

ITALY TURMOIL

Downfall of the world's oldest bank

The inside story of Monte dei Paschi, the Italian financial icon rescued by the state and now being investigated for fraud

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REUTERS/ STEFANO REILLANDINI

The fax marked 'confidential' gave the chairman clear advice: the questions he would field and, most important of all, the answers he would need.

Written in English by Gian Luca Baldassarri, then head of finance at Italian bank Monte dei Paschi, the July 7, 2009 fax told Giuseppe Mussari, the lender's chairman at the time, what he should say in a conference call with bankers from Japan's Nomura later that day.

It also indicated where power lay inside the Italian bank. Most staff at the bank's headquarters, a restored 14th-century fortress in Siena, viewed Baldassarri as the key influence in the institution, according to reports by internal auditors seen by Reuters and interviews with 10 senior bank sources.

The activities of the two men lie at the heart of a scandal that has ricocheted from the rolling hills of Tuscany right up to the European Central Bank (ECB) in Frankfurt.

Prosecutors in Siena are investigating allegations of corruption and fraud in connection with Monte dei Paschi's 9 billion euro (\$11.7 billion) acquisition of Antonveneta, a Padua-based bank, in 2007. At least 14 people are under scrutiny, and the scandal put financial mismanagement centre stage in the recent Italian election, helping the anti-establishment 5-Star Movement led by comedian Beppe Grillo win 25 percent support in the poll - the most of any single party.

On Wednesday, the head of Monte dei Paschi's communications unit was found dead at the bank's headquarters in Siena. Police are examining whether David Rossi, who was not under personal investigation but whose house had been searched as part of the Monte dei Paschi inquiry, committed suicide.

Mussari, Baldassarri and Antonio Vigni, the former director general of the bank, are under investigation for allegedly misleading the Bank of Italy over the Antonveneta deal and the true nature of derivatives contracts, which Monte dei Paschi's current management has said were restructured to hide losses. Those deals include a trade carried

out with Nomura and discussed on the July 7, 2009 conference call.

Prosecutors are also investigating whether Baldassarri took a slice of financial transactions for himself, and are investigating Mussari and Vigni for alleged market manipulation and false information in the prospectus of the Antonveneta deal.

Baldassarri is currently in prison after prosecutors, fearing he would flee Italy, had him arrested on Feb. 14. His home in Miami has been seized and another house in Milan searched. The former finance head has not commented publicly on the allegations against him, but his lawyer, Filippo Dinacci, has said that Baldassarri told prosecutors the bank's internal risk management unit and the Bank of Italy were fully informed of all the transactions he carried out. Dinacci declined to comment to Reuters, saying his client preferred to exercise his right to defend himself in court.

Vigni's lawyer, Roberto Borgogno, said his client was answering prosecutors' questions and providing all the necessary information; he declined to comment further.

Mussari's lawyer, Fabio Pisillo, said he would wait until the investigation was concluded before commenting.

The investigation, along with derivatives losses of nearly \$1 billion, threatens the very existence of Monte dei Paschi. It also calls into question how well Italy's financial system is regulated, and has added to worries about the euro zone.

Mario Draghi, governor of the Bank of Italy at the time of Monte dei Paschi's controversial deals and now chief of the ECB, is having to defend his oversight of Monte dei Paschi just as the euro zone's central bank prepares to take over direct supervision of the bloc's largest lenders.

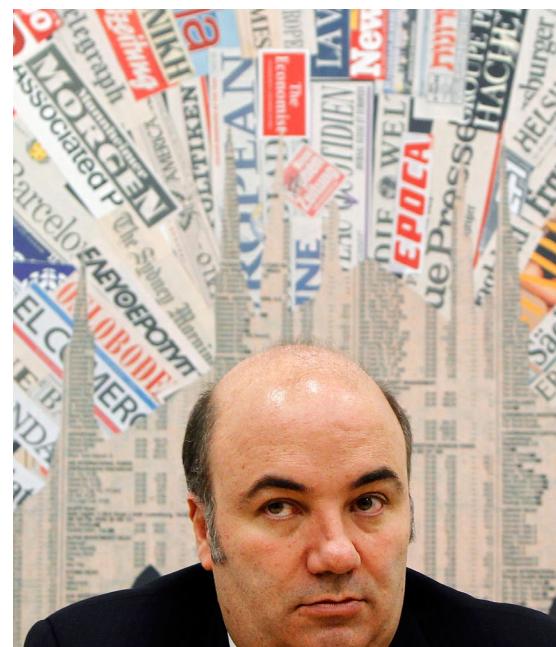
SIENA'S CASH MACHINE

Established 20 years before Christopher Columbus sailed to America and a survivor of fascism, famine and war, Monte dei Paschi is more than an icon of Siena; it is



THE OLD AND THE NEW: The former chairman of Monte dei Paschi, Giuseppe Mussari, oversaw bold expansion plans before the bank's near collapse. Below, Fabrizio Viola, who became CEO of the bank in January 2012.

REUTERS/TONY GENTILE/ALESSANDRO GAROFALO





CITY BENEFACTOR: Monte dei Paschi, based in Siena, is the largest local employer and its related foundation has funded many projects in the region, including training horses for the traditional Palio race. **REUTERS/STEFANO RELLANDINI**

the city's ATM.

With 31,000 staff, the bank is Siena's largest employer and is referred to locally as "Daddy Monte". The bank's main shareholder is a charitable foundation that used its dividends to dole out nearly 2 billion euros in mostly local funding between 1996 and 2010 on everything from a biotech facility to training horses for the famous annual Palio race.

Run by allies of Italy's main centre-left party, the Democratic Party, the Monte dei Paschi Foundation's system of patronage has helped keep Siena and the surrounding region of Tuscany loyal to the left for decades.

In 2001, the local centre-left politicians who name most of the foundation's board chose Mussari to be its chairman. A rare outsider, hailing from Calabria in the 'toe' of Italy, Mussari was articulate and handsome, with a mop of dark hair now flecked with grey. At the foundation he quickly impressed.

"When he arrived no one really knew who he was and people thought he had been put there so that he could be manipulated easily. But actually he grew into the role pretty quickly," said the person who worked with Mussari at the foundation.

The foundation names half of the bank's

board, including the chairman, and in 2006 Mussari moved to that role.

Travelling to work on a scooter, with a picture of Che Guevara on his cellphone and a small rucksack slung on one shoulder, he typified the city's peculiar mix of leftwing politics, patronage and finance.

Mussari was adept at cultivating powerful connections. But he looked to Baldassarri for the financial firepower Monte dei Paschi and its political backers needed to catapult it into the premier league of Italian banking.

THE GOLDEN GOOSE

Baldassarri had long experience of finance, having worked at Banca di Roma and Banca Nazionale dell'Agricoltura, two

\$5.2 billion

Amount of Monte dei Paschi bonds bought by the state in February to prop up the bank

Source: Monte dei Paschi

mid-sized lenders, before joining Monte dei Paschi in 2001, the year Mussari became the foundation's chairman.

A former colleague at Monte dei Paschi described Baldassarri as "a finance wizard who did not use his status to put on airs and make people feel inferior." Others said he was reserved and good-mannered.

Balding and bespectacled, the 51-year-old did not look a Gordon Gekko-type. His annual salary was around 450,000 euros before bonuses and he kept a low public profile, leaving the schmoozing and socialising to Mussari.

But Baldassarri and a small band of trusted lieutenants transformed the finance department into what former colleagues and internal audit documents say was essentially a bank within a bank, ramping up Monte dei Paschi's exposure to opaque financial deals with little scrutiny from management.

Senior sources with direct knowledge of the inner workings of the bank in that period told Reuters that the top brass had a limited understanding of markets. That meant Baldassarri and his team could engage more freely in risky bets, including complex derivative trades.

A source who knew Baldassarri directly

told Reuters he was very smart and it was unsurprising that Vigni and Mussari may not have grasped what he was doing. "It might seem strange to say that now, but when things were going well he (Baldassarri) was considered the golden goose for Monte dei Paschi as he made a lot of money for them".

WARNING SIGNS

But Reuters has learned that significant red flags were being raised. A senior manager at the bank sent hundreds of internal emails to Monte dei Paschi's then executives between 2006 and 2012 warning them about the risks of Baldassarri's trades, including allegedly concealed losses on the bank's financial portfolio, a high-level source said.

The existence of internal emails questioning Baldassarri's trades is backed up by interviews with two further sources and reinforced by bank documents, including letters from internal auditors, reviewed by Reuters. One confidential letter was addressed to Vigni at the end of June 2009 and alleged Baldassarri and his team made deals outside market prices and used an array of small, obscure brokers as counterparts. The letter, the existence and content of which were confirmed by two senior sources, prompted an inspection by the bank's internal audit committee, which uncovered "systematic overshooting of risk limits."

Discussions within the bank over the issues raised went on for nearly two years; but little changed.

The high-level source said the former finance chief could be combative with critics and tended to get his way.

In a judicial document confirming Baldassarri's arrest and reviewed by Reuters, Vigni, the former director general, was quoted as telling magistrates: "I have always trusted Baldassarri blindly."

However, according to the document, Baldassarri said that Vigni knew what was happening at the bank.

"He was a competent person and was able to manage the bank ... He was able to



ANGRY STAFF: As profits plummeted and the bank made cuts, thousands of staff protested last year. Facing huge losses, Monte dei Paschi was forced to seek state help. **REUTERS/GIAMPIERO SPOSITO**

realise the scale of the financial commitment for the bank stemming from the purchase of financial products, including structured trades," Baldassarri was quoted as saying.

Baldassarri's lawyer and Vigni's lawyer declined to comment.

Last month prosecutors seized around 40 million euros as part of their investigation. The seizure order, seen by Reuters, said the funds belonged to five people, including Baldassarri, being investigated for criminal conspiracy to commit fraud. This month prosecutors seized a further 6 million euros in connection with the case.

Monte dei Paschi's internal audit committee, according to internal bank documents, also complained to Vigni that Baldassarri was using his cell phone to execute trades. The bank's rules required the use of its own fixed-line phones so that conversations could be recorded.

"Baldassarri replied that because he was making deals with Asia on a different time zone, he had to make the calls from home," a senior source told Reuters.

THE DEAL

Between 2001 and 2007, Monte dei Paschi's profit jumped 132 percent. In 2006 income from its own trading of financial instruments represented more than half the bank's annual profit.

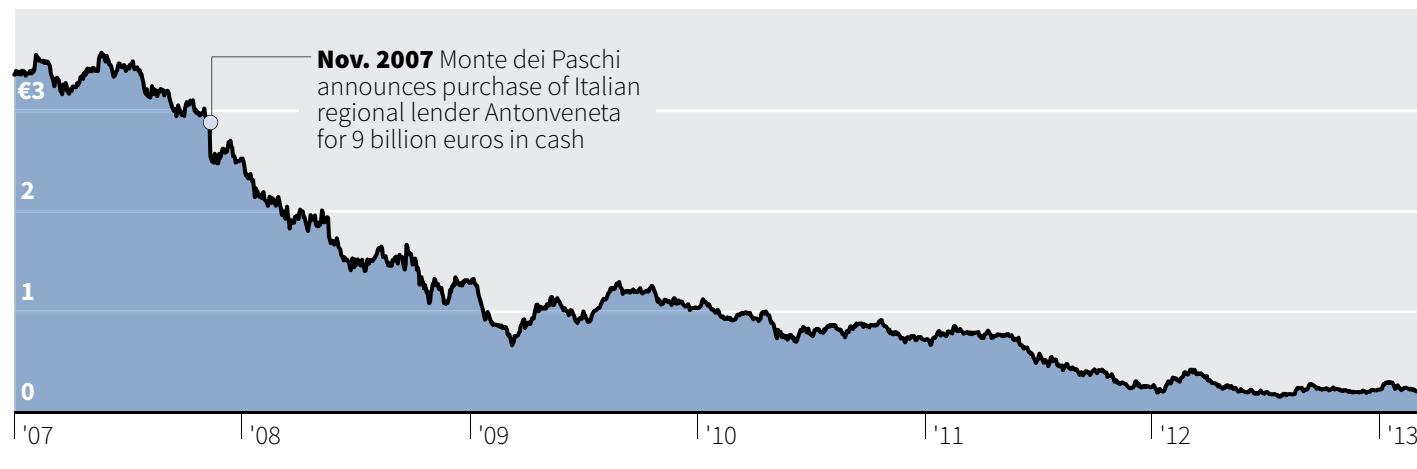
But Mussari wanted the group to grow even bigger, saying it would do so through "sheer hard work." In 2007, when Spain's Santander offered to sell Antonveneta, Mussari seized the chance to leapfrog rivals and become Italy's third-largest lender.

Mussari offered Santander's veteran chairman Emilio Botin 9 billion euros in cash for Antonveneta just weeks after Santander had paid 6.6 billion euros for it.

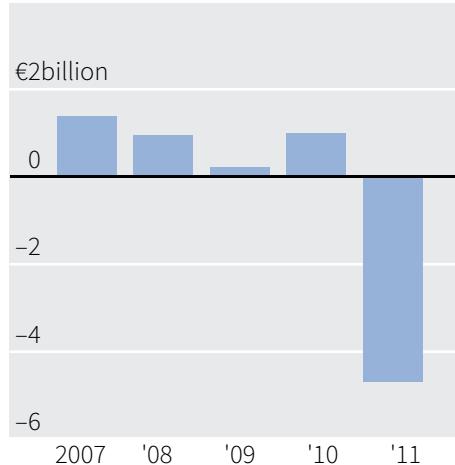
Mussari was afraid France's BNP Paribas would trump him, according to a financial police report, and did not conduct due diligence on Antonveneta. Prosecutors in Siena are now investigating whether Monte dei Paschi's former management deliberately overpaid Santander for Antonveneta and whether bribery was involved. Monte dei Paschi's current management says it has found no evidence of bribery.

Hitting trouble: Monte dei Paschi by numbers

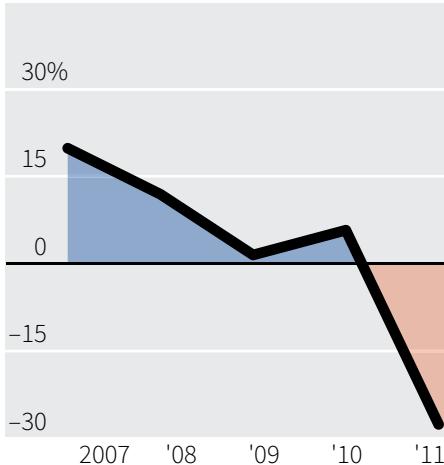
SHARE PRICE



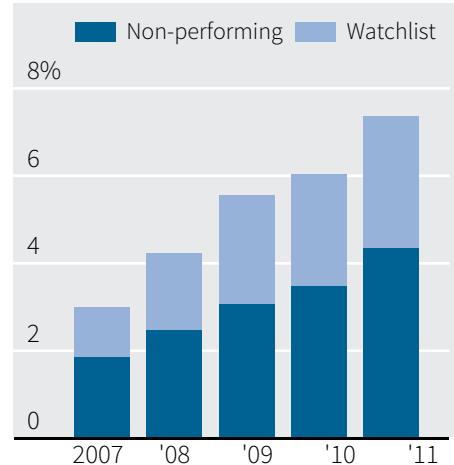
NET PROFIT/LOSS



RETURN ON EQUITY



LOAN QUALITY RATIOS*



*As percentage of total loans

Source: Monte dei Paschi financial disclosures

Prosecutors have asked Santander's Botin to answer questions about the deal, a judicial source told Reuters. Santander has declined to comment.

Several bankers say the price tag for Antonveneta did not seem excessive in 2007 at the height of the financial boom. However, other investment bankers and former managers at Monte dei Paschi told Reuters Mussari was outsmarted by Botin and was out of his depth.

Antonveneta caused problems immediately. A week after the deal was announced, the senior executive in charge of the

acquisition, Giuseppe Menzi, complained in an email to Vigni that Antonveneta would need "shock therapy" to deal with its poor organisation and zero loan growth.

The email is part of a financial police report seen by Reuters. Menzi declined to comment.

Funding the all-cash offer was an even bigger problem. Monte dei Paschi carried out a 5 billion euro capital increase and then got a further 1 billion euros through a complex hybrid instrument, called Fresh 2008, which was structured by U.S. investment bank JP Morgan.

Half of the Fresh notes, convertible into Monte dei Paschi shares, were sold to the Monte dei Paschi Foundation, which began sinking into debt as it tried to keep a majority stake in the bank.

When the Bank of Italy, in the autumn of 2008, demanded changes to the terms of the Fresh notes, Monte dei Paschi complied. But prosecutors now allege it also struck a deal with JP Morgan and Bank of New York, which acted as an intermediary for the transaction, and failed to disclose full details to the central bank.

If those allegations prove correct, the

Bank of Italy approved the Fresh notes deal under false premises and Monte dei Paschi should not have been able to buy Antonveneta, a move which stretched its finances to the limit just before the outbreak of the global debt crisis.

JP Morgan and Bank of New York declined to comment.

PELTED WITH COINS

Under Baldassarri Monte dei Paschi amassed more financial holdings, as a proportion of assets, than any other Italian bank, including 26 billion euros of Italian government bonds. Some board members, as well as senior managers at the bank, criticised the type and size of investments carried out by Baldassarri's department and the lack of accountability, banking sources said.

A Bank of Italy report, dated Nov. 9, 2010 and seen by Reuters, shows that inspectors from Italy's central bank also raised concerns about risky derivatives trades. The central bank says its supervision was thorough and the Monte dei Paschi executives at the time did not disclose full details of some deals.

In a twist worthy of a paperback thriller, Monte dei Paschi's new management say the true nature of one complex deal, known as the "Alexandria" transaction, only became clear in October 2012 when they found a document tucked away in a safe in Vigni's former offices. The document showed that the Alexandria trade and a long-term repurchase agreement, which had looked separate, were in fact linked and meant to spread losses over nearly 30 years.

In February 2012 the bank's new CEO Fabrizio Viola fired Baldassarri, citing poor performance. Mussari, who gave Baldassarri a letter of commendation when he left, according to a senior source at the bank, was replaced as chairman of the bank in April 2012.

Since 2007, Monte dei Paschi's market value has dropped to 2.4 billion euros from 11.4 billion. The bank has just received a 4



ELECTORAL GAIN: Monte dei Paschi's woes helped make financial mismanagement a key part of the recent Italian election in which the anti-establishment 5-Star Movement led by comedian Beppe Grillo, above, won more support than any other single party. **REUTERS/MAX ROSSI**

billion euro state bailout, its second since 2009, and is seeking at least 1.2 billion in damages from former executives and two banks involved in its derivative trades.

The near collapse of the bank has also imperiled the foundation. Its net wealth has shrunk to 1.3 billion euros in 2011 from 5.2 billion in 2006 and it was forced last year to cut its stake in the bank to 35 percent from 49 percent to repay creditors.

Residents in Siena, fearful for the city's future, are angry. They pelted Mussari with coins and cried "thief!" as the former chairman arrived for questioning in the prosecutor's office last month.

"I don't fear too much for me, I don't have many shares," said Marcella Mugnaini, a small shareholder in Monte dei Paschi and a former employee. "But for the city, the

employees of Monte dei Paschi, who don't know where they will end up, and the bank, the world's oldest, to be reduced like this - we cannot accept that."

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