day-to-day control and monitoring of the risk exposures generated in these areas and for the control of operating limits and delegated powers in accordance with the guidelines given and approved by the Parent Company.

The Economic Capital by risk factor, therefore, results from the corresponding operating metrics of risk quantification. VaR measurements by risk factor maintain their own "individual" validity in accordance with current regulations and international best practices and are determined with generally differentiated holding periods and confidence intervals.

The total of these micro risk-factors, which directly impact the Group's equity, is subject to regular measurement by the Parent Company's Risk Management Area which prepares all the periodical documentation for the Parent Company's Risk Committee and for the Board of Directors.

Instead, the Parent Company's Operational Planning & Control Area is responsible for reporting risk-adjusted performance results and determining the specific value creation in a risk-adjusted logic using metrics of measurement consistent with both the income and absorbed economic capital components. Moreover, it reformulates



the risk measures received from the Risk Management Area for the Group's individual legal entities and business units. The allocation of capital, in terms of balance, forecasts and periodical monitoring, is also determined –on the basis of measurements from the Risk Management Area- by Planning in conjunction with the corporate bodies of each legal entity, with specific reports prepared according to the individual business lines of the banks included in the scope of consolidation. The reports are submitted to the Parent Company's Risk Committee for approval.

The Overall Economic Capital is calculated by the Risk Management Area of the Parent Company through the application of a suitable method of integration and results from the combined measurement of each risk factor listed.

The measurements are standardised both in terms of time horizon (yearly holding period) and selected confidence interval (99.93%) - in line with the rating assigned to the Montepaschi Group by the official rating agencies – and are subject to intra-risk and inter-risk diversification processes.

The methodologies at the basis of integration are founded upon the principle that the overall internal capital needed to cover the Group's exposure to all risks, does not simply involve adding up the individual

risks (*building block approach*).

This principle lies in the imperfect correlation among the risk factors. The joint impact of all risk factors is usually less severe for the reason that, because they are not perfectly correlated, benefits may emerge from diversification.

The initial risk integration methodologies used by the Montepaschi Group were based upon the 'variance-covariance' approach.

In 2010, the integration methodology continued to be fine-tuned according to a multivariate "t-Student copula" approach.

Against a simpler and less expensive implementation in terms of IT software and calculation times, the variance-covariance model is penalised by extremely strong underlying methodological assumptions (all marginal distributions and the joint distribution of losses follow a Normal distribution pattern) and does not correctly capture the tail dependences which are, on the other hand, fundamental to determining Economic Capital with the percentiles normally used for this type of analysis.

Using the actual loss data observed, the "copula t-Student" model is capable of more efficiently modelling the correlation among risk factors, without making assumptions on the marginal distributions and more appropriately capturing the tail dependences (and therefore the extreme episodes of joint losses simultaneously linked to the



different risks.). In addition to being more robust, this approach also results as being more prudential. In order for this model to be implemented, it was necessary to retrieve and reconstruct the time series of risk factor-induced losses and engineer an IT and computational infrastructure capable of producing this kind of data.

The final output reveals the Overall Economic Capital or the Overall Internal Capital at Group-level, broken down by the different risk type, Legal Entity and business unit, indicating the impact of inter-risk diversification with respect to the building block approach which, on the other hand, does not entail quantification.

The calculation, analysis and reporting frequency with which the Group's Economic Capital is measured currently stands at one month. The table below illustrates the salient features of the individual internal models adopted by risk type, with the final column showing the result from their reconciliation and processing within a logic of risk integration for the purpose of calculating Economic Capital.



Main characteristics of models

Type of risks	Measure	Model	Risk factors	Correlation	Reconciliation
Performing loans	1 Y VaR, 99.93%	Beta Distribution weighted on Group parameters	PD and LGD differentiated by type of counterparty, CCF differentiated by product	Correlation based on multivariate analysis between internal default macroeconomic variables	t-Student Copula
Equity investments	3 M VaR, 99%	Parametric VaR	Volatility in stock prices and comparable indices	Correlations between stock prices and proxy indices	1 Y, 99.93%, t-Student Copula
Market (Banking Book)	1 Y, shift 25bp sensitivity	Maturity Gap	Bucketing on parallel and twist shift nodes of Interest rates		1 Y, 99.93%, t-Student Copula
Market (Trading Book)	1day VaR 99%	VaR historical simulation - full revaluation	All market risk factors (IR, EQ, FX, CS,...)	Implicit in the full revaluation historical simulation	1 Y, 99.93%, t-Student Copula
Operational	1 Y VaR, 99.9%	LDA integrated with external data, in addition to qualitative self assessment	Frequency and severity by event type	Perfect correlation for conservative reasons	99.93%, t-Student Copula
Business	1 Y EaR, 99%	Parametric EaR	Volatility of costs and revenues	Correlation between costs and revenues	99.93%, t-Student Copula
Real Estate	1 Y VaR, 99%	Parametric VaR	Volatility of real estate indices	Correlation between proxy indices	99.93%, t-Student Copula

Other measurable risk factors of significance (e.g. Issuer Risk, UCITS risk) are included in the Economic Capital, on an add-on, non-diversified basis.

Their quantification for Economic Capital purposes is carried out on the basis of methodologies borrowed from the regulatory supervisory approaches.

1.14 Stress Test Analyses

In compliance with the guidelines set forth by the Basel Committee and Best Practices, new prudential supervisory provisions for banks require credit institutions to carry out adequate stress testing exercises. Stress testing is commonly described as “the set of quantitative and qualitative techniques with which banks assess their vulnerability to exceptional but plausible events”. The objective is thus to evaluate the impact of a “state of the world” that is considered extreme, but which, despite a low probability of occurrence, may generate significant economic consequences for the Group.

Among the events considered plausible for the definition of tension-inducing scenarios, the following are to be taken into consideration:

- *trend-based scenarios*: assumptions are



made of shocks that are due to a combination of risk factors which were historically observed in the past and whose recurrence and plausibility retain a certain degree of likelihood and recurrence;

- *discretionary scenarios*: assumptions are made of shocks due to a combination of risk factors which may emerge in the near future, depending on the foreseeable environmental, social and economic developments.

Under 'exceptional events', low-frequency circumstances are considered, whose occurrence would have an extremely serious impact on the banking Group.

Within this area, the Montepaschi Group's methodological approach to stress-testing is based upon the identification of main risk factors whose objective is to select events or combinations of events (scenarios) which reveal specific vulnerabilities at Group-level. To this end, specific stress plans have been put in place on Pillar I risks (credit, market and operational) which were then made to converge – together with stress events designed ad hoc on other risk factors – into an overall Pillar II stress test plan, aimed at determining the potential impact on the Group within the ICAAP process.

With regard to Credit risk in particular, the Montepaschi Group has defined a macro-economic regression model to estimate the

variations in the Probability of Default as a function of changes in the main credit drivers. Credit drivers which significantly describe PD variations are identified beforehand. On the basis of the regression model, credit driver disturbances are then estimated according to the current and prospective economic situation. The shock applied to the *credit drivers* determines the change in credit portfolio PD, triggering the simulation of a hypothetical counterparty *downgrading*, with consequent risk variations in terms of Expected Loss, Unexpected Loss and input from new Defaults.

With regard to Operational Risk, appropriate historical scenarios are defined, which are relevant in terms of both *severity* and *frequency*. In this way, it is possible to evaluate the Group's vulnerability to exceptional events - in the case of severity - and plausible events, in terms of frequency.

As for Market Risk, stress tests consist in the definition of historical scenarios (main crises historically observed in international markets), or discretionary, isolating those components towards which the Group is particularly exposed and, therefore, more vulnerable. These stress events are applied and simulated upon Equity, Credit Spread, Forex and Interest Rate on a daily basis.

In terms of Counterparty, Concentration and Issuer Risk, a stress scenario has been defined that is consistent with the scenario



used for Credit Risk. For Equity Investment, Business and Real Estate, on the other hand, sensitivity tests are defined with respect to specific, appropriately identified risk factors, thus determining scenarios of maximisation of historical volatility for the indices of reference. With regard to Interest Rate Risk in the Banking Book, stress scenarios are defined and differentiated shocks are applied to the individual nodes of the curves for the terms of reference.

The results from the stress tests are submitted to the Top Management and Board of Directors. They are formally examined by the BoD as part of the ICAAP Annual Report approval process, with a view to providing a self-assessment of the current and prospective capital adequacy of the Montepaschi Group.

1.15 The Risk Disclosure Process

An effective Risk Management Process involves the setting up of a specific Risk Disclosure sub-process, with the intent to properly produce, distribute and communicate risk data to all relevant parties with appropriate timing and methods. This is, first and foremost, an internal management need for every bank, both with regard to awareness of corporate issues and in terms of input needed to make appropriate management choices when it comes to governance.

The importance of formalising an adequate internal process for the communication of relevant data is explicitly required by national legislation (see for ex. Bank of Italy's "Circular Letter no. 263/2006" and "Supervisory Provisions concerning Banks' Organisation and Corporate Governance" and by the main international bodies (Basel

Committee, CEBS, ...), for the purpose of increasing the awareness of corporate entities with regard to risk management at banking group level.

With regard to the Risk Disclosure Process, the Montepaschi Group has, over the years, prepared an overall framework of reference, through the following organisational and governance solutions:

- regulations governing the operations of the Parent Company's Risk Committee, with the explicit intention to regulate communication to the BoD of the documents discussed and the major decisions taken;
- organisational allocation of the Risk Management Area with direct reporting to the Chairman of the BoD, the CEO and a functional connection with the CFO,



with the aim of increasing the independence and effectiveness of its actions with respect to the Business Units and the related disclosure requirements;

- creation of Risk Disclosure Staff within the Risk Management Area of the Parent Company;
- regulations envisaging adequate risk reporting to be incorporated, for internal and external purposes, in all major Group directives concerning Risk, Internal Models, Financial Accounting and Public Disclosure. Furthermore, in the course of 2009 the BoD of the Parent Company issued a specific resolution, which established that an additional risk information flow be addressed, at least once a month, to the Chairman of the BoD, the Internal Controls Committee and the CEO with a summary of these risk reports being submitted to the BoD at least on a quarterly basis. This reporting flow should be intended as forming part of the Risk Management Area's regular disclosure on risk control. In this way, the intention was to further reinforce the risk communication process towards the Group's senior management.

The Risk Management Area includes the Risk Disclosure Staff, who have the task of supervising, developing and coordinating the Group's Risk Disclosure Model, through

the identification of all relevant players, systems, processes and reports. The Model is structured into two levels. At a first level:

- each Service of the Risk Management Area produces and validates its own Risk metrics based on its internal management models and autonomously governed procedures;
- each Service of the Risk Management Area produces its own operating Risk Reporting for internal operating purposes (i.e. validation report, control of operating limits) and for reconciliation with the BUs.

On a second level, the Risk Disclosure Staff starts from results produced by the various Services and summarizes the Management Risk Reporting for internal and external purposes;

- integrates the Management Risk Reporting with "key risk messages" highlighting issues of particular/critical significance, for submission to the Top Management and other Corporate Bodies;
- interfaces with Investor Relations, units under the relevant Manager in charge, the CFO, the CEO and Chairman *Business Management Offices* (it. Segreteria) on risk reporting issues.

By way of example, some salient features of the "Parent Company's Risk Committee Dislo-



sure” process are reported below. Pursuant to Regulation no. 1 of Banca MPS, the Parent Company’s Risk Committee is, *inter alia*, entrusted with the task of “[...] preparing the risk management policies to be submitted to the BoD, assess the Group’s risk appetite, in line with the Group’s annual and multiannual value creation objectives, verify and monitor the overall risk trends and the comprehensive compliance with the limits set at the various levels of operations. *In particular, [the Risk Committee] reviews the reports prepared by the functions in charge of positions exposed to the different risk factors measured and to the absorption of regulatory and economic capital [...]. It ensures that a comprehensive risk measurement and reporting system is maintained over time, through the production of appropriate management and operational reports*”.

Business management for the Committee is taken care of by the Risk Management Area, which is also in charge of drafting the documents for discussion.

The Committee’s main resolutions and a summary of its findings are later submitted to the BoD by way of a regular communication process.

Within the framework of all information flows directed to the Risk Committee, at least one Group-wide Report is envisaged to be drafted specifically by the Risk Manage-

ment Area (hereinafter the “Risk Management Report”) with the following items being its main focus.

With regard to the operational Economic Capital, analyses are carried out in order to:

- quantify and determine the absorption of the Montepaschi Group’s diversified and non- diversified Economic Capital by risk factor and Bank/BU.
- compare against budgeted risk appetite

As far as **Credit Risk** is concerned, analyses are mainly conducted on the following:

- *risks of the performing and defaulting loan portfolio by Legal Entity, Client Segment, Master Scale and Industrial clusters;*
- trends in the risks of the performing and defaulting loan portfolio;
- *quality breakdown* of the risks of the performing loan portfolio and composition of the defaulting loan portfolio;
- geographical and sectorial concentration analysis into different areas of economic activity.

With respect to **Assets & Liabilities Management**, analysis is mainly conducted on the following:

- impact on the economic value (Sensitivity), by Legal Entity, BU, curve bucket;
- analysis of Liquidity Risk
- analysis of on demand accounts
- monitoring of operating limits.



As for **Market Risk in the Trading Book**, analyses are mainly focused on:

- trend in the market risk profile of the Group's Trading Book: operational VaR;
- VaR disaggregation by Legal Entity and Risk Factor, diversified and non diversified VaR;
- main portfolio exposures; analysis of issuer risk; analysis of concentration risk; monitoring of operating limits.

In terms of Operational Risk, analyses are mainly conducted on the following:

- data on losses (quantitative information);
- major-impact losses tracked in the quarter and analysis of causes;
- Operational VaR analysis on different regulatory event types.

As needed, the Risk Management Report is integrated with specific points/issues of attention (i.e. Equity Investment Portfolio Risk Analysis, "ad hoc" simulations, Scenario/Stress analyses, etc.). The report also provides information with regard to progress made by the relevant units on main projects

underway, as well as regulatory updates and in-depth reviews of primary topics of interest that, on a case by case basis, result as being of particular importance. The basic contents of the Report enable the Risk Committee to gain a sufficiently complete – though concise – overview of the Montepaschi Group's main risks, highlighting any possible vulnerabilities in the overall risk profile and its development over time, risk concentration in specific segments or Business Units, tensions in terms of 'erosion' of the operating limits delegated to the BoD, exposures to new markets/risk factors. Analysis of the actual Economic Capital, in particular, makes it possible to assess the actual and prospective absorption at both cumulative level and with regard to each individual risk factor, even with reference to Second Pillar risks which fall within the assessment of Group Capital Adequacy for ICAAP purposes. Reporting is subject to continuous improvement with a view to making it increasingly more in line with control, operating guidance and corporate governance requirements.

1.16 Governance of the 'Pillar 3 (Third Pillar of Basel 2) - Disclosure to the Public' process

The process of the Third Pillar of Basel 2 ("Pillar3 - Disclosure to the Public") is internally regulated and governed by the Montepaschi Group in Regulation no. 1 of the Parent Company and a specific Group

Directive. The BoD, in its capacity as the Group's **Strategic Supervision Body**:

- defines the Disclosure to the Public process;
- approves the organisational procedures



and units identified, as well as Group guidelines on the definition of the table contents;

- approves periodic updates to the Pillar3 Report.

With regard to the Pillar 3 Disclosure production process, the **Managing Body**, represented by the Parent Company's General Management:

- defines the objectives, roles and responsibilities of the Group's units involved in the process;
- submits periodic Pillar3 report updates to the BoD.

The Pillar3 Report production process incorporates the following phases:

- Report definition;
- periodic drafting of the Report;
- data quality and overall consistency checks;
- Report approval and publication.

The Risk Disclosure Staff of the parent Company's Risk Management Area is responsible for the overall supervision and general coordination of the above-described process and for the final drafting of the Report. To this end, it avails itself of support from the following functions: Balance Sheet, Supervisory Reporting, Capital Adequacy Control and all other designated Group

functions which contribute to and validate the information falling within their spheres of competence. In the Montepaschi Group, a statement of responsibility by the Chief Reporting Officer is envisaged for the Pillar3 Report. With regard to the validation and approval process, the Pillar3 Report as a whole is shared by and between the Risk Management Area, the CFO and the Chief Reporting Officer. It is later forwarded to the CEO and eventually to the BoD for final approval.

Once BoD approval is obtained, the Report is published on the Montepaschi Group's website, as provided for by supervisory regulations.

The coordination function supports Investor Relations on Pillar3 related issues and collaborates in dealing with any feedback from the Market on these issues. The Parent Company's Risk Committee is informed of any irregularities detected in the review phase while drafting the Pillar3 Report.

In accordance with external provisions and with the internal controls system model adopted by the Montepaschi Group, the Internal Controls Area periodically reviews the entire process, with a view to verifying its set-up and making sure that implementation is appropriate and effective and results are correct.



Table 2 - Scope of application

Qualitative disclosure

The disclosure contained in this document (Disclosure to the Public) refers solely to the Monte dei Paschi di Siena “Banking Group” as defined by Supervisory provisions. It is noted no restrictions or other impediments exist that may prevent a prompt transfer of regulatory capital or funds within the Group. In compliance with supervisory provisions, there being no capital deficiencies at consolidated level, the individual capital requirement for the Group banks is reduced by 25%. It is further noted that no non-consolidated entities are included in the Montepaschi Group.



Quantitative disclosure

The following table reports all entities included in the scope of consolidation as at 31.12.2010:

Table 2.1 - Scope of consolidations as at 31.12.2010

	Registered office	Sector	Shareholding %	Type of relationship (a)	% voting rights (b)	Treatment in the Balance Sheet	Treatment for Supervisory purposes
BANCA MONTE DEI PASCHI DI SIENA S.p.a	Siena	Banking				Full	Full
MPS GESTIONE CREDITI S.p.a	Siena	Credit recovery management	100,00	1	100,00	Full	Full
MPS LEASING E FACTORING S.p.a	Siena	Leasing and factoring	100,00	1	100,00	Full	Full
MPS COMMERCIALE LEASING S.p.a	Siena	Leasing and factoring distribution through non-banking channels	100,00	1	100,00	Full	Full
BANCA MONTE PASCHI BELGIO S.A.	Bruxelles	Banking	100,00	1	100,00	Full	Full
MONTE PASCHI BANQUE S.A.	Parigi	Banking	100,00	1	100,00	Full	Full
MONTE PASCHI MONACO S.A.M.	Montecarlo	Banking	100,00	1	100,00	Full	Full
BANCA ANTONVENETA S.p.a	Padova	Banking	100,00	1	100,00	Full	Full
MPS CAPITAL SERVICE BANCA PER LE IMPRESE S.p.a	Firenze	Banking	99,92	1	99,92	Full	Full
MPS VENTURE SGR S.p.a	Firenze	Private equity fund management	70,00	1	70,00	Full	Full
BIVERBANCA CASSA RISP. BIELLA E VERCELLI S.p.a	Biella	Banking	60,42	1	60,42	Full	Full
BANCA POPOLARE DI SPOLETO S.p.a	Spoletto	Banking	26,01	7	26,01	Proportional	Proportional
MONTE PASCHI IRELAND LTD	Dublino	Financial activity	100,00	1	100,00	Full	Full
MONTE PASCHI FIDUCIARIA S.p.a	Siena	Trust company	100,00	1	100,00	Full	Full
CONSUM.IT S.p.a	Siena	Consumer credit	100,00	1	100,00	Full	Full
MPS TENIMENTI POGGIO BONELLI e CHIGI SARACINI SOCIETA' AGRICOLA S.p.a	Siena	Wine industry	100,00	1	100,00	Full	Full
MPS PREFERRED CAPITAL I LLC	Delaware	Financial vehicle	100,00	1	100,00	Full	Full
MPS PREFERRED CAPITAL II LLC	Delaware	Financial vehicle	100,00	1	100,00	Full	Full
MONTE PASCHI CONSEIL FRANCE SOCIETE PAR ACTIONS SEMPLIFIEE	Parigi	Financial Intermediary	100,00	1	100,00	Full	Full
MONTE PASCHI INVEST FRANCE SOCIETE PAR ACTIONS SEMPLIFIEE	Parigi	Financial Intermediary	100,00	1	100,00	Full	Full
MONTEPASCHI LUXEMBOURG S.A.	Bruxelles	Financial vehicle	100,00	1	100,00	Full	Full
ANTONVENETA CAPITAL LLC I	Delaware	Financial vehicle	100,00	1	100,00	Full	Full
ANTONVENETA CAPITAL LLC II	Delaware	Financial vehicle	100,00	1	100,00	Full	Full
ANTONVENETA CAPITAL TRUST I	Delaware	Financial vehicle	100,00	1	100,00	Full	Full
ANTONVENETA CAPITAL TRUST II	Delaware	Financial vehicle	100,00	1	100,00	Full	Full
AGRISVILUPPO S.p.a	Mantova	Financing for agricultural development	99,07	1	99,07	Full	Full
GIOTTO FINANCE 2 S.p.a	Padova	Special purpose vehicle	100,00	1	100,00	Full	Full
CIRENE FINANCE S.r.l	Conegliano	Special purpose vehicle	60,00	1	60,00	Full	Full



Table 2.1 - Scope of consolidation as at 31.12.2010 (continued)

	Registered office	Sector	Shareholding %	Type of relationship (a)	% voting rights (b)	Treatment in the Balance Sheet	Treatment for Supervisory purposes
ULISSE 2 S.p.a	Milano	Special purpose vehicle	100,00	1	100,00	Full	Full
INTEGRA S.p.a	Firenze	Consumer credit	50,00	7	50,00	Proportional	Proportional
MAGAZZINI GENERALI FIDUCIARI MANTOVA S.p.a	Mantova	Deposit and custody warehouses (for third parties)	100,00	1	100,00	Full	Full
MPS IMMOBILIARE S.p.a	Siena	Real estate	100,00	1	100,00	Full	Full
CONSORZIO OPERATIVO GRUPPO MPS	Siena	IT and Information services	99,79	1	99,79	Full	Full
MPS COVERED BOND S.r.l	Conegliano	Conegliano Special purpose vehicle	90,00	1	90,00	Full	Full
G.IMM.ASTOR S.r.l	Lecce	Real estate renting	52,00	1	52,00	Full	Full
MONTE PASCHI ASSURANCES FRANCE S.A	Parigi	Insurance	99,40	1	99,40	Full	Excl. from Cons.
IMMOBILIARE VICTOR HUGO S.C.I.	Parigi	Real estate	100,00	1	100,00	Full	Full

(a) Type of relationship:

1 majority of voting rights at ordinary shareholders' meetings

2 dominant influence at ordinary shareholders' meetings

3 agreements with other shareholders

4 other forms of control

5 unified management under art. 26.1 of Decree 87/92

6 unified management under art. 26.2 of Decree 87/92

7 joint control

(b) Actual voting rights in ordinary shareholders' meetings.



Table 3 - Regulatory capital structure

Qualitative disclosure

The regulatory capital and capital ratios are calculated on the basis of capital and P&L results as determined by applying the IAS/IFRS international accounting principles and taking account of the Supervisory instructions issued by the Bank of Italy in the thirteenth update to Circular no. 155/91 “Instructions for preparing reports on regulatory capital and prudential ratios” and in the sixth update to Circular no. 263/06 “New Regulations for the Prudential Supervision of Banks”.

The regulatory capital differs from net accounting equity as determined on the basis of IAS/IFRS international accounting principles, since Supervisory regulations are aimed at safeguarding capital quality and reducing the potential volatility induced by IAS/IFRS application.

The elements that constitute the regulatory capital need to be readily available to the Group, for them to be used, with no limitation, to absorb risks and corporate losses. These components need to be stable and their amount is stripped of any tax charges.

Regulatory capital is made up of basic capital and supplemental capital. Both core capital (Tier 1) and supplementary capital (Tier

2) are determined as the algebraic sum of all of their positive and negative items, subject to prior consideration of the so-called “prudential filters”.

This expression is understood as all those positive and negative items adjusting regulatory capital, introduced by regulatory authorities with the express purpose of reducing the potential volatility of capital. Deduction of the elements described in Table 3.1.1. must be taken from core and supplementary capital (50% from Tier 1 and 50% from Tier 2 capital).

**Table 3** Regulatory capital structure

Tier I capital

The main contractual characteristics of the innovative and non-innovative instruments which, together with share capital and reserves, are included in the calculation of Tier 1 capital, are summarised in the following table:

Features of subordinated instruments

Type of instrument	Interest rate	Step Up	Issue date	Maturity	Prepayment starting from	Curr.	Original amount in currency units	Contrib. to Reg. Capital (euro/ thousands)
F.R.E.S.H. (Floating Rate Exchangeable Subordinated Hybrid)	Euribor 3m + 88 bps	NO	30/12/2003	N.A.	(a)	EUR	700,000	470,596
Capital Preferred Securities I ^A tranche	Euribor 3m + 3.75 bps: from 21/03/2011 Euribor 3m + 562.5 bps	YES	21/12/2000	N.A.	(b)	EUR	80,000	80,000
Capital Preferred Securities II ^A tranche	Euribor 3m + 3.10 bps: from 27/09/2011 Euribor 3m + 465 bps	YES	27/06/2001	N.A.	(b)	EUR	220,000	220,000
Preferred Capital I LLC	7.59% fixed: from 07/02/2011 Euribor to 3m +390 bps	YES	07/02/2001	N.A.	(c)	EUR	350,000	350,000
"Tremonti bond"	8.50%	YES	30/12/2009	N.A.	(d)	EUR	1,900,000	1,900,000
Total Preference shares and capital instruments (Tier I)								3,020,596

(a) **F.R.E.S.H.** (Floating Rate Equity-linked Subordinated Hybrid) instruments, issued by vehicle "MPS Preferred Capital II LLC" for a nominal value of EUR 700 mln, are perpetual innovative instruments with no repayment or step-up clauses, which are convertible into shares. In September of each year from 2004 through 2009 and however, at any time effective as of 1 September 2010, the instruments are convertible upon investor request. In addition, an automatic conversion clause is provided for in the event that, after the seventh year from the issue date, the reference price of the ordinary shares should exceed a set amount. The return is not cumulative with the option of not paying the return itself if in the previous financial year the Bank did not have any distributable profit and/or did not pay any dividend to the shareholders. The unpaid return is considered definitely forfeited. The rights of the holders of the instruments are guaranteed on a subordinated basis. In the event of liquidation of the Parent Bank, the rights of the investors will be subordinated to all of the Parent Bank's creditors who are not equally subordinated, including holders of securities coming under Tier 2 capital and will override the rights of Parent Bank's shareholders. In virtue of these characteristics, these instruments can be calculated in the core Tier1 capital. The structure provided for the establishment of a limited liability company and of a business trust which issued convertible preferred securities and convertible trust securities, respectively.

The Parent Bank underwrote an on-lending contract as a contract of subordinated deposit.

The conditions of the on-lending contract are substantially

the same as the conditions of the convertible preferred securities.

There was no conversion in the course of 2010.

(b) **Securities are unredeemable**. Only a total and partial repayment option of the notes is provided for in favour of the issuer, exercisable respectively after 21/03/2011 and 27/09/2011. As reported to the market on 18 January 2011, the Parent Company took the decision not to exercise the option on the first tranche as at 21.03.2011 and to increase the spread to 630 bps.

(c) **Preference shares**, (CPS), amounting to a nominal value of EUR 350 mln, are unredeemable securities with a thirty year term. As communicated to the market on 18 January 2011, the Parent Company took the decision not to exercise the call option on these instruments, i.e. proceed with redemption upon the sole initiative of the issuer Banca Monte dei Paschi di Siena S.p.a, after 10 years from issue and upon prior approval of the Bank of Italy and increase the spread to 630 bps. .

(d) **Tremonti Bonds** are "Convertible financial instruments" issued by the Parent Bank pursuant to Art. 12 of Legislative Decree No. 185 of 28 November 2008, converted, with amendments, by Law No. 2 of 28 January 2009 ("Legislative Decree No. 185") on 30 December 2009 and subscribed by the Ministry of Economy and Finance (MEF). Interest is paid annually on the basis of a fixed 8.5% rate until 2010. These instruments are designed to strengthen the Group's regulatory capital position and support economic development with a particular focus on small-medium enterprises.



Table 3 Regulatory capital structure

Tier II capital

The following sections set out in tabular form the main contractual characteristics of the hybrid capital instruments and subordinated liabilities that contribute to supplementary capital.

Characteristics of subordinated instruments

Type of instruments	Interest rate	Step Up	Issue date	Maturity	Prepayment starting from	Curr.	Original amount in currency units	Contrib. to Reg. Capital (euro/ thousands)
Subordinated bond loan	4.875% fixed	NO	31-05-2006	31-05-2016	(*)	EUR	750,000	750,000
Subordinated bond loan	5.750% fixed	NO	31-05-2006	30-09-2016	(*)	GBP	200,000	290,162
Subordinated bond loan	Euribor 6m+ 2.50%	NO	15-05-2008	15-05-2018	(*)	EUR	2,160,558	2,151,293
Total Hybrid Instruments (Upper Tier II)								3,191,455
Subordinated bond loan	CMS Convexity Notes	NO	7-07-2000	7-07-2015	(*)	EUR	30,000	30,000
Subordinated bond loan	CMS Volatility Notes	NO	20-07-2000	20-07-2015	(*)	EUR	25,000	25,000
Subordinated bond loan	5.6 % fixed	NO	9-09-2010	9-09-2020	(*)	EUR	500,000	493,399
Subordinated bond loan	Euribor 3m+0.40 % until 30/11/2012, then Euribor 3m+1%	YES	30-11-2005	30-11-2017	30-11-2012	EUR	500,000	498,207
Subordinated bond loan	Euribor 3m+0.40% until 15/01/13, then Euribor 3m+1%	YES	20-12-2005	15-01-2018	15-1-2013	EUR	150,000	136,894
Subordinated bond loan	7.44% fisso	NO	30-06-2008	30-12-2016	(*)	EUR	250,000	247,895
Subordinated bond loan	Euribor 3m+0.60% until 1/11/07, then Euribor 3m+0.90%	YES	1-11-2002	1-11-2012	1-11-2007	EUR	75,000	27,903
Subordinated bond loan	Euribor 3m+1.40% until 30/04/2013, then Euribor 3m+2%	YES	30-04-2008	30-04-2018	30-4-2013	EUR	450,000	45
Subordinated debt ABN AMRO	Euribor 3m + 2.8%	NO	10-10-2006	10-10-2016	10-10-2011	EUR	400,000	400,000
Subordinated bond loan	6.4% until 31/10/2013, then Euribor 3m + 3%	YES	31-10-2008	31-10-2018	31-10-2013	EUR	100,000	108,620
Subordinated bond loan	7% fixed	NO	4-03-2009	4-03-2019	(*)	EUR	500,000	498,284
Subordinated bond loan	5% fixed	NO	21-04-2010	21-04-2020	(*)	EUR	500,000	491,397
Subordinated debt	adjustable	NO	30-09-2003	30-09-2013	30-9-2008	EUR	7,000	4,200
Subordinated debt	Euribor 6m+0.60%	NO	7-12-2005	7-12-2015	(*)	EUR	7,801	6,242
Subordinated debt	Euribor 6m+0.60%	YES	15-04-2008	15-04-2018	15-4-2013	EUR	3,901	2,126
Subordinated debt	Euribor 6m+0.60%	YES	18-04-2008	18-04-2018	18-4-2013	EUR	11,702	2,822
Total Subordinated Instruments (Lower Tier II)								2,973,034
Total Hybrid and Subordinated Instruments included in Tier II								6,164,489

(*) No pre-payment clauses are envisaged



Quantitative disclosure

Table 3.1 - Breakdown of Regulatory Capital

	dec-10	dec-09
Total Tier 1 positive items	17,962,240	17,689,738
Total Tier 1 negative items	7,959,141	8,028,078
Total items to be deducted	860,698	568,233
Tier 1 capital (Tier 1)	9,142,401	9,093,427
Total Tier 2 positive items	6,404,315	6,349,436
Total Tier 2 negative items	87,779	84,385
Total items to be deducted	860,698	568,233
Tier 2 capital (Tier 2)	5,455,838	5,696,818
Items to be deducted from Tier 1 and Tier 2 capital	454,700	409,818
Regulatory Capital	14,143,539	14,380,427
Tier 3 capital (Tier 3)	-	-
Regulatory Capital inclusive of Tier 3	14,143,539	14,380,427

Under the measures set forth by the Bank of Italy on 18 May 2010 regarding prudential filters for regulatory capital, the Group opted for the symmetrical treatment of revaluation reserves relating to debt securities issued by Central Governments of EU countries held in the "Available for Sale" portfolio. Consequently, for these securities, the impact of changes in AFS reserves upon regulatory capital as of 1 January 2010, amounting to approximately Euro 854.8 mln, has been completely sterilized.

In 2010, Regulatory capital (including Tier 3) decreased by approx. EUR 237 mln (-2%), totalling EUR 14,143.5 mln, compared to EUR 14,380.4 mln at the end of 2009. The reduction in Regulatory Capital is attributable to a decrease in Tier 2 capital of EUR 241 mln di Euro, only partially offset by the EUR 49 mln rise in Tier 1.

The Tier 1 increase was also positively influenced by:

- the capitalisation of profits for the year, in the amount of EUR 413.8 mln with an increase of 189 mln (+84%) towards the end of 2009;
- the net reduction in goodwill for approx. EUR 115.4 mln, mainly due to the disposal of branches (for appros. EUR 146 mln).

By contrast, it was negatively influenced by:

- the annual fee paid on account of the acquisition by the Parent Bank BMPS of the dividend entitlement acquired on 295,236,070 ordinary shares subscribed



by J.P. Morgan following the increase in shareholders' equity in 2008. The fee mentioned is influenced by the availability of profits;

- fixed interest rate (8.50% up to 2010) on the issue of the "Tremonti – Bonds";
- a greater difference between expected losses and the net value adjustments of EUR 265.6 mln (+62% vs. the end of 2009)

For the sake of completeness, it should be noted that for the purposes of consolidated capitalisation this does not contain the capital gain of EUR 405.5mln deriving from the demerger of the company "Consorzio Perimetro Proprietà Immobiliari", which was not included in the calculation of regulatory capital as at 31 December 2010, since not all related terms and conditions had yet been met on this date.

In 2010, the Tier 2 capital decreased by €241 mln, totalling EUR 5,455.8 mln, compared to EUR 5,696.8 mln at the end of 2009. The reduction is largely owing to the greater difference between expected losses and net value adjustments of EUR 265.6mln and to the increase in items to be deducted following the acquisition of the interest in the company, Asset Management Holding.

At 31 December 2010, there were no subordinate Tier 3 securities.

The regulatory capital quantified at 31 De-

cember 2010 also takes into account the items introduced by banks which apply internal models for the determination of capital requirements in view of credit and operational risks. Among such corrections we must mention the adjustments to be made directly to capital due to the differences resulting between overall impairment losses on loans and the respective expected losses quantified according to the criteria of internal models. For the Group, since the expected losses exceed the net impairment losses, the difference was deducted by 50% from Tier 1 capital and 50% from Tier 2 capital (table 3.1.1.).

The following table illustrates the constituents of Tier 1 and Tier 2, with a focus on the Group's most relevant aspects.



Table 3.1.1 - Breakdown of Tier 1 and Tier 2 Capital

	dec-10	dec-09
Share capital	3,782,216	4,553,774
Share premium	4,002,908	4,048,671
Reserves	5,964,635	5,842,272
Held-to-maturity innovative and non-innovative capital instruments	470,596	470,596
Innovative capital instruments	650,000	650,000
Grandfathered instruments	770,998	-
Profit for the period	413,764	224,426
Prudential filters: decreases in Tier 1 capital	1,907,123	1,900,000
Total Tier 1 positive items	17,962,240	17,689,738
Treasury shares	24,613	32,079
Goodwill	6,607,843	6,723,204
Other intangible assets	864,524	803,156
Loss for the period	-	-
Other negative items	-	-
Prudential filters: decreases in Tier 1 capital	462,161	469,639
Total Tier 1 negative items	7,959,141	8,028,078
Shareholdings in credit and financial institutions with a share of $\geq 20\%$ of the equity of the investee	100,438	50,566
Shareholdings in credit and financial institutions with a share of $> 10\%$ but $< 20\%$ of the equity of the investee	19,956	30,090
Shareholdings in credit and financial institutions with a share of $\leq 10\%$ of the equity of the investee	-	-
Shareholdings in insurance companies	49,461	62,332
Surplus of expected losses in respect of related write-downs	690,842	425,245
Total items to be deducted	860,698	568,233
Total Tier 1 capital	9,142,401	9,093,427



Table 3.1.1 - Breakdown of Tier 1 and Tier 2 Capital (continued)

	dec-10	dec-09
Valuation reserve	239,827	226,258
Held-to-maturity innovative and non-innovative capital instruments, not eligible for inclusion in Tier 1 capital	-	-
Non-innovative capital instruments not eligible for inclusion in Tier 1 capital	-	-
Hybrid capital instruments	3,191,454	3,191,978
Subordinated liabilities	2,973,034	2,931,200
Other positive items	-	-
Total Tier 2 positive items	6,404,315	6,349,436
Other negative items	2,730	5,462
Prudential filters: deductions from Tier 2 capital	85,049	78,923
Total Tier 2 negative items	87,779	84,385
Shareholdings in credit and financial institutions with a share of $\geq 20\%$ of the equity of the investee	100,438	50,566
Shareholdings in credit and financial institutions with a share of $> 10\%$ but $< 20\%$ of the equity of the investee	19,956	30,090
Shareholdings in insurance companies	49,461	62,332
Surplus of expected losses in respect of overall write-downs value adjustments	690,842	425,245
Total items to be deducted	860,698	568,233
Total Tier 2 capital	5,455,838	5,696,818
Items to be deducted from Tier 1 and Tier 2 capital	454,700	409,818
Regulatory Capital	14,143,539	14,380,427
Tier 3 Capital	-	-
Regulatory Capital inclusive of Tier 3	14,143,539	14,380,427



With regard to Tier 1, its positive items include: paid up capital, share premium, profit and capital reserves, innovative and non-innovative capital instruments and retained earnings; added to these items are the positive prudential filters represented by the issuance of so-called “Tremonti bonds”.

In fact, the Group has participated in the initiative brought about by the Ministry of Economy and Finance, aimed at ensuring an adequate flow of financing to the economy and an adequate level of capitalisation to the banking system. Pursuant to Art. 12 of Legislative Decree No. 185 of 28 November 2008, transposed, as amended, into Law no. 2 of 28 January 2009 (“Legislative Decree No. 185”), on 30 December 2009 the Group issued “Convertible financial instruments” (“Tremonti bonds”) subscribed by the Minister of Economy and Finance (MEF). The process for the issuance of the Tremonti bonds involved the Group in a number of activities aimed at fulfilment of the commitments undertaken upon signing of a “Memorandum of understanding.” In short, by signing the Memorandum of Understanding the group undertook to:

- have a code of ethics governing the compensation of corporate top managers and market traders;
 - provide adequate disclosure among its customers of the initiatives undertaken to implement the commitments signed.
- The negative items in the Tier 1 capital, on the other hand, include: treasury shares in the portfolio, intangible assets (including goodwill), any losses posted in previous years and in the current period, and the negative balance of the reserves for assets available for sale. With a specific regard to the treatment of AFS reserves under regulatory capital, this includes the prior offsetting of reserve balances - calculated net of tax if any - for debt securities on the one hand and equity securities on the other. Each of the two net balances determined in this way is, if negative, entirely deducted from Tier 1 while, if positive, is computed 50% in Tier 2. This treatment, defined as an *asymmetric* approach, was the only one applicable to AFS reserves by Italian banks until the end of 2009. In 2010, under the measures “Regulatory capital - prudential filters” of 18 May 2010, the Bank of Italy offered the possibility of opting for symmetrical treatment on debt securities issued by Central Governments of EU countries, as per CEBS guidelines which provide for the full neutralisation of AFS reserves for the



purposes of regulatory capital. The decision by Italian banks to opt for the symmetric approach, therefore, involves sterilisation of the impacts from positive and negative AFS reserves - formed as of 2010 - on regulatory capital relating to debt securities issued by the Central Governments of EU countries. The Montepaschi Group opted for the symmetric approach.

Among the negative prudential filters noted in the Tier 1 capital, the following are worth mentioning:

- the 50% decrease in net profits, already computed entirely in the basic capital, recognised on the profit and loss statements as a result of the accounting treatment of substitute tax due to the tax deduction for goodwill (regulations provide that such filters must be reduced by 1/8 per year in the years after the deduction);
- the net accrued capital gain (write-down of liabilities), net of tax effects, relative to hybrid capitalisation instruments and subordinated debt issued by the Group, classified among financial liabilities valued at fair value and computed in Tier 2.

The overall Tier 1 capital is made up of the difference between the algebraic sum of the positive and negative items and the items to be deducted, the criteria for the determination of which are indicated below:

- equity investments and other items (innovative capital instruments, hybrid capitalisation instruments and subordinate debt) issued by banks and financial firms not fully or proportionately consolidated are deducted 50% from the core capital and 50% from the supplementary capital. The regulations previously in force provided instead for deducting that aggregate from the sum of core and supplementary capital;
- the use of internal models for the determination of capital requirements in view of credit risks entails identifying in the regulatory capital the difference between expected losses and net impairment losses; if the expected losses exceed the impairment losses, the difference is deducted 50% from the Tier 1 capital and 50% from the supplementary capital; if the expected losses are lower than the net impairment losses, the difference is computed in the supplementary capital within the limit of 0.6% of credit risk weighted assets;
- the equity investments held in insurance companies and the subordinate debt issued by such companies are deducted 50% from Tier 1 and 50% from Tier 2 when they have been acquired after 20/07/2006; if they were acquired prior to that date, on the other hand, they continue to be deducted from the sum of



the core and supplementary capital until 31/12/2012.

As far as supplementary capital is concerned, the positive items comprising it include valuation reserves, hybrid capitalisation instruments, subordinated debt and the positive net balance of reserves for assets available for sale.

The negative items include the negative prudential filter proportionately at 50% of the positive balance of the AFS reserve computed among the positive items of the supplementary capital; in fact, these reserves are computed 50% in the supplementary capital. The overall supplementary capital is made up of the difference between the algebraic sum of the positive and negative items and the items to be deducted, determined according to the criteria described above.

As far as prudential filters are concerned, it is also worth mentioning the following:

- for hedging transactions, the profits and losses not realised on cash flow hedges, recognised in the appropriate reserve under shareholders' equity, are not computed in the regulatory capital
- as to fair value option liabilities of natural hedge both unrealised capital gains and capital losses recorded in the profit and

loss account are fully relevant except for the component due to changes in its creditworthiness;

- the equity investment in the Bank of Italy is not considered for purposes of quantifying capital and therefore the respective capital gain deriving from valuation at fair value is not computed in the reserves for instruments available for sale.



Table 4 – Capital adequacy

Qualitative disclosure

The capital management activity involves all the policies and choices necessary to define the size of the capital and the optimum combination between different alternate capitalization instruments, so as to ensure that the amount of capital and the correlated ratios are consistent with the risk profile assumed and so as to observe regulatory requirements. From this standpoint, Group-wide capital management has become increasingly more fundamental and strategic, taking into account that the quality and sizing of the capital resources of the individual companies that form part of it are defined in keeping with the more general objectives of the Group itself.

The Group is subject to the capital adequacy requirements established by the Basel Committee according to the rules defined by the Bank of Italy (“New prudential supervisory instructions for banks,” 6th update of Circular 263 of 27 December 2006 and “Instructions for preparing reports on regulatory capital and prudential ratios”, 13th update of Circular No. 155/91).

Based on such rules, the ratio between capital and risk weighted assets must be at least 8% on a consolidated level; compliance with the requirement on a consolidated basis is

verified every six months by the Bank of Italy. At the individual level, for banks belonging to a banking group, it is provided that the requirements in terms of credit, market, counterparty and operational risk are reduced by 25%, subject to meeting the afore-mentioned overall capital requirement of 8% on a consolidated basis.

Along with the observance of mandatory minimum capital ratios (“pillar one”), the regulations require the use of internal methodologies intended for determining current and future capital adequacy (“pillar two”).

The existence, along with the mandatory minimum ratios, of “pillar two” in fact expands the concept of capital adequacy, which takes on a more global connotation aimed at overall verification of capital needs and the sources actually available, consistent with the strategic and developmental objectives of the Group itself.

For purposes of ensuring continual and effective oversight of all aspects of capital adequacy, the Group recently introduced a Capital Adequacy Function, which plays a direct and coordinating role in monitoring the Group’s capital adequacy.

The function aims to:

- coordinate on an ongoing basis the dif-



<p>ferent activities carried out by other functions which directly or indirectly generate different impacts on current and future capitalisation levels;</p> <ul style="list-style-type: none">• monitor capital level on an ongoing basis;• implement effective capital management processes.	<p>processes deemed material and significant; the resulting output of this process contributes to the final evaluation of capital adequacy.</p> <p>The CFO is responsible for the ICAAP process, while the Capital Adequacy function coordinates the different functions involved and materially prepares the content of the report. Since ICAAP also requires an evaluation of future capital adequacy, the Group has implemented a structured capital simulation process, whereby it estimates future capital requirements and the associated regulatory capital ratios, the overall internal capital and the future AFRs. In addition, the outputs produced are redetermined subjecting the input variables to stress conditions, based on a hypothetical recessive scenario and prepared by the competent functions. Through this scenario, the overall impact on capital ratios is determined and the sustainability of the correlated contingency plans is evaluated.</p> <p>In addition to the above-described processes, a further method of monitoring capital adequacy is the activity of capital targeting – both regulatory and operational – which the Group has adopted, together with the Capital Planning activity, for several years now; These activities are at the basis of the Risk Appetite and Capital Allocation processes. The Capital Planning activity is geared towards identifying the dynamics of capital</p>
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and regulatory ratios, in line with current and future developments of the Group's activities and in consideration of market and regulatory potential changes.

The Capital Allocation activity, on the other hand, allows for making allocation of the internal capital to the Group's different business areas and territorial divisions, to which risk-adjusted income components are also allocated; All this is aimed at determining the creation of value and performance of each business unit, which allows for guiding value creation objectives by implementing risk-return remixing procedures among the different risk-taking entities or portfolios.

For this latter purpose, with the "Value Creation" Project, carried out by the Capital Adequacy function, a systematic analysis was begun of the added value with individual customers, aimed – through active management by the commercial network of inefficient capital positions – at reducing the operational absorption of internal capital, curbing the associated capital requirements and, in general, maximising the yield on portfolio assets. Periodic activity of monitoring the regulatory ratios ("pillar one") and the operational capital ratios ("pillar two"), together with space and time analyses of individual events that have an impact on the types of risk measured, allow for prompt intervention either through appropriate activities for redirecting the underlying operating assets

or through actions on capital aggregates. All this is aimed at observance of the adequacy indices set in the Business Plan and in the annual Risk Appetite.

Furthermore, a multi-period Capital Planning framework allows for evaluating the extent to which the Group's growth targets have been achieved, while the development of scenario or what-if analyses on capital adequacy levels, together with monitoring progress made on the achievement of capitalisation objectives, allows for an ex-ante understanding of specific operational policies and one-off operations.

In terms of action plans, observance of capital adequacy is sought through several levers, including of course those centred on the composition and level of capital (capital increases, convertible bonds, subordinate bonds, etc.), policies for optimisation and mitigation of all types of risks, such as, for example, those based on managing loans in keeping with the implied risk reflected by the type of counterparty or product, and, lastly, on policies for generating financing internally and correlated payout policies.



Quantitative disclosure

Effective as of 2008, the Group has been calculating prudential ratios in accordance with the principles contained in the New Accord on Capital Adequacy known as Basel II; additionally, following authorization from Supervisory Authorities, the Montepaschi Group has been using internal advanced ratings-based (AIRB) models since 30 June 2008 for the calculation of capital requirements for credit and operational risks, in relation to the regulatory “Retail exposures” and “Exposures to corporates” portfolio. The scope of application of the AIRB method as at today includes the Parent Company Banca MPS, MPS Capital Services Banca per le Imprese and Banca Antonveneta. Capital requirements against credit risk for the remaining portfolios and entities of the Group are calculated according to the standardized approach. Capital requirements in relation to market risk are instead calculated for all Group entities by adopting the standardized approach. Capital ratios for Operational Risk are calculated according to the AMA – Advanced Measurement Approach for an extent equal to 94.8% of the Banking Group’s scope, as estimated on the basis of consolidated income from banking activities as at 31.12.2010. The standardized approach is used for the remaining part of the scope. The consolidated requirement is conceived of as a sum of the individual requirements of

the individual entities of the Banking Group, net of exposures arising from intragroup relations falling within the calculations of credit, counterparty and settlement risk as well as application of adjustment factors (floors”).

The application of internal models is in fact allowed on condition that it is in compliance with a number of qualitative and quantitative limits set forth in the Supervisory regulations. In particular, limits are established (so-called “floors”), whereby any savings on capital obtained with the internal models is subject to maximums to be parameterised with respect to the requirements calculated based on the previous regulations (Basel I). Such limitations are expected to be eliminated in the future, taking into account the continuous fine-tuning and consolidation of the internal models adopted. In addition to the Total Capital Ratio, expressed as a ratio between regulatory capital and risk weighted assets which, pursuant to Basel 2 regulations, must be at least equal to 8% on a consolidated level, the Group ascertains its capital soundness also by means of its Tier 1 Ratio expressed as a ratio between Core Capital and risk-weighted assets.

The following table reports the Group’s capital requirements as at 31 December 2010 and 31 December 2009, calculated as indicated above, broken down by type of risk/methodology and related capital ratios.



Table 4.1 - capital requirements and capital ratios

	dec-10	dec-09
Credit Risk		
Standardised approach	4,481,841	6,453,797
Advanced Internal Rating Based approach	3,982,477	2,958,171
Total	8,464,318	9,411,968
Market Risk		
Standardised approach	504,848	580,144
Internal models approach	-	-
Concentration risk	-	-
Total	504,848	580,144
Operational Risk		
Foundation approach	52,016	53,714
Standardised approach	-	-
Advanced Measurement Approach	641,001	648,544
Total	693,017	702,258
Adjustment to capital requirements for intra-group transactions	-923,127	-1,072,389
Regulatory Capital Floor	-	49,961
Other requirements	-	-
Aggregate Capital Requirements	8,739,056	9,671,942
Risk-weighted assets	109,238,200	120,899,275
Tier 1 Ratio	8.4%	7.5%
Total Capital Ratio	12.9%	11.9%



Total risk-weighted assets as of 31 December 2010 amounted to EUR 109,238 mln, reporting a decrease (-10%) compared to the end of the previous financial year (see table 4.1). The reduction summarises the effect of multiple efficiency-boosting drivers in the risk weighting of the Montepaschi Group's exposures. The main ones include:

- the authorisation for advanced treatment of exposures of the former Banca Antonveneta merged into Monte dei Paschi and those of new Banca Antonveneta;
- the dynamics of risk allocation for less risky and/or more secure assets;
- increased alignment with the trends for the period, as far as the risk measures underlying regulatory models are concerned;
- lending models that increasingly factor in stricter regulatory obligations when setting traditional objectives.

The "floor", or level below which risk-weighted assets cannot fall, is currently calibrated at 85%, against a previous level of 90% for risk-weighted assets calculated on the basis of prior regulatory provisions in Basel 1. This new minimum level for 2011 completes the set of factors which lay down the conditions surrounding the origin of the RWA figure. The total of *risk-weighted assets* includes the assets of the company "Consorzio Perimetro Gestione Proprietà Immo-

biliari" - in line with the actions taken for the calculation of regulatory capital - since not all the conditions required for prudential recognition had yet been fulfilled on this date.

At the end of 2010, the Tier 1 capital ratio was 8.37%, while the total capital ratio was 12.95%.

The details of capital requirements broken down by type of risk and regulatory portfolio are reported in the following tables.



Table 4.2 - Capital Requirements for Credit Risk

Standardised approach	dec-10	dec-09
Exposures to central governments and central banks	1,555	363
Exposures to regional governments and local authorities	51,866	52,307
Exposures to non-commercial and public sector entities	72,564	81,787
Exposures to multilateral development banks	1	-
Exposures to international organisations	-	-
Exposures to supervised institutions	318,871	325,301
Exposures to corporates	2,293,335	3,778,744
Retail exposures	486,975	782,819
Exposures secured by real estate property	280,052	355,302
Past due exposures	155,621	448,817
High-risk exposures	101,398	96,606
Exposures in the form of covered bonds	562	-
Short term exposures to corporates	-	-
Exposures to Undertakings for Collective Investments in Transferable Securities (UCITS)	93,355	27,886
Other exposures	585,297	466,126
Securitisation exposures	40,390	37,739
Total Standardised Approach	4,481,841	6,453,797
Advanced Internal Ratings-Based approach		
Corporate exposures	2,795,957	2,186,615
Retail exposures	1,185,065	769,712
↳ Secured by real estate property	640,693	312,801
↳ Qualifying revolving retail exposures	484	36
↳ Other exposures	543,888	456,874
Other assets	1,455	1,844
Total Advanced Internal Ratings-Based approach	3,982,477	2,958,171
Total Credit Risk	8,464,318	9,411,968



Table 4.3 - Capital Requirements for Market Risk

Standardised approach	dec-10	dec-09
General market risk	238,863	337,647
Specific risk	167,430	179,507
Position risk of Undertakings for Collective Investments in Transferable Securities (UCITS)	43,238	29,874
Options	7,493	9,113
Foreign exchange risk	47,824	24,004
Commodities risk	-	-
Total Standardised Approach	504,848	580,144
Internal models		
Total Internal models	-	-
Concentration risk	-	54
Total Market Risk	504,848	580,144

Table 4.4 - Capital Requirements for Operational Risk

Breakdown of Operational Risk by:	dec-10	dec-09
Foundation approach	52,016	53,714
Standardised approach	-	-
Advanced approach	641,001	648,544
Total Operational Riski	693,017	702,258



Table 5 - Credit Risk: General disclosures for all banks

Qualitative disclosure

For classification of impaired loans into the various categories of risk (non-performing, watchlist, restructured and past due exposures), the Montepaschi Group refers to the regulations issued by the Bank of Italy, as supplemented with internal provisions which set out automatic criteria and rules for the transfer of receivables from and to different risk categories.

In line with supervisory definitions, impaired loans are intended to include the following:

- loans more than 180 days past due;
- restructured loans or loans being restructured;
- watchlist loans;
- non-performing loans

The definition of watchlist loans, following the amendment introduced by the Bank of Italy in the course of 2008, was broadened to include loans that are more than 270 days overdue.

Classification takes place independently, except for loans more than 180 days past due and watchlist loans more than 270 days past due, which are measured using automated procedures. With regard to other defaulted loan categories, the Montepaschi Group has drawn up an accurate process of classifica-

tion and determination of value adjustments to be applied based on the expertise of relationship managers and support provided by dedicated units specialised in the management of impaired loans.

When classifying loans as watchlist or non-performing, the relationship manager defines, on the basis of evidence available, an estimated measurement of failed recovery, broken down into exposure related to the actual loan and exposure related to interest and other expenses.

Subsequently, the head office departments specialised in the management of impaired loans periodically review these loan positions and the relative estimated failed recoveries, inserting changes, if any, in estimated losses.

These estimates are the calculation basis for the analytical valuation and subsequent determination of the balance sheet value adjustments.

Regarding the provisions made with respect to collaterals issued and obligations undertaken with third parties, if these are classified as defaulted, the same methodology is followed as the one described above.



Methodology for determining value adjustments

For the purpose of determining adjustments to the book-value of loans (customer loans, loans to banks, unsecured loans), an analytical and collective valuation is carried out considering the various levels of impairment as indicated below.

An **analytical assessment** is made of:

- nonperforming loans
- watchlist loans
- restructured loans

Whereas the following are subject to **collective assessment**:

- past due loans and/or overdrafts that are more than 180 days overdue
- exposures subject to country risk
- performing loans

In line with the indications set out in the Bank of Italy's recent update of Circular no. 262/2005, for loans past due and/or overdrawn for more than 180 days, the following tables, however, are reflective of an analytical assessment.

In the case of individually analysed positions, the amount of the valuation adjustment for each receivable is equal to the difference between the book value as of measurement date (amortised cost) and the actual value of the expected future cash flows as calculated by applying the original effective interest rate.

Expected cash flows take account of the expected repayment schedule, the expected recovery value of the collaterals, if any, as well as the costs expected to be incurred for the recovery of the credit exposure.

The value adjustment is posted to profit and loss under account 130 net adjustments/reversals due to impairment of loans. The adjustment component attributable to the discounting of cash flows is calculated on an accrual basis in accordance with the effective interest rate method and posted under reversals.

If the quality of the impaired receivable has improved to such a point that there is reasonable certainty of timely recovery of the principal and interest, its original value is reinstated in the following years to the extent in which the reasons determining the adjustment disappear, provided that such valuation can be objectively linked with an event which occurred after the adjustment.

The write-back is posted to the profit and loss statement and may not in any case exceed the amortised cost that the receivable would have had without prior adjustments.

Receivables with no objective evidence of loss are subject to a collective assessment of impairment. Such valuation, developed on the basis of a risk management model, is carried out by category, with receivables grouped together according to credit risk, and the relative loss percentages are estimat-



ed taking into account historical series based on elements noticeable on the date of valuation which allow an estimate of the value of latent loss in each category.

The model, for this type of valuation, involves the following steps:

- Segmentation of the loan portfolio by:
- Client segment (turnover);
- Economic business sector;
- Geographical location;
- Determination of the loss rate of individual portfolio segments, using the historical experience of the Group as reference.

The procedure for calculation of provisions in relation to guarantees issued and commitments with third parties, follows the same rules as those envisaged for provisions made with regard to cash positions included in the performing loan portfolio.

Value adjustments determined collectively are posted to the profit and loss statement. Any additional write-downs or write-backs are recalculated differentially, at year-end or on the dates of interim reports, with reference to the entire loan portfolio on the same date.



Quantitative disclosure

A breakdown of financial assets by portfolio 5.1.1 and 5.1.2 below.
lio and credit quality is reported in Tables

Table 5.1.1 - Summary of financial assets by portfolio

Portfolio	Total		Period average	
	dec-10	dec-09	dec-10	dec-09
1. Financial assets held for trading	33,250,441	23,178,781	32,007,606	22,637,675
2. Financial assets available-for- sale	19,475,910	12,527,322	16,049,094	9,027,984
3. Financial assets held-to-maturity	3	3	3	3
4. Loans and advances to banks	9,709,880	10,327,520	11,233,076	13,653,357
5. Loans and advances to customers	156,237,581	152,413,441	153,844,039	147,625,884
6. Financial assets designated at fair value	39,500	39,564	39,884	143,012
7. Financial assets held for sale	51,870	-	17,290	21,405
8. Hedging derivatives	313,412	198,703	237,917	142,034
Total	219,078,597	198,685,334		

Values reported in the tables above reflect those used in the Financial Statements and refer to positions in both the Banking Book and Regulatory Trading Book. Data reflects the logic of the Financial Statements and is therefore reported net of permitted offsetting, but does not take account of any credit risk mitigation actions.

The current table refers to Table A.1.1. of part E in the Consolidated Notes to the Financial Statements (Section. Credit Quality).



Table 5.1.2 - Breakdown of financial assets by portfolio and credit quality

Portfolio/Quality	NPLs	Watchlist loans	Restructured loans	Past-due	Other assets	Total
1. Financial assets held for trading	7,440	16,125	13,664	1,895	33,211,317	33,250,441
2. Financial assets available for sale	4,589	761	-	-	19,470,560	19,475,910
3. Financial assets held to maturity	-	-	-	-	3	3
4. Loans and advances to banks	4,824	10,662	-	103	9,694,291	9,709,880
4. Loans and advances to customers	5,485,087	4,014,586	1,248,738	632,244	144,856,926	156,237,581
6. Financial assets designated at fair value	-	-	-	-	39,500	39,500
7. Financial assets held for sale	-	-	-	-	51,870	51,870
8. Hedging derivatives	-	-	-	-	313,412	313,412
Total 31/12/2010	5,501,940	4,042,134	1,262,402	634,242	207,637,879	219,078,597
Total 31/12/2009	4,672,113	3,774,654	702,858	1,108,750	188,426,959	198,685,334

The table provides a breakdown of financial assets by accounting portfolio and credit quality. Values reported in the table reflect those used in the Financial Statements and refer to positions in both the Banking Book and Regulatory Trading Book. The current table refers to Table A.1.1 of Part E in the Consolidated Notes to the Financial Statements (Section Credit Quality)



Table 5.2 - On and off-balance sheet exposures to customers: geographical breakdown

ITALY	dec-10			dec-09		
	Exposure		Adjustments	Exposure		Adjustments
	Gross	Net		Gross	Net	
A. Balance-sheet exposures						
A.1 Non-performing loans	12,309,252	5,441,772	6,867,480	10,431,882	4,608,419	5,823,463
A.2 Watchlist loans	4,965,664	3,928,761	1,036,903	4,567,480	3,687,996	879,484
A.3 Restructured loans	1,336,347	1,241,621	94,726	726,042	701,346	24,696
A.4 Past due	674,839	631,399	43,440	1,173,964	1,106,177	67,787
A.5 Other exposures	171,127,292	170,318,237	809,055	139,827,960	139,020,657	807,303
Total A	190,413,394	181,561,790	8,851,604	156,727,328	149,124,595	7,602,733
B. Off-balance-sheet exposures						
B.1 Non-performing loans	93,895	72,412	21,483	99,088	79,334	19,754
B.2 watchlist credits	52,690	46,887	5,803	59,785	56,504	3,281
B.3 Other impaired assets	74,482	72,121	2,361	48,121	46,062	2,059
B.4 Other exposures	17,632,171	17,598,895	33,276	16,369,893	16,342,234	27,659
Total B	17,853,238	17,790,315	62,923	16,576,887	16,524,134	52,753
Total (A+B)	208,266,632	199,352,105	8,914,527	171,631,417	163,975,931	7,655,486

The table provides a geographical breakdown of balance-sheet and off-balance-sheet exposures to customers. Values reported in the table reflect those used in the Financial Statements (see Tab. B.2 in Part E of the Consolidated Notes) and refer to positions in both the Banking Book and Regulatory Trading Book.



Table 5.2 - On and off-balance sheet exposures to customers: geographical breakdown (continued)

OTHER EUROPEAN COUNTRIES	dec-10			dec-09		
	Exposure		Adjustments	Exposure		Adjustments
	Gross	Net		Gross	Net	
A. Balance-sheet exposures						
A.1 Non-performing loans	124,620	42,573	82,047	122,920	43,539	79,381
A.2 Watchlist loans	119,917	84,523	35,394	103,666	69,394	34,272
A.3 Restructured loans	7,494	7,117	377	-	-	-
A.4 Past due	848	804	44	2,163	2,054	109
A.5 Other exposures	6,525,062	6,518,978	6,084	25,611,516	25,605,444	6,072
Total A	6,777,941	6,653,995	123,946	25,840,265	25,720,431	119,834
B. Off-balance-sheet exposures						
B.1 Non-performing loans	-	-	-	-	-	-
B.2 watchlist credits	2,602	919	1,683	-	-	-
B.3 Other impaired assets	375	375	-	8,101	7,724	377
B.4 Other exposures	20,150,705	20,150,015	690	9,681,744	9,681,563	181
Total B	20,153,682	20,151,309	2,373	9,689,845	9,689,287	558
Total (A+B)	26,931,623	26,805,304	126,319	35,530,110	35,409,718	120,392

The table provides a geographical breakdown of balance-sheet and off-balance-sheet exposures to customers. Values reported in the table reflect those used in the Financial Statements (see Tab. B.2 in Part E of the Consolidated Notes) and refer to positions in both the Banking Book and Regulatory Trading Book.



Table 5.2 - On and off-balance sheet exposures to customers: geographical breakdown (continued)

USA	dec-10			dc-09		
	Exposure		Adjustments	Exposure		Adjustments
	Gross	Net		Gross	Net	
A. Balance-sheet exposures						
A.1 Non-performing loans	39,847	9,188	30,659	39,145	7,760	31,385
A.2 Watchlist loans	1,316	1,253	63	708	655	53
A.3 Restructured loans	-	-	-	-	-	-
A.4 Past due	20	19	1	457	447	10
A.5 Other exposures	742,030	740,223	1,807	805,397	803,824	1,573
Total A	783,213	750,683	32,530	845,707	812,686	33,021
B. Off-balance-sheet exposures						
B.1 Non-performing loans	543	434	109	645	516	129
B.2 watchlist credits	32	32	-	31	31	-
B.3 Other impaired assets	-	-	-	2	2	-
B.4 Other exposures	2,081,380	2,079,885	1,495	1,532,798	1,532,693	105
Total B	2,081,955	2,080,351	1,604	1,533,476	1,533,242	234
Total (A+B)	2,865,168	2,831,034	34,134	2,379,183	2,345,928	33,255

The table provides a geographical breakdown of balance-sheet and off-balance-sheet exposures to customers. Values reported in the table reflect those used in the Financial Statements (see Tab. B.2 in Part E of the Consolidated Notes) and refer to positions in both the Banking Book and Regulatory Trading Book.



Table 5.2 - On and off-balance sheet exposures to customers: geographical breakdown (continued)

ASIA	dec-10			dec-09		
	Exposure		Adjustments	Exposure		Adjustments
	Gross	Net		Gross	Net	
A. Balance-sheet exposures						
A.1 Non-performing loans	2,888	96	2,792	2,841	92	2,749
A.2 Watchlist loans	628	27	601	578	109	469
A.3 Restructured loans	-	-	-	-	-	-
A.4 Past due	7	7	-	22	21	1
A.5 Other exposures	145,210	144,532	678	148,465	147,808	657
Total A	148,733	144,662	4,071	151,906	148,030	3,876
B. Off-balance-sheet exposures						
B.1 Non-performing loans	-	-	-	-	-	-
B.2 watchlist credits	-	-	-	-	-	-
B.3 Other impaired assets	-	-	-	-	-	-
B.4 Other exposures	107,315	107,268	47	41,568	41,544	24
Total B	107,315	107,268	47	41,568	41,544	24
Total (A+B)	256,048	251,930	4,118	193,474	189,574	3,900

The table provides a geographical breakdown of balance-sheet and off-balance-sheet exposures to customers. Values reported in the table reflect those used in the Financial Statements (see Tab. B.2 in Part E of the Consolidated Notes) and refer to positions in both the Banking Book and Regulatory Trading Book.



Table 5.2 - On and off-balance sheet exposures to customers: geographical breakdown (continued)

REST OF THE WORLD	dec-10			dec-09		
	Exposure		Adjustments	Exposure		Adjustments
	Gross	Net		Gross	Net	
A. Balance-sheet exposures						
A.1 Non-performing loans	1,624	221	1,403	1,538	215	1,323
A.2 Watchlist loans	24	22	2	-	-	-
A.3 Restructured loans	-	-	-	-	-	-
A.4 Past due	15	15	-	27	26	1
A.5 Other exposures	685,228	684,814	414	691,945	691,616	329
Total A	686,891	685,072	1,819	693,510	691,857	1,653
B. Off-balance-sheet exposures						
B.1 Non-performing loans	-	-	-	-	-	-
B.2 watchlist credits	-	-	-	-	-	-
B.3 Other impaired assets	-	-	-	-	-	-
B.4 Other exposures	240,020	239,978	42	75,099	75,099	-
Total B	240,020	239,978	42	75,099	75,099	-
Total (A+B)	926,911	925,050	1,861	768,609	766,956	1,653

The table provides a geographical breakdown of balance-sheet and off-balance-sheet exposures to customers. Values reported in the table reflect those used in the Financial Statements (see Tab. B.2 in Part E of the Consolidated Notes) and refer to positions in both the Banking Book and Regulatory Trading Book.



Table 5.3 - On and off-balance-sheet exposures to banks: geographical breakdown

ITALY	dec-10			dec-09		
	Exposure		Adjustments	Exposure		Adjustments
	Gross	Net		Gross	Net	
A. Balance-sheet exposures						
A.1 Non-performing loans	6,000	-	6,000	6,000	-	6,000
A.2 Watchlist loans	3,056	2,392	664	-	-	-
A.3 Restructured loans	-	-	-	-	-	-
A.4 Past due	133	103	30	19	19	-
A.5 Other exposures	12,451,168	12,442,124	9,044	6,034,311	6,025,087	9,224
Total A	12,460,357	12,444,619	15,738	6,040,330	6,025,106	15,224
B. Off-balance-sheet exposures						
B.1 Non-performing loans	-	-	-	-	-	-
B.2 watchlist credits	503	503	-	-	-	-
B.3 Other impaired assets	144	137	7	1,109	1,054	55
B.4 Other exposures	3,153,548	3,153,480	68	2,619,355	2,618,854	501
Total B	3,154,195	3,154,120	75	2,620,464	2,619,908	556
Total (A+B)	15,614,552	15,598,739	15,813	8,660,794	8,645,014	15,780

The table provides a geographical breakdown of balance-sheet and off-balance-sheet exposures to banks. Values reported in the table reflect those used in the Financial Statements (see Tab. B.3 in Part E of the Consolidated Notes) and refer to positions in both the Banking Book and Regulatory Trading Book.



Table 5.3 - On and off-balance-sheet exposures to banks: geographical breakdown (continued)

OTHER EUROPEAN COUNTRIES	dec-10			dec-09		
	Exposure		Adjustments	Exposure		Adjustments
	Gross	Net		Gross	Net	
A. Balance-sheet exposures						
A.1 Non-performing loans	15,239	3,478	11,761	21,448	9,457	11,991
A.2 Watchlist loans	35,948	7,475	28,473	35,307	12,971	22,336
A.3 Restructured loans	-	-	-	-	-	-
A.4 Past due	-	-	-	-	-	-
A.5 Other exposures	4,012,305	4,010,623	1,682	6,721,729	6,719,388	2,341
Total A	4,063,492	4,021,576	41,916	6,778,484	6,741,816	36,668
B. Off-balance-sheet exposures						
B.1 Non-performing loans	-	-	-	-	-	-
B.2 watchlist credits	-	-	-	-	-	-
B.3 Other impaired assets	-	-	-	-	-	-
B.4 Other exposures	6,732,040	6,731,589	451	4,640,270	4,639,738	532
Total B	6,732,040	6,731,589	451	4,640,270	4,639,738	532
Total (A+B)	10,795,532	10,753,165	42,367	11,418,754	11,381,554	37,200

The table provides a breakdown by sector of balance-sheet and off-balance sheet exposures to banks. Values reported in the table reflect those used in the Financial Statements (see Tab. B.3 in Part E of the Consolidated Notes) and refer to positions in both the Banking Book and Regulatory Trading Book.



Table 5.3 - On and off-balance-sheet exposures to banks: geographical breakdown (continued)

USA	dec-10			dec-09		
	Exposure		Adjustments	Exposure		Adjustments
	Gross	Net		Gross	Net	
A. Balance-sheet exposures						
A.1 Non-performing loans	26,461	2,475	23,986	26,460	2,492	23,968
A.2 Watchlist loans	-	-	-	-	-	-
A.3 Restructured loans	-	-	-	-	-	-
A.4 Past due	-	-	-	-	-	-
A.5 Other exposures	559,507	555,252	4,255	518,447	518,362	85
Total A	585,968	557,727	28,241	544,907	520,854	24,053
B. Off-balance-sheet exposures						
B.1 Non-performing loans	-	-	-	-	-	-
B.2 watchlist credits	-	-	-	-	-	-
B.3 Other impaired assets	-	-	-	-	-	-
B.4 Other exposures	580,888	580,882	6	390,494	390,479	15
Total B	580,888	580,882	6	390,494	390,479	15
Total (A+B)	1,166,856	1,138,609	28,247	935,401	911,333	24,068

The table provides a breakdown by sector of balance-sheet and off-balance sheet exposures to banks. Values reported in the table reflect those used in the Financial Statements (see Tab. B.3 in Part E of the Consolidated Notes) and refer to positions in both the Banking Book and Regulatory Trading Book.



Table 5.3 - On and off-balance-sheet exposures to banks: geographical breakdown (continued)

ASIA	dec-10			dec-09		
	Exposure		Adjustments	Exposure		Adjustments
	Gross	Net		Gross	Net	
A. Balance-sheet exposures						
A.1 Non-performing loans	-	-	-	-	-	-
A.2 Watchlist loans	1,766	1,556	210	2,141	1,549	592
A.3 Restructured loans	-	-	-	-	-	-
A.4 Past due	-	-	-	-	-	-
A.5 Other exposures	213,894	213,660	234	407,479	407,103	376
Total A	215,660	215,216	444	409,620	408,652	968
B. Off-balance-sheet exposures						
B.1 Non-performing loans	-	-	-	-	-	-
B.2 watchlist credits	2,235	2,079	156	2,234	2,078	156
B.3 Other impaired assets	-	-	-	-	-	-
B.4 Other exposures	59,866	59,770	96	71,132	71,063	69
Total B	62,101	61,849	252	73,366	73,141	225
Total (A+B)	277,761	277,065	696	482,986	481,793	1,193

The table provides a breakdown by sector of balance-sheet and off-balance sheet exposures to banks. Values reported in the table reflect those used in the Financial Statements (see Tab. B.3 in Part E of the Consolidated Notes) and refer to positions in both the Banking Book and Regulatory Trading Book.



Table 5.3 - On and off-balance-sheet exposures to banks: geographical breakdown (continued)

REST OF THE WORLD	dec-10			dec-09		
	Exposure		Adjustments	Exposure		Adjustments
	Gross	Net		Gross	Net	
A. Balance-sheet exposures						
A.1 Non-performing loans	234	92	142	233	123	110
A.2 Watchlist loans	-	-	-	-	-	-
A.3 Restructured loans	-	-	-	-	-	-
A.4 Past due	-	-	-	-	-	-
A.5 Other exposures	99,170	99,108	62	344,346	344,306	40
Total A	99,404	99,200	204	344,579	344,429	150
B. Off-balance-sheet exposures						
B.1 Non-performing loans	-	-	-	-	-	-
B.2 watchlist credits	-	-	-	-	-	-
B.3 Other impaired assets	-	-	-	-	-	-
B.4 Other exposures	174,294	174,096	198	164,654	164,524	130
Total B	174,294	174,096	198	164,654	164,524	130
Total (A+B)	273,698	273,296	402	509,233	508,953	280

The table provides a breakdown by sector of balance-sheet and off-balance sheet exposures to banks. Values reported in the table reflect those used in the Financial Statements (see Tab. B.3 in Part E of the Consolidated Notes) and refer to positions in both the Banking Book and Regulatory Trading Book.



Table 5.4 - On- and off-balance sheet exposures to customers: breakdown by sector

Gouvernement and central Banks	dec-10				dec-09			
	Exposure		Adjustments		Exposure		Adjustments	
	Gross	Net	Specific	portfolio	Gross	Net	Specific	portfolio
A. Balance-sheet exposures								
A.1 Non-performing loans	29	-	29	x	27	-	27	x
A.2 Watchlist loans	-	-	-	x	-	-	-	x
A.3 Restructured loans	-	-	-	x	-	-	-	x
A.4 Past due	21	20	1	x	12	12	-	x
A.5 Other exposures	26,312,596	26,312,124	x	472	17,533,367	17,532,810	x	557
Total A	26,312,646	26,312,144	30	472	17,533,406	17,532,822	27	557
B. Off-balance-sheet exposures								
B.1 Non-performing loans	-	-	-	x	-	-	-	x
B.2 watchlist credits	-	-	-	x	-	-	-	x
B.3 Other impaired assets	-	-	-	x	-	-	-	x
B.4 Other exposures	5,817,490	5,817,490	x	-	982,094	982,094	x	-
Total B	5,817,490	5,817,490	-	-	982,094	982,094	-	-
Total (A+B)	32,130,136	32,129,634	30	472	18,515,500	18,514,916	27	557

X: value attributable

The table provides a breakdown by sector of balance-sheet and off-balance-sheet exposures to customers. Values reported in the table reflect those used in the Financial Statements (see Tab. B.1 in Part E of the Consolidated Notes) and refer to positions in both the Banking Book and Regulatory Trading Book.



Table 5.4 - On- and off-balance sheet exposures to customers: breakdown by sector (continued)

Other public entities	dec-10				dec-09			
	Exposure		Adjustments		Exposure		Adjustments	
	Gross	Net	Specific	portfolio	Gross	Net	Specific	portfolio
A. Balance-sheet exposures								
A.1 Non-performing loans	748	478	270	x	565	438	127	x
A.2 Watchlist loans	48	13	35	x	44	11	33	x
A.3 Restructured loans	-	-	-	x	-	-	-	x
A.4 Past due	-	-	-	x	-	-	-	x
A.5 Other exposures	4,185,257	4,183,674	x	1,583	3,833,935	3,831,776	x	2,159
Total A	4,186,053	4,184,165	305	1,583	3,834,544	3,832,225	160	2,159
B. Off-balance-sheet exposures								
B.1 Non-performing loans	-	-	-	x	-	-	-	x
B.2 watchlist credits	-	-	-	x	-	-	-	x
B.3 Other impaired assets	-	-	-	x	-	-	-	x
B.4 Other exposures	587,521	587,513	x	8	339,966	339,946	x	20
Total B	587,521	587,513	-	8	339,966	339,946	-	20
Total (A+B)	4,773,574	4,771,678	305	1,591	4,174,510	4,172,171	160	2,179

X : value not attributable

The table provides a breakdown by sector of balance-sheet and off-balance-sheet exposures to customers. Values reported in the table reflect those used in the Financial Statements (see Tab. B.1 in Part E of the Consolidated Notes) and refer to positions in both the Banking Book and Regulatory Trading Book.



**Table 5.4 - On- and off-balance sheet exposures to customers:
breakdown by sector (continued)**

Financial companies	dec-10				dec-09			
	Exposure		Adjustments		Exposure		Adjustments	
	Gross	Net	Specific	portfolio	Gross	Net	Specific	portfolio
A. Balance-sheet exposures								
A.1 Non-performing loans	131,772	25,987	105,785	x	134,771	28,313	106,458	x
A.2 Watchlist loans	126,844	59,599	67,245	x	75,152	28,390	46,762	x
A.3 Restructured loans	21	21	-	x	-	-	-	x
A.4 Past due	21,814	20,600	1,214	x	1,852	1,769	83	x
A.5 Other exposures	17,957,464	17,945,159	x	12,305	16,592,581	16,573,575	x	19,006
Total A	18,237,915	18,051,366	174,244	12,305	16,804,356	16,632,047	153,303	19,006
B. Off-balance-sheet exposures								
B.1 Non-performing loans	200	160	40	x	1,197	958	239	x
B.2 watchlist credits	26	24	2	x	1,307	1,305	2	x
B.3 Other impaired assets	-	-	-	x	5,279	5,014	265	x
B.4 Other exposures	6,322,609	6,320,464	x	2,145	3,651,788	3,650,845	x	943
Total B	6,322,835	6,320,648	42	2,145	3,659,573	3,658,124	506	943
Total (A+B)	24,560,750	24,372,014	174,286	14,450	20,463,929	20,290,171	153,809	19,949

X: value not attributable

The table provides a breakdown by sector of balance-sheet and off-balance-sheet exposures to customers. Values reported in the table reflect those used in the Financial Statements (see Tab. B.1 in Part E of the Consolidated Notes) and refer to positions in both the Banking Book and Regulatory Trading Book.



**Table 5.4 - On- and off-balance sheet exposures to customers:
breakdown by sector (continued)**

Insurance companies	dec-10				dec-09			
	Exposure		Adjustments		Exposure		Adjustments	
	Gross	Net	Specific	portfolio	Gross	Net	Specific	portfolio
A. Balance-sheet exposures								
A.1 Non-performing loans	247	146	101	x	13	10	3	x
A.2 Watchlist loans	-	-	-	x	20	14	6	x
A.3 Restructured loans	-	-	-	x	-	-	-	x
A.4 Past due	-	-	-	x	-	-	-	x
A.5 Other exposures	1,335,747	1,335,579	x	168	797,370	795,854	x	1,516
Total A	1,335,994	1,335,725	101	168	797,403	795,878	9	1,516
B. Off-balance-sheet exposures								
B.1 Non-performing loans	-	-	-	x	-	-	-	x
B.2 watchlist credits	-	-	-	x	-	-	-	x
B.3 Other impaired assets	-	-	-	x	-	-	-	x
B.4 Other exposures	1,528,490	1,528,478	x	12	1,161,501	1,161,358	x	143
Total B	1,528,490	1,528,478	-	12	1,161,501	1,161,358	-	143
Total (A+B)	2,864,484	2,864,203	101	180	1,958,904	1,957,236	9	1,659

X: value not attributable

The table provides a breakdown by sector of balance-sheet and off-balance-sheet exposures to customers. Values reported in the table reflect those used in the Financial Statements (see Tab. B.1 in Part E of the Consolidated Notes) and refer to positions in both the Banking Book and Regulatory Trading Book.



**Table 5.4 - On- and off-balance sheet exposures to customers:
breakdown by sector (continued)**

Non-financial companies	dec-10				dec-09			
	Exposure		Adjustments		Exposure		Adjustments	
	Gross	Net	Specific	portfolio	Gross	Net	Specific	portfolio
A. Balance-sheet exposures								
A.1 Non-performing loans	10,320,032	4,526,370	5,793,662	x	8,697,862	3,841,865	4,855,997	x
A.2 Watchlist loans	4,256,618	3,413,644	842,974	x	3,780,228	3,080,167	700,061	x
A.3 Restructured loans	1,342,288	1,247,224	95,064	x	724,911	700,273	24,638	x
A.4 Past due	382,670	362,936	19,734	x	803,418	761,841	41,577	x
A.5 Other exposures	82,912,578	82,251,563	x	661,015	84,152,928	83,484,908	x	668,020
Total A	99,214,186	91,801,737	6,751,434	661,015	98,159,347	91,869,054	5,622,273	668,020
B. Off-balance-sheet exposures								
B.1 Non-performing loans	93,760	72,236	21,524	x	98,142	78,544	19,598	x
B.2 watchlist credits	52,756	45,333	7,423	x	57,143	53,926	3,217	x
B.3 Other impaired assets	72,129	69,839	2,290	x	49,663	47,534	2,129	x
B.4 Other exposures	25,192,375	25,159,405	x	32,970	20,086,061	20,059,594	x	26,467
Total B	25,411,020	25,346,813	31,237	32,970	20,291,009	20,239,598	24,944	26,467
Total (A+B)	124,625,206	117,148,550	6,782,671	693,985	118,450,356	112,108,652	5,647,217	694,487

X: value not attributable

The table provides a breakdown by sector of balance-sheet and off-balance-sheet exposures to customers. Values reported in the table reflect those used in the Financial Statements (see Tab. B.1 in Part E of the Consolidated Notes) and refer to positions in both the Banking Book and Regulatory Trading Book.



**Table 5.4 - On- and off-balance sheet exposures to customers:
breakdown by sector (continued)**

Other	dec-10				dec-09			
	Exposure		Adjustments		Exposure		Adjustments	
	Gross	Net	Specific	portfolio	Gross	Net	Specific	portfolio
A. Balance-sheet exposures								
A.1 Non-performing loans	2,025,403	940,869	1,084,534	x	1,765,086	789,399	975,687	x
A.2 Watchlist loans	704,039	541,330	162,709	x	816,988	649,571	167,417	x
A.3 Restructured loans	1,532	1,493	39	x	1,130	1,073	57	x
A.4 Past due	271,224	248,688	22,536	x	371,353	345,102	26,251	x
A.5 Other exposures	46,521,180	46,378,685	-	142,495	42,502,302	42,377,627	x	124,675
Total A	49,523,378	48,111,065	1,269,818	142,495	45,456,859	44,162,772	1,169,412	124,675
B. Off-balance-sheet exposures								
B.1 Non-performing loans	479	451	28	x	393	348	45	x
B.2 watchlist credits	2,541	2,480	61	x	1,366	1,304	62	x
B.3 Other impaired assets	2,728	2,657	71	x	1,282	1,239	43	x
B.4 Other exposures	763,106	762,691	x	415	1,479,693	1,479,297	x	396
Total B	768,854	768,279	160	415	1,482,734	1,482,188	150	396
Total (A+B)	50,292,232	48,879,344	1,269,978	142,910	48,612,394	47,317,761	1,169,562	125,071

X: value not attributable

The table provides a breakdown by sector of balance-sheet and off-balance-sheet exposures to customers. Values reported in the table reflect those used in the Financial Statements (see Tab. B.1 in Part E of the Consolidated Notes) and refer to positions in both the Banking Book and Regulatory Trading Book.



Table 5.5 - Time breakdown by contractual residual maturity of financial assets

Account/Maturity	On demand	1 to 7 days	7 to 15 days	15 days to 1 month	1 to 3 months	3 to 6 months	6 months to 1 year	1 to 5 years	Over 5 years	Unspecified maturity
Governement securities	3	792,137	719,644	1,414,736	2,206,817	684,462	608,961	7,865,626	10,160,890	-
Other debt securities	576,553	72,722	97,431	197,823	1,006,978	594,381	877,693	3,317,069	3,410,604	8,904
Units in UCITS	1,358,099	-	-	-	-	-	-	3,274	14,442	-
Loans	31,132,110	3,551,233	2,831,580	8,077,229	10,257,782	13,113,624	10,677,396	34,732,554	52,987,919	773,085
- to banks	4,840,301	1,073,747	554,162	2,262,830	483,735	915,559	839,098	235,629	12,318	12,609
- to customers	26,291,809	2,477,487	2,277,419	5,814,400	9,774,047	12,198,065	9,838,298	34,496,925	52,975,601	760,477
Balance sheet assets (31/12/2010)	33,066,766	4,416,092	3,648,656	9,689,788	13,471,578	14,392,467	12,164,050	45,918,523	66,573,853	781,989
Balance sheet assets (31/12/2009)	33,436,405	11,380,994	2,234,601	5,102,192	7,172,058	13,926,932	11,827,387	41,590,341	58,644,139	2,713,236
Financial derivatives with exchange of principal	508,791	5,414,268	427,927	4,035,369	8,461,926	2,178,235	2,398,511	4,186,023	1,478,791	14,597
- Long positions	257,766	2,514,638	219,646	2,128,682	4,260,840	1,300,258	1,238,816	2,053,697	374,697	7,298
- Short positions	251,025	2,899,630	208,281	1,906,686	4,201,086	877,977	1,159,696	2,132,326	1,104,095	7,298
Financial derivatives without exchange of principal	601,245	2,706,121	753,932	775,887	4,597,220	3,609,945	6,105,965	14,571,949	10,168,962	-
- Long positions	343,534	1,350,475	379,092	437,116	2,340,643	1,834,025	3,026,758	7,364,539	5,504,970	-
- Short positions	257,711	1,355,646	374,840	338,772	2,256,577	1,775,920	3,079,208	7,207,410	4,663,992	-
Deposits and borrowings receivable	429,476	-	11,338	415,428	135	8,232	332	-	-	-
- Long positions	429,476	-	2,761	-	67	-	166	-	-	-
- Short positions	-	-	8,577	415,428	67	8,232	166	-	-	-
Irrevocable commitments to disburse funds	8,643,489	7,045	5,543	422,446	708,460	1,353,641	2,044,990	46,361,884	12,507,360	561,871
- Long positions	1,165,658	1,956	5,543	222,446	468,508	819,086	1,228,326	23,485,729	8,630,176	479,022
- Short positions	7,477,831	5,089	-	200,000	239,952	534,555	816,665	22,876,154	3,877,184	82,849
Financial guarantees issued	413	-	2	9	28	413	75	1,417	1,121	59,067
Off-balance sheet transactions (31/12/2010)	10,183,413	8,127,434	1,198,742	5,649,139	13,767,768	7,150,467	10,549,873	65,121,272	24,156,234	635,535
Off-balance sheet transactions (31/12/2009)	22,301,028	4,192,217	5,567,516	6,703,942	13,853,690	32,822,094	14,326,431	58,263,189	44,249,036	697,982

The table reports the time breakdown of financial assets by residual contractual life. Values reported in the table reflect those used in the Financial Statements and refer to positions in both the Banking Book and Regulatory Trading Book.



Table 5.6 - Balance sheet exposures to banks: changes in overall value adjustments

Source/Categories	NPLs	Watchlist	Restructured	Past due	Total 31/12/2010	Total 31/12/2009
A. Gross exposure, opening balance	42,070	22,928	-	1	64,999	70,043
↳ of which: financial assets sold and not derecognised	-	-	-	-	-	-
B. Increases	3,709	7,236	-	29	10,974	13,905
B.1 Value adjustments	3,630	7,236	-	29	10,895	12,416
B.2 Transfers from other impaired exposures	-	-	-	-	-	-
B.3 Other increases	79	-	-	-	79	1,489
C. Reductions	3,890	817	-	-	4,707	18,949
C.1 Writebacks from evaluation	271	449	-	-	720	678
C.2 Writebacks from recoveries	3,619	-	-	-	3,619	-
C.3 Write-offs	-	368	-	-	368	-
C.4 Transfers to other impaired exposures	-	-	-	-	-	-
C.5 Other reductions	-	-	-	-	-	18,271
D. Gross exposure, closing balance	41,889	29,347	-	30	71,266	64,999
↳ of which: financial assets sold and not derecognised	-	-	-	-	-	-

The values reported are compiled according to the rules used for table A 1.5 in Part E of the Notes to the Consolidated Financial Statements (Section A "Credit Quality")



Table 5.7 - Balance sheet exposures to customers: changes in overall value adjustments

Source/Categories	NPLs	Watchlist	Restructured	Past due	Total 31/12/2010	Total 31/12/2009
A. Gross exposure, opening balance	5,938,301	914,279	24,695	67,909	6,945,184	5,543,068
↳ of which: financial assets sold and not derecognised	-	-	-	-	-	762,456
B. Increases	1,855,644	617,763	82,385	47,322	2,603,114	2,551,571
B.1 Value adjustments	1,433,028	588,970	70,576	39,546	2,132,120	2,026,318
B.2 Transfers from other impaired exposures	215,502	7,161	6,707	550	229,920	252,744
B.3 Other increases	207,114	21,632	5,102	7,226	241,074	272,509
C. Reductions	809,564	459,079	11,977	71,746	1,352,366	1,149,455
C.1 Writebacks from evaluation	388,918	163,768	7,521	44,658	604,865	507,478
C.2 Writebacks from recoveries	85,881	35,431	609	10,364	132,285	85,188
C.3 Write-offs	154,960	35,103	1,204	5,498	196,765	303,972
C.4 Transfers to other impaired exposures	2,008	216,754	2,313	8,845	229,920	231,081
C.5 Other reductions	177,797	8,023	330	2,381	188,531	21,736
D. Gross exposure, closing balance	6,984,381	1,072,963	95,103	43,485	8,195,932	6,945,184
↳ of which: financial assets sold and not derecognised	-	20	-	60	80	8,428

The values reported are compiled according to rules used for table A 1.8 in Part E of the Notes to the Consolidated Financial Statements (Section A "Credit Quality").



Table 6 – Disclosures for portfolios treated under the standardised approach and specialised lending and equity exposures treated under IRB approaches

Qualitative disclosure

The Montepaschi Group uses the following official rating agencies for legal entities not subject to AIRB validation as well as for statutory portfolios, for which the advanced internal rating system to calculate capital absorption on credit risk is not used:

- Standard & Poor's;
- Moody's Investor Service;
- Fitch Ratings,

The Montepaschi Group, with the above exceptions, uses the official ratings on the following portfolios:

Portafolios and official ratings

Rating characteristics (a)	ECA/ECAI	Portfolios
Exposures to governments and central banks	✓ Standard & Poor's Moody's Investor Service Fitch Ratings	Solicited/Unsolicited
Exposures to multilateral development banks		
Exposures to international organisations	✓ Standard & Poor's Moody's Investor Service Fitch Ratings	Solicited
Exposures to corporates and other persons		
Exposures to undertakings for collective investment in transferable securities (UCITS)		
Securitization positions with short-term ratings	✓ Standard & Poor's Moody's Investor Service Fitch Ratings	NA
Securitization positions other than those with short-term rating		

(a) • **solicited rating:** a rating assigned for a fee following a request from the entity evaluated. Ratings assigned without such a request shall be treated as equivalent to solicited ratings if the entity had previously obtained a solicited rating from the same ECAI

• **unsolicited rating:** a rating assigned without a request from the entity evaluated and without payment of a fee.



Quantitative disclosure

In 2010, the Montepaschi Group was authorised to extend application of the AIRB model to the exposures of new Banca Antonveneta and to those of ex-Antonveneta merged into the Parent Company. This led to the standard method being applied to a different and more limited scope than the one in December 2009, resulting in a reduction of exposures subject to this method, as shown in table 6.1 below. At present the standard method is applied to all portfolios and entities of the Group with the exception of the portfolios, *Exposures to corporates* and *Retail exposures*, belonging to the following entities:

- *Banca Monte dei Paschi*
 - *MPS Capital Services Banca per le Imprese*
 - *Banca Antonveneta*
- for whom the advanced IRB model is adopted, details of which are described in table 7 below.
- The table below shows the details of the banking Group's exposures subject to credit risk – standard method, determined according to the rules of Prudential Supervision and including the effects from risk mitigation techniques (netting agreements, guarantees, etc.).



Table 6 Disclosures for portfolios treated under the standardised approach and specialised lending and equity exposures treated under IRB approaches

Table 6.1 – Portfolios treated under the standardised approach

Standard portfolios	Classes of creditworthiness							Total	Deduction from regulatory capital
	1	2	3	4	5	6	No credit-worthiness class applied		
Central governments and central banks	26,741,230	16,112	17,844	552	-	-	16,749	26,792,487	-
Regional governments and local authorities	3,192,433	-	-	11,236	-	603	-	3,204,272	-
Non-commercial and public sector entities	1,362,758	25	15,546	396	-	-	616,090	1,994,815	-
Multi-lateral development banks	811,416	-	-	-	-	-	-	811,416	-
International Organisations	-	-	-	-	-	-	102	102	-
Supervised institutions	12,754,104	633,232	186,141	151,826	55,001	1,787	147,985	13,930,076	240,788
Corporates	1,079,590	712,301	214,178	2,716,680	25,335	63,559	13,665,533	18,477,175	-
Retail exposures	-	-	-	-	-	-	7,637,759	7,637,759	-
Exposures secured by real estate property	-	-	-	-	-	-	7,252,619	7,252,619	-
Past due exposures	-	-	-	-	-	-	1,643,600	1,643,600	-
High-risk exposures	-	-	-	-	-	-	759,134	759,134	-
Exposures in the form of covered bonds	70,252	-	-	-	-	-	-	70,252	-
Short-term exposures to corporates	-	-	-	-	-	-	-	-	-
Exposures to UCITS	-	-	-	108	-	-	1,166,825	1,166,933	-
Other exposures	-	-	-	-	-	-	9,746,951	9,746,951	553,622
Securitization positions	91,206	372,714	69,789	12,537	5,059	1,087	8,782	561,175	-
Total 31/12/2010	46,102,990	1,734,384	503,498	2,893,335	85,396	67,036	42,662,128	94,048,766	794,410
Total 31/12/2009	46,246,656	1,977,976	976,116	267,818	35,967	11,971	73,649,607	123,166,112	695,794

The Table shows the Banking Group's exposures reported by classes of creditworthiness (ECA/ECAI rating) and by regulatory exposure classes. Class 1 contains positions with the lowest risk weighting ratios which correspond to the best ratings (e.g. Aaa for Moody's, AAA for Fitch and AAA for Standard & Poor's); the higher the creditworthiness class, the higher the risk weighting becomes, with class 6 defining the worse ratings (eg. Caa1 and lower for Moody's, CCC+ and lower for Fitch and CCC+ and lower for Standard & Poor's). The external ratings used in this table reflect the relevant treatment set out for prudential supervision purposes. The last column, "Deductions from regulatory capital", shows exposures not considered for weighting purposes as they are directly deducted from regulatory capital.



Table 7 – Credit risk: disclosures for portfolios treated under IRB approaches

Qualitative disclosure

7.1 AIRB Authorisation

With decree no. 647555 of 12 June 2008, the Bank of Italy authorised the Montepaschi Group to use advanced internal rating based (AIRB) systems to calculate the capital requirements for credit and operational risk. In particular, whereas the Montepaschi Group will use the standardised approach ratios for Exposure at Default (EAD), the Group is by contrast authorised to use:

- internal Probability of Default (PD) estimates, for the portfolio of exposures to corporates and retail exposures;
- internal Loss Given Default (LGD) estimates for the portfolio of exposures to corporates and retail exposures.

For portfolios other than those mentioned

above, the standardised approach will be used and applied according to the roll-out plan submitted to the Supervisory Authorities.

As for legal entities, the scope of application of the authorised approaches shall be the following:

- AIRB: Banca Monte dei Paschi di Siena, MPS Capital Services, Banca Antonveneta;
- the remaining legal entities of the Montepaschi Group will use the standardised approach.

7.2. Internal rating system structure

The Montepaschi Group began using internal rating systems for the measurement of credit risk in 2002. The first Probability of Default (PD) models were developed for the small and medium-sized enterprises (SMEs) and Small Businesses (SB) portfolios which still remain the “core business” of the Group; subsequently, rating models were also estimated for other types of exposure and a Loss

Given Default (LGD) estimation model was implemented.

The rating system has thus become, over time, one of the main elements of assessment for all units involved in the credit industry, both at Head Office level (Risk Management, Chief Financial Officer, General Management, Risk Committee, Board of Directors) and at branch level (Credit Manage-



ment Area, Loan Lab units and Relationship Managers).

Thanks to the experience accumulated, the Montepaschi Group has decided to further invest in internal rating systems, starting, at the beginning of 2006, with the Basel II Project aimed at improving the existing internal procedures by adjusting them to the new prudential supervisory regulations for Banks which came into force on January 1, 2007 with Legislative Decree no. 297 dated 27 December 2006. This project ended in 2008 with the authorisation from the Bank of Italy to use advanced internal rating systems (AIRB) for PD and LGD with a view to calculating capital requirements for portfolios of “non-financial companies” and “retail exposures” for the above-mentioned banks. In line with an internal overall ‘advancement plan’, the MPS Group continued the process of refinement/revision of its rating models for corporate and retail clients in the course of 2009, leading it to obtain authorisation by the Supervisory body (with decree of 25/08/2010) to use advanced internal rating based systems for the Group’s new entity, “Banca Antonveneta”, acquired in 2008.

For the estimation of PD and LGD models in line with lending and credit collection activities, meetings were held, during the development phase, with the persons in charge of the credit granting and credit collection management processes for a shared selection

of variables and consistency of results.

The development of the internal rating systems involved the adoption of strict and advanced statistical methodologies in compliance with the requirements set out in the regulations; at the same time, models were selected in such a way as to make results consistent with the historical experience of the bank in credit management. Lastly, in order to optimise the proper use of these new instruments, the rating models were shared with a top-down approach – from Risk Management down to individual client managers by means of intense training.

Estimation of the LGD model was based on internal data relative to capital flows, recoveries and expenses actually incurred on positions transferred to the non-performing portfolio. Results obtained from model application were then compared with data recorded by MPS Gestione Crediti Banca, a company of the Group dedicated to the management and recovery of non-performing loans.

The introduction of advanced rating systems in the credit process was an important cultural step forward which is now becoming a well-established practice for all business units of the Group.

The main characteristics of the advanced rating systems are as follows:

- for all regulatory portfolios subject to validation, the rating is calculated with a



- counterparty-based approach for each individual borrower, in line with the accepted management practice which provides for the assessment of credit risk, both in the disbursement and monitoring phases;
- Ratings are based upon a Group logic: each individual counterparty is assigned a single rating at banking Group level, based on the set of information pertaining to all lending banks within the AIRB scope; there is one LGD reference definition for retail banks while there are different reference definitions for product companies;
 - LGD reflects the economic (and not only the accounting) loss incurred; for this reason, LGD estimates must also include the costs incurred for the recovery process and a time factor;
 - The rating model segmentation is defined in such a way as to make the individual model clusters consistent with commercial objectives, credit process logics and regulatory portfolios set out in the regulations;
 - Loss given default is differentiated by type of loans and an LGD value is assigned at the level of each individual transaction;
 - Customer segmentation for LGD estimation and assignment follows the same logics as with the rating models; for clusters to acquire significance, segments were aggregated together under “Retail” for retail exposures and “Corporate” for exposures to non-financial corporates;
 - The loss rate is differentiated by geographical area since historical and current recovery rates are different among Northern Italy, Central Italy and Southern Italy and Islands;
 - Loss on defaulted positions other than non-performing loans is estimated with a Cure Rate approach. With regard to counterparties whose exposures are administratively classified as Watchlist, Restructured and Past Due, the percentage of exposures reverting back to a performing status was calculated and used to adjust LGD for positions other than NPLs.
 - The calculation of the final rating is differentiated by type of counterparty. The credit process envisages a level of in-depth analysis proportional to counterparty risk: the assessment of loan disbursements is based on a complex multi-level structure for medium-large corporate counterparties (SME and Large Corporate (LC) segments), whose exposure and concentration risks are higher, and a simplified structure for Small Business and Retail clients;
 - In line with this process, the final rating for SMEs and LC is the result of a number of different factors: statistical rating, qualitative rating, overrides and valuation of the ‘economic group’ which businesses



belong to; for SB and Retail counterparties the rating is calculated only on the basis of statistical factors;

- The rating has a 12-month internal validity period and is usually reviewed on a yearly basis, except for rating reviews following well-structured codified practices or that are brought forward on client managers' request or following serious counterparty deterioration.

The Montepaschi Group has adopted one Master Scale for all types of exposures: this enables all units involved in credit management to immediately compare the risk level associated with different counterparties or portfolios; furthermore, the probabilities of default of internal rating classes were mapped against Standard & Poor's external rating scale so as to make internal risk measurements comparable to those available on the financial market.

The rating system development and monitoring activities are functionally assigned to the Risk Management Area. The estimation procedure is carried out according to an internal development protocol to make sure that estimation activities are transparent and visible for the Internal Controls and Auditing departments.

Risk Management periodically carries out

monitoring/backtesting analyses on the internal models to verify their performance stability over time.

Should significant vulnerabilities emerge from the analyses, model fine-tuning or 're-estimation' procedures are put in place.

The Montepaschi Group currently has 14 rating models and one LGD model (differentiated by geographical area, type of loan, type of guarantee, guarantee coverage ratio and exposure at default) for the measurement of risk in validated regulatory portfolios. The internal roll-out plan over the next few years includes extending the models to all Group Business Units and to the other regulatory portfolios.

Overall master scale of the MPS Group

PD Class	PD up to
1	0.13%
2	0.46%
3	2.42%
4	16.03%
5	45.00%
6	Default



7.3. Use of Internal Models

Prior to authorisation from the Bank of Italy enabling the Montepaschi Group to calculate capital absorptions according to the rules set out for the advanced internal rating systems, the Group used the parameters underlying the calculation of Risk Weighted Assets also for other operational and internal management purposes. The basic principle called for the use of Basel 2 input factors –as much in line with operating requirements as possible- even though, for obvious reasons, operational practices naturally diverge from supervisory standards, with some methodological fine-tunings and adjustments required for internal purposes and calculation systems. In particular, common “across-the-board” parameters used for both “supervisory reporting” and “operational” practices are in relation to the Probabilities of Default (PD) resulting from internal rating systems and the loss rates on the “impaired” portfolio (LGD). The latter provide the basis of calculation for different systems of measurement and monitoring, and specifically for:

- **Measurement of economic capital for credit risk.** Among the inputs used for the credit model and related VaR output to be operational, the same PD and LGD variables are applied as those that are also used for regulatory purposes. It is clear that certain adjustments have been necessary, such as the use of probabilities

of default “not subject” to validation for portfolios other than “Corporate” and “Retail”, resulting from internal rating systems not yet subject to validation or from main rating agencies, appropriately mapped to the internal master scale. With regard to LGD, the Group uses parameters estimated on the basis of portfolios subject to validation according to provisions set out by supervisory authorities, although excluding the economic downturn effect that is contemplated only for regulatory purposes; out-of-validation portfolios use parameters estimated on the basis of medium-long term recovery rates, if any, or LGD rates in line with those set out by internal provisions under the FIRB approach.

Specific emphasis must be placed on economic capital measurements for legal entities outside the scope of validation. In light of the principle of univocal ratings, wherever possible, the Group uses, for customers of these legal entities, the final rating assigned to borrowers “shared” with the entities subject to validation (given that “customer sharing” is very high between validated and non-validated legal entities), since the determination of shared customers’ ratings, based on financial, ‘behavioural’ and qualitative data, is in any case grounded in quantita-



tive and qualitative data arising from exposures consolidated at Group level subject to AIRB treatment or in qualitative assessments made by the client managers, against the overall exposure background. With reference to the remaining part of the loan portfolio, the same rules as those described above were applied to portfolios not included in the AIRB scope, pertaining to the approved legal entities.

As far as the LGD parameter is concerned, non-validated legal entities are assigned loss rates arising from the specific business sector in which the legal entity subject to measurement is involved (in the case of MPS Leasing and Factoring, for example, medium-long term loss rates were estimated in relation to the typical forms of business of this legal entity) whereas, in relation to the remaining types of exposures, the Group has used loss rates determined on the basis of the clients pertaining to the legal entities subject to validation, it being understood that NPLs in the Montepaschi Group are centrally managed for all legal entities by MP Gestione Crediti and are therefore based on the operational, qualitative and implementation metrics used by the banks subject to validation. Although EAD for supervisory purposes follows the standardised approach as it is not subject to validation, it is calculated

as the sum of drawn amounts plus undrawn balance (Committed Amount – Drawn Amount) multiplied by a Credit Conversion Factor (CCF) which differs by type of exposure and worsens as the default probability assigned increases.

- For the **calculation of risk-adjusted performance and measurement of value creation**, the Group follows the same calculation logic as used in the loan portfolio model both for legal entities subject to validation and for those that are excluded from the scope. Furthermore, whenever new estimates or readjustments are made to the internal rating systems subject to validation, adjustment results are incorporated in the VBM procedures which ensure continuous output alignment with the latest updates.
- The parameters which feed the calculation model for the **risk-adjusted pricing process** are the same as those used for the loan portfolio model, even though with some extensions implicit in the pricing model. The pricing model which price-marks different types of loans with different maturities, requires input not only from the annual Probability of Default but also from marginal, forward and multi-period PDs. For these reasons, the Montepaschi Group has developed specific calculation methodologies for these default probabilities, all in compliance



with the annual PD resulting from the validated rating systems. Similarly, LGD calculation is based on the same criteria as those used and mentioned above for the Loan Portfolio Model, though not taking account of economic downturns.

- In relation to **credit process monitoring** (loan trend management, systematic surveillance, operating powers,...), the following should be noted:
 - Processes of loan disbursement to customers included in the AIRB scope of application have been completely ‘re-engineered’ with the Electronic Credit Facility Record software. The Montepaschi Group’s counterparty rating is the result of a process which evaluates - in a transparent, structured and consistent manner - all the economic-financial, ‘behavioural’ and qualitative information relative to customers with whom the bank has credit risk exposures, based on model definitions, the use of information sources and methodological / operational solutions diversified by homogenous groups of counterparties. The Official Rating thus determined has ordinary validity up to the twelfth following month and shall be reviewed by the end of that month. However, the rating review in the monitoring process may be prompted at an earlier date during the validity period if ongoing, major monthly statistical PD variations – exceeding specific cut-offs – are intercepted. The loan disbursement system is organised into several ‘paths’, depending on the type of customer and transaction requested, which envisage the possibility of executing the process of assigning a rating to each counterparty and do not allow for any decision-making powers to be exercised in the absence of a valid rating.
 - The current algorithm for automatic detection of positions under Systematic Surveillance is based on the use of new rules which make use of two metrics:
 - a) an “Official” Rating, i.e. the rating calculated by the internal models on which the stabilisation rules are applied;
 - b) the synthetic anomaly index (it. ISA) in relation to the customer’s credit behaviour, calculated in the presence of at least one reported critical event, which increases in grade based on the risk level, as made available in the Operating Credit Management system. The Systematic Surveillance process is fed with data relating to the ‘critical portfolio’, identified as a result of a combination of the two metrics with a total score being assigned to each position, which is equal to the simple sum of the scores relating to the Official Rating and the Synthetic Anomaly Index



of reference. Defaulting and E3-rated positions are automatically classified as “disengagements” (it. *in disimpegno*).

- The Simplified Renewal process for the electronic credit facility record is based upon the monitoring of ratings over time and a timely revision of the credit facility record when the level of impairment is such that there is an increased perception of risk resulting from either the credit facility being intercepted by the Systematic Surveillance software or serious ISA (Synthetic Anomaly Index) events being reported. This process is applied to all counterparties with credit facilities subject to revision, which have matured or will mature in the month of reference.
- the post-loan disbursement monitoring process is under review with the optimisation of algorithm-based detection of positions at risk based, not only on the rating, but also on other risk parameters;
- The principle underlying decision-making powers provides for levels to be assigned on the basis of individual counterparty ratings, exposure amounts, counterparty risk ‘intensity’ depending on the characteristics of the transactions (type and guarantees) and type of borrower.
- on the basis of these levels, the system

for assigning powers identifies a nominal amount for each risk aggregate: power of approval is assigned to the decision-making bodies, making reference to the combination of rating class and type of loan granted according to the principle of delegating decision-making powers for the worst rating to the uppermost levels. Exception to this rule is made for the Board of Directors, which has the highest level of decision-making powers, and for the levels of approval assigned to corporate decision-making bodies (the Parent Company’s Credit Committee and Executive Committee).

The policies for recognition of credit risk mitigation guarantees are implemented through a dedicated IT process which is applied for reporting purposes and does not overlap the rules for managing guarantees and collaterals applicable to the loan disbursement process.

The IT application manages all rules for the admissibility of guarantees. The process is based on a first step registry of all guarantees, which outlines the Group operational framework. At a later stage, the data of each individual guarantee is assessed through an analysis of its specific characteristics.

In particular, the following general requirements are verified:



- legal certainty;
- enforceability of Guarantee against third parties;
- timely liquidation;
- compliance with organisational requirements;

The importance of the internal ratings for operating purposes made it necessary to set up a rating system control and validation unit within the Montepaschi Group, which is organisationally independent from - and acts as a point of reference and guidance for - the unit established for the systems' development, maintenance and review. This unit meets the "Credit Risk Control Unit" requirements of statutory regulations for validation controls to be fulfilled.

7.3.1. Risk management models

An advanced internal rating system, according to current regulations in force (see Circular no. 263 BI – Title II, Chapter 1 - Section III), should provide for appropriate forms of review and inspection at all levels of control activities. The AIRB system used by the Montepaschi Group provides for the execution of automatic controls, i.e. controls regulated by specific operational protocols (e.g. hierarchical controls), within the operating units involved in the process of rating assignment. These controls are aimed

at making sure that activities preliminary to rating assignment are properly performed (i.e. selection of a model suitable for customer or transaction assessment, identification of economic or legal relations between customers, compliance with internal procedures oriented to obtaining the information necessary for the assignment and updating of the rating).

The Model and Credit System Validation Staff (responsible for validation controls, hereinafter referred to as "Staff") within the Credit G Area, shall be responsible for the following levels of review contemplated by the regulations. The Staff steadily evaluates whether the estimates of all important risk components are accurate and produces the annual Internal Rating System (hereinafter IRS) Validation Report of the Montepaschi Group expressing an opinion on the regular operations, prediction power and overall performance of the IRB system adopted. The Risk Committee expresses its opinion on the annual validation of the IRS Validation Report, on the basis of the opinion of the validation unit. The Internal Controls Area (hereinafter ICA) is responsible for the valuation of the functional efficiency of the overall controls on the rating system (reviews). The methods adopted by the above operating units in relation to the operational procedures of validation and review are briefly illustrated below.



7.3.2 Internal Rating System Validation Process

The responsibility for IRS validation has been allocated to the Risk Committee of the Parent Company. The Risk Committee is supported by the Staff unit in carrying out operational activities that are functional to validation. The Staff unit was established in 2006 with the specific task of reviewing the proper operations of the IRS and checking compliance with the regulatory requirements set out in Circular no. 263 of the Bank of Italy.

The results of these controls are pointed out and reported periodically to the Top Management, the first level units and the ICA. Once a year these results are included in the “Annual Internal Rating System Validation Report” which expresses an overall opinion on the position of the IRS with respect to the supervisory requirements. The Risk Committee validates the IRS on an annual basis, in accordance with such opinion. The validation process, within which the above-mentioned controls are carried out with a view to finally validating the Rating System, consists of the following formal validations:

- validation of the **rating attribution** process: checks compliance of the internal rating assignment process with the minimum organisational requirements of Cir-

cular no. 263 of the Bank of Italy, with a specific focus on the analysis of consistency of modifications to the rating models attributable to human action with the guidelines given to the units involved in rating assignment ;

- validation of **models**: checks that the statistical models for the production of the risk parameters used by banks maintain specific performance levels and comply with the minimum organisational and quantitative requirements provided for by the rules; and in particular the following is verified:
 - performance: assessment of the prediction power of the model and therefore its power to separate highly solvent customers from potentially hazardous customers;
 - grading: check whether the risk preliminarily assigned to each class of rating matches the observed historical risk;
 - stability: assessment of the stability of the assigned ratings over time;
 - stress testing: review of stress testing activities carried out on the models by the model development unit.
- validation of **IT systems**: reviews compliance with the minimum requirements set out by the regulations in relation to the quality of data used by the IRS;
- validation of the **use of the IRS in corporate processes**: reviews the actual use of



the rating system in the business, by identifying the players and processes involved with particular reference to the loan disbursement and renewal processes.

The process of validation involves the preparation of questionnaires for each scope of action identified, with the objective of checking compliance of each aspect of the IRS with regulatory requirements. The detailed positions on each requirement are collated in an overarching opinion of validation through a system of scoring of the replies and weighting of the questions.

The methods chosen meet the requirement of making the process of validation transparent and objective, not only with respect to the Supervisory Authorities but especially to each operating unit which develops the IRS and is informed of any faults in the system, for correction. This ensures easier action on the gaps and consequently a better control of the proper operations of the IRS by the Staff.

7.3.3 Process of internal review of the internal rating system

In line with the existing regulations (see Supervisory Instructions – Title IV, Chapter 11, Section II), the Internal Controls Area of the Montepaschi Group adopts the professional Standards and guidelines of the main domestic and international entities, through

an independent and objective activity of assurance and advice aimed at controlling, also through on site inspections, the regular operations and risk trend and assessing the functional efficiency and compliance of the Internal Control Systems in order to improve the effectiveness and efficiency of the organisation.

The introduction of advanced systems of risk measurement and management (in particular, with reference to credit risk, see Circular no. 263 of 27 December 2006 “New regulations for the prudential supervision of banks” – Title II, Chapter 1, Second part, Section III) determined an extension of activities mandated to the Internal Audit unit and related responsibilities. The role assigned to the unit represents a further specialisation of activities traditionally falling within the sphere of competence of the ICA, which can be usefully supported by a well-established systemised approach that has been in use for some time now. The overall review approach focuses on the objective of providing a coherent assessment of adequacy, in terms of both effectiveness and efficiency, of the control systems of the rating-based process of governance and management of credit risk.

In particular, the responsibilities assigned to the internal audit unit by the above-mentioned Circular, with reference to the review of the advanced models for credit risk assessment and management can be summarised



in three following points:

1. assessment of the overall functional efficiency of the control system of the AIRB approach;
2. assessment of the functional efficiency and regularity of the internal validation process;
3. review of system compliance with the requirements for regulatory use of risk estimates.

However, the main operating components attributable to the adoption of an internal rating system require that the review of that process be considered as part of a larger analysis and assessment of the whole loan management process. The objective is to ensure the materialisation of important synergies from the point of view of the actual cost of implementation and, above all, the overall and coherent observation of the events analysed which share different audit findings on the rating process stemming from the reviews carried out in the distribution network and Group companies.

The audit controls to be carried out for an assessment of the above-mentioned aspects are in relation to the following kinds of activities:

- functional efficiency checks, i.e. control activities for identifying any existing adequate rules (process regulations, circulars, system of the limits and authorisa-

tion powers etc.) instruments, IT systems and formalised processes, which ensure the mitigation of risk and the effectiveness and efficiency of the activities, i.e. the adequacy of the overall organisational solutions with respect to the objectives to be achieved.

- conformity checks i.e. control activities, normally on a sample basis, for reviewing the regularity in terms of application and compliance with the internal rules and identified best practices. Failing any internal formalised operational/regulatory references, conformity checks also ensure the review of normally adopted practices. Thus, having ascertained the material control of the significant aspects by the units/ activities assessed, it is possible to concentrate any comments and remarks on failure to anticipate these aspects.

As a result of the different kinds of control, the internal audit unit performs its responsibilities which consist in reviewing the validity of the whole IRS and the validation process as well as compliance of the system with the regulatory requirements.



7.4. Description of the Internal Rating Systems

For the calculation of capital absorption against credit risk, the Montepaschi Group uses **internal rating systems** for the following regulatory classes:

- Corporates,
- Retail exposures.

7.4.1. Internal Rating Model for

Corporates

PD models

In 2009, PD and LGD models were re-estimated. The methodological decisions taken were essentially in line with previous models and the developments introduced were continuously compared and contrasted among all relevant functions.

For the re-estimation of PD models, the Montepaschi Group adopted a default-based methodology. Among the statistical techniques used in the estimation of models with dichotomous bad/good target variables, a logistic regression was selected, characterised by the optimal trade-off between statistical soundness and interpretability of results

The “non-financial businesses” portfolio includes all balance-sheet and unsecured exposures to companies with registered offices in Italy and relating to the banks, Monte dei Paschi, Antonveneta and Capital Services. The Montepaschi Group operates almost entirely in the domestic market and

therefore, due to the low significance of foreign operations, it took the decision to exclude all exposures to foreign Corporates from the application of advanced systems. The data source observation period for the estimation of PD is 7 years (2002-2008), in compliance with Bank of Italy regulatory instructions.

- **Model segmentation**

Corporate customers were segmented beforehand in order to obtain consistent clusters by risk profile. To this end, a size logic was used (based on the legal form of a company and its turnover) which appears to be consistent from both the statistical and operational point of view. Any information on turnover is obtained from the company balance sheet prepared in accordance with the Fourth EEC Directive in relation to the last available annual report. The segment of Small Businesses (one-man businesses and partnerships) consists of companies which are not subject to the obligation



of preparing balance sheets for legal purposes; tax data are not currently used in the segmentation.

- **Definition of Default**

During the stage of development of the PD models, the following definition of default was used: defaulting counterparties are a sub-group of customers with an exposure (credit line granted or drawn) which, in an ordinary condition in a specific month of the year, show at least one impairment anomaly within the following twelve months. The anomalies contained in the definition of default include non-performing loans, watchlist loans, restructured loans. Past-due positions for a period in excess of 180 days are included as of 2006, the year from which the reporting of such positions became mandatory. Furthermore, the decision was taken to use an internal definition of past due, so called “technical”, to identify instances not representative of a state of financial difficulty that is liable to generate an economic loss (option granted to banks by the regulations at issue), in line with client managers’ actual business-based expectations of economic loss. The rules applied, and subjected to review in the course of last year, allowed a sub-set of alerts to be identified, involving vulnerabilities similar to

other impairment states (particularly watchlist); the rationale adopted was aimed at integrating defaulting positions with positions which show no temporary anomaly but are characterised by aspects featuring in other states of impairment. The definition of ‘technical past due loans’ was used consistently for PD and LGD estimates. Defaulting positions are identified at MPS Banking Group level.

- **Development stages of the rating models** Two main stages of development are envisaged for each rating model: score model estimate and grading.

- **Score model estimate**

All information sources available are taken into account for the estimate of each rating model. A modular approach was adopted to maximise the prediction power of each information source, i.e. a (financial, internal trend, industry trend) standard module was estimated for each information source with the following determination of the final model as a combination of all modules.

The information sources used for corporate models are the following:

- balance sheet reports,
 - internal trend data,
 - industry data (Central Credit Registers of the Bank of Italy and



of trade associations).

As far as the balance sheet is concerned, a set of indicators covering all areas of inquiry contemplated by corporate financial analysis was determined, including: debt coverage, financial structure, liquidity, profitability, productivity, development. With reference to lending trend components, the variables normally used by the account managers for risk valuation were restated: types of use of loan forms, account movements, number of irregularities found. The variables are calculated for each type of loan (callable, self-liquidating, upon maturity etc.) and are determined at the Group level over a time horizon of 12 months. As per the internal practice, the stage of development follows all procedures contemplated by a statistical inquiry: determination of a development sample (70%) and a test sample (30%), fact-finding analyses and preliminary data treatment, univariate analyses, correlation analyses and short list determination, multivariate analyses, model selection and review of out of sample performances.

▪ **Grading**

Grading is a process for estimating the function which transforms the score models output into default probability,

i.e. the probability that a counterparty is in default within one year.

The internal method envisages the estimate of a function which shows the best fitting level with bad rates (default rates observed) associated with the bucket scores included in the grading sample. From a technical viewpoint, this is done through the linear regression between the bad rate logarithm and an appropriate conversion of the average bucket score (normally exponential functions are used) linked to the model anchor point.

The anchor point represents the level of risk traditionally associated with the specific segment which the model is calibrated on.

It is calculated on the basis of the long term default rate and qualitative considerations the analyst deems appropriate to introduce.

In particular, for the purpose of being in line with the 'Basel 2 compliant' definition and achieving appropriate prudential metrics, it was decided to reweigh the default rates taking account of the past due (only technical) effect, also in the first four years of the historical series.

The model anchor point was therefore determined by introducing the specific weight of the past due loans examined



in 2006 (net of the so-called technical past due loans) in the other estimate periods.

The estimated grading function is used to calculate the point-in-time PD which is subsequently mapped on the Montepaschi Group Master Scale; Each counterparty is assigned a PD level corresponding to its rating class.

LGD Model

The estimated loss rate, as provided for by the “New regulations for the prudential supervision of banks”, is the long term average of realised losses, weighted by the number of counterparties and not by exposure.

The Group uses a work-out model based on historical evidence of sets of defaulting transactions with similar characteristics. The database used to estimate the parameter includes all balance-sheet and unsecured exposures relating to the banks within the scope of validation, that were classed as “non-performing” from January 1987 to June 2009, for which either the recovery process has terminated or, if still active, whose balance is zero or seniority exceeds 15 years.

The relevant clusters for the estimates include the geographic area, type of customers, loans, exposures transitioning to a default state, guarantees and their percentage of coverage.

- **Model segmentation**

The corporate segment includes all counterparties which have been segmented according to the rating model logics and can be defined as large corporates, SMEs, small businesses or small economic players.

- **Definition of Default**

During the stage of development of the LGD model, the definition of default used was the same as the one for rating models: defaulting counterparties are a sub-group of customers with an exposure (credit line granted or drawn) which, in an ordinary condition in a specific month of the year, show at least one impairment anomaly within the following twelve months.

- **Development stages of the LGD model**

The LGD estimate includes three main stages: (i) the measurement of the loss rate actually registered in the history of each individual legal entity in relation to the non-performing customers, (ii) the calculation of the LGD downturn, i.e. an indicator which takes account of the adverse phases of the economic cycle; (iii) the calculation of the LGD for all loan statuses other than non-performing loans.

- **Loss Rate for Non-Performing Positions**



Realised collections minus the costs incurred with respect to defaulting exposures are compared to calculate the LGD rate actually observed on non-performing positions. Considering that reference is made to the registered economic loss, and not only to the accounting loss, all movements are discounted as of the date the loan is classified as non-performing. The interest rate used for discounting is the risk free rate plus a spread which remunerates the opportunity cost of each bank resulting from the non-use of the capital not repaid by the customer.

As provided for by the regulations, a lower limit of 0% is set since the average LGD cannot be negative.

- **Downturn LGD**

The relation between collection rates and default rates was analysed to determine the adjustment to be made to the LGD estimates in case of a possible downturn of the economic cycle; once a negative relation between the two series was ascertained, a regression model was clearly formulated between collection rates and macroeconomic variables. Once the collection rates of expansionary and recessive cycles are determined, the downturn LGD is calculated as long-term default-weighted average, suitable for the recessive phases of the economic cycle.

- **Overall LGD**

The estimated loss rates on defaulting positions other than non-performing loans starts from the estimated cure rate, i.e. the percentage of Watchlist Loans, Restructured Loans, or Past Due Loans reverting to performing loan status.

All corporate performing loans as of January 2002 showing one irregularity from February 2002 to January 2009 were selected to determine this.

A weighted average of the downturn LGD was calculated, using the cure rates multiplied by the probabilities of default as weights, to determine the LGD rates for the different statuses of default. The LGD to be applied to all loan transactions of performing customers was determined by using the grading clusters of the rating models.

7.4.2. Internal Rating Model for Retail Exposures

PD models

A default-based methodology has also been adopted for “Retail exposures”. The portfolio includes all balance-sheet and unsecured exposures relating to loans granted by the banks, Monte dei Paschi, Antonveneta and Capital Services to Retail customers (natural persons or joint coobligations of natural persons). The data source observation period for



the estimation of PD is 4 years (2005-2008). The Montepaschi Group, in view of the operational pricing practice currently applied, prudently decided to assign an observed probability of default rate not lower than an A1 rating to best-credit-standing Retail customers.

developments are those relating to loans granted by the Group (overdraft facilities, mortgages and small loans) and to the personal data available for the Client and connected parties.

LG models

- **Model segmentation**

The Retail portfolio was segmented drawing a distinction between jointly liable individuals and individual natural persons; in turn, the latter were classified on the basis of their holding an installment product (mortgage loans or small personal loans) or not.

The criteria were selected on the basis of the risk profile associated to the cluster and internal historical records.

The LGD model for retail exposures includes the stages contemplated for the corporate model.

The comments on the estimate data base are only in relation to the Retail segment.

- **Definition of Default**

The Group used the definition of default adopted for the Corporate models also in relation to the PD models applied to the portfolio of retail exposures.

- **Development stages of the rating models**

Following are the specific aspects concerning the Retail models, which were developed and graded in accordance with the principles adopted for the Corporate models. For the Retail segment, the main sets of information regarding



Quantitative disclosure

In the second half of 2010, the Bank of Italy authorised the Montepaschi Group to use the advanced internal rating systems (AIRB) for the calculation of capital requirements against credit risk relating to exposures of the subsidiary, Banca Antonveneta, and those of Banca Antonveneta merged into the Parent Company. The extension of the AIRB model to a wider scope in 2010 justifies much of the increase in total AIRB exposures recorded in December 2010 as compared to December 2009, as can be seen in table 7 below.

Table 7 - Total AIRB Exposure

PD Class	dec-10		dec-09	
	Exposures to corporates	Retail exposures	Total Exposure AIRB	Total Exposure AIRBB
Class 1	6,434,007	11,151,791	17,585,798	11,507,553
Class 2	16,902,742	17,538,832	34,441,575	22,368,513
Class 3	31,977,868	8,609,579	40,587,447	30,698,711
Class 4	12,167,377	1,348,890	13,516,267	11,033,752
Class 5	3,275,906	290,170	3,566,076	2,493,746
Class 6	14,595,592	2,371,714	16,967,307	9,951,895
Total	85,353,492	41,310,977	126,664,469	88,054,170



Following are the quantitative tables for the class of activity.
advanced IRB approach for each regulatory

Table 7.1 - Exposures to corporates - SMEs

PD Class	Exposure	Unused Amount ^(a)	dec-10				dec-09	
			Credit equivalent	Average Credit Conversion Factor (average CCF)	Average weighted LGD (LGD%)	Average Risk Weighting factor (RW%)	Exposure	
Class 1	2,921,756	4,492,421	458,241	10.20%	36.96%	19.91%	1,600,409	
Class 2	6,800,590	5,293,198	592,169	11.19%	34.91%	39.22%	4,496,051	
Class 3	14,148,419	5,407,525	869,658	16.08%	33.34%	64.67%	11,349,674	
Class 4	6,324,204	1,421,071	307,102	21.61%	33.45%	104.78%	5,573,452	
Class 5	1,631,721	305,938	35,741	11.68%	33.58%	161.29%	1,109,703	
Class 6	7,820,673	405,734	63,529	15.66%	43.76%	-	4,678,554	
Total	39,647,364	17,325,886	2,326,441				28,807,843	

* For reporting purposes, Unused Margins and respective Credit Equivalents refer to issued guarantees and revocable and irrevocable commitments to disburse funds.

Table 7.2 - Exposures to corporates (Other companies)

PD Class	Exposure	Unused Amount ^(a)	dec-10				dec-09	
			Credit equivalent	Average Credit Conversion Factor (average CCF)	Average weighted LGD (LGD%)	Average Risk Weighting factor (RW%)	Exposure	
Class 1	2,945,980	7,027,910	821,599	11.69%	40.01%	22.86%	2,708,617	
Class 2	6,688,884	9,723,935	1,809,490	18.61%	38.39%	45.97%	5,137,242	
Class 3	6,492,577	5,274,837	1,029,124	19.51%	41.64%	85.25%	5,789,050	
Class 4	1,502,545	976,109	241,935	24.79%	39.23%	143.16%	1,088,786	
Class 5	762,362	301,337	93,628	31.07%	42.52%	243.64%	526,988	
Class 6	1,808,445	262,962	100,993	38.41%	45.64%	-	963,112	
Total	20,200,794	23,567,090	4,096,768				16,213,795	

* For reporting purposes, Unused Margins and respective Credit Equivalents refer to issued guarantees and revocable and irrevocable commitments to disburse funds.



Table 7.3 - Retail exposures – Secured by real estate - SMEs

PD Class	Exposure	Unused Amount ^(a)	dec-10				dec-09	
			Credit equivalent	Average Credit Conversion Factor (average CCF)	Average weighted LGD (LGD%)	Average Risk Weighting factor (RW%)	Exposure	
Class 1	131,052	14,885	7,437	49.97%	21.77%	5.87%	28,825	
Class 2	1,107,600	159,961	80,023	50.03%	23.13%	15.23%	244,768	
Class 3	3,835,796	635,926	318,740	50.12%	23.58%	38.19%	724,584	
Class 4	1,452,354	241,573	120,252	49.78%	23.71%	97.84%	263,023	
Class 5	344,801	46,095	22,856	49.58%	24.10%	143.76%	73,857	
Class 6	389,925	9,677	4,771	49.30%	24.67%	-	102,018	
Total	7,261,528	1,108,116	554,079				1,437,074	

* For reporting purposes, Unused Margins and respective Credit Equivalents refer to issued guarantees and revocable and irrevocable commitments to disburse funds.

Table 7.4 - Retail exposures – Secured by real estate - Individuals

PD Class	Exposure	Unused Amount ^(a)	dec-10				dec-09	
			Credit equivalent	Average Credit Conversion Factor (average CCF)	Average weighted LGD (LGD%)	Average Risk Weighting factor (RW%)	Exposure	
Class 1	9,739,150	50,648	22,406	44.24%	14.53%	4.47%	5,822,648	
Class 2	16,397,539	33,539	10,042	29.94%	15.25%	9.06%	9,702,946	
Class 3	7,364,363	44,659	17,385	38.93%	15.58%	21.39%	5,444,487	
Class 4	1,070,271	12,493	3,649	29.20%	15.78%	66.43%	931,269	
Class 5	241,581	1,379	245	17.75%	16.57%	100.41%	224,594	
Class 6	470,609	5,209	1,241	23.82%	16.73%	-	496,174	
Total	35,283,512	147,928	54,967				22,622,119	

* For reporting purposes, Unused Margins and respective Credit Equivalents refer to issued guarantees and revocable and irrevocable commitments to disburse funds.



Table 7.5 - Retail exposures – Qualifying revolving

PD Class	Exposure	Unused Amount ^(a)	dec-10				dec-09	
			Credit equivalent	Average Credit Conversion Factor (average CCF)	Average weighted LGD (LGD%)	Average Risk Weighting factor (RW%)	Exposure	
Class 1	7,464	6,489	-	-	34.19%	2.70%	129	
Class 2	10,125	2,065	-	-	35.72%	6.22%	535	
Class 3	16,343	1,838	-	-	38.25%	18.83%	926	
Class 4	2,558	115	-	-	43.37%	65.99%	260	
Class 5	401	4	-	-	36.60%	112.81%	46	
Class 6	328	127	-	-	51.55%	-	32	
Total	37,219	10,638	-				1,928	

* For reporting purposes, Unused Margins and respective Credit Equivalents refer to issued guarantees and revocable and irrevocable commitments to disburse funds

Table 7.6 - Other retail exposure - SMEs

PD Class	Exposure	Unused Amount ^(a)	dec-10				dec-09	
			Credit equivalent	Average Credit Conversion Factor (average CCF)	Average weighted LGD (LGD%)	Average Risk Weighting factor (RW%)	Exposure	
Class 1	435,219	733,452	61,501	8.39%	33.01%	8.83%	364,339	
Class 2	2,305,669	2,227,087	176,655	7.93%	34.04%	21.33%	1,885,178	
Class 3	7,501,076	4,162,529	424,396	10.20%	42.03%	42.79%	6,557,696	
Class 4	2,888,274	792,438	84,289	10.64%	37.64%	63.88%	2,947,850	
Class 5	537,021	107,867	8,295	7.69%	37.46%	98.35%	521,565	
Class 6	4,576,548	273,097	40,087	14.68%	55.95%	-	2,776,378	
Total	18,243,807	8,296,470	795,222				15,053,007	

* For reporting purposes, Unused Margins and respective Credit Equivalents refer to issued guarantees and revocable and irrevocable commitments to disburse funds.



Table 7.7 - Other retail exposures - Individuals

PD Class	dec-10						dec-09
	Exposure	Unused Amount ^(a)	Credit equivalent	Average Credit Conversion Factor (average CCF)	Average weighted LGD (LGD%)	Average Risk Weighting factor (RW%)	Exposure
Class 1	1,405,177	1,133,747	71,915	6.34%	16.40%	5.13%	982,587
Class 2	1,131,169	381,165	27,172	7.13%	19.24%	11.14%	901,793
Class 3	1,228,873	496,730	61,237	12.33%	26.94%	28.24%	832,294
Class 4	276,061	45,119	8,507	18.86%	23.98%	39.85%	229,112
Class 5	48,188	6,004	666	11.09%	23.90%	63.01%	36,993
Class 6	1,900,778	24,318	3,098	12.74%	46.50%	-	935,627
Total	5,990,246	2,087,085	172,596				3,918,406

* For reporting purposes, Unused Margins and respective Credit Equivalents refer to issued guarantees and revocable and irrevocable commitments to disburse funds.



Table 8 – Risk mitigation techniques

Qualitative disclosure

8.1. Netting policies

With reference to the retail and corporate loan portfolio, the Montepaschi Group does not apply any netting processes to the credit risk exposures with on- or off-balance sheet items with opposite sign.

The Montepaschi Group adopts policies

reducing the counterparty risk with institutional counterparties, by entering into netting agreements and collateral agreements both in relation to derivatives and repos (repurchase agreements).

8.2. The Management of Collaterals

The Montepaschi Group has fulfilled the obligations set out by the New Regulations for Prudential Supervision for the purpose of recognition of risk mitigation effects produced by any existing collaterals securing the loan. The disbursement of loans secured by collaterals is subject to specific control measures, differentiated by type of guarantee pledged, which are applied during the phase of disbursement and monitoring. Two main types of guarantees, subject to different regulations, can be identified by volumes of loans granted and number of customers, namely Mortgages and Pledges (Cash and Securities).

With reference to compliance with the main organisation requirements for the mitigation of risk, the Group ensured:

- the presence of an IT system in support

of the life cycle phases of the guarantees (acquisition, valuation, management, re-valuation and enforcement);

- Regulated policies for the management of guarantees (principles, practices, processes), available to the users;
- the presence of regulated, documented procedures for the management of guarantees (principles, practices, processes), available to the users;
- independence of the customers' insolvency risk (Internal rating) from any existing Collaterals.

For the purpose of limiting residual risks (termination or non-existence of the value of protection), the Montepaschi Group requires that:

- In the case of a mortgage guarantee, the



acquisition of the right be flanked by the underwriting of insurance policies (catastrophic events) in relation to the assets covered by the guarantee, and a report prepared by reliable experts;

- In the case of a pledge, the original value should be reinstated (ensuring the continuity of the guarantee through papers amending the original guarantee) in view of the depreciation of goods pledged. In the case of redemption of the pledge, the repayment should be made at the Bank (collection).

The Montepaschi Group identified a set of technical forms (by purpose of the loan/type of customer) providing for the admissibility of mortgage guarantees. Within the IT system, the proposal of financing one of these types of loans triggers a request for detailed information on the characteristics of the real estate subject to guarantee (valuation) which, after loan approval, will make the acquisition steps compulsory.

In the specific case of mortgage loans to retail customers, the loan is disbursed according to specific disbursement processes, characterized by a standardised valuation/inquiry process, which gather all information necessary for the proper management of real estate guarantees.

The Montepaschi Group has developed one single process for the acquisition of collateral

als which is at the same time a working instrument and the expression of the Group's management policies. The instrument can activate different paths on the basis of the type of guarantee. The management of guarantees starts after loan disbursement approval, the process of which is broken down into different stages:

- acquisition (also multiple acquisition); the controls of (formal and amount) consistency with the guarantees proposed during the authorisation phase are performed in this stage;
- adjustment/change/amendment; useful to amend the characteristics of a guarantee without interrupting loan protection;
- query; gives information about the present data and the historical trend of guarantees received;
- Repayment/Cancellation

A system to monitor the value of the collaterals on the basis of market values is in place. Monitoring of pledge transactions is carried out on a daily basis for listed securities deposited with the bank, while for mortgages, real estate value is currently verified once a year for non-residentials (where real estate is subject to point-in-time appraisals every three years for loans with exposures in excess of three million euro) and once every three years for residentials, using a market indices revaluation.



In this respect, it is appropriate to underline that an assessment is made on the assets pledged as collateral during the mortgage loan approval phase.

In the specific case of retail mortgage loans, a dedicated disbursement process subordinates disbursement to the submission of a technical survey on the asset pledged, thus ensuring the fulfilment of obligations and compliance with relevant validity requirements upon acquisition of the guarantee. If the value of the property pledged as a guarantee is subject to market or foreign exchange risks, the Montepaschi Group uses the concept of guarantee differential, which is understood as a percentage of the value of the guarantee offered, determined as a function of asset value volatility. The only portion of the loan covered by the value of the assets net of the differential is considered as

guaranteed during the approval phase. The monitoring phase requires the adjustment of the guarantees with a market value lower than the value approved, net of the differential. This is notified by the Operating Management units, through an automated process of daily credit monitoring which alerts the Network with events which may modify risk perception.

The availability of collaterals does not alter the valuation of the insolvency risk of a customer. However, it has an impact on the approval process since loan disbursements with mitigated risk are subject to different discretionary powers (this difference at Banca MPS is even more marked due to the introduction of authorization levels dedicated only to Land and Building Credit).

8.3. The Collaterals accepted by the Montepaschi Group

The Montepaschi Group accepts different instruments to protect loans which can be summarised in the following categories:

- Pledge of sums deposited with the Bank;
- Pledge of securities and mutual funds deposited with the Bank;
- Mortgages on immovables (real estate);
- Mortgages on movables;
- Pledge of sums deposited with other banks;
- Pledge of securities deposited with other banks ;
- Pledge on other entitlements (insurance policies and Portfolios under Management);
- Pledge on loans;
- Pledge on commodities;
- Other forms of collaterals (Insurance, Guarantee funds).

As at today, the first three categories (ac-



counting for more than 98% of the nominal amount of the collaterals received) are compliant with regulatory/legal/organisational requirements set out by the New Supervisory Regulations for the enforcement of credit risk mitigation standards.

All types that may be received by the Montepaschi Group are entered into a structured collateral management process, under which all sub-steps are operationally shared.

If the measures of monitoring of the collaterals show operational irregularities during the acquisition phase or any inadequacies/losses of the values received as a pledge, events falling within the scope of credit monitoring policies are put in place, which trigger operational obligations of credit risk assessment.

8.4. Reports on Concentrations

The main concentration of collaterals is linked with retail mortgage loans.

However, it cannot be referred to as risk concentration by virtue of the principle of risk fragmentation which is implicit in this type of customers. Special provisions are in force on mortgage loans for Retail customers with amounts exceeding EUR 3 mln, a threshold beyond which the value of the collateral is kept up-to-date with regular appraisals of

the property. The value of real estate in relation to transactions below the threshold of relevance is updated through the measurement of the average values of the real estate market. Any information on the evaluations is provided, on an annual basis, by specialised industry operators (extraordinary updates may be generated by significant variations in the very short period).



Quantitative disclosure

Table 8.1 - Exposures secured by guarantees

Regulatory portfolio	Financial collaterals		Personal guarantees		Total	
	dec-10	dec-09	dec-10	dec-09	dec-10	dec-09
Central Governments and Central banks	1,306	7,346,281	17,452	24,797	18,758	7,371,078
Regional governments and local authorities	7,775	10,010	34,596	79,704	42,371	89,714
Non-commercial and public sector entities	493,152	294,847	4,122	3,445	497,274	298,292
Multilateral development banks	118	702	-	-	118	702
International organisations	-	-	102	102	102	102
Supervised institutions	48,182,879	25,668,192	32,374	133,024	48,215,253	25,801,216
Exposures to Corporates	3,874,077	11,502,566	73,347	99,407	3,947,424	11,601,973
Retail exposures	1,959,922	1,991,459	-	-	1,959,922	1,991,459
Exposures secured by real estate	4,466	8,731	-	-	4,466	8,731
Past due exposures	44,138	82,242	-	-	44,138	82,242
High risk exposures	-	-	-	-	-	-
Exposures in the form of covered bonds	-	-	-	-	-	-
Short-term exposures to corporates	-	-	-	-	-	-
Exposures to UCITs	2,326,906	-	-	-	2,326,906	-
Other exposures	19,920	25,007	-	-	19,920	25,007
Securisation exposures	-	-	-	-	-	-
Total	56,914,659	46,930,037	161,993	340,479	57,076,652	47,270,516

The table provides, by regulatory asset class, the exposures of the banking group considered for credit risk purposes – standardised method secured by financial collaterals and by personal guarantees; the exposures taken into consideration are determined according to prudential supervisory regulations, net of any netting agreements. Therefore, the table does not include all types of guarantees; for example, the exposures guaranteed by real estate are not included, since they are not recognised for the purpose of risk mitigation and are directly reported in the same class, as shown in table 6.1.

There are no exposures hedged with credit derivatives, which are valid for the purpose of the risk mitigation techniques.



Table 9 – Counterparty risk

Qualitative disclosure

The Montepaschi Group is committed to monitoring counterparty risk, understood as the risk that the counterparty in a transaction involving specific financial instruments (i.e. OTC derivatives, *securities financing transactions* and long settlement transactions) is in default before the settlement of the transaction.

In conformity with regulatory requirements, the Montepaschi Group uses the “current value” method to calculate the value of exposures for OTC derivatives and long settlement transactions. This method consists in calculating current and potential exposure using the market value as the current exposure and the regulatory add-on to represent, in a simplified manner, the potential future exposure.

For SFTs (*securities financing transactions*), the comprehensive method with supervisory volatility adjustments is used.

The Group has adopted credit risk mitigation measures such as netting agreements, collaterals, break clauses, etc. to substantially limit the risk assumed.

From an operational point of view, activities relevant for the purpose of counterparty risk may be broken down into two macro-segments on the basis of both counterparty characteristics (ordinary clients and institu-

tional counterparties) and the operational and monitoring methods put in place by the Group.

With regard to business with financial institutions, counterparty risk exposure on individual creditlines is monitored on a daily basis by the control units of the various Business Units. In short, the daily process involves:

- granting credit lines to counterparties on the basis of requests from Business Unit staff, with a periodical review of the limits set;
- inserting the limits in the management systems;
- inserting the deals and collaterals according to ISDA/ISMA standards and related Credit Support Annexes (CSA) and Global Master Repurchase Agreements (GMRA) signed with each counterparty;
- daily activities to monitor and exchange collaterals with counterparties in relation to the market value of outstanding positions (Collateral Management);
- daily monitoring of drawn and overdrawn amounts - also in real time - considering, among other things, the guarantees pledged or received.
- the Legal function periodically checking whether netting clauses and collaterals



- set out in the bilateral CSA and GMRA agreements signed with the counterparties are judicially and administratively valid in the event of their default, by making reference to the case law of their respective countries.
- are associated with an underlying position, even if they are contractually and administratively separate from it;
 - show limited elements of complexity;
 - on the overall position covered, they hold no financial leverage.

The process for derivative transactions with ordinary clients is based on the distinction of roles and responsibilities among the different entities within the Group. Trading in derivatives with customers provides for centralisation of product factors and market risk monitoring within MPS Capital Services, with allocation, management and monitoring of counterparty credit risk for customers in the bank's networks.

To this end, Retail banks:

- authorise the credit facilities granted to customers;
- manage each transaction in their books;
- take care of the related documents and regulatory requirements;
- review the amounts drawn with respect to the credit facilities granted

With regard to products offered to customers, from a general point of view, a series of common elements are typical of most operations. Specifically, the products traded:

- are not of a speculative nature;
- are for the exclusive purpose of covering risk;

Finally, with regard to liquidity risk, assessments are carried out on any further additions to the guarantees required by institutional counterparties should the Montepaschi Group be downgraded as a result of signed CSA and GMRA agreements.

To reduce counterparty risk in 2010, the Montepaschi Group joined the swap clear service managed by the central counterparty, LCH Clearnet London for activities with OTC derivatives, with Barclays as the clearing broker.

The centralisation of a part of trading in OTC derivatives to LCH makes it possible to completely eliminate the risk of default from these activities since LCH is the guarantor and direct manager of flows deriving from the contracts. Any default of a member of the service is covered by the guarantee funds and backup systems of LCH.



Quantitative disclosure

Table 9.1 - Counterparty risk: derivatives

	Gross Positive Fair value (book values)	Effect of nettings agreements	Netted Fair value	Effect of collateral arrangements	Net Credit Exposure
Derivatives as at 31/12/2010	8,332,865	6,570,630	1,762,235	410,905	4,853,821
Derivatives as at 31/12/2009	9,801,392	7,902,089	1,899,304	497,313	4,102,662

The table represents the exposure of the Banking Group to counterparty risk for derivative instruments. All the financial and credit derivatives traded over the counter (OTC) with any counterparty (institutional, corporate, retail counterparties etc.) are included in the table irrespective of the regulatory (trading and banking) portfolio they belong to. In particular, the "gross positive fair value" corresponds to the book value of the above-mentioned contracts and therefore is inclusive of the netting agreements. The "Nettings" represent the gross positive fair value amount, which as a result of the agreements executed with the counterparties, is offset with negative value transactions. The net "netted fair value" indicates the positive fair value amount remaining after the nettings. The "Exposure" is a value calculated according to prudential supervisory requirements. In the Current Value method adopted by the Montepaschi Group, it is based on the positive fair value net of nettings; this value is increased by the future credit exposure (add-on) and reduced by the effects of the guarantee agreements. The future credit exposure takes account of the probability that in future the current value of the contract, if positive, may increase or, if negative, may become a credit position. This probability is linked with the volatility of the underlying market factors and the residual maturity of the contract. In other terms, it is calculated on the basis of the notional amount of all the derivatives taken into consideration, both with a positive and negative fair value. With regard to LSTs (Long Settlement Transactions) and SFTs (Securities Financing Transactions), the overall exposure recorded comes to approximately Euro 1.89 billion.

Table 9.2 - Derivatives: breakdown of positive fair value by type of underlying

	Interest rates	Foreign currencies and gold	Equity securities	Credits	Other	Total
Derivatives as at 31/12/2010	6,489,998	374,573	370,352	1,094,340	3,602	8,332,865
Derivatives as at 31/12/2009	8,583,605	533,152	257,560	402,335	24,740	9,801,392

The table illustrates the breakdown of the positive gross fair value of OTC derivative contracts by type of underlying assets

Table 9.3 - Credit derivatives: notional amounts

Group of Products	Banking Portfolio		Regulatory Trading Book	
	Protection purchases	Protection sales	Protection purchases	Protection sales
Credit default swap	249,823	833	28,273,900	28,344,509
Total as at 31/12/2010	249,823	833	28,273,900	28,344,509
Total as at 31/12/2009	347,610	-	13,497,945	13,183,675

The table shows the notional values of credit derivative contracts, by portfolio (banking and trading book) and the role played by the Montepaschi Group (buyer/seller of protection).



Table 10 – Securitisation transactions

Qualitative disclosure

10.1. Securitisation activity: Bank objectives and roles

The Group operates in the securitisation market both as an originator, through the issue of notes from originated securitisations, and as an investor through subscription of securities from third-party securitisations.

Originated securitisations include:

- securitisation transactions structured with the aim of deriving economic advantages regarding the optimisation of the loan portfolio, the diversification of sources of funding and the reduction of the cost of funding and the alignment of the natural maturities of assets and liabilities (securitisation transactions in the strict sense).
- securitisations aimed at strengthening the available funding sources, through the conversion of the loans sold into securities that can be refinanced (self-securitisations). Self-securitisation transactions are part of the more general policy of strengthening the group's liquidity position and are not included in securitisations of a stricter sense since they do not transfer risk outside the Group.

Securitisations

in the strict sense of the term

In general this type of transactions involve the spin-off of a package of assets (gener-

ally loans) recognised in the balance sheet of Group banks and its subsequent transfer to a Special Purpose Entity. The SPE, in turn, finances the purchase through the issue and placement of securities. Resources raised in this way are returned to the Montepaschi Group (theseller), whereas the commitments to the subscribers are met using the cash flows generated by the loans sold.

Following is an outline of the Group's main securitisation transactions - originated in previous years and outstanding at 31 December 2010 - broken down into quality/type of underlying and vehicle company:

- securitisation of performing loans:
 - Siena Mortgages 03 – -4 Srl (repurchased on 15/2/2010)
 - Siena Mortgages 10 -7 Srl
 - Mantegna Finance Srl
 - Mantegna Finance II Srl
 - Spoleto Mortgages S.r.l.
 - Giotto Finance 2 SpA (repurchased on 14/04/2010)
- securitisation of non-performing loans:
- Ulisse 2 SpA (repurchased on 5/11/2010)
 - Ulisse 2 SpA (repurchased on 5/11/2010)
 - Ulisse 4



- securitisation of other assets:

- Gonzaga Finance S.r.l.
- Vintage Capital S.r.l.

The portfolio securitised through the Siena Mortgages vehicles comprises real estate-backed loans issued by both the Parent Company and by other banks within the Group, while Mantegna Finance S.r.l. and Mantegna Finance II S.r.l. were originated from Banca Agricola Mantovana S.p.A. and Spoleto Mortgages S.r.l. from Banca Popolare di Spoleto S.p.A.. Subsequent to the merger by absorption of Banca Antonveneta in December 2008, the Parent Company took over from Banca Antonveneta as the Servicer of Giotto 2 S.p.A.. It was repurchased in April 2010.

With regard to the securitisation of non-performing assets, the Ulisse 2 S.p.A. portfolio, sold in August 2001, was repurchased by the Parent Company on 5/11/2010. Ulisse 4 is a non-performing loan securitisation, originated in 2001 by Banca Popolare di Spoleto, a bank jointly controlled by the Parent Company and proportionately consolidated at 26.005%.

Gonzaga Finance Srl is a securitisation of securities effected in 2000 by the former Banca agricola Mantovana.

This type of securitisation transaction is characterised by the derecognition of underlying assets (see Accounting Policies in

the section below). Added to these in 2010 were the securitisations effected through the vehicle Casaforte e Siena Mortgages 10 -7, which, despite being securitisations in the stricter sense, from an accounting viewpoint do not involve the derecognition of underlying assets.

Self securitisations

These transactions involve the transfer of a package of assets (generally loans), originated by Group banks, to a Special Purpose Entity which, in turn, finances the purchase through the issue of Residential Mortgage-Backed Floating Rate Notes (also known as Residential Mortgage-Backed Securities or RMBSs). All Residential Mortgage Backed Securities (RMBS) issued are signed by the Parent Company. Although the Group's full underwriting did not generate any direct cash flows from the market, it still provided the Group with securities that could be used for ECB refinancing and repo transactions, thereby improving the MPS's safety margin and liquidity risk position. In fact, securities that can be allocated with an AAA rating represent the Group's main core for covering short-term obligations using instruments that can be readily liquidated.

In this logic, as of 2007 five self-securitisation transactions have been carried out on performing residential mortgage loans.

The category includes the two performing



loans transactions effected in December 2007 and March 2008 for a total amount of approx. €8.5 bln through the vehicle company, Siena Mortgages 07-5 S.p.A.

Two further transactions were carried out in 2009 through the vehicle company, Siena Mortgages 09-6, for the nominal amount of EUR 8.5 bln.

On 6 July 2010 the Consum.it securitisation transaction was completed with the sale of a portfolio consisting of 341,309 performing consumer loans of the company, Consum.it, with instalments regularly paid as at the date of valuation of the disposed portfolio and a remaining debt in the region of EUR 3 bln. MPS Asset Securitisation S.p.a., later named “Consum.it Securitisation S.r.l.” was used as the transferee of the transaction-underlying assets. The vehicle is 90% owned by Stichting Giglio S.p.A. and 10% owned by the Parent Bank. This structure makes it possible to ensure the vehicle’s independence. On 30 June 2010, “Consum.it Securitisation S.r.l.” financed purchasing of the portfolio by issuing Asset-Backed Fixed-rate Securities in the following tranches:

Securities	Rating Fitch/ Moody’s	Total consideration
Class A	AAA/Aaa	1,710.00
Class B	A/Aa3	540.00
Class C	Caa2/nr	750.00
Class D	NR	132.00

A cash reserve of EUR 132.3 mln was set

up, which corresponds to the Class D Junior securities, and posted to loans and advances to customers in the balance sheet. From an accounting standpoint, self-securitisation transactions do not involve derecognition of underlying assets (see Accounting Policies in the section below).

Securitisation transactions completed in 2010

In light of a revival in the European ABS market and with a view to achieving economic benefits in the management of reserve assets, in 2010, in addition to the plan for the issue of covered bonds, the MPS Group also effected two securitisation transactions (sec. in the strict sense), Siena Mortgages 10-7 S.r.l and Casaforte S.r.l.

On 30 September 2010, the first of the 2 securitisation transactions for the year was carried out. Its portfolio contained 34,971 Bmps performing, real-estate backed loans with instalments regularly paid as at the date of valuation of the disposed portfolio and a remaining debt of approx. EUR 3.5 bln. Siena Mortgages 02 -3 S.r.l. was used again as the transferee of the transaction underlying assets and it was renamed Siena Mortgages 10-7 S.r.l. The special-purpose vehicle is 93% owned by Stichting Canova, a foundation incorporated under Dutch law, and the remaining part is owned by the Parent Company. The vehicle structure



ensures its independence. On 22 November 2010, Siena Mortgages 10-7 financed purchasing of the portfolio by issuing Residential Mortgages Backed Floating Rate Securities of the following classes:

Securities	Rating Fitch/ Moody's	Total consideration
Class A1 Senior	AAA/Aaa	595.00
Class A2 Senior	AAA/Aaa	400.00
Class A3 Senior	AAA/Aaa	1,666.90
Class B Mezzanine	NR /Caa1	817.60
Class C Junior	NR/NR	106.63

Classes A1 and A2 (senior securities) were placed with market investors, whereas the remaining classes of notes issued by the vehicle were underwritten by the Parent Company; the deal has de facto re-opened Southern Europe's securitisation market . A1 and A2 did not entail the derecognition of the underlying assets from the balance sheet of the Parent Company (transferor), which has substantially retained all risks and benefits associated with the property of the assets sold. An offsetting entry for the cashflows arising from the disposal of tranche A1 and A2 was posted on the liabilities side of the balance sheet.

With a view to enhancing part of the Group's properties used in the business, the Parent Company formalised an additional securitisation transaction for an amount of EUR 1.67 bln on 21 September 2010. In this case, the transaction was completed

at the end of December with the transfer of receivables arising from a mortgage loan granted to the consortium company "Perimetro Gestione Proprietà Immobiliari", to vehicle **Casaforte srl**. The latter arises from the change in the company name of Giotto Finance SpA following the merger by absorption of Banca Antonveneta. It was repurchased in April 2009.

On 22 December, the vehicle Casaforte Srl (with share capital entirely held by Stichting Perimetro and registered offices in Amsterdam) issued asset backed securities (classes A, B and Z) in the following tranches:

Securities	Rating Fitch	Total consideration
Class A	A-	1,536.64
Class B	NR	130.00
Class Z	NR	3.00

Class B and Z notes are not offered to the public. They were placed with professional and/or qualified investors.

Covered bond transactions

Moreover, in 2010, with a view to improving the mid-long term financial profile, the Board of Directors of the Montepaschi Group authorised a programme for the Issuance of **Covered Bonds** in the amount of EUR 10 bln. The strategic reasons that led to covered bonds being identified as the preferred instrument for improving the Group's mid-long term financial profile can



be traced to two main factors:

- Developments in the financial markets which made “secured” instruments such as Covered Bonds more attractive than “unsecured” debt;
- The opportunity to obtain important benefits including extension of maturities, reduction of funding costs and diversification of lending sources.

The deal is structured into the following stages:

- a) the Parent Company transfers, without recourse, a pool of assets having certain characteristics to the vehicle, MPS Covered Bond S.r.l., thus forming a segregated *Cover Pool*;
- b) the Parent Company grants a subordinated loan to the vehicle, for the purpose of financing payment of the assets’ purchase price by the vehicle;
- c) the Parent Company issues covered bonds secured by an autonomous, irrevocable and unconditional first-demand guarantee issued by the vehicle for the only benefit of the bond-holding investors and hedging counterparties involved in the transaction; the guarantee involves limited recourse to the assets of the Cover Pool owned by the vehicle (guarantor).

The structure of the deal is such that the

Parent Company is the transferor (a), lender (b) and issuer (c) in the transaction.

In order to allow the transferee to meet the obligations of the collateral pledged, the Parent Company uses appropriate Asset & Liability Management techniques to secure a trend of substantial balance between the maturities of cash flows arising from the assets sold and maturities of payments due in relation with the covered bonds issued and other costs of the transaction.

The Programme was structured in compliance with applicable rules and regulations which authorise the issuance of covered bonds only if the transferring and issuing banks meet certain capital requirements.

The structure for the issuance of covered bonds is subject to stringent regulatory requirements and, for the purpose of maintaining an appropriate ratio between Cover Pool (mortgage and residential assets) as collateral and notes issued, it particularly involves continuous actions by BMPS as transferor and servicer of the Pool transaction as well as the control of external auditors (Deloitte & Touche) as Asset Monitor. Actions will consist in checks being conducted on the integrity of transferred assets in buybacks, integrations and new disposals of additional assets.

The portfolio held for sale at the date of valuation (21/5/2010) consisted in 36,711 performing residential loans of Banca MPS



(including the former branches of Banca Agricola Mantovana, Banca Antonveneta and Banca Toscana merged into Banca MPS) relating to land and construction secured by first mortgages, in line with the repayment schedule as at the date of portfolio valuation.

The price of disposal of the initial portfolio is approx. EUR 4.4 bln, equivalent to the book value of the mortgages.

A new portfolio with characteristics similar to the previous one was sold in November 2010 (19,058) for the amount of approx. EUR 2.4 bln.

As regards Covered Bonds, it is not the vehicle that issues the notes but MPS directly.

The issuance of Covered Bonds is currently structured as follows:

Characteristics of the notes

Amount	Euro 1 billion	1.250 billion Euros
Rating (Fitch/Moody's)	AAA/Aaa	AAA/Aaa
Issuer	Banca MPS S.p.A.	Banca MPS S.p.A.
Type	Issuance of ordinary, non-subordinated, non-convertible bonds	Issuance of ordinary bonds
Interest Rate	Fixed yearly rate of 3.125%	Fixed yearly rate of 2.50%
Issuer Date	30/06/2010	23/09/2010
Legal maturity	30/06/2010, extendable to 30/06/2015	23/09/2013 extendable to 23/09/2014



From an accounting viewpoint, the Covered Bonds plan does not involve derecognition of assets sold. It should be noted that:

- transferred loans continue to be reported in the Parent Company's balance sheet inasmuch as the Parent Company retains the risks and rewards of ownership of the loans transferred;
- the loan disbursed by the Parent to the Vehicle is not classified as a separate item in the balance sheet, since it is offset with the amount due to the Vehicle in which the initial transfer price was recognised. The loan, therefore, is not subject to credit risk assessment, because this risk is entirely reflected in the assessment of transferred loans, which continue to be reported in the Parent Company's balance sheet.
- Loans are subject to movements based on own events (figures and assessment); instalments collected by the Parent (which also acts as a servicer) are reallocated daily to the Vehicle's "Collection Account" and accounted for by the Parent as follows:
 - collection of principal from borrower is recognised as an offsetting entry to the loan to the borrower;
 - reallocation of principal to the Vehicle is recognised as an offsetting entry to the recognition of a loan to the Vehicle;
 - this loan is paid off upon repayment of the subordinated loan;
- interest from borrower is recognised as an offsetting entry to Account 10 "Interest income: Loans and advances to customers" (interest on loans continues to be recognised on an accrual basis);
- reallocation of interest to the Vehicle is recognised as an offsetting entry to the recognition of a loan to the Vehicle;
- this loan is paid off upon collection of the receive leg of the Cover Pool Swap;
- The Vehicle "MPS Covered Bond S.r.l." is invested in by the Parent Company for a control stake of 90%, recognised under Account 100 "Equity Investments" and included in the Group's consolidated financial statements under the comprehensive approach.
- Bonds issued are posted to Account 30 "Debt securities in issue" on the liabilities side, and related interest expense is recognised on an accrual basis.

Third-party securitisations

The Montepaschi Group plays a role in the securitisation market also as an investor. For this reason, a portion of the Group's capital is allocated to stock market investments, even though Banking and Trading Book investment volumes account for 0.8% of



the consolidated assets. The overall book value of long positions in structured credit products amounts to EUR 1,967.33 mln in an area in which the Group pursues a multitude of objectives. In particular, the Group aims to:

- attain a risk-adjusted return that is significantly higher than the cost of allocated capital so as to create value for the shareholders;
- achieve diversification with respect to other risks that are typical of its business;
- maintain in-depth and up-to-date knowledge of financial market trends which additionally and inevitably condition the domestic markets in which the Group mainly operates.

In pursuing the above objectives, the Group set up a specifically dedicated unit within the Finance Area of the Parent Company. The scope of operations within the financial markets tends to be as broad as possible so as to draw the maximum benefit from risk diversification and reduced exposure to specific sectors of the stock market. For this purpose, in addition to typical investment activities in government bonds, securities and forex markets, 2002 also saw the launch of targeted activity on the market of corporate bonds and credit derivatives.

The specifically dedicated unit followed market pattern developments over time,

making investments in structured bonds as well. These investments are compliant with the above-mentioned process of diversification. Financial technology has actually made it possible over time to take positions on specific credit risk components such as correlation and recovery through structured bonds. This parent company structure is also supported by a specialised *desk* within MPS Capital Services. The investment process, for this area too, starts with the specific analyses and evaluations made by the traders in a bottom-up logic. The process is included in the overall monitoring of portfolio risks. In other terms, positions are taken following an analysis by traders and within the maximum risk profile of the portfolios. All operations in securities markets are subject to risk limits set by the Board of Directors that are monitored daily by the Business Control Units and the Parent Bank's Central Risk Management Unit. These are stop-loss and risk limits, which also include, in particular, nominal limits for maximum exposure for major issuer categories broken down by rating.

Securitisations: methods for calculating risk weighted exposures

The MPS Group applies the standardised approach for calculation of the capital requirement for credit risk relating to securitised exposures.



Accounting policies

The accounting of securitisation transactions effected by the Group before the International accounting standards came into force differs from the accounting of transactions effected thereafter.

The loans underlying pre-IAS transactions were derecognised from the transferor's financial statements which only include credit enhancements, if any, executed by the transferor.

Any consolidation of the Special Purpose Entities (SPEs) relating to these transactions only takes their working capital into account. Transferred loans, posted "under the line" in the SPE's financial statements, were not consolidated in the Group's financial statements. Upon the first-time application of the International accounting standards, the Group availed itself of the option not to post the assets underlying transactions effected prior to 1 January 2004, which were derecognised on the basis of the previous national standards. The assets, therefore, have never been included in the consolidated financial statements. The relative junior securities underwritten have been classified among receivables.

For transactions completed subsequent to the entry into force of International Accounting Standards, with which receivables were sold to vehicle companies and in which - even with formal transfer of

legal ownership of the receivables - control over the cashflows deriving therefrom and most risks and rewards are maintained, the loans that are the object of the transaction are not eliminated (non derecognition).

Therefore, the receivables are maintained in the financial statements of the originator as a payable with the vehicle company net of the securities issued by the company itself and repurchased by the seller. The profit and loss statement also reflects the same accounting criteria. These sale transactions had no economic impact on the originator's financial statements and thus, for the purposes of calculating capital absorption, the loans were maintained in the Group's weighted assets as if they had never been sold.



10.2. Control and Management Reporting systems

The trend of the transactions is steadily monitored through the periodical (quarterly and half-yearly) recording of remaining principal repayment flows, default and bad debt positions (in relation to performing securitisations). The Montepaschi Group set up a specific unit within the Parent Company's Credit Policies and Planning area, responsible for coordinating performing securitisations. Non-performing securitisations are managed by a separate unit of the subsidiary, MPS Gestione Crediti S.p.A.

Furthermore, a specific Group Directive requires a half-yearly report to be submitted to the Top Management showing the performance of transactions executed by the Banking Group over time.

The above-cited companies are securitisation vehicles with the Group in the role of originator. As at today, the Montepaschi Group has not acted as a sponsor of any securitisation transactions.

The Finance Area participates in securitisation activities as an investor, only in relation to third-party securitisations. Investment in this area relates to the diversification of the risk profile of the managed portfolio and the maximisation of the risk-return targets.



Rating Agencies for securitizations

Type ^(a)	Rating agencies
MULTIORIGINATOR	
SIENA MORTGAGES 03-4 (BMPS BT BAM)	Fitch Rating Ltd Moody's Investors Service Ltd Standard & Poor's Rating Services
ORIGINATOR	
SIENA MORTGAGES 10-7 (BMPS)	Fitch Rating Ltd Moody's Investors Service Ltd
SIENA MORTGAGES 07-5 (BMPS)	Fitch Rating Ltd
SIENA MORTGAGES 07-5/BIS (BMPS)	Moody's Investors Service Ltd
SIENA MORTGAGES 09-6 (BMPS)	Fitch Rating Ltd
SIENA MORTGAGES 09-6/BIS (BMPS)	Fitch Rating Ltd Moody's Investors Service Ltd
GONZAGA FINANCE (BAM)	Moody's Investors Service Ltd Standard & Poor's Rating Services
MANTEGNA FINANCE (BAM)	Moody's Investors Service Ltd Standard & Poor's Rating Services
MANTEGNA FINANCE II (BAM)	Moody's Investors Service Ltd Standard & Poor's Rating Services
GIOTTO FINANCE 2 SPA (BAV) repurchased on 14/04/2010	Moody's Investors Service Ltd Standard & Poor's Rating Services
SPOLETO MORTGAGES 03 4 (BPSPOLETO)	Moody's Investors Service Ltd Standard & Poor's Rating Services
CASAFORTE (BMPS)	Fitch Rating Ltd Moody's Investors Service Ltd
CONSUM.IT securisation S.r.l (CONSUM.IT)	Fitch Rating Ltd Moody's Investors Service Ltd
MPS COVERED BOND	Fitch Rating Ltd Moody's Investors Service Ltd
NON PERFORMING	
ULISSE 2 SPA (MPS GCBANCA) repurchased on 5/11/2010	Fitch Rating Ltd Moody's Investors Service Ltd
ULISSE 4 (BP SPOLETO)	Moody's Investors Service Ltd

(a) Originator in brackets.



Quantitative disclosure

Table 10.1 - Underlying securitisation exposures

Type of securitised asset	Exposure		Losses for the period
	net	of which impaired	
Non-performing loans	13,618	13,618	-
Mortgage loans	24,218,013	-	-
Bonds and credit derivatives	15	-	-
Other performing loans	-	-	-
Total as at 31/12/2010	24,231,646	13,618	-
Total as at 31/12/2009	15,098,729	189,743	-



Table 10.2 - Type of exposure by risk weight bands

Exposures / Underlying assets	Risk weight band						Total
	20%	50%	100%	350%	1250%	1250% no Rating	
Originated securitisations	-	-	-	-	-	5,338	5,338
Residential mortgage loans	-	-	-	-	-	5,338	5,338
Third party securitisations	91,206	372,714	69,789	12,537	6,146	3,444	555,837
Bonds	-	-	-	-	-	-	-
Non-performing loans	-	49,824	-	-	-	-	49,824
Residential mortgage loans	69,055	1,326	3,362	-	-	-	73,743
Loans	7,577	321,564	64,236	9,901	5,059	-	408,337
Commercial mortgage loans	1,230	-	2,191	2,637	-	-	6,058
Consumer Loans	8,553	-	-	-	1,087	-	9,640
Leasing	4,791	-	-	-	-	-	4,791
Re-securitisation	-	-	-	-	-	3,444	3,444
Total 31/12/2010	91,206	372,714	69,789	12,537	6,146	8,782	561,175
Total 31/12/2009	20,284	413,057	70,468	14,965	5,671	5,393	529,839

The table above details the exposures to securitisations by risk weight bands and type of transaction. The amounts shown, in line with prudential regulations, relate to the 'self' and 'third-party' securitised exposures included in the banking book and, therefore, do not include the exposures to securitisations included in the regulatory trading book. It is noted that, in compliance with supervisory regulations, self securitisations do not include securitised assets:

- a) that refer to transactions that are not recognised as securitisations for prudential supervisory purposes, since they do not entail the actual transfer of credit risk,
- b) whose overall risk-weighted value of exposure to the same securitisation exceeds the risk-weighted value of underlying securitised assets, calculated as if they had not been securitised (cap test). Both in the case of a) and b), capital requirements are calculated in relation to securitised assets and not to the corresponding securitisation exposures. Additionally, securitised assets are classified in their original regulatory classes (exposures secured by real estate, etc.) and are therefore excluded from "securitisations".



Table 12 – Operational risk

Qualitative disclosure

The Montepaschi Group has implemented an integrated risk management system on the basis of a governance model which involves all the companies of the Montepaschi Group included in the scope of application. The approach defines the standards, methods and instruments that make it possible to measure risk exposure and the effects of mitigation by business area.

The Montepaschi Group was authorised by the Bank of Italy on 12 June 2008 to use the internal advanced measurement approach (AMA) for the calculation of capital requirements for operational risks. The advanced model officially started operating on 1 January 2008. The first consolidated regulatory reporting on the basis of the model was prepared in relation to the results as at 30 June 2008.

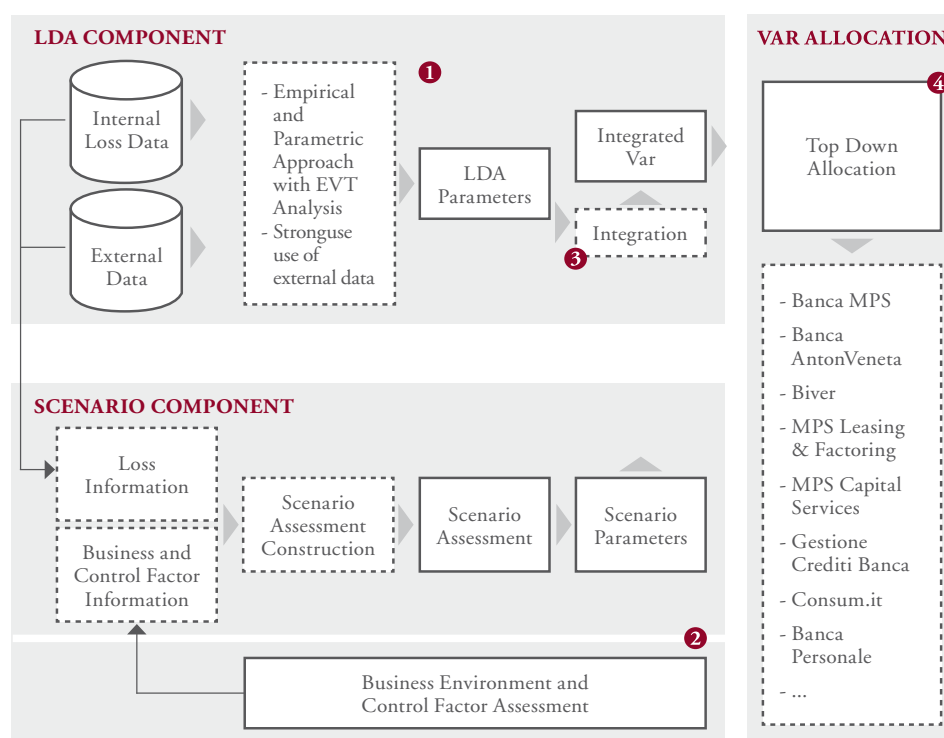
The Bank of Italy granted the authorisation after verifying compliance with the requirements set out in Circular 263. Verification involved all aspects of risk measurement, management and mitigation, with strong engagement from the Group's Top Management. All the domestic banking and financial components are incorporated in the scope of advanced measurement approach (AMA). Pending the developments of the

Business Plan, the foundation approaches were adopted for foreign companies.

Compared to the previous financial year, novelties in 2010 included completion of initiatives aimed at extending the advanced model for operational risk measurement and management to Biverbanca. An additional novelty was the merger by absorption of Paschi Gestione Immobiliare by and into the Group, whereby the Group's property management area started to undergo reorganisation. The advanced approach adopted by the Montepaschi Group is designed so as to homogeneously combine all the main qualitative and quantitative information (or data) sources (Mixed LDA-Scenario Model).

The quantitative Loss Distribution Approach component is based on the statistical collection, analysis and modelling of internal and external historical loss data (Italian Database of Operational Losses, DIPO). The model includes calculation in relation to the 7 categories of events established by Basel 2 used as risk classes, with the adoption of Extreme Value Theory techniques.

The estimated frequency of occurrence is based exclusively on internal data. The qualitative component focuses on the evaluation



of the risk profile of each unit and is based on the identification of relevant scenarios. In this framework, the companies are involved in process and risk identification, risk evaluation by process managers, identification of possible mitigation plans, discussion (in scenario-sharing sessions) of priorities and technical-economic feasibility of mitigation actions with the H.O. units.

The AMA model, which had been running in parallel for two years prior to final approval, ensured a better informed management of operational risk and a gradual reduction of risk within the Group.

In 2009 the Group completed an important project to rationalise the insurance plans inherited from the various extraordinary transactions carried out in recent years.

Consequently, the policies were redefined

to ensure greater coverage both in terms of events and of widening the scope of application. The deductibles and maximum limits were therefore adjusted to make the transfer of operational risk more effective. At present, pending revision of the regulations of reference, the Montepaschi Group has taken the decision not to use such policies to any extent in order to reduce capital requirements. However, in the future the Group intends to consider the use of operational risk transfer techniques, properly documented and in line with the provisions of Circular 263, for the purpose of reducing capital requirements.

Finally, the percentage breakdown of operational losses recorded in 2010 is reported, divided into the following risk classes:

- Internal fraud: Losses arising from unau-



- thorised activities, fraud, embezzlement or violation of laws, regulations or corporate directives that involve at least one internal resource of the Group;
- External fraud: Losses due to fraud, embezzlement or violation of laws by subjects external to the Group;
 - Employment relationships and Occupational safety: Losses arising from actions in breach of employment, occupational health and safety laws and agreements, payment of compensation for personal injury or episodes of discrimination or failure to apply equal treatment;
 - customers, products and operating practices: Losses arising from non-fulfilment of professional obligations with customers or from the nature and characteristics of the product or service provided;
 - property damage: Losses arising from external events, including natural disasters, acts of terrorism or vandalism;
 - business disruptions and system failures: Losses due to business disruption or system failures or interruption;
 - process management, execution and delivery: Losses arising from operational and process management shortfalls, as well from transactions with business counterparties, vendors and suppliers.
- With respect to 2009, a decrease was recorded for operational risk events, confirming the positive trend already observed in previous years.

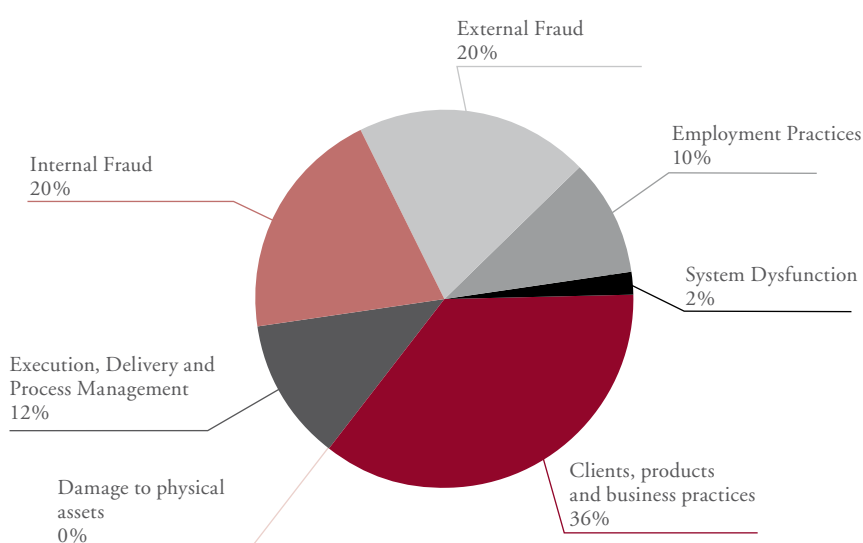




Table 13 – Equity exposures: disclosures for banking book positions

Qualitative disclosure

13.1 Purpose of exposures

Exposures in equity instruments are held by the Group for strategic purposes (group investments, affiliated companies and joint ventures), institutional purposes (investments in trade associations, local entities and institutions), purposes functional to the bank's business and the development of commercial business, financial investment purposes (limited to the investments associated with the merchant banking business of MPS Capital Services). Other investments exist, which include investments no longer considered as strategic and that are being sold, as well as investments in companies in liquidation. Equities exposures included in the banking book are classified for balance sheet purposes under available-for-sale financial assets and equity investments.

13.2 Measurement and accounting criteria

13.2.1 Assets available for sale

Classification criteria

This category includes non-derivative financial assets which are not classified as loans, financial assets designated at fair value through profit and loss or financial assets held to maturity.

In particular, this category also comprises strategic equity investments which are not managed for trading purposes and cannot be defined as controlling interest, connection and joint control, and bonds which are not subject to trading.

Such investments may be transferred for any

reason, such as liquidity requirements or variations in interest rates, exchange rates, or stock price.

Recognition criteria

Financial assets represented by debt or equity securities are initially booked at the settlement date, whereas receivables are initially booked as of the disbursement date. On initial recognition, the assets are reported at their fair value which normally corresponds to the price paid, inclusive of transaction costs or income directly attributable to the instrument. If recognition occurs as a result of reclassification from assets held to maturity



ty, the value at which the assets are booked is represented by the fair value as of the date of the transfer. In the case of debt instruments, any difference between the initial value and the value of repayment is posted to P&L and spread out over the life of the debt instrument in accordance with the method of amortised cost.

Measurement criteria

After initial recognition, financial assets available for sale are measured at fair value, with interest being recognised in the income statement as resulting from the application of the amortised cost and with appropriation to a specific net equity reserve of the gains or losses arising from changes in fair value net of the related tax effect, except losses due to impairment.

Foreign exchange fluctuations in relation to non-monetary instruments (equity instruments) are posted to the specific net equity reserve, whereas changes in monetary instruments (loans/receivables and debt instruments) are allocated to profit and loss. Equities, for which it is not possible to determine a reliable fair value, are maintained at cost, adjusted for any impairment losses.

Financial assets available for sale are reviewed for objective evidence of impairment at each balance sheet and interim reporting date. Indicators of a likely impairment are, for instance, significant financial difficulty of the issuer, non-fulfilment or defaults in

payments of interest or principal, the possibility that the borrower is declared bankrupt or submitted to other forms of insolvency proceedings, the disappearance of an active market for the assets. In particular, as far as equity instruments that have a quoted market price in an active market are concerned, a market price as at the date of the financial statements lower than the original purchasing cost of at least 30% or a market value lower than the cost lasting more than 12 months are considered an objective evidence of value reduction.

If further reductions take place in subsequent financial years, these are charged directly to the profit and loss statement. Any writedowns recognised as a result of the impairment test are booked to the profit and loss statement as an operating expense.

If the reasons for impairment cease to exist, following an event which occurred after recognition of impairment, writebacks are recognised in equity in the case of equity instruments, and through profit and loss in the case of debt securities.

Derecognition criteria

The financial assets are derecognised from the balance sheet when the contractual rights to the cash flows derived from the assets expire or when the financial asset is sold and virtually all of the risks and rewards in relation thereto are transferred. Securities received within the scope of a transaction



that contractually provides for subsequent sale are not recognised in the financial statements, and securities delivered within the scope of a transaction that contractually provides for subsequent repurchase are not derecognised from the financial statements. Consequently, in the case of securities acquired with an agreement for resale, the amount paid is recognised in the financial statements as loans and advances to customers or banks, while in the case of securities transferred with an agreement for repurchase, the liability is shown under deposits from customers or deposits from banks or under other liabilities.

Criteria for the reporting of income and expenses

Upon disposal, exchange with other financial instruments or measurement of a loss of value following impairment testing, the fair value results accrued to the reserve for assets available for sale are reversed to profit and loss under:

account “100 – Gains/Losses on purchase/disposal of: b) financial assets available for sale”, in the case of disposal;

account “130 - Net impairment losses/reversals” on: b) financial assets available for sale”, in the case of recognition of impairment.

If the reasons for impairment cease to exist, following an event which occurred after the impairment was recognised, the impairment loss is appropriately reversed:

through profit and loss in the case of loans or debt securities, and through net equity in the case of equity instruments..

13.2.2. Equity investments

Classification criteria

The account includes equity investments held in related enterprises and jointly controlled entities. For classification purposes in this item, companies with contractual agreements, shareholders’ pacts or agreements of a different nature for the joint management of business and the appointment of the directors are considered as jointly controlled entities.

Associates include (i) companies where a share of 20% or higher of voting rights is held, and (ii) companies which – owing to specific legal ties such as the participation in shareholders’ pacts – have to be considered as subject to significant influence.

The classification of equity investments is made regardless of the legal status and the computation of voting rights includes any potential voting rights currently exercisable.

Recognition criteria

Equity investments included in this item are initially recognised at purchase cost.

Revenue recognition and measurement criteria

Equity investments in associates and joint ventures are recognised at cost. The book values are tested for impairment at each



balance-sheet or other interim report date.

If evidence of impairment indicates that there may have been a loss in value of an equity investment, then the recoverable value of the investment (which is the higher of the fair value, less costs to sell, and the value in use) should be estimated. The value in use is the present value of the future cash flows expected to be derived from the investment, including those arising from its final disposal.

Should the recoverable value be less than its carrying value, the difference is recognised immediately in profit or loss under Account “240 - Gains (losses) on equity investments”.

Should the reasons for impairment no longer apply as a result of an event occurring after the impairment was recognised, reversals of impairment losses are credited to the same account in profit and loss.

The profit related to the equity investments is booked to profit and loss of the Parent Company regardless of whether it was generated by the investee before or after the date of the acquisition. If, after recognition of dividends, the carrying amount of the investment in the separate financial statements exceeds the carrying amount in the consolidated financial statements of the investee's net assets (including associated goodwill), then the Group is required to consider whether an indication of impairment exists.

Derecognition criteria

The financial assets are derecognised from the balance sheet when the contractual rights to the cash flows derived from the assets expire or when the financial asset is sold and virtually all of the risks and benefits in relation thereto are transferred.

If a company is committed to a plan to sell a subsidiary that involves loss of control over said subsidiary, all the subsidiary's assets and liabilities should be reclassified as assets held for sale, regardless of whether the company will retain a non-controlling interest after the sale.



Quantitative disclosure

Table 13.1 - Equity exposures: disclosures for banking book positions

Type	Book Value	Fair Value	Market Value	Exposure	Realised gains/losses	Unrealised gains/losses	
						Total	of which included in Tier 1 and Tier 2 capital
Available For Sale securities (A)	663,842	663,842	x	663,842	41,359	100,102	50,051
quoted	318,093	318,093	318,093	318,093	25,941	54,575	27,288
unquoted	345,749	345,749	x	345,749	15,418	45,527	22,764
Investments (B)	122,008	x	x	200,199	581,010	-	-
quoted	3,700	x	x	3,700	-	-	-
unquoted	118,308	x	x	196,499	581,010	-	-
Total 31.12.2010 (A+B)	785,850	663,842		864,041	622,369	100,102	50,051
quoted	321,793	318,093	318,093	321,793	25,941	54,575	27,288
unquoted	464,057	345,749	x	542,248	596,428	45,527	22,764
Total 31.12.2009 (A+B)	659,126	597,609		747,184	245,225	108,754	54,377

x = value not attributable

PN = Patrimonio Netto, Net Equity

PB, PS = Patrimonio di Base (Core Capitale) and Patrimonio Supplementare (Supplementary Capital), respectively

The table illustrates exposures in capital instruments broken down by the respective accounting portfolio. Values refer to the exposures included in the Banking Book and do not include exposures in capital instruments which are deducted for the calculation of Regulatory Capital. In the column "Exposure" the related value is calculated according to the rules of Prudential Supervision and thus differs from the Book value. The value of the Exposure also includes the value of the shareholding in MPS Tenimenti which, for prudential purposes, is calculated with the net equity method while for Financial Statements the comprehensive method is applied.



Table 14 – Interest rate risk on positions in the banking book

Qualitative disclosure

In accordance with international best practices, the Banking Book refers to all of the commercial operations of the Bank in relation to the transformation of maturities with respect to balance-sheet assets and liabilities, Treasury, foreign branches, and hedging derivatives of reference. The definition of the scope of the Banking Book (in line with that for the regulatory book) and the process of centralising the management of ALM are contained in a resolution by the Board of Directors of the Parent Bank, aimed at centralising Asset & Liability Management and operational limits for interest rate risk of the Group Banking Book as approved previously in September 2007 and updated in October 2009 to adjust the overall framework to the changed share ownership structure, as well as to develop the approach in keeping with the format outlined in the regulatory provisions (Bank of Italy Circ. 263).

The Banking Book also includes active bonds held for investment purposes, classified as either AFS or L&R. The same ALM rate risk metrics of measurement used for other accounts were also applied to this aggregate.

The operational and strategic choices for

the Banking Book, adopted by the Finance Committee and monitored by the Risk Committee of the Parent Company, are based first on exposure to interest rate risk for a variation in the economic value of the assets and liabilities of the Banking Book by applying a parallel shift of 25bp, 100bp and 200bp, the latter in accordance with the requirements set out in the “second pillar” of Basel 2.

The risk measurements of the retail banks of the Montepaschi Group are calculated by using, among other things, a model for the valuation of demand items or core deposits, whose characteristics of stability and partial insensitivity to variations in interest rates are described in systems with a statistical/predictive model (replicating portfolio), which takes into consideration a significant historical series of customer behaviours in the past.

In addition, the Montepaschi Group's ALM model includes within rate risk measurements, a behavioural model which takes into account the aspect of mortgage advance repayment (prepayment risk). Loan prepayment rates and, in particular, home mortgage prepayment rates have become potentially more unstable due to a series of



concomitant factors, such as, for example, the greater volatility of the rate curve due to the recent crisis.

The Montepaschi Group is committed to the continual updating of risk measurement methodologies by gradually fine-tuning estimation models so as to include all major factors that progressively modify the interest rate risk profile of the banking book. Notably, significant developments in the risk profile characteristics can be observed at this stage owing to recent regulatory changes, growing number of contractual options, operating practices adopted and changes in behavioural patterns, all of which make the risk profile more dependent on market performance and especially interest rates and their volatility.

In 2010, the Group carefully monitored the various cases, particularly in relation to the growing popularity of products with contractual options such as capped mortgages.

The Group adopts a rate risk governance and management system which, in accordance with the provisions of the Supervisory Authority, avails itself of:

- a quantitative model, which provides the basis for calculation of risk indicators for the interest rate risk exposure of the Group and Group companies/entities;
- risk monitoring processes, aimed at ongoing verification of compliance with the operational limits assigned to the Group

overall and to the individual business units;

- risk control and management processes, geared toward bringing about adequate initiatives for optimising the risk profile and activating any necessary corrective actions.

Within the above system, the Parent Company has opted for a centralisation of the responsibility for defining the policies aimed at managing the Group Banking Book and controlling its related interest rate risk



Quantitative disclosure

The sensitivity of the Montepaschi Group, at -2,481.54 EUR/mln a rise on the end of at the end of 2010, suggests a profile of 2009. exposure to rate hike risk. With a shift of +200 bp in the interest rate curve, total sen- Risk is almost entirely allocated to exposu- sivity of the economic value would stand res in Euro.

Table 14.1 - Interest Rate Risk in the Banking Book (IRRBB)

Shift (+/-)	Effect on Economic Capital (EUR/mln)	
	dec-10	dec-09
Eur +200bp	-2,470.50	-1,239.23
Usd +200bp	-4.07	5.16
Other +200bp	-6.97	-17.66
Total +200bp	-2,481.54	-1,251.74
Eur -200bp	2,439.39	1,634.74
Usd -200bp	3.72	1.75
Other -200bp	8.50	13.94
Total -200bp	2,451.61	1,650.44

The amount of the economic value at risk is, in any case, below the level considered as a critical threshold by current regulations. Moreover, it should be noted that, in the event of a climb in interest rates, the Group's net interest income sensitivity would be positive in any case.



Declaration of the Financial Reporting Officer

Pursuant to para. 2, article 154-bis of the Consolidated Law on Banking, the Financial Reporting Officer, Mr. Daniele Bigi, declares that the accounting information contained in this document corresponds to the underlying documentary evidence and accounting records.

Siena, 21 April 2011

Daniele Bigi

Financial Reporting Officer



Glossary of the main terms used

ABS: *see* Asset Backed Securities

Advanced Internal Rating Based (AIRB): advanced internal models used to calculate capital requirements for credit and counterparty risk within the Basel 2 international framework. They differ from the FIRB models since with the AIRB approach, the banks uses its own internal estimates for all inputs. See also PD, LGD, EAD.

Advanced Measurement Approach (AMA): advanced internal models used to calculate capital requirements for operational risk within the “Basel 2” international framework. The approach involves the measurement of capital requirements by the bank through calculation models based on operational loss data and other valuation elements the bank collects and processes.

AFS: *see* Available For Sale

AIRB: *see* Advanced Internal Rating Based

ALM: *see* Asset & Liability Management

AMA: *see* Advanced Measurement Approach

Asset & Liability Management (ALM): the set of risk management models and techniques applied to the Banking Book for the purpose of measuring interest rate risk and liquidity risk. See also Banking Book, Interest Rate Sensitivity, Shift Sensitivity, Economic Value Approach.

Asset Backed Securities (ABS): Financial Securities whose coupon yield and redemption are guaranteed by a pool of assets (collateral) of the issuer (usually a Special Purpose Vehicle), exclusively intended to ensure satisfaction of the rights attached to said financial securities. Typically, they are broken down into RMBS and CMBS.

Available For Sale (AFS): IAS category used to classify the assets available for sale.

Banking Book: in accordance with International best practices, the term “banking book” refers to all of the non-trading operations of the Bank in relation to the transformation of maturities with respect to balance-sheet assets and liabilities, Treasury, foreign branches and hedging derivatives. The interest rate, liquidity and forex risk of the Banking Book are typically measured through Asset & Liability Management (ALM) models. See Regulatory Banking Book.

Basel 1: the regulations relating to the applica-

tion of Minimum Capital Requirements issued by the Basel Committee in 1988.

Basel 2: the regulations relating to the application of the New Capital Accord issued by the Basel Committee in 2006.

BCU: *see* Business Control Unit.

bp (basis point): one hundredth of a percentage point, ie. $1bp = 0.01\% = 0.0001$.

BU: Business Units.

Business Control Unit (BCU): Local, first-level risk management functions, located within the areas / business units (BUs).

Cap test: the test undergone by all securitisation transactions recognised for prudential purposes, according to which the risk-RWAs of securitisation positions are compared with those of securitised exposures (calculated as though the latter were not securitised). If the RWAs of the former are greater than those of the latter (cap) then the latter are taken into consideration.

Capital position: the difference between Regulatory Capital, including Tier 3 capital and Overall Capital Requirements. The difference may be positive (surplus), or negative (deficient), according to whether the Regulatory Capital is higher or lower than the Overall Capital Requirement.

Capital Requirements Directive (CRD): EU directive no. 2006/48 and 2006/49, transposed by the Bank of Italy into Circular Letter no. 263/2006 of 27 December 2006 and subsequent updates.

Capital Requirements: the sum of capital, calculated according to supervisory regulations, destined to cover the single risks of the First Pillar in compliance with the supervisory framework.

CCF: Credit Conversion Factor

CDO: *see* Collateralised Debt Obligation

CDS: *see* Credit Default Swap.

CMBS: *see* Commercial Mortgage Backed

(CDO) Securities Collateralised Debt Obligation: Securities issued based on differentiated risk classes with various tranches following the securitisation of a portfolio of debt instruments



incorporating the credit risk. Typically characterised by the presence of a financial lever.

(CMBS) Commercial Mortgage Backed Securities: ABS with underlying commercial mortgages.

Confidence level: level of probability linked to VaR measurements.

Consolidated Law on Banking (it. *Testo Unico Bancario*, T.U.B): Legislative decree no. 385 of 1 September 1993, as amended and supplemented.

Core Capital (Tier 1): defined by the Supervisory framework as the sum of the following components: (+) general banking risk fund (+) capital (+) share premium reserve (+) reserves (+) innovative capital instruments (-) retained losses (-) capital subscribed and not paid in (-) treasury shares (-) other intangible assets (-) goodwill.

Core Tier 1 ratio: the ratio between Tier 1 capital, net of preference shares, and total risk-weighted assets. The Tier 1 ratio is the same ratio inclusive of the preference shares in the numerator.

Corporate clients: Customer segment consisting of medium- and large-sized companies (midcorporate, large corporate).

Counterparty risk: counterparty risk is the risk that the counterparty in a specific financial transaction is in default prior to settlement. Counterparty risk is associated with certain, specifically-identified types of transactions, which: 1) generate an exposure that is equal to their positive fair value; 2) have a market value which evolves over time depending on underlying market variables; 3) generate an exchange of payments or an exchange of financial instruments or goods against payment. The categories of transactions subject to counterparty risk are:

- credit and financial derivative instruments traded *Over the Counter* (OTC);
- Securities Financing Transactions (SFTs);
- Long Settlement Transactions (LST).

Covered bond: Special bank bond that, in addition to the guarantee of the issuing bank, is also backed by a portfolio of mortgage loans or other high-quality loans sold to a special purpose vehicle.

CRD: *see* Capital Requirements Directive.

Credit Default Swap (CDS): Contract under which one party transfers to another the credit

risk of a loan or security contingent on occurrence of a default.

Credit derivatives: Derivative contracts for the transfer of credit risks. These products allow investors to perform arbitrage and/or hedging on the credit market, to acquire credit exposures of varying maturities and intensities, to modify the risk profile of a portfolio and to separate credit risks from other market risks.

Credit Risk Mitigation (CRM): set of credit risk mitigation techniques recognised for supervisory purposes (e.g., compensation of accounts in balance sheet, personal guarantees, credit derivatives, financial collaterals), for which the following eligibility requirements apply - legal, economic and organisational - for the purpose of reducing risk.

Credit risk: the risk that a debtor may default on his obligations, either at maturity or subsequently. Credit risk is associated with an unexpected change in creditworthiness of a responsible party - towards whom there is an exposure - which generates a corresponding unexpected change in the value of the credit position.

CRM: *see* Credit Risk Mitigation.

Current Value method: Supervisory method used to determine counterparty risk in derivatives and the capital requirement to cover it. The current value is calculated adding the replacement cost (or intrinsic value, determined on the basis of the "mark-to-market" value of the derivative, if positive) to the future credit exposure (approximating the time value of the derivative, i.e. the probability that, in the future, the intrinsic value will increase, if positive, or convert into a credit exposure if negative); the future credit exposure is determined for all contracts, independently of the positive value of the replacement cost, multiplying the nominal value of each derivative contract by coefficients differentiated by residual maturity and type of contract.

Default, credit exposures in: these include nonperforming loans, watchlist loans, restructured loans and past-due.

Default, the state of: state of insolvency or delinquency of a debtor. Declared inability to honour one's debt and/or make the relevant interest payments.

Delta EL: *see* Surplus of expected loss value over the value of net provisions.

DIPO (*Database Italiano Perdite Operati-*



ve): The Italian Database of Operational Losses. Database used for operational risk.

Diversification: benefit arising from the simultaneous holding of financial instruments which depend upon risk factors not perfectly matched. In the case of VaR, this corresponds to the correlation effect among risk factors on the overall VaR value.

Duration Gap: the difference between the duration of assets and liabilities of a given portfolio in relation to the total amount of assets.

Duration: also defined as average financial duration, this is a synthetic index which represents the weighted arithmetic mean of time upon expiry of the individual components of a cashflow (principal + interest), since the weights are determined as current values of the individual components, calculated on the basis of the term structure of the interest rates. It is typically used as a measurement of bond price sensitivity to interest rate fluctuations.

EAD: *see* Exposure-at-Default.

ECA: Export Credit Agency.

ECAI: External Credit Assessment Institution.

Economic Capital: the capital needed to deal with any loss in value generated by unexpected changes in conditions, internal or external, as a consequence of risk. It is calculated on the basis of risk measurement models developed by the Risk Management area. In general, it is obtained on the basis of a consistent transformation in terms of holding period and confidence interval of VaR measurements calculated for individual risk factors and appropriately diversified. The confidence interval is a function of the bank's objective rating. The Economic Capital is the internal estimation of capital needed to deal with risk that is the necessary operational equivalent of Capital Requirements (Regulatory Capital).

Economic Value approach: measure of the changes in the Banking Book overall net current value (defined as the difference between the current value of assets, the current value of liabilities and the value of hedging derivatives) in the presence of different alternative interest rate scenarios. The focus is placed on the changes in the net current economic value of the Bank and takes account of all maturities of assets, liabilities and off-balance-sheet items existing at the time of each valuation. It is typically measured with shift sensitivity assumptions. See also ALM, Banking Book, Interest Rate Sensitivity, Shift

Sensitivity.

Equity Tranche: the portion of the portfolio that is at greater risk, also known as "first loss"; it is subordinate to all other tranches; it is therefore the first to be impacted by the losses that may arise during the recovery of underlying assets.

Expected Loss: the total amount of net losses which, on average, the bank can expect (estimate) to incur in the 12 month period following the date of reference on the total amount of performing loans in the portfolio upon measurement. Since it is an estimate, it does not represent the actual risk of the credit exposure. Estimated ex-ante as the "cost of doing business", it ought to be directly included, in terms of spread, in the pricing conditions applied to the customer and covered using an appropriate accounting provision policy. It is defined as the product of the probability of default (PD), loss given default (LGD) and exposure at default (EAD):

$$\bullet \text{ PA} = \text{PD} \times \text{LGD} \times \text{EAD}.$$

Exposure at Default (EAD): estimated future value of an exposure upon default of a client. Defined as:

$$\bullet \text{ EAD} = \text{Drawn Amount} + k (\text{Committed amount} - \text{Drawn Amount}) \text{ where } k (0 \leq k \leq 1) \text{ represents the expected "drawn" percentage of the unused amount before default.}$$

The EAD essentially depends on the technical form of the loan and is faced up to through loan trend management.

Value required in the advanced model for credit risk measurement (AIRB - "Advanced Internal Rating Based Approach") as set out by Basel 2. For regulatory purposes, a credit conversion factor (CCF) is applied to the EAD.

Fair Value (FV): the amount at which an asset could be bought or sold or a liability incurred or settled, in an arm's length transaction between willing, independent parties.

FIRB: *see* Foundation Internal Rating Based.

Floor: The lower limit set for Overall Capital Requirement by the Bank of Italy in the event that the bank and the banking groups calculate Capital Requirements for Credit Risk or for Operational Risk through internal models; the basis of reference for the calculation of the Floor up to 2009 was provided by Basel 1; as of 2010, the basis of reference is represented by standard Basel 2 (i.e. the standardised approach for Credit Risk and the foundation approach for operational risk).

**Foundation Internal Rating Based (FIRB):**

the internal models used to calculate capital requirements for credit and counterparty risk within the international Basel 2 Accord. It differs from the AIRB approaches because, in this case, only the PD parameters are estimated by the bank.

Held For Trading (HFT): IAS category used to classify trading assets and liabilities.

HFT: *see* Held for Trading.

Holding period (hp): forward-looking length of time for which a position is held.

IAS/IFRS: the International Accounting Standards are issued by the International Accounting Standards Board (IASB). The standards issued after July 2002 are called IFRS (International Financial Reporting Standards).

ICAAP: *see* Internal Capital Adequacy Assessment Process.

Internal Capital Adequacy Assessment Process (ICAAP): Under the “Second Pillar” (Chapter III of the Bank of Italy’s Circular Letter no. 263/2006) banks are required to adopt processes and instruments for determining the level of internal capital needed to cover any type of risk, including risks different from those covered by the total capital requirement (“First Pillar”), when assessing current and future exposure, taking into account business strategies and developments in the economic and business environment.

IMA: *see* Internal Models Approach.

Impairment: when referred to a financial asset, a situation of impairment is identified when the book value of an asset exceeds its estimated recoverable amount.

Interest Rate Sensitivity: measurement of the impact an unexpected shift (parallel or not) in the yield curves by maturity generates on the bank’s economic value. It is typically used to measure the interest rate risk of the Banking Book within the Asset & Liability Management (ALM) systems. The value is obtained from calculating the variation in the current value of the real and notional cashflows of sheet assets, liabilities and off-balance items existing at a certain date when there is a variation in the yield curve (eg. +25 bp) with respect to the values of the baseline. Measurement of risk as potential loss which emerges following an adverse movement in the structure of yield curves, schematically

defined as:

$$\bullet \text{ VA} = \text{VA}' - \text{VA}$$

where:

- VA = variation in current value, ie. Sensitivity measurement;
- VA = current value of cash flows calculated on the basis of the yield curve at the recognition date;
- VA' = current value of the same cash flows calculated on the basis of the yield curve assumed (e.g. parallel upward shift of +25 bp”).

If, for example, a +25bp shift in the yield curve results in $\text{VA} > 0$ (positive sensitivity), this means that the bank is “liability sensitive”, ie. it has more liabilities coming to maturity/being repriced than assets, and therefore its economic value is at risk in the event of a decrease in market interest rates.

If, on the other hand, a +25bp shift in the yield curve results in $\text{VA} < 0$ (negative sensitivity), this means that the bank is “asset sensitive”, ie. with more assets coming to maturity/being repriced than liabilities, thus having an economic value that is at risk in the event of an increase in market interest rates.

Internal Models Approach (IMA): method of VaR internal models for the calculation of capital requirements for market risk.

Investment grade: issuers or issues with a rating between AAA and BBB-.

Issuer risk: connected to the issuer’s official rating, this is the risk of decreasing portfolio value due to the unfavourable change in the issuer’s credit standing up to the extreme case of default, in the buying and selling of plain vanilla or credit structured bonds, ie. purchase/selling of protection through credit derivatives.

Junior tranche: in a securitisation transaction it is the lowest-ranking tranche of the securities issued (Equity tranche), being the first to bear losses that may occur in the course of the recovery of the underlying assets.

L&R (Loans & Receivables): IAS category used to classify credit.

LDA: *see* Loss Distribution Approach.

LGD: *see* Loss Given Default.

Liquidity Risk: the risk that a company will be unable to meet its payment obligations due to its inability to liquidate assets or obtain adequate funding from the market (funding liquidity risk) or due to the difficulty/impossibility of rapidly



converting financial assets into cash without negatively and significantly affecting their price due to inadequate market depth or temporary market disruptions (market liquidity risk).

Long Settlement Transactions (LSTs): long settlement transactions (in which a counterparty commits to delivering (receiving) a security, commodity or foreign currency against receipt (delivery) of cash payment, other financial instruments or goods with settlement upon a pre-established contractual date, later than the one determined by market practice for these types of transaction, namely five days from the transaction stipulation date.

Loss Distribution Approach (LDA): model used to assess exposure to operational risk. It makes it possible to estimate the amount of expected and unexpected loss for any event/loss combination and any business line.

Loss-Given-Default (LGD): is the discounted net loss measured over the years on positions classified as defaulting. LGD is estimated in the form of a coefficient ranging from 0 to 1 based on the following drivers: type of borrower, type of guarantee pledged, technical form of lending. This value is required within the framework of the Advanced Internal Ratings-Based Approach for credit risk under Basel 2. When conditioned on adverse macro-economic scenarios (or downturns), the LGD parameter is defined as “downturn LGD”.

Lower Tier 2: it designates subordinated liabilities that meet the eligibility criteria for inclusion in supplementary (Tier 2) capital.

LST: *see* Long Settlement Transactions.

M (Maturity): the residual life of an exposure, calculated according to prudential requirements for credit risk. For banks authorised to use internal ratings, it is explicitly considered if the advanced approach is adopted, while it is predetermined by legislation if the FIRB approach is adopted.

Market Risk: the risk of value loss on a financial instrument or a portfolio of financial instruments, resulting from an unfavourable and unexpected change in market risk factors (interest rates, share prices, exchange rates, price of goods, indices,...). A typical risk of the trading book.

Mark-to-market: valuation of a position at market value, usually from the trading book. For instruments officially traded on organised mar-

kets, it corresponds daily to the market closure price. For unlisted instruments, it results from the development and the application of specifically-developed pricing functions which determine the valuation starting from the market parameters relating to the respective risk factors. It is at the basis of the calculation of P&L in the trading book.

Mezzanine tranche: in a securitisation transaction, it is the tranche ranking between junior and senior tranche. As a rule, the mezzanine tranche is broken down into 2-4 tranches with different levels of risk, subordinated one to the other. They are typically characterised by an investment grade rating.

Monoline insurer: insurance companies specialised in guaranteeing payment of interest and notional amount of bonds upon default of the issuer. They are so called because, in general, they guarantee a service that is limited to a single industrial sector.

Non performing: term generally referring to loans for which payments are overdue.

Operational risk: the risk of incurring losses due to inadequacy or failure of processes, human resources or internal systems, or as a result of external events. These include, among others, loss deriving from fraud, human error, business disruption, system failure, breach of contract, natural disasters. Operational Risk includes legal risk while it does not include strategic or reputational risk (included in Pillar II of Basel 2).

OTC derivatives: financial and credit derivatives traded over the counter (eg: swaps, forward rate agreements).

OTC: *see* OTC derivatives.

Overall Capital Requirement (or Regulatory Capital): the sum of capital requirements relating to the individual type of risk, as well as those provisioned for real estate and equity investments assumed for credit recovery (“building block”). With regard to credit risk, the capital requirement is equal to 8% of risk-weighted assets.

P&L: *see* Profit & Loss.

Past due: *see* Default.

PD: *see* Probability of Default

Performing: term generally referring to loans characterised by regular performance.



Preference shares: innovative capital instruments, usually issued by foreign subsidiaries, and included in tier 1 capital if their characteristics ensure the banks' asset stability. See also Core Tier 1 Ratio.

Private equity: activity aimed at the acquisition of equity investments and their subsequent sale to specific counterparties, without public offerings.

Probability of Default (PD): the probability that a customer/counterparty will default within the space of 1 year. Each PD derives from an internal ratings system and thus falls within a specific range of values corresponding to those used by the official rating agencies (masterscale) so as to obtain standardised data processing between internal and external rating systems.

The PD strongly depends upon the definition of default: from the stricter sense of default limited exclusively to non-performing loans, the meaning has been broadened by the Basel 2 framework to include watchlist loans, restructured loans, loans under restructuring and past and overdue loans for over 180 days (timeframe set out by Basel 2). A value that is required by the advanced model for credit risk measurement (AIRB - "Advanced Internal Rating Based Approach") as provided for by Basel 2.

Profit & Loss (P&L): operational profit or loss indicator of the Trading book which expresses the difference in value of an instrument or a portfolio in a given timeframe, calculated on the basis of market values and directly validated/listed ("mark-to-market") or determined on the basis of internally-adopted pricing models ("mark-to-model").

Prudential ratios: there are two particularly significant ones:

- the ratio between Regulatory Capital including Tier 3 Capital and the result from overall capital requirements multiplied by 12.5 (Total Capital Ratio);
- the ratio between Tier 1 Capital and the result from overall capital requirements multiplied by 12.5 (Tier 1 ratio).

RAPM: cfr. Risk Adjusted Performance Measurement.

Rating: the degree of risk of non-compliance regarding a specific debtor (counterparty or issuer rating) or a single loan (issuance rating). It is typically expressed through a qualitative assessment belonging to a grading scale. If determined by a rating agency it becomes an "official" rating. If it is based upon internally-developed

models it is called an "internal" rating. It expresses the likelihood of default or insolvency.

Regulatory Banking Book: comprises all positions that are not assigned to the Regulatory Trading Book; its definition is therefore 'residual' in nature, even though most of a retail bank's exposures are assigned to this portfolio; in general, the rules for determining the capital requirements for Credit Risk are applied to the Regulatory Banking Book. See also Banking Book.

Regulatory capital: defined on the basis of Supervisory banking regulations, it is the numerator of the prudential ratio; it is calculated by starting from net equity and then carrying out adjustments, integrations, applying filters and making deductions; it is made up of Tier 1, Tier 2, net of deductions. Banks are required to constantly hold a total of Capital for regulatory purposes (including tier 3 capital) not lower than the Overall Capital Requirements, which is equal to the sum of Capital Requirements prescribed against Credit and Counterparty Risk, Market and Operational Risk, and those estimated for real estate and equity investments assumed for credit recovery.

Retail Clients: customer segment mainly including households, professionals, retailers and artisans.

Risk Adjusted Indicators: see Risk Adjusted Performance Measurement.

Risk Adjusted Performance Measurement (RAPM): measurement of performance adjusted by risk. Method of measurement of profitability, which is defined as "risk adjusted" in that - on the one hand - it includes a new P&L negative component under Profit for the Year, that rises as the expected risk component increases (Expected Loss), and - on the other - replaces the "book value" capital used in the transaction with the Economic Capital.

Risk factor: the driver/variable which determines the variation in value of a financial instrument.

Risk Weighted Assets (RWA): a definition that applies to Credit and Counterparty risk; in particular, with regard to exposures subject to standard methods, it results from the application of certain risk weights to exposures as determined by supervisory regulations.

Risk: can be defined as an unexpected potential economic loss. Risk is an economic loss in the sense that, against the commercial initiatives



undertaken, if risk emerges it always results in a loss of value in the books of the Bank. Risk is an unexpected loss and implies the need to set aside a corresponding sum of capital in order to guarantee the bank's stability and solvency over a long period. Risk is a potential loss in the sense that there may or may not be a certain confidence level (probability) in the future (forward looking) estimate and it is therefore an estimate, not a known value. Since risk is potential, it is always prospective or forward-looking. It is not the measurement of an economic effect that has already materialised. Risk is covered by the bank's capital, both in the form of Regulatory Capital and that of Economic Capital.

RMBS: *see* Residential Mortgage Backed Securities.

RWA: *see* Risk Weighted Assets.

Scoring: a company's customer analysis system which consists in an indicator resulting from both an analysis of book data and an assessment of the performance forecast for the sector, on the basis of statistic-based methodologies.

Security Financing Transactions (SFT): repos and reverse repos on securities or commodities, securities or commodities lending or borrowing transactions and margin lending transactions. Senior/SuperSenior tranche: the tranche with the highest degree of credit enhancement, ie. the highest level of privilege in terms of remuneration and reimbursement priorities. It is higher in rating than the mezzanine tranche.

Seniority: Level of subordination regarding the repayment of notes, generally broken down (in decreasing order) into SuperSenior, Senior, Mezzanine, Junior.

Servicer: in securitisation transactions it is the subject that - on the basis of a specific servicing contract - continues to manage the securitised loans or assets after they have been transferred to the special purpose vehicle responsible for issuing the securities.

Settlement Risk: the risk that arises in transactions on securities when, after expiry of a contract, the counterparty is in default with regard to delivery of securities or payment of amounts due.

SFT: *see* Security Financing Transactions.

Shift Sensitivity: measurement of the impact of an unexpected and parallel shift in the yield curve upon the bank's economic value. See ALM,

Banking Book, Interest Rate Sensitivity, Economic Value Approach.

SMEs: Small and Medium Enterprises.

SPE/SPV: *see* Special Purpose Entities or Special Purpose Vehicles.

Special Purpose Entities or Special Purpose Vehicles (SPE/SPV): established in pursuit of specific objectives, mainly to isolate financial risk. The assets consist in a portfolio, the proceeds of which are used for the servicing of bond loans issued. Typically used in asset securitisation transactions.

SREP: *see* Supervisory Review and Evaluation Process.

Stress test: a set of quantitative and qualitative techniques used by banks to assess their vulnerability to exceptional, though plausible, events.

Supervisory Review and Evaluation Process (SREP): a process put in place by the Supervisory Authorities with the objective of analysing the ICAAP process developed by the banks, verifying the congruence of results, providing an overall assessment of the banks and implementing, where necessary, the appropriate corrective measures, both organisational and financial.

Supplementary Capital (Tier 2): defined by the Supervisory framework as: (+) valuation reserves (+) Tier 2 subordinated liabilities (+) non-committed credit risk fund (+) hybrid capital instruments not included in Tier 1 capital (-) net capital losses on held to maturity investments (-) loan losses in the course of the year (+/-) net gain/losses on listed non-banking/financial equity investments.

Surplus expected losses on net provisions ("Delta PA"): the difference between expected losses and overall net value adjustments, limited to the exposures subject to internal models for credit risk; it is a component of the Regulatory Capital.

Syndicated lending: loans arranged and secured by a pool of banks and other financial institutions.

Tertiary Capital (Tier 3): defined by the Supervisory framework, it is used to cover up to a maximum of 71.4% of capital requirements against market risk.

Tier 1 Ratio: ratio of a bank's core capital to its total risk-weighted assets. It is a measure of capi-



tal adequacy defined in the Supervisory Regulations (stemming from the 1998 Basel Capital Accord known as Basel 1) as a solvency ratio for banks. No mandatory minimum level is required for this ratio by the Bank of Italy.

Tier 1: *see* Core Capital.

Tier 2: *see* Supplementary Capital.

Tier 3: *see* Tertiary Capital.

Total Capital Ratio: ratio of a bank's total regulatory capital to its total risk-weighted assets. It is a measure of capital adequacy defined in the Supervisory Regulations (stemming from the 1998 Basel Capital Accord known as Basel 1) as a solvency ratio for banks. This ratio must be no lower than 8%.

Trading Book: positions intentionally held for trading purposes and destined to be disposed of in the short term and/or assumed with the aim of benefitting, in the short term, from the differences between purchase and sale price, or other price or interest rate variations. It consists in a set of positions in financial instruments and commodities held for trading or to cover risk inherent in other constituent of the same portfolio. For eligibility to be included under the trading book prudential treatment, the financial instruments must be exempt from any clause which would limit their tradeability or, in alternative, fully covered. Furthermore, the positions must be frequently and accurately assessed. The trading book must be actively managed.

UCITS: Undertakings for collective investments in transferable securities (UCITS).

Upper Tier 2: identifies hybrid capital instruments (e.g. perpetual loans) that make up the highest quality constituents of Tier 2 capital.

Value-at-Risk (VaR): probability measure of a portfolio's market risk. It is defined as the maximum potential loss in value of an asset or portfolio over a defined period (*holding period*) for a given *confidence interval* (with the *confidence level* expressing probability). As an example, with regard to the trading book, the VaR model estimates the maximum decrease (loss) that a portfolio is expected to incur with a specified probability (for ex. 99%), over a defined time horizon (for ex. 1 day). In this example, a 1 day VaR with a 99% confidence implies that there is only a 1% chance of the Bank losing more than the VaR amount in one single working day.

Volatility risk: measure of the exposure to fluc-

tuations in the historical or implied volatility of market risk factors. It is connected with the amplitude of price, rate, and foreign exchange fluctuations over a set period of time and is an integral part of market risk.



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