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A bank's crisis: the case of Monte dei Paschi di Siena

Emanuele Menasci 31785

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Gonçalo Rocha

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Abstract

The case retraces the main attributes that characterised the crisis of the Italian bank Monte dei Paschi di Siena. Among these, a key role was played by the peculiar governance structure of the institution, as well as the elevated amount of non-performing loans that it presented on balance sheet.

After more than 10 years of dissipation of resources and poor results, the Italian government operated a precautionary recapitalization to bail-out the bank in 2017.

Keywords

Banking foundation, inorganic growth, non-performing loans, precautionary recapitalization.

Monte dei Paschi di Siena: the oldest bank in the world

Monte dei Paschi di Siena (MPS) is the oldest bank of the world. Although it has been one of the largest Italian institutions for several years, a recent series of scandals and hazardous management decisions have led the Italian government to bail it out in 2017.

MPS' centuries-old history traces back to 1472, when the Magistracies of the Republic of Siena ordered the foundation of "Monte Pio" pawn agency. The organization had the ultimate objective of giving aid to the most needful social classes of Siena.

With the beginning of the 17th century, due to the increasing impelling needs of the citizens of Siena, a new mount of piety, the "Monte non valicabile dei Paschi della città e stato di Siena" was created. In 1783, after more than 100 years of close operation, the two mounts merged into a single institution called Monti Riuniti ("combined mounts").

Almost one century later, at the time of the unification of Italy, Monti Riuniti was the largest and most solid bank of the country. In 1872, thanks to the approval of a new charter, the bank was given its current name. The statute also specified that "Monte dei Paschi is an institution of the city of Siena to whom it owes its origin, therefore the Municipality of Siena maintains supervision, direction and safeguard [of the bank] and manages [it] by means of an elective board". Moreover, the new charter established that half of the bank's net income would be devoted to projects of aid and public utility for the city of Siena. Through the statute, the embedded relationship existing between the bank and the local community had been recognized at a political level.

In 1936, a deep transformation of the Italian banking system was operated by the fascist government. The 1936 Banking Law was based on the principle of separation between banks and companies, establishing that banks were forbidden to hold participations in private enterprises. In particular, MPS' was declared a public-law credit institution under the jurisdiction of the Italian government. Despite of the remonstrance of the Municipality of Siena, a new statute was approved with an official decree of the head of Government. Above all, the decree established that the President and three members of the Deputation of the bank would now be appointed by the Italian government, rather than the Municipality of Siena, which would still nominate 4 out of the 8 members of the management board. This specification, while maintaining a strong political influence within the bank's governance, unfastened MPS' dependence on the city of Siena and its local politics.

After the WWII, MPS carried out a series of acquisitions of smaller institutes that led it to be a landmark of systemic relevance not only for the region of Tuscany, but also for the whole Italy.

While the bank pursued its development objectives, a disruptive change was about to take place in terms of banking regulation. In fact, in 1990, Law n. 218 30/07/1990 (so-called "Amato law") abrogated the 1936 Banking Law. In particular, the public-law credit institutions defined in 1936 were now allowed to split themselves into two entities: on one hand an enterprise that performed the banking activity and, on the other hand, a foundation (so-called "banking foundation") to whom was allocated the activity of general aid in several fields. In this splitting procedure, the banking foundation had the role of entirely subscribing the capital for the creation of the bank; moreover, the law stated that the foundations must maintain the majority of their equity stakes.

Due to the mentioned regulation, the formal privatization of MPS occurred in 1995, when the bank was split into two organizations: Banca Monte dei Paschi di Siena S.p.A. and Fondazione Monte dei Paschi di Siena (MPS foundation). While the former performs the bank activities of credit, finance, and insurance, the latter pursues the aims of charity, aid and social benefit within the province of Siena. This partition process had the odd effect of reinforcing the political influence that had shaped MPS' activity until then. In fact, by looking at the charter of the MPS Foundation, it seems clear that the relationship between Siena's political parties and MPS had been brought back to how it used to be before 1936. The statute established that the 16 members of the Deputation (the foundation's administrative body) were appointed as follows:

- 8 members by the Municipality of Siena
- 5 by the Province of Siena
- 1 by the University of Siena
- 1 by the Tuscany Region
- 1 by Archdioceses of Siena, Colle Val d'Elsa and Montalcino

The foundation was, in turn, responsible for appointing the board of MPS, since it was the main shareholder of the bank. As it may be grasped, the privatization had only taken place on a formal level; on the practical one, it was still Siena's local administration that indirectly managed the MPS' businesses.

The tight chain built by Siena's political system could not be broken even by the law n. 461 23/12/1998 (so-called "Ciampi law"), aimed at harmonizing and integrating the limited regulation regarding the banking foundations. In particular, on one hand, it ultimately qualified the foundations as private-law institutions, with full statutory and managerial autonomy. On the other hand, contrary to the Amato law, the rule stated the obligation for the foundations to give up their controlling interests in the banks by no later than 2003. Nevertheless, the MPS foundation retained control over the Monte dei Paschi, drawing upon legal tricks that allowed it to comply with the Ciampi law while maintaining the actual control over Monte dei Paschi di Siena; later on, the Foundation would even run into debt in order to keep its position of strength into MPS.

The described mechanism gave rise to the so-called “Siena system”: a complex network of interests and tied participations that, especially in its early stages, created wealth and growth in the whole Municipality of Siena, mainly thanks to the re-investment of the MPS’ (often) distributed earnings. The “system” deliberately outlined the strategies for the bank; more specifically, the pattern chosen was the one of the inorganic growth. In relation to this, MPS acquired Banca Agricola del Salento in 1998.

One year later, on June 25th 1999, Monte dei Paschi di Siena was listed on the Italian stock exchange, registering requests for stock purchases of more than 10 times the offering[1]. The successful operation was welcomed by the whole Siena community and its political parties, especially considering the MPS foundation was able to retain 60% of the MPS equity, maintaining controlling interests in the bank.

In 2000, MPS acquired Banca del Salento (better known as Banca 121), on the basis of the defined strategy of inorganic growth. The institution was regarded as “the bank of the future”[2] and MPS acquired it for 2500 billions of Italian lira (around €1,29 bn); the price was regarded as very high at the time[3], considering that equity value of Banca 121 was in the order of 800 billions of lira (€413 mln). Besides the monetary price, MPS paid around 1000 billions of lira (more than €500 mln) in the years following the acquisition, as a compensation for the customers object of misselling by Banca 121; the bank had been responsible for the sale of innovative, risky financial contracts (namely the so-called “MyWay” and “4You”) to customers unaware of their exposure. All in all, the acquisition was regarded as a fiasco by the public opinion, that drew a connection between its failure and the political influences pressuring MPS.

The election of Giuseppe Mussari as president of the foundation first (2001), and of MPS later (2006), radicalized the control of Siena’s political parties over the bank; indeed, Mussari was a

[1] Signoretti, Fabio Massimo. 1999. “Mps, Collocamento Record Titoli Assegnati a Sorteggio.” *Repubblica*, June 19, 1999.

[2] Banca 121 had been the first “multi-channel” bank of the country, specializing in the online banking services. See Gatti, Claudio. 2006. “Mps e Quell’acquisto Costoso Nel Salento.” *Il Sole 24 Ore*, September 27, 2006.

[3] “MPS, Dal Grande Inciucio Alla Bancarotta?” 2015. QuiFinanza. 2015.

young lawyer widely known[4] to be supportive of the governing party “Democratici di Sinistra” (DS).

Few years later, in 2003, a legal “trick” allowed the institution to realize the duty previously imposed by the Ciampi law. Through the conversion of a group of ordinary stocks into preferred shares, the MPS foundation fell below the level of 51% of the bank’s equity, going from 58,6% to 49%[5]. However, the preferred shares still granted MPS the majority of the votes in the extraordinary general meetings, and the level of 49% was more than enough to control the bank on a de facto basis. Control that led, at least partially, to the fatal acquisition of Banca Antonveneta in 2008.

The last step of the inorganic growth: Antonveneta acquisition

On November 8th 2007 Monte dei Paschi di Siena announced that it had reached an agreement with Banco Santander for the acquisition of the Italian institute Banca Antoveneta. MPS won the deal against the competition of BNP Paribas, after having received an ultimatum of the president of Santander, who threatened the Italian bank to open a competitive bid if it would not raise its offer.

In the wave of a large process of banks mergers[6], the deal was perceived as the last opportunity to adapt MPS’ structure to the increasingly competitive international markets; in relation to this, strong pressures in favour of a large acquisition were coming from both Rome’s government and Siena’s local entities[7]. Through the investment, MPS became the third bank for capitalization in Italy, with a market share of 10%, adding 1000 branches to already existing 2000. However, the acquisition would be one of the most debated in the history of Italy, mainly because of the price paid and other related issues.

At the date of the announcement, the declared price was €9.3 bn, 6 of which later reported as goodwill; considering the financial expenses, the actual purchase price ultimately rose to around €10.3 bn[8]. MPS paid Antonveneta at multiple “P/Branch” of 8,9 in line with the Italian average; the P/E of 26,2 appeared to be fairly above the mean value of 23,3[9]. However, the oddest figure

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[4] Peruzzi, Cesare. 2016. “Monte Paschi Da Ferdinando II Ad Oggi: Parabola Della Banca Più Antica Del Mondo.” Il Sole 24 ORE, December 27, 2016.

[5] Signoretti, Fabio Massimo. 2003. “Mps, La Fondazione Sotto Il 50%.” *Repubblica*, May 16, 2003

[6] Above all the noteworthy merger between Banca Intesa and Sanpaolo Imi.

[7] “In Merito Alla Fondazione Monte Dei Paschi Di Siena e Alla Banca Monte Dei Paschi Di Siena. I Rapporti Con La Regione Toscana.”

[8] Ibidem

[9] Biasia, Chiara. 2013. “Le Operazioni Di M&A Nel Settore Bancario Italiano. Il Caso Banca MPS - Antonveneta.”

arises from the comparison between this acquisition and the purchase of Antonveneta by Banco Santander itself. In fact, Antonveneta had been acquired few months earlier by Santander from ABN Amro for €6.6 bn; through the sale to MPS, Santander ultimately realized a capital gain of more than €3 billion in just 3 months[10] .

In addition to the already expensive price, MPS had to settle a debt of €7.9 bn that Antonveneta presented on balance sheet towards Santander. It seems worthy to mention that the existence of this obligation was only assessed after the announcement of the deal; in fact, as reported by one of the prospectuses of the operation[11], MPS had already closed the costly deal without performing any kind of due diligence, mainly because of the pressures coming from the selling-side. This additional duty determined the payment of more than 17 billions of euro to Santander, that MPS delivered entirely by cash, through 8 checks[12] between May 2008 and April 2009.

Apart from the debit, the following weaknesses were ascertained only after the closing of the deal[13]: Antonveneta was poorly divisionalised, provisions for 2007 had to be re-assessed, costs were already relatively low and the bank presented problems in managing the external and internal communications.

Because of the elevated capital requirements necessary for sustaining the acquisition, the Bank of Italy requested MPS to fulfil specific financing needs, in order to ensure the financial feasibility of the transaction. Therefore, the acquisition process only started on May 2008, after the approval of the financing plan elaborated by MPS. This consisted 4 legs[14], as follows:

1. A €5 bn recapitalization. Not to lose control, the MPS foundation subscribed pro-rata for €2,8 billion and ended up concentrating 75% of its capital in the bank. From that moment on, the foundation's destiny would have been, unfortunately, strictly dependent on the performance of Monte dei Paschi.
2. Issue of new shares for a total value of €950 mln. In particular, the shares were an innovative form of hybrid securities, denominated "FRESH", (Floating Rate Equity-linked Subordinated Hybrid Preferred Securities). The FRESH emission was subscribed by JP Morgan (JPM), which financed it through the issue of bonds convertible in MPS

[10] Ibidem.

[11] Banca Monte dei Paschi di Siena. 2008. "Prospetto Informativo Relativo All'offerta in Opzione e All'ammissione a Quotazione Sul Mercato Telematico Azionario Organizzato e Gestito Da Borsa Italiana s.p.a. Di Azioni Ordinarie Di Banca Monte Dei Paschi Di Siena s.p.A."

[12] Conti, Camilla, and Luca Piana. 2012. "La Lista Segreta Del Monte." *L'Espresso*, December 2012.

[13] Biasia, Chiara. 2013. "Le Operazioni Di M&A Nel Settore Bancario Italiano. Il Caso Banca MPS - Antonveneta."

[14] Banca Monte dei Paschi di Siena. 2008. "Documento Informativo Relativo All'acquisizione Di Parte Di Banca Monte Dei Paschi Di Siena S.p.A. Dell'intero Capitale Sociale Di Banca Antonveneta S.p.A."

shares (FRESH bonds). JPM retained only the usufruct of the shares, and it was established that MPS had to pay a coupon to JPM only in the case of dividend distribution; the coupon, in turn, represented the repayment for the FRESH bonds. Therefore, JPM was just an intermediary into this transaction, while the actual financers were the subscribers of the FRESH bonds. Among these, the MPS foundation had purchased €490 mln of bonds, even engaging into debt to finance the transaction[15].

3. Issue of 10-year subordinated bonds for a comprehensive amount of €2.16 bn.
4. A bridge financing with a pool of banks (Merrill Lynch, Credit Suisse, JPMorgan, Citi, Mediobanca and Goldman Sachs) for a total value of €1.56 bn, to be paid back through the sale of non-strategic assets.

The derivatives scandal

Apart from the costly Antonveneta acquisition, other happenings determined, later on, serious effects on the bank's financial statements and reputation. In particular, the derivatives scandal comprises three complex contracts defined before the financial crisis of 2008. During that period, derivatives were extremely appealing because they could yield high returns with (just apparently[16]) low risk combinations; therefore, even commercial banks like MPS were approaching to these instruments. The scandal emerged after the finding of a document (so-called "mandate agreement") at the end of 2012, and led MPS to the restatement (in 2012) of some items of the 2011 financial statements, in accordance with IAS 8; this, in turn, determined a negative effect on the regulatory capital of the bank in the balance sheet of 2012 as well[17]. In chronological order, the most problematic MPS' derivatives were Santorini, Alexandria and Nota Italia.

Santorini was born in 2002, when MPS gave up its participation in Sanpaolo IMI to Deutsche Bank (DB), by selling Sanpaolo shares for a total value €785 mln. In particular, €329 mln of these were injected by MPS in the special-purpose vehicle (SPV) Santorini Investment Ltd, participated by Deutsche and MPS, respectively for 51% and 49%. Then, it was defined a collared equity swap between Santorini and Deustche, whose underlying were the Sanpaolo IMI shares at the last traded price of €11,74. According to this contract, Deutsche had to pay

[15] Bernabei, Stefano. 2012. "Mps-Antonveneta, La Storia Del Fresh Nei Carteggi Con Bankitalia." *Reuters*, May 21, 2012.
[16] Ratings on derivatives were very high and did not reflect the actual risk of the contracts.
[17] The description of the derivatives is entirely based on the specifications made by Monte dei Paschi into its annual report 2012.

the shares' dividends to Santorini and, at the contract maturity, the delta, if positive, between the market price of the stocks and their last traded price (€11,74), given a certain cap. On the other hand, Santorini was compelled to pay a fixed rate of 4,81% to Deutsche and, at maturity, the difference, if negative, between the market price and the last traded price of the shares, given a certain floor.

In 2006 DB withdrew from Santorini, and MPS remained 100% owner of the SPV. Meanwhile, as the maturity of the equity swap was approaching, Sanpaolo IMI shares were trading even below the established floor, resulting in a potential loss of 362 million euros for Santorini (therefore for MPS) in 2008. This could not happen, since MPS was expected to pay out dividends, allowing the foundation to receive the coupon on the FRESH. The plot of interests led MPS to restructure Santorini with DB in December, 2008. First of all, Deutsche and Santorini agreed to a three-leg derivative contract on Italian BTPs[18], that was soon closed out, determining a €364 mln capital gain that offset the potential loss. Secondly, MPS agreed to a total return swap on €2045 mln BTPs with Deutsche bank, that comprised the following mutual obligations:

1. MPS sells BTPs to Deustche, receiving the market value at the effective date.
2. At each BTP's coupon payment, MPS receives the coupon from Deutsche and pays a floating rate.
3. At maturity, Deutsche provides Monte de' Paschi with an amount equal to the value actually received from the BTP's face value repayment.

To sum up, the overall operation cancelled out the effects of the original Santorini derivative (the equity swap), allowing the Italian bank not to report a loss in 2008. However, the loss would not, of course, disappear; it would be spread all over the duration of the new contract.

On the accounting point of view, Monte dei Paschi did not derecognize the BTPs from its assets and recognized among its liabilities a long term repo (LTR) of the amount received (recognition at cost). Only in 2012, it was ascertained that the liability should have been recognized at the fair value, rather than at cost. The error was estimated in the amount of €429 mln gross tax, and led to the correction of the equity value as at 31/12/2011 for -327,8 million euros.

Alexandria is probably the most discussed operation, since it gave rise to the whole scandal. The derivative arose at the end 2005, and it was arranged by the London branch of Dresdner Bank. In particular, MPS acquired bonds issued by the "first-level" vehicle Alexandria, at the face value of €400 mln. However, the amount raised through the emission of the notes was

[18] Italian treasuries: "Buoni del Tesoro Poliennali".

invested by Alexandria in the securities issued by another SPV: Skylark. This company, in turn, used most of the collected liquidity for the purchase of a risky portfolio of US' asset-backed securities and credit default swaps (CDS). By retracing the streamline of cash flows, it can be understood that the actual value of the financial instruments held by MPS was depending on the ABS and CDS owned by Skylark; technically, Alexandria is a CDO-Squared, one of the kind of instruments that determined the financial crisis of 2008. Moreover, what seems curious is that both Skylark and Alexandria were vehicles owned by Dresdner Bank; therefore, the bank had managed the whole operation in order to invest in risky securities, dropping the likely losses on Monte dei Paschi di Siena.

And that is what happened indeed. During and after the financial crisis, the Alexandria notes lost 55% of their value, determining a negative amount to be reported by MPS on the 2009 income statement of €220 mln. Taking this into account, as well as the need of the MPS' foundation for a dividend pay-out in order to receive the FRESH coupons, MPS designed a deal with the Japanese bank Nomura to spread the loss over the future years; both the aim and the contractual structure of the agreement were similar to the restructuring of Santorini. First, Nomura substituted the original notes with others of higher quality; the substitution happened without causing any economic effect into MPS' financial statements. Then, MPS would pay back Nomura through a long-term repo transaction (LTR) for €3050 mln of BTPs.

MPS did not disclose the terms of this agreement neither to the authorities of the Bank of Italy and Consob nor to the audit advisors of KPMG; this led them to consider the two operations (asset substitution and LTR) as distinct ones, and to accept the 2009 balance sheet reporting the long term repo as a liability at cost. Only three years later, after the replacement of MPS top management, the new general manager Fabrizio Viola found out the "mandate agreement" in a safe of the bank's headquarters; the document included the terms of the transaction between MPS and Nomura, certifying the link between the asset substitution and the structured LTR. Therefore, the two operations had to be considered as "linked transactions" for a correct financial reporting; in particular, as for Santorini, the LTR should have been reported at the fair value rather than at cost. This error yielded to the restatement of the equity value as at 31/12/2011 of -284,1 million euros.

Last, **Nota Italia** is a derivative entered by MPS in 2006. At the time, MPS purchased from JP Morgan bonds denominated "Floating Rate Notes with Collateral Substitution Right due 2037" for a face value of $639 mln. It was established that, in case of default of Italy, the original collateral of the notes may be substituted with securities issued by the Italian government itself, making the notes worth zero (or close by) in the end. All in all, MPS was selling to JP Morgan a credit default swap on Italy, gambling on the country's stability. From an accounting point of view, the notes Nota Italia were split between a bond component and a derivative component. The derivative component was reported at its fair value, measured by taking into consideration the probability of occurrence of the two risks that it incorporated: the risk of Italy's default and the risk of default of the original collateral. In details, the probability of default of Italy was considered as subordinated to the non-default of the first collateral. After a deeper analysis, this accounting policy was reviewed in 2012, by considering the two risks cumulatively. The change in accounting policy, in accordance with IAS 8, led to the restatement of the equity value as at 31/12/2011 of -184,3 million euros.

All in all, the derivatives, determined a negative effect on MPS' capital of about €800 mln in 2012, calculated as the sum of the restatements.

Moreover, the instruments generated most of the liquidity problems that characterized the bank along the years. In fact, the long term repos exposed MPS to the "margination" duty towards its counterparties (Deutsche Bank and Nomura), calculated as the positive difference between the repo value and the mark to market value of the BTPs underlying the repos[19] . During 2011, the crisis of the Italian sovereign debt dramatically reduced the value of the BTPs, pushing MPS to higher and higher margination payments that affected its liquidity position. In the second half of 2011, the Bank of Italy was forced to several lending operations for a total of €6 billion in order to resolve MPS' illiquidity problem[20].

Finally, not only MPS had increased its exposition to the BTPs, but it had also cancelled the only positive aspect of owning Italian treasuries in the period of the Italian sovereign debt crisis: the coupon receiving. Through the swaps on the BTPs, MPS basically nullified the value of the coupons[21] indeed.

It can be understood that, leaving aside Nota Italia, the restructuring of the derivatives, performed to safeguard the MPS foundation, turned out to be a disaster for the Italian bank.

The years following Antonveneta: between recapitalizations and State aids

On the verge of a new era due to the Antonveneta acquisition (or at least this is what was

[19] Banca d'Italia, Consob, and IVASS. 2013. "Trattamento Contabile Di Operazioni Di 'Repo Strutturati a Lungo Termine.'"

[20] Commissione Parlamentare Di Inchiesta Sul Sistema Bancario e Finanziario - Banca Monte Dei Paschi Di Siena.

[21] Soldavini, Pierangelo. 2013. "Mps per Tutti. Tutto Quello Che Avreste Voluto Sapere Sul Caso (Ma Non Avete Mai Osato Chiedere)." *Il Sole 24 Ore*, January 30, 2013.

expected), MPS realized a net income of €922 million in 2008[22], also thanks to the restructuring of Santorini derivative. Even if decreasing by 35,7% from the result of the previous period, the profit allowed the bank to distribute a dividend of €0,013 per share. The MPS foundation received €64 mln in aggregate, used for the usual distributions across the Siena's territory and for the beginning of the debt repayment.

Apart from the diminishing net income, which may be due to the adverse macroeconomic conditions[23], the main negative point emerging from the financial statements was represented by the value of the regulatory capital ratios. In fact, even if the total capital ratio of 9,32% was well above the limit value (8%) requested by the newly implemented Basel II regulation, the fall in value of the Tier 1 capital ratio (from 6,10% to 5,13%), probably due to the costly Antonveneta acquisition, triggered an alarm button. In order to improve the quality of its capital, the bank demanded for €1,9 bn of the so-called "Tremonti bonds". These were bonds issued by healthy banks and submitted by the Italian government in 2009; their aim was to support the lending to companies and families, by reinforcing the banks' regulatory capital "Core Tier 1" (or Common Equity Tier 1 – CET1). Technically, the bonds presented the following attributes[24]:

- Subordinated, because in case of insolvency of the bank they were remunerated only after the other types of debt.
- Hybrid, since they presented characteristics of both shares and bonds. In particular, there was a face value to be paid back (like bonds), while yearly interest had to be paid only conditional on a positive net income (similar to shares' dividends).
- Convertible, at the bank's request, into ordinary shares.
- Perpetual, because they had no expressed maturity and could be paid back at any moment.

One year later, the Tremonti bonds proved to be affective, allowing MPS to close the 2009 fiscal year with an improved Tier 1 capital ratio of 7,5%. However, quite surprisingly, the net income was still decreasing, making someone doubt about the actual value of the Antonveneta operation; the reported net income was just 220 million euros, a value that would have been even negative without the restructuring of Alexandria. The positive outcome allowed to pay dividends of €0,01 only to the preferred stocks (entirely held by the foundation), such that the MPS foundation received 184.000 euros (from the dividends) plus 7 million euros (from the

[22] The main figures of MPS' financial statements are reported in the exhibits (years 2008-2017).
[23] Financial crisis 2018.
[24] "Capire i Tremonti Bond." n.d. Il Sole 24 Ore.

FRESH bonds) to be entirely used, again, for both distributions and debt repayments[25].
In July 2010, MPS passed the stress tests performed by the European Banking Authority (EBA) on the capital adequacy of the major European banks. As a confirmation to the outcome of stress test, the balance sheet for the year 2010 illustrated an increase in both the Tier 1 and the total capital ratios (from 7,5% to 8,4% and from 11,9% to 12,9% respectively). The result was extremely positive also in terms of financial performance: the registered net income was 985,5 million euros, showing a significant increase (348%) with respect to 2009. But it was just the quiet before the storm.
The 2011 started with a €2,2 billion recapitalization, entirely subscribed by the MPS foundation not to lose control of the bank; part of the amount needed for the subscription was raised, again, through debt by the Siena’s aid institution. The capital increase was part of the regulatory capital improvement program, formally encouraged[26] by the president of the European Central Bank (ECB) Mario Draghi and in line with the Basel III accords, implemented in the European Union (EU) on a step-by-step basis starting from 2011. Also, it was aimed at the reimbursement, in the future, of the Tremonti bonds. Yet, this would not happen; instead, the capital was used for maintaining the bank’s functioning during and after the year that may be seen as the worst one along MPS’ history. In fact, the recognition of the Antonveneta operation’s flaws, in the form of goodwill impairment for €4,52 billion determined huge losses for the bank in 2011 (-4,69 billions of euro).
Considering the whole 2011, the only positive point was represented by the passage of the stress tests during the summer, and the increase of the regulatory ratios from the previous year. However, the crisis of the Italian sovereign debt determined a downside in terms of capital adequacy. According to an exercise performed by the EBA on the capital exposure of the EU banks to the sovereign debt (Septmber 2011), MPS presented a capital shortfall of €3,3 bn, to be restored by June 2012 in order to reach a CET1 ratio of 9%.
Despite of the EBA’s requests, Monte de’ Paschi preferred not go on the market to recapitalize, since it was considered too risky in a period of adverse structural conditions. Instead, additional capital was raised through the disposal of non-core assets (above all, the sale of BiverBanca) and the conversion of the FRESH bonds into shares. However, in June 2012, the capital shortfall was still estimated at a value of €1,3 bn. On the occasion of the presentation of the industrial plan 2012-2015 in June, MPS informed the Bank of Italy that it would not be able to meet the

[25] “In Merito Alla Fondazione Monte Dei Paschi Di Siena e Alla Banca Monte Dei Paschi Di Siena. I Rapporti Con La Regione Toscana.”
[26] Greco, Andrea. 2011. “Moral Suasion Del Governatore Sulle Banche.” *Repubblica*, February 27, 2011.

capital requirements. Therefore, it asked for state aids in the amount of €3,4 billion, 1,9 of which to substitute the previous Tremonti bonds and 1,5 to cover the estimated capital shortfall. The measure was accepted by the European Commission in December, conditional on the presentation of a restructuring plan by MPS. Finally, €4,071 bn of Monti bonds were issued by MPS and subscribed by the Italian Ministry of Economics and Finance on 28/02/2013. The additional €671 mln were due to the derivatives scandal[27] and its expected impact on the bank's capital, as well as the anticipated payment of the interests on the Tremonti bonds.

A couple of months after the issue of the bonds, in April 2013, the balance sheet for the period 2012 was approved by the shareholders and made public. It reported, again, a heavy loss of €3,17 billion. As for 2011, part of the negative result was due to the impairment on goodwill for €1,53 bn. The remaining half, instead, was caused by the provisions on credits; the portfolio of non-performing exposures[28] had increased to €29,5 bn (+28%) during 2012, inducing the bank to report provisions for €2,67 bn. At the time, the non-performing exposures represented 19,1% of the total credits. Indeed, this value would raise even more in the following years, and the NPLs would be the reason of several problems for MPS (and the whole Italian banking system).

In October 2013, as conditional to the Monti bonds issue, the restructuring plan 2013-2017 was presented. Besides the strategic goals aimed at the reduction of costs, the plan envisaged[29] the reduction of the Italian BTPs portfolio, a €2,5 bn recapitalization by the end of 2014 and the repayment of €3 bn of Monti bonds in 2014.

The fiscal year 2013 was closed with a net reported loss of €1,44 bn. Again, the provisions on credits had a very negative impact of 2,82 billions of euro; also, the NPLs portfolio had raised to 36 billions of euro. The NPLs accounted now for 24,5% of the total credits.

During June 2014 a recapitalization of €5 billions was performed and €3 billions of Monti bonds were paid back, as established by the restructuring plan. Thanks to the delay in the timing of the recapitalization requested by the MPS foundation, the major shareholder was able to take part to the capital raising for its share, dropped to 2,5%. In fact, the MPS foundation had carried out a series of disposals of the MPS' stocks starting from December 2013, when it still accounted for 33,5% of the bank's capital; the measure had been taken in order to restore the

[27] Scacciavillani, Gaia, and Giovanna Trinchella. 2012. "Alessandro Profumo, l'uomo Di Brontos Che Ora Chiede 3,9 Miliardi Allo Stato." *Il Fatto Quotidiano*, November 29, 2012.

[28] "Non-performing exposure" (NPE) and "non-performing loan" (NPL) will be used interchangeably. Also, if not differently specified, any value referring to the MPS' credits and the non-performing exposures is to be considered as gross of accumulated provisions.

[29] Banca Monte dei Paschi di Siena. 2013. "Il CDA Approva Il Piano Di Ristrutturazione 2013-2017."

financial stability, by extinguishing the previously-originated debts. The sales operated by the foundation represented the end of the Siena system as it had been known until then: the politics' chains tying MPS had been finally (but temporarily) broken.

Despite of the recapitalization, MPS failed the EU-wide stress tests 2014. These outlined a capital shortfall of about 2 billion euros, to be restored in the least possible time.

The stringent standards adopted by the EBA also had an impact on the 2014 balance sheet: MPS reported higher NPLs (€45,3 billion) and provisions (€7,82 bn), mainly due to a change in the policy for the classification and the valuation of the NPLs' portfolio, that raised to 31,7% of the total credits; this revision had been determined, in turn, by the Asset Quality Review developed by the EBA together with the stress tests. The elevated value of the provisions was, again, the main responsible the huge losses reported by the Italian bank (€5,34 bn).

In relation to the capital shortfall evidenced by the stress tests 2014, MPS performed a new recapitalization between May and June 2015. Through the operation, the Italian bank raised additional capital for 3 billions of euro that were used, in part, to pay back the remaining Monti bonds. Instead, the Monti bonds' interests were paid back through the emission of stocks; through this transaction, the Italian Government stepped into the bank's equity with a share of 4%.

All in all, 2015 seemed to be a year of recovery for MPS that, after 4 year of losses, reported a positive net income of 388 millions euro. Also, thanks to the recapitalization, the regulatory ratios (Total Capital ratio of 16% and CET1 of 12%) were in line with the Basel III requirements.

The last failure to the stress tests and the bail-out

Despite of the recovering net income, the NPEs had kept growing during 2015, registering the highest NPLs-to-credits ratio in Italy of 34,8% (total NPLs portfolio of €46,9 bn). This would ultimately affect the bank in 2016. In fact the ECB warned the Italian bank to reduce its portfolio of NPEs by 2018. MPS presented a restructuring plan to solve the issue before the stress tests 2016. The plan, approved by the ECB on the same day of the publication of stress tests' results, envisaged the disposal of the whole portfolio of €27,7 bn Bad Debts[30] (book value of €10,5 bn at June 2016); this would be supported[31] by a new recapitalization of 5 billions euro, accountable in part for the provisions on the remaining NPEs and, for the other part, for the loss

[30] Bad Debts are a subcategory of non-performing exposures.

[31] Davi, Luca. 2016. "Mps, via Libera Della Bce Al Piano Su Sofferenze e Aumento Di Capitale." *Il Sole 24 ORE*, July 16, 2016.

due to the disposal of the NPLs at a price below their book value.
For what regards the stress tests, as anticipated, the outcome was extremely poor for the Italian bank: among 51 European institutes, MPS was the only bank failing the screening in the adverse scenario (CET1 of -2,23%).
On 25/11/2016 the shareholders formally approved the €5 billion recapitalization, to be carried out after the Italian constitutional referendum for the amendment of the Italian Constitution. The recapitalization would be made of two legs: first, the conversion into shares of the subordinated bonds and second[32], the actual capital raising based on an anchor investor (identified in the Qatar fund QIA). Among the political uncertainties due to the negative result of the referendum, the whole operation started out on the 19th of December. Few days after the recapitalization was declared failed due to the lack of an anchor investor, since the Qatar fund had stepped away after the warning results of the Italian referendum. Consequently, MPS' stocks were suspended from trading on the Italian stock exchange.
Considering these happenings, the Italian Government issued a Decree-law[33] that would lead to the bail-out of Monte dei Paschi di Siena. The rescue would occur under the "precautionary recapitalization" umbrella, as allowed by the European Bank Recovery and Resolution Directive (BRRD) in the cases of crises of solvent institutions with systemic relevance. However, the procedure was still subject to the approval of the ECB that, considered the overall situation, had requested for an even higher capital restoring of €8,8 billion.
In June, after a long negotiation, the European Authorities approved the precautionary recapitalization of MPS, but conditional on very strict policies: application of the burden sharing principle, dismissal of the whole portfolio of bad debts, and the definition of a ceiling to the management's salaries. The main point was represented, again, by the NPLs' disposal. Indeed, they were the real problem of the Italian bank: the balance sheet 2016 had reported provisions for €4,5 bn, which in turn were responsible for a net loss of €3,38 billion. Therefore, it is comprehensible that the Authorities wanted to make sure to reduce the huge impact of the non-performing exposures on Monte dei Paschi's financial stability. As such, the bank revised the deal previously formulated with the fund Atlante II for the disposal of the portfolio of €9,4 billions of net bad debts (gross amount of €28,6 bn) at the total price of 5,5 billions of euro. In particular, the sale would occur through the securitization of the NPLs: the resulting mezzanine and junior tranches would be purchased by Atlante II for about €1,5 bn, and the senior tranche

[32] The conversion was obviously conditional the bondholder's approval.
[33] *Il Fatto Quotidiano*. 2016. "Banche, Gentiloni Vara Il Salvarisparmio: '20 Miliardi Di Nuovo Debito per Liquidità e Aumenti Di Capitale,'" December 19, 2016.

of €3,3 bn would be sold to private investors, under the GACS umbrella. The difference between the securitization price and the book value (around €4 bn) was reported in the half-yearly income statement as a provision, in order to adjust the book value of the bad debts to their expected sale price[34].

Thanks to the disposal plan, the precautionary recapitalization was ultimately approved by the European Authorities, even reducing the needed amount to €8,3 billion. Finally, the recapitalization was performed[35] by the Italian Ministry of Economics and Finance (MEF), that submitted new shares of MPS for a total value of 3,85 billions of euro. Simultaneously, the activation of the burden sharing forced the conversion of the subordinated bonds into ordinary stocks, for an amount of €4,47 bn. Due to the procedure, the Italian Government was now the main shareholder of MPS, holding 53,5% of its equity. However, the amount was expected to raise, because of the reimbursement, to be operated by the State, of the small investors who had seen their bonds converted into shares because of the burden sharing process. The reimbursement terminated in November 2017 when, at the end of an exchange offer, the Italian Government paid back the small investors for a total amount of €1,53 bn; the MEF raised to 68% of the capital of MPS. All in all, the Italian tax payers invested 5,4 billions of euro for the bail-out of Monte dei Paschi di Siena.

Recently, the securitization of the NPLs has started[36], through the subscription of the mezzanine tranche by Quaestio SGR, the company managing the Atlante II fund. The process is still ongoing, and it will be ultimately completed through the sale of the senior and junior tranches. Will it be the start of new future for the oldest bank in the world, or it will be just another Italian disillusion?

[34] *Reuters*. 2015. "Mps, Cartolarizzazione Con Atlante 2 Da 26,1 Mld Al 21%," July 5, 2015.

[35] Trovati, Gianni. 2017. "Allo Stato Il 53% Di Montepaschi: Salvataggio Al via a 6,49 Euro Ad Azione." *Il Sole 24 ORE*, July 29, 2017.

[36] *Affaritaliani.It*. 2018. "Mps, Decolla La Cartolarizzazione Delle Sofferenze. Rally Del Titolo," January 10, 2018.

TEACHING NOTE

1. What are the major drivers of the crisis of Monte dei Paschi? What is the role played by the MPS foundation?

The whole story of the crisis of Monte Paschi di Siena may be split into two main periods that, in turn, are linked to the two drivers that impacted on the bank's operations and financial stability. First, there is the inorganic growth, whose main step was the Antonveneta acquisition, that led, directly or indirectly, to both report huge losses and present capital shortfalls between 2009 and 2014. Second, the non-performing exposures represented the Achille's heel that has affected Monte Paschi di Siena since 2013/2014. As it emerges from the text, the two aspects would be, in some cases, overlapping and interrelated; the sharp distinction is indeed proposed just at theoretical level, in order to frame the happenings for an easier understanding. Moreover, it shall be remarked that, while the first driver only represented a serious pitfall for MPS, the NPLs are a phenomenon that still hurts the whole Italian banking system, even if MPS has proved to be one of the most troubled institutes in relation to it.

Within these variables, the MPS foundation played a key role and it may be considered , as well as the Siena system that it represented, the major responsible for the crisis of MPS. While this connection may appear as quite straightforward in relation to the inorganic growth, it probably would not be the case for the non-performing loans. Therefore, together with the clarification of these concepts, some economics findings will be illustrated to draw on.

Laeven and Levin (2008) showed that, within the field of banks' governance, the existence of a large owner is often associated with higher "risk taking" for a bank; this happens because large owners have greater power than smaller ones to increase the bank's incentives to take on risk (John, Litov, and Yeung, 2008). If we consider that the paper defines "large power" shareholders as the ones with at least 20% voting rights, the connection with the MPS case, where the foundations held 58% of the rights (including the preferred stocks) until 2012, seems obvious. In the case of MPS, it shall also be reminded that, through the foundation, the board of directors was not only subject to the strength exercised by a powerful shareholder, but also to the Siena's political and social influence that was pushing towards a large acquisition.

Indeed, in the case of Monte dei Paschi, the higher risk was definitely embodied by the acquisition of Antonveneta itself, that may be regarded as the original cause that led to a series of unfavourable events. In fact, the pricy acquisition determined the need for the Tremonti bonds and the reported impairment on goodwill in 2011 and 2012 (as well as the respective losses). Moreover, the purchase of the FRESH bonds by the foundation forced the bank to restructure Santorini and Alexandria, rather than closing out the positions as a sound management practice would have required. The restructuring pushed the bank into the liquidity crisis in 2011 and to be called for a recap by the ECB; this was substituted by the emission of the Monti bonds and, in order to pay back the governmental aids, a recapitalization of €5 billion was carried out in 2014, when the MPS foundation had just reached the 2,5% of the bank's capital. This may be seen as the point that ultimately completed the vicious circle started in 2008 with the acquisition of Antonveneta; eventually, the series of controversial happenings had led the foundation to be almost excluded from the bank's equity.

Despite of the of the 2014 recap, MPS' troubles were not over yet. MPS had the largest NPL to credits ratio among the Italian banks; the NPLs crisis was just about to start, leading the Italian bank to the several troubles observed in the case and to be finally bailed-out by the Italian government. As already mentioned, identifying responsibilities for the MPS foundation, and in general for the Siena system, in relation to this "second driver" might be tricky. However, as recently demonstrated, the presence of politically connected directors within the banks' board might alter the issue of credit; the likely reason is that, because of the political connections, loans would be granted in order to pursue personal and party's political goals. In particular, Morpurgo, Brogi, Caselli and D'Amico showed that, especially for local banks, boards composed by a higher proportion of politically connected directors are linked to a larger share of NPLs for a bank. This finding is extremely suitable for explaining the MPS case indeed. In fact, the board of directors of MPS presented a majority of directors appointed by the MPS foundation, since it was the main shareholder of the bank. The representatives of the foundation, in turn, were nominated by the political party governing the Municipality and the Province of Siena. Given these relationships, it seems clear the political influence that characterised not only the MPS foundation, but also Monte dei Paschi di Siena. Therefore, considering the Morpurgo et. al paper, it is fair to state that also the extremely large share of NPLs has been determined, again, by the complex mechanisms of interests and relationships that was realized through the participation of the foundation in the bank's capital.

In relation to this point, one might argue that, while the foundation had retained control until 2013, the NPLs seriously affected Monte de' Paschi's financial stability starting from 2014. As an answer to this criticism, it shall be borne in mind that the non-performing exposures only represent an accounting classification for already existing credits; indeed, these credits had been issued when the foundation still played a critical role within the bank's "life".

2. **Considering your answer to the previous question, what could have been the mechanisms to prevent the municipalities' intervention, and therefore the political influence, within the MPS' governance?**

Considering the two drivers, and their respective roots, that ultimately determined the crisis of MPS, two main lines of intervention could have been implemented in order to improve the bank's governance. In fact, in accordance with the economics theories illustrated so far, the depletion of the power of the main shareholder and the reduction of political connections within the bank's board may had led to a decrease in risk-taking strategies and a better allocation of credit respectively. These two measures may have been realized through several strategies.

For what regards the reduction of the power of the main shareholder, the first possibility would have been to simply force the foundation to sell part of its shares. This is what happened with Ciampi law in 1998 indeed. However, such a policy might be perceived as too strict and even unfair, because it would deprive the foundation of its main assets, draining resources from the whole local community of Siena, that firmly relied on the bank's incomes and dividends distribution. This is probably what induced the foundation to convert ordinary stocks into preferred ones, in order to comply with the Ciampi law while keeping on exerting the most possible control on the bank, still owning 58% of its capital (48% ordinary shares + 10% preferred ones). Leveraging onto this decision, a second strategy comes to mind; it is exactly the conversion of ordinary shares into preferred ones. Since this type of instrument eliminates the voting rights associated with the ordinary shares, it would be perfect for reducing the foundation's power at the shareholders' meetings of MPS. This would happen without harming the interest of the foundation in receiving yearly premiums from the bank; indeed, the conversion would even reinforce this right, because of the higher dividends yielded by the preferred stocks.

Finally, a third mechanism that could have been implemented is represented by the direct imposition of a limit to the major shareholder's votes. In fact, by establishing a cap level to the exercisable voting rights, the MPS foundation would have had less authority to increase the incentives of the bank to take on risk.

Considering the policies described so far, one major flaw of both the second and third option would have been the increase in power of the minority shareholders; they would have been entitled with as many rights as a major shareholder, and this might have ultimately resulted in the "excessive risk taking" described by Laeven and Levin. Therefore, the best alternative seems the actual enforcement of the Ciampi law. Probably, even a stronger policy than the one envisaged by the Ciampi law would have been needed, obliging the MPS foundation to sell shares for an amount such that it would reach less than 20% of the bank's capital (in line with the Laeven and Levin theory); also, shares should have been purchased within a certain limit (i.e. 3-4%) by the investors, in order to avoid the appearance of a new large shareholder. In order to ensure transparency and the full accomplishment of the goals, the whole process may have been directed by an external party, such as the Bank of Italy or the ABI (Italian Banking Association).

A second point to consider should have been the political connection within the MPS' board; by limiting this feature, the credit allocation probably would have improved. In order to eliminate, or at least to reduce the political influence expressed through the MPS foundation, two general approaches could have been adopted; either directly working on the MPS board, or dealing with the top of the pyramid, the MPS foundation. In particular, for the first option, in addition to the policies described so far (preferred shares and so on), another possibility might have been to establish the ineligibility for individuals who had been, along their life, inscribed to political parties, either just in the region of Tuscany or in the whole Italian territory. Also, it could have been envisaged a ratification mechanism for the MPS board, entitling the Bank of Italy to approve its election and, in some extreme cases, to ban some of its members.

Secondly, another way might have been to rethink the organization of the whole MPS foundation. In fact, by looking at the composition of the Deputation, it is easy to understand how the Siena's politics parties played a key role in appointing the foundation's members and guiding its actions. By making some members of the administrative body eligible by non-local entities, for example the Bank of Italy or Ministry of Economics and Finance (MEF), the political influence would have been reduced. Also, forbidding the transfer from the Deputation of the foundation to the MPS board (as happened with the president Mussari in 2006) might have been a good measure.

Finally, higher accountability and more transparency should have been imposed to the MPS foundation. In fact, as outlined by Jassaud N., foundations were subject to low internal accountability and external supervision, resulting in weak corporate governance practices and very poor clarity regarding the appointment of their governing bodies; also, foundations were not required to comply with uniform accounting and disclosure practices. With regards to the MPS foundation, it seems extremely odd that the major shareholder of the third Italian largest bank could have been subject to such restricted compliance; indeed, it is a paradox that the "owner" of a bank, probably the most controlled institute in the world, has to comply, instead, with a very poor and confused regulation. In order to improve this aspect, that ultimately generates an impact on the political influence within MPS, Jassaud suggested to establish a third party ratification for the foundation's financial statements; also, in order to develop a more transparent corporate governance, term-limits should have been introduced for the Deputation members and it should have envisaged a period of grace between political office roles and the eligibility for the foundation bodies, as it happens for the boards of directors of the banks.

3. What are the main characteristics of the Antonveneta acquisition, and how did they impact on MPS financial results?
What are the determinants associated with M&A cash financing, and how do they fit the acquisition of Antonveneta?
Which are the main pitfalls of not executing a due diligence? How do they show up in MPS case?

MPS acquired Antonveneta from Banco Santander, at the final price of €10,3 billion, 6 of which reported as goodwill. While the deal was announced in 2007, the whole process started out almost one year later, when MPS submitted a specific financing plan to the Bank of Italy.
As it emerges from the case, the initial decision through which the price (€9,3 bn at the beginning) was settled was rather hurried, given the ultimatum of the president of the selling-side.
Despite of the financing plan, MPS reported a decreasing tier 1 ratio in the 2008 financial statements; this led the bank to ask for the governmental aids known as "Tremonti bonds". Later on, the impairments on goodwill determined deep losses for the bank in 2011 and 2012.
One of the main characteristics of the operation was the funding technique adopted; the acquisition was totally cash-financed, and the payment was performed through the emission of 8 cheques to Banco Santander. In order to understand the main reasons for M&A cash financing and how they match the case of MPS, the findings of Faccio M. and Masulis R. W. (2002) will be illustrated. They performed a series of regressions to account for the link between the major characteristics of European M&A deals and the financing strategy adopted (cash or stock). All in all, the researchers showed that the financing decision is influenced by several factors related to the features of the bidder, the target and the deal, as well as country-specific characteristics. In particular, the main variables considered, and their respective results, are the following:

1. *Corporate control*. The use of cash in M&As increases when the bidder's controlling shareholder has between 40% and 60% voting rights. This happens because, by using cash, the shareholders are not subject to any dilution.

2. *Size of the bidder*. Larger bidders appear to be more likely to use cash, probably because of the greater facility in issuing debt.
3. *Size of the deal*. For relatively high value deals, stock financing seems to be the most preferred way.
4. *Asymmetric information*. Bidders tend to use stocks when they believe that they are overvalued.
5. *"Nationality" of the deal*. Cash is preferred for cross-border transactions, while stock payments are used for domestic M&As.
6. *"Growth opportunities"*. Target companies are likely to request for stock payment when the bidder shows an elevated growth over time.

Also, as shown by Fishman S. J. (1989), cash financing is usually connected with the pre-emption of competition; by accelerating the timing of the deal execution, cash payments enable bidders to prevent offers from competitors.

When analysing the case of MPS, it seems remarkable how most of the described determinants also characterise the acquisition of Antonveneta. Indeed, the major shareholder owned between 40% and 60% of voting rights (precisely the MPS foundation was at 48%), MPS had a significant debt capacity (as it later issued debt for financing the operation), the transaction was "international", and the final offer was done in order to exclude the competition of BNP Paribas. In relation to these considerations, one is particularly relevant: the cash was probably preferred over stocks in order to avoid the dilution of the MPS foundation that, as it has been described so far, represented the major root of each of MPS' strategies.

Another peculiarity of the Antonveneta deal was the closing without the completion of a due diligence process. The due diligence is an unbiased, objective analysis of the acquisition target; it represents a fundamental step of an M&A transaction. It focuses on financial reports, tax issues, asset valuation and operations and it gives confidence to the acquirers about the transaction's value and its main risks (Angwin, Duncan 2001). Eventually, due diligence may detect issues that could not be identified otherwise, such as manipulated financial statements, poor internal communication, pending litigations and tax contingencies. In particular, Adolph G., Gillies S. and Krings J. underline the importance of carrying out not only a financial and legal due diligence, but also a strategic one. While the first two relate to the analysis of financial statements and cash flow projections, as well as tax-related problems and possible ongoing legal proceedings, the third means evaluating the degree of fit of the target and the acquirer's capability to fully unlock the potential of the acquired company. Indeed, as the authors suggest, "whereas financial and legal due diligence ascertain the potential value of a deal and concern buying the company at the right price, strategic due diligence explores whether that potential is realistic". This may be summarised by identifying the two objectives of the whole due diligence process:

1. Determining the actual value of the target, by deeply evaluating its financial statements and discovering any hidden liabilities that may affect the business in the future (legal and financial due diligence).
2. Understanding your capabilities to realize that value, by taking into consideration the level of fit between the two companies (strategic due diligence).

In the case of Monte dei Paschi, due to the short time of the operation, as well as the pressures imposed by Banco Santander, the bank did not perform any kind of due diligence for the acquisition of Banca Antonveneta. This, ultimately resulted in not identifying some serious flaws of Antonveneta that, if recognized earlier, may have led to a different decision, or at least to lower the bid for the Italian bank. In particular, still referring to the mentioned article, a thorough due diligence process would have led to the following:

- Legal and financial analysis would have discovered the €7,9 bn debt towards Santander and the fact that the provisions had to be revised.
- Strategic due diligence would have assessed that Antonveneta was badly divisionalised, it presented a poor internal and external information management and the costs were already very low, meaning a potential difficulty at improving the bank's financial performance.

4. What is bail-in and what is its rationale? Why it was not applied in the case of Monte dei Paschi di Siena?

The bail-in represents the main measure envisaged by the Bank Recovery and Resolution Directive (BRRD) for solving the European banks' crises. The main idea behind the rule is to define a tool that stems from saving banks through public interventions (bail-outs), as these involve the use of taxpayers' money. Therefore, the bail-in entered into force in the EU since January 2016. Under this norm, if a bank is failing or it is likely to fail, and the normal insolvency proceedings would not safeguard the stability of the system, the institution is maintained into operation ("resolved") through the write down of shares and the conversion of liabilities into equity, in order to recapitalize the institution and allow for the absorption of the losses[37]. The conversion or the write off are executed following the liabilities' order of

[37] "Changes in the Way Banking Crises Are Managed." n.d. Banca d'Italia.

subordination; only the deposits up to €100.000 and the secured liabilities are excluded from this process. So, it seems remarkable that not only the subordinated bonds participate to the losses but, if necessary, also the senior obligations (if not secured) are switched to equity or written off.

However, room for flexibility was left by the regulators, that envisaged the possibility of the State-operated "precautionary recapitalisation", in special cases of solvents banks who were unable to collect new equity on the markets following a stress test or a comprehensive assessment. This particular type of "bail-out" is also conditional on further specifications, specifically met by MPS[38]:

- The aids are conceded "in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability"; this means that the institution has a systemic relevance.
- Precautionary recapitalisations "shall be confined to solvent institutions".
- The measure is "conditional on final approval" by the European Authorities.
- The recapitalization operated by the State must presents "precautionary and *temporary* nature".
- The capital injection has to be "proportionate" to the capital need of the bank, meaning that it shall not exceed the capital shortage estimated by the supervisor.
- The measure is adopted under the burden sharing principle, similarly to the bail-in; both the shareholders and the *subordinated* bondholders must participate to the process. As happened with MPS, while the first are strongly diluted, the second ones are compulsorily converted into equity.

In relation to this last point, it shall be noticed that, while with the bail-in forces all the liabilities (with the already-said exceptions) to conversion, in the case of a precautionary recapitalisation only the subordinated bonds are involved.

Considering the description so far, it may appear that the measure of the "precautionary recapitalisation" goes against the rationale of the BRRD itself, being this the epilogue of public bail-outs. This point seems in line with the studies of Kahn C. M. and Santos J. A. C. (2005), who examined the time-consistency of regulation. In particular, they reflected on the following. When a crisis arises, larger institutions are generally bailed-out, because of their systemic relevance for the structure of the financial markets. This leads regulators to say "never again",

[38] Mesnard, B, A Margerit, and A Magnus. 2017. "Precautionary Recapitalisations under the Bank Recovery and Resolution Directive: Conditionality and Case Practice."

and to define new regulations that should prevent other bail-outs. However, being the rules settled by taking into consideration the previous crisis, they lack time-consistency, since they cannot forecast each possible future scenario. Therefore, in the future, there will be other, “new” good reasons for saving banks in trouble; the institutions will happen to be bailed-out again, in contradiction with the previously-established regulation. Knowing this, banks will ultimately engage in moral hazard, even if the above mentioned rules are exactly intended to avoid it, by warning the markets that banks will not be publicly rescued anymore.

In relation to the BRRD, it seems that, understanding the time-consistency problem of regulation, the European regulator left himself a room for more tailored measures in the case of the manifestation of the above mentioned “good reasons” not to apply the bail-in; this has been done through the institution of the precautionary recapitalisation. In particular, in the case of MPS, these “good reasons” may be seen as the existence of subordinated bonds held by families and small investors who purchased them before the coming into force of the BRRD, therefore unaware of the risks related to the bail-in. By becoming a shareholder of Monte dei Paschi, the Italian Government was able to reimburse those investors who unfairly saw their bonds being converted into shares.

5. What are the most used strategies for the management of the non-performing exposures in Italy? How were they developed over years? How is Monte de' Paschi moving forward in this process?

A proper handling of the non-performing loans mainly comprises two possibilities: either keeping the exposures on-balance sheet or the sale to third entities. While the first option forces the banks to stock provisions, which in turn affect P&L account, and periodically write-off the NPLs, the second alternative might lead to report a loss all at once, when the sale price is significantly lower than the book value of the loans. As Jassaud N. and Kang K. pointed out, the level of provisions of Italian banks did not keep the pace with the increase in the NPLs that, between 2008 and 2014 have grown at the yearly rate 20%, ultimately reaching the peak of €341 billion at the end of 2014 (gross amount), mostly due to the prolonged recession that worsened borrowers’ ability to pay back their obligations; the relatively low level of provisions, as well as the lengthy judicial process that raises the cost of foreclosure for banks, determined very poor incentives to either write offs the NPEs or to proceed to their disposal. Considering the circumstances, the authors aimed at the creation of a more efficient market for the resolution of the NPLs’ problem.

From that moment on, a lot has been done. In particular, measures were adopted in the directions of incentivizing the provisioning and the write-off of the NPEs, as well as facilitating their disposal. In relation to the first, the ECB's "Guidance to Banks on Non-Performing Loans" pressured the banks to revise their NPL strategies, requiring more structured disclosure; also, the publication of an "Addendum" to the guidance has settled even more stringent prudential provisioning rules.

Secondly, several initiatives have contributed to the develop more efficient practices and markets for the sale of the non-performing loans. In this sense, the best strategy identified was the one of the securitisation. Banks sell their NPLs to a special purpose vehicle, that funds the purchase through the emission of asset-backed securities, whose collateral is represented by the NPLs; the emission takes place in several tranches (senior, mezzanine and junior) with different levels of subordination, that are paid back through the recollection of the bad loans. Ad-hoc funds Atlante and Atlante II, sponsored by the Government and financed by banks and other institutions, were constituted for the acquisition of mezzanine and junior tranches. Finally, the State-backed guarantee GACS ("Garanzia cartolarizzazione sofferenze") for the equity tranches was envisaged by the Italian Government.

The mentioned policies determined an improvement of the overall Italian situation, considering the NPLs had been constantly decreasing, reaching the value of 300 euro billion in June 2017 (gross amount). By looking at the recent developments, PwC forecasts 2018 to be "the year of NPE transformation and breakthrough".

Within this frame, MPS happens to play a key role. Indeed, while the NPEs of the bank have negatively affected the Italian scenario during the last years (as reported in the case, it was the worst bank in Italy for NPLs-to-credits ratio), MPS will now be the leader of the transformation predicted by PwC. In fact, after the failure of the first deal with Atlante II because of the unsuccessful recapitalization in 2016, MPS, under the new governmental management, has just started the disposal of €28,6 billion of bad loans, through the combination of the Atlante II investments and the GACS guarantee. Indeed, on 10/01/2018 Atlante II acquired the mezzanine tranche for €805 mln. The junior and the senior tranche will follow, purchased by Atlante II and private investors (under the GACS) respectively.

EXHIBITS

Exhibit 1 – Net income and non-performing loans figures after Antonveneta acquisition (in millions).

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Net Income	931.110	224.615	986.983	-4.688.739	-3.191.919	-1.438.924	-5.342.892	389.868	-3.231.372	-3.502.245
NPLs (gross amount)	12.843.578	17.152.937	19.563.098	23.013.382	29.505.190	36.039.376	45.324.754	46.857.725	45.785.468	20.920.063
Total credits (gross amunt)	151.676.387	160.157.855	165.238.062	156.917.000	154.838.710	146.932.095	142.773.189	134.730.372	132.846.364	97.579.552
NPLs/credits ratio (gross)	8,5%	10,7%	11,8%	14,7%	19,1%	24,5%	31,7%	34,8%	34,5%	21,4%
Annual provisioning charge (P&L)	1.002.282	1.452.710	1.125.509	1.309.189	2.666.549	2.749.775	7.821.435	1.991.083	4.467.024	5.323.687
Cumulative provisions ("loans towards customers")	5.310.563	6.931.696	8.182.443	9.533.465	12.108.451	15.047.246	22.181.659	22.703.894	25.465.520	10.567.973
Losses on write-offs (A)	131.040	131.462	51.501	35.345	52.217	49.674	51.779	63.516	121.465	142.728
Cumulative provions, net of write-offs' losses (B)	5.179.523	6.800.234	8.130.942	9.498.120	12.056.234	14.997.572	22.129.880	22.640.378	25.344.055	10.425.245
Losses on write-offs/cumulative provisions ratio (A/B)	2,53%	1,93%	0,63%	0,37%	0,43%	0,33%	0,23%	0,28%	0,48%	1,37%

Exhibit 2 – Net income trend, years 2008-2017.

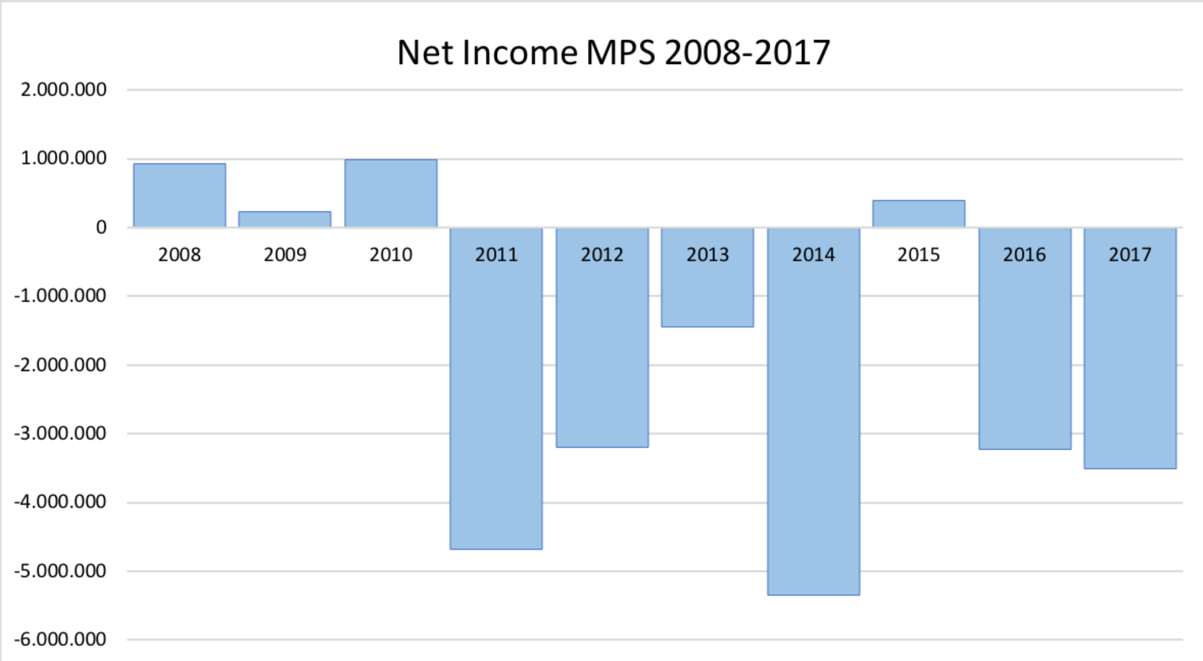


Exhibit 3 – MPS' total credits and the relative share of the non-performing loans during yeas 2008-2017.

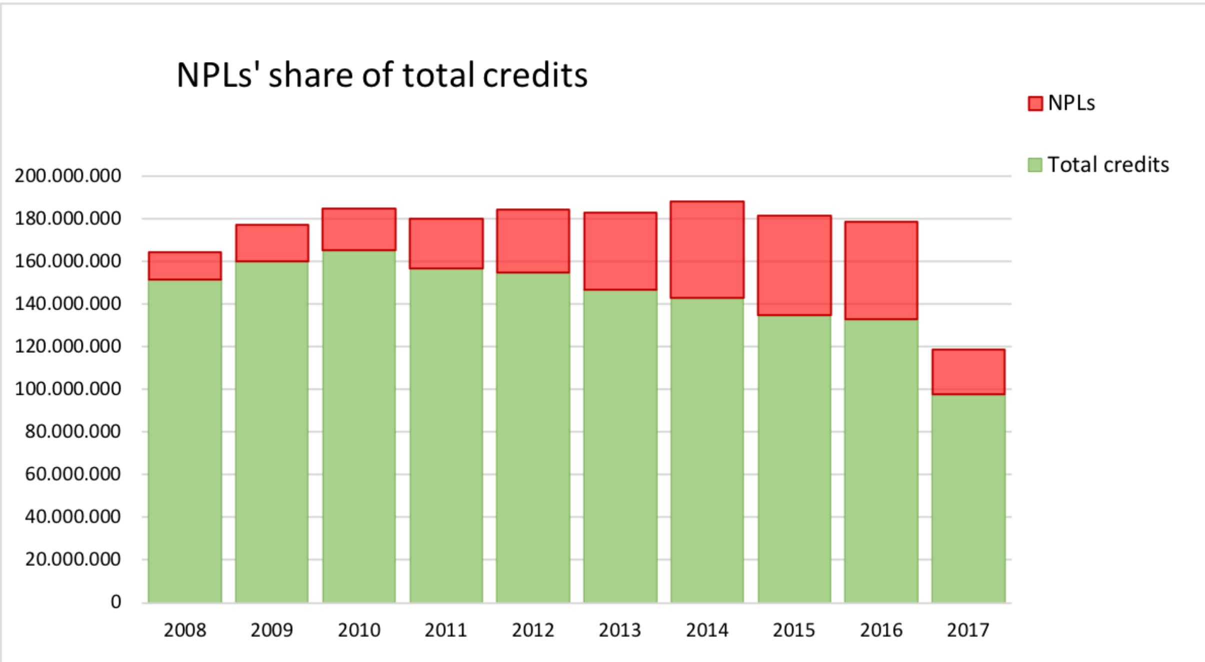


Exhibit 4 – Non-performing loans to credits ratio, years 2008-2017

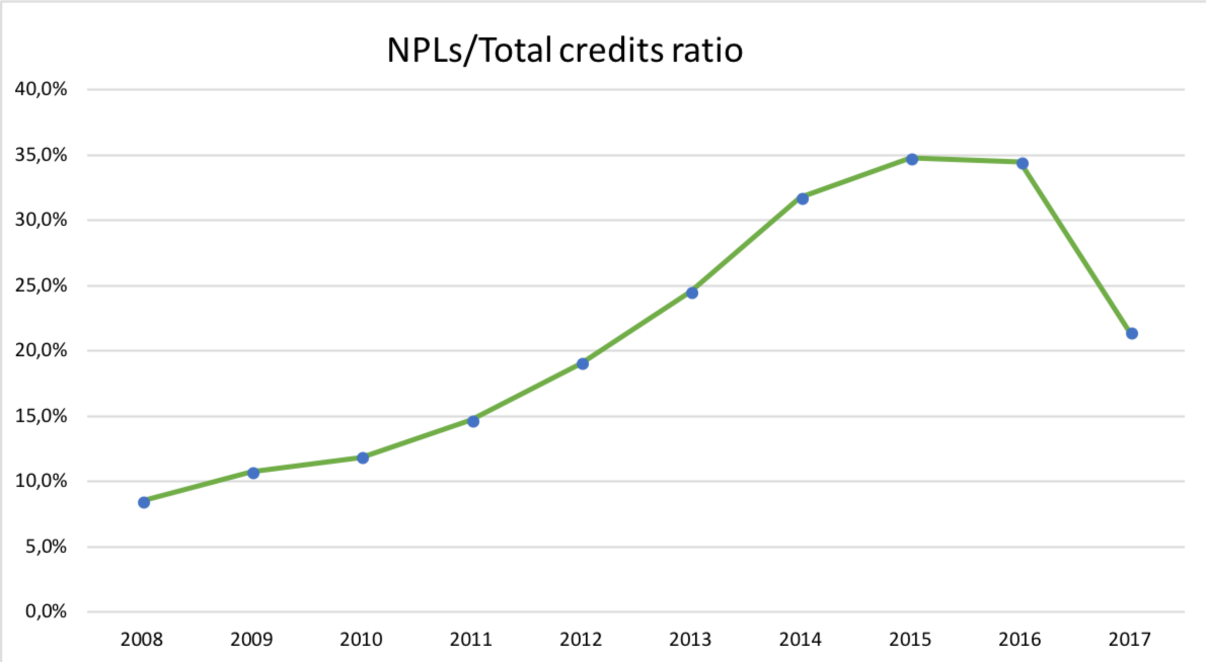


Exhibit 5 – Reported provisions on credits for the years 2008-2017 (P&L account).

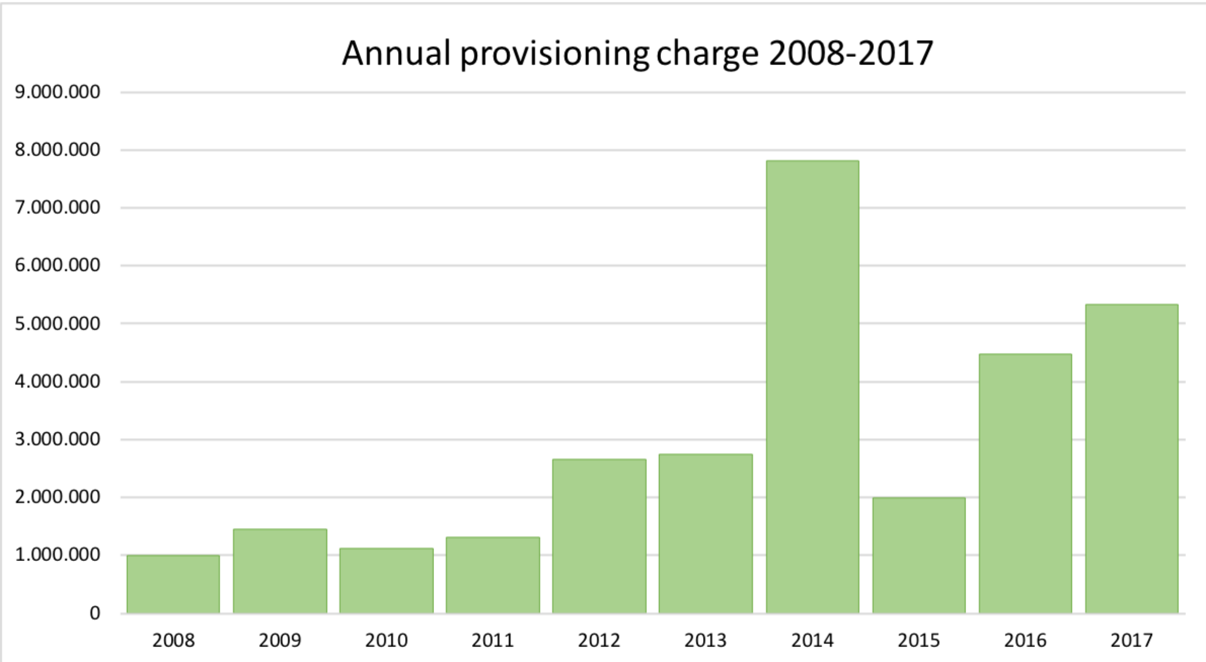
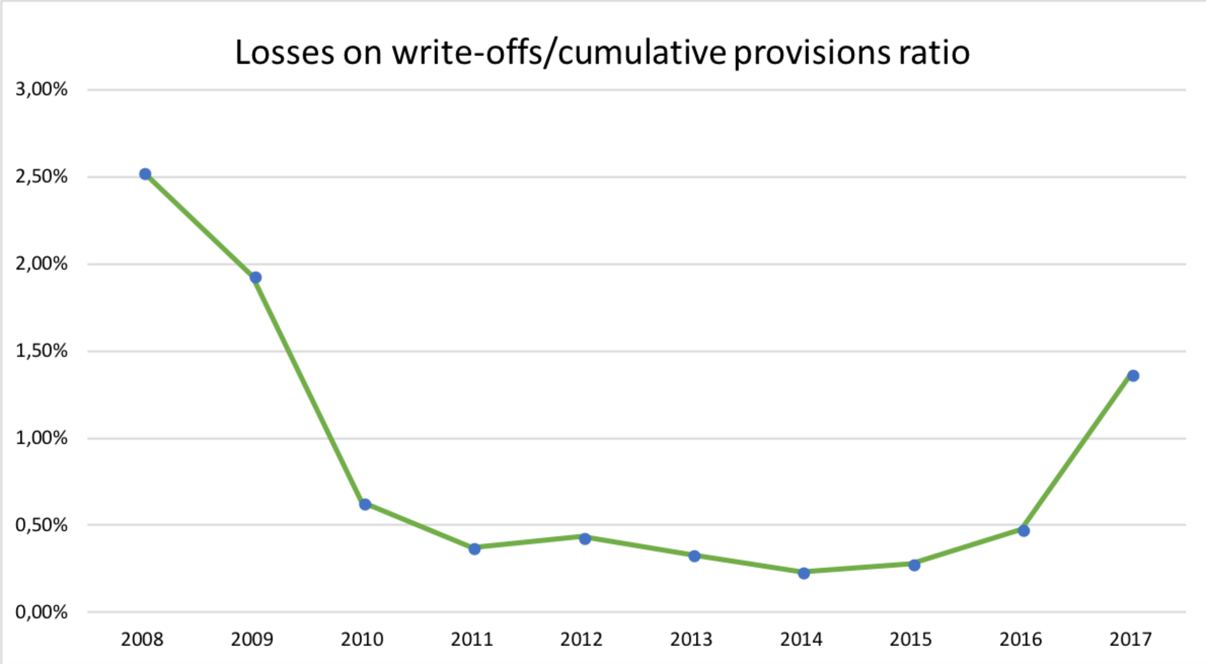


Exhibit 6 – Losses on write-offs/cumulative provisions ratio for years 2008-2017. "Cumulative provisions" stand for the balance sheet account of accumulated provisions.



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