

REPORT ON THE SYSTEM OF INTERNAL CONTROL AND RISK MANAGEMENT

(main characteristics of the financial reporting process, including consolidated reporting, ex art. 123 bis, paragraph 2, letter b), of the Consolidated Law of Finance)

Company: **Banca Farmafactoring S.p.A.**

Website: **www.bancafarmafactoring.it**

Report refers to: **Financial year ending December 31, 2016**

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SUMMARY

GLOSSARY	3
1. PROFILE OF THE ISSUER	5
2. SYSTEM OF INTERNAL CONTROL AND RISK MANAGEMENT	6
2.1. First-level controls	8
2.2. Second-level controls	8
2.3. Third-level controls	9
3. MAIN CHARACTERISTICS OF THE FINANCIAL REPORTING PROCESS, INCLUDING CONSOLIDATED REPORTING	10

GLOSSARY

Chief Executive Officer: member of the administrative function of the Parent Company, meaning the member of the Board of Directors to whom, pursuant to the Italian Civil Code, responsibilities are delegated for current operations, understood as the implementation of the guidelines approved by the strategic supervisory function during the year.

Bank or BFF or Parent Company: Banca Farmafactoring S.p.A., parent company of the Banca Farmafactoring Banking Group.

Code/Corporate Governance Code: the Corporate Governance Code of listed companies, approved in March 2006 by the Corporate Governance Committee and advocated by the Italian Stock Exchange (Borsa Italiana S.p.A.), in accordance with the most recent update of July 9, 2015.

Board of Statutory Auditors: the Board of Statutory Auditors of the Bank.

Board/Board of Directors: the Board of Directors of the Bank.

Corporate Control Functions: together, the Compliance Function, the Risk Management Function, the Internal Audit Function and other structures that have control functions, that is, the aggregate of the corporate functions that, by law, by-laws, regulations or self-regulation have the responsibility of control within the Parent Company.

Compliance Function: the corporate function ascertaining compliance with regulations, attributed to the Compliance and Anti-Money Laundering (AML) Function of the Parent Company.

Internal Audit Function: the corporate function of internal auditing, attributed to the Internal Audit Function of the Parent Company.

Risk Management Function: the corporate function that controls risks, attributed to the Risk Management Function of the Parent Company.

BFF Banking Group or Group: The Banca Farmafactoring Banking Group, as defined by art. 60 of the Consolidated Law of Banking.

Model 231: the organizational, management and control model adopted by the Bank, in accordance with articles 6 and 7 of Legislative Decree No. 231/2001.

OdV: the Supervisory Body formed by the Bank pursuant to and in accordance with Legislative Decree No. 231/01.

RAF: the “Risk Appetite Framework” (a system of risk objectives), that is, the framework that defines—consistently with the maximum acceptable risk, with the business model and with the strategic plan—the risk propensity, the risk tolerance, the risk limits, the risk governance policies, the processes necessary to define them and implement them, including at the Group level.

Regulation of Corporate Governing Bodies, Control Functions and Information Flows, or ROA: the Regulation of Corporate Governing Bodies, Control Functions and Information Flows, adopted by the Board of Directors, to discipline the duties and responsibilities of the company's governing bodies and Corporate Control Functions, as well as the information flows between the company's governing bodies and the Corporate Control Functions, in addition to those of the Risk Committee and Supervisory Body.

The ROA is posted on the Bank's website at the following address:
<https://www.bancafarmafactoring.it/documents/33221/50115/BFF+Regulations+Bodies+Corporate+i+11dic2015/230e89f4-035a-4b5a-8008-c290cae01d21>

Report: this report.

ICS: Internal Control System.

Independent Audit Firm: the independent audit firm registered in the special register established by art. 161 of the Consolidated Law of Finance, mandated with the audit of the financial statements of the Bank.

By-laws: the by-laws of the Bank, in effect at the date of the Report.

Consolidated Law of Finance: Legislative Decree No. 58 of February 24, 1998, and subsequent updates.

Consolidated Law of Banking: Legislative Decree No. 385 of September 1, 1993, and subsequent updates.

1. PROFILE OF THE ISSUER

The Bank mainly concentrates its business on the management and sale of non-recourse receivables due from the Public Administration, and, as the Parent Company, pursuant to art. 61, paragraph 4, of the Consolidated Law of Banking, issues, in exercising management and coordination activities, directives to the Group companies, also for the execution of the instructions circulated by the Bank of Italy and in the interests of the stability of the Group itself.

BFF has adopted a traditional administration and control system, composed of:

- the Board of Directors, with strategic supervisory functions
- the Chief Executive Officer, with management functions, and
- the Board of Statutory Auditors, with control functions

Corporate governance also provides for the creation of a Supervisory Board and specific committees with analytical, consulting and proactive responsibilities serving the corporate governing bodies with strategic and management supervision functions, meaning:

- the Remuneration Committee
- the Related Party Transactions Committee
- the Nomination Committee
- the Risk Committee

The audit of the financial statements is delegated to an independent audit firm in accordance with the regulations in force on the subject.

The Report, approved by the Board of Directors on February 13, 2017, is published, simultaneously with the Report on Operations, on the Bank's website, and was prepared solely for the purposes indicated in art. 123 *bis*, paragraph 2, letter b) of the Consolidated Law of Finance, meaning with reference to the **main characteristics of the existing system of internal control and risk management in relation to the financial reporting process, including consolidated reporting.**

2. SYSTEM OF INTERNAL CONTROL AND RISK MANAGEMENT

The Group has suitable management and control mechanisms in place to mitigate the risks to which it is exposed. These safeguards are part of the organizational structure and the Internal Control System. They aim to ensure that the management practices grounded in the canons of efficiency, effectiveness and fairness, covering every type of business risk, are consistent with the characteristics, dimensions and complexity of the business activities carried out by the Group.

The Bank adopted a system of internal control and risk management that involves, each according to its specific responsibilities, the following:

- a) the **Board of Directors**, which the role of guidance and assessment of the system's adequacy, and has identified, within the Board, the (i) **Chief Executive Officer**, who is charged with creating and maintaining an effective system of internal control and risk management, in addition to (ii) the **Risk Committee**, which is tasked with lending support, by appropriate oversight activities, to the assessments and the decisions made by the Board of Directors regarding the system of internal control and risk management, as well as the approval of the related periodic financial reports;
- b) the **Risk Management Function** and the **Compliance and AML Function**, which bears specific responsibilities on the subject of internal control and risk management, according to the dimensions, complexity and risk profile of the company;
- c) the **Internal Audit Function**, charged with the duty to verify that the system of internal control and risk management is functioning and adequate;
- d) the **Board of Statutory Auditors**, which monitors the effectiveness of the system of internal control and risk management.

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More specifically, the Group considers the optimization of the governance of risks to be a fundamental aspect, in observing the following risk statements:

1. ensure that regulatory requirements are met, guaranteeing that the levels of capital and liquidity of the Group remain strong from the standpoint of the first and second pillars, both under normal operating conditions and under stress scenarios;
2. maintain a low risk profile;

3. guarantee an adequate financial leverage level, through a policy of capitalization consistent with the level of the assets;
4. ensure the availability of high quality liquidity assets (Liquidity Coverage Ratio) and sources of stable funding (Net Stable Funding Ratio), such that the Group continuously maintains a level of liquidity sufficient to absorb potential shocks in the short and long term;
5. implement an adequate ICS.

The Group, therefore, has adopted a structured reference framework by implementing a disciplined process based on a specific internal RAF regulation. This is evaluated by the Board in relation to the business model and the strategic plan, and calls for the approval of risk objectives and risk tolerance.

The RAF identifies the risk appetite level. This is understood as the risk objectives or risk propensity which the Bank, at the Group level, intends to accept in pursuing its strategic objectives and also in defining its specific operating limits. It is defined consistently with the ICS and, above all, with ICAAP - Internal Capital Adequacy Assessment Process (assessment of the adequacy of its current capital and, prospectively, in relation to the risks assumed and the corporate strategies).

The Board of Directors has set out the guidelines for the internal control system, ensuring that the main corporate risks are identified, managed and monitored in an adequate manner. Specifically, it has assessed all types of risk at the consolidated level and has approved the assumption of risk in a broad manner for all the Group companies and for all the countries in which it operates.

Furthermore, the Board of Directors:

- has identified the aggregate of risk appetite indicators and the relative computation metrics;
- has defined and approved the risk appetite, the risk tolerance and the risk governance policies;
- has established the operational limits consistent with the risk propensity;
- has ensured that the implementation of the RAF is consistent with the risk objectives and the risk tolerance envisaged.

The SCI was developed consistently with the rules and regulatory framework, with the organization structure of the Group and in line with the standards and national and international best practices. Specifically, in compliance with the regulatory provisions, it is built on the following three levels of defense.

2.1. First-level controls

The first-level controls, so-called line controls, aim to ensure that transactions are properly executed and are performed by the operating structures that carry them out, with the support of computer procedures.

2.2. Second-level controls

The second-level controls (risk management and compliance controls) – aim to guarantee the correct implementation of the risk management process, the compliance of company operations with procedures and control over the risk of money laundering and terrorism financing – are entrusted to the Risk Management Function and the Compliance and Anti-Money Laundering (AML) Function, which, consistently with the existing prudential supervisory discipline, have the following main responsibilities:

- **Risk Management:** ensures the interconnectivity of the risk measurement and control system with the processes and methodologies of the company's activities, coordinating with the interested company structures. It oversees the realization of the process for determining capital adequacy, monitors the controls over the management of risk in order to define the methodologies used to measure risk, assists the Corporate Governing Bodies in designing the RAF, verifies that the limits assigned to the various operating functions are being observed and checks that the operations of the individual areas are consistent with the assigned risk and return objectives.
- **Compliance:** supervises, according to a risk-based approach, the management of the risk of non-compliance with regulations, with regard to all the activities falling within the regulatory perimeter for BFF and the Group, continuously verifying whether internal processes and procedures are adequate in preventing such risk and identifying the relevant risks to which BFF and the subsidiaries are exposed; it measures, assesses and monitors the relevant risks; guarantees an overall and integrated vision of the risks to which BFF and the subsidiaries are exposed, ensuring adequate disclosure to the corporate governing bodies of BFF and the subsidiaries.
- **Anti-Money Laundering (AML):** has the task of (i) preventing and avoiding the occurrence of money laundering and terrorism transactions, also identifying continuously the applicable rules in this area; (ii) verifying the coherence of the processes with the objective of ensuring

that BFF and the subsidiaries conform to the law on matters of anti-money laundering and anti-terrorism. It is also responsible for the controls required by the anti-money laundering law, so as to prevent the use of the financial system for purposes of laundering the profit from criminal activities, and the financing of terrorism.

During 2016, the Risk Management Function and the Compliance and AML Function were separated and a new individual with the necessary professional characteristics was appointed head of the latter function. Moreover, a “local” Compliance and AML Function was set up at Magellan S.A. (Magellan), which reports directly to the Management Board of this company and, functionally, to the Compliance and AML Function of BFF.

2.3. Third-level controls

Internal audit activities are conducted by the Group’s Internal Audit Function, in a staff position to the Board of Directors. The Internal Audit Function carries out independent controls, not only at the Parent but also at the subsidiary Farmafactoring España S.A. under a specific servicing agreement which governs the provision of the audit service, and in an institutional environment, as a function of the Parent for the subsidiary Magellan. The ROA specifies that the Internal Audit Function, within the third-level controls, should evaluate the overall functioning of the ICS and bring to the attention of the corporate boards possible improvements, with particular reference to the Risk Appetite Framework, to the process for the management of risks as well as the tools for their measurement and control.

The person in charge of the Internal Audit Function has the necessary autonomy and is independent of the operating structure, in compliance with Bank of Italy’s regulation on the subject of internal controls, and, with regard to internal regulations, organizationally oversees the company processes. The Internal Audit Function carried out, for the year 2016, the testing activities established in the three-year 2016-2018 audit plan of the Banking Group, conducting follow-up activities and reporting on the results of its testing on a quarterly basis to governance and control bodies of the Bank.

Specifically, the Internal Audit Function lent support to BFF in restructuring the audit process for the subsidiary Magellan, based upon a rationale referring to subsidiaries of a supervised banking group. It also carried out intragroup testing on the processes considered of greater relevance from a regulatory standpoint.

Furthermore, the Internal Audit Function also completed the testing that was planned for 2016,

according to a risk-based framework, on the Bank's structures (including the Spanish branch) and on the subsidiary FFE.

The process for audit planning and management was certified under the quality standard UNI ISO 9001:2008.

The person in charge of the Internal Audit Function, as the head of the internal whistleblowing process, in conformity with the banking regulatory requirements of reference, prepared the 2016 statement, which indicates that no reports were received in this regard.

It should be noted that the Bank has a Model 231 that is periodically monitored by the Supervisory Body to ascertain its adequacy through planned testing activities.

Farmafactoring España S.A. began a project in the second half of 2016 aimed at the adoption, pursuant to art. 31-*bis* of the Spanish Criminal Code, of an organizational, management and control Model similar to the Italian Model, with the consequent identification of a Supervisory Body with functions similar to that of the Italian Supervisory Body.

3. MAIN CHARACTERISTICS OF THE FINANCIAL REPORTING PROCESS, INCLUDING CONSOLIDATED REPORTING

The Board of Directors assesses, at least once a year, the completeness, the adequacy, the functionality and the reliability of the ICS and, more in general, its compliance with regulatory requirements.

The ICS includes the system of internal control and risk management associated with the consolidated financial reporting process, which is directed to ensuring the reliability, accuracy, dependability and timeliness of the process itself.

At the operational level, the current process for the preparation of the consolidated financial statements of the Bank is based on the decentralization of the safeguards controlling the generation of the data for the Reporting Package. This is accomplished through the counterparts of the Planning, Administration and Control Departments in the subsidiaries, (also referred to hereafter as the "Subsidiary entities") and the subsidiaries which in turn consolidate the financial statements of their subsidiaries (also referred to as "Entities responsible for the consolidation of their subsidiaries") that provide information supplementing the following activities carried out by the Planning, Administration and Control Department of the Parent Company:

- a central control over the consolidation processes, which includes defining the instructions, uniform principles and specific timing for the preparation of the periodic consolidated accounting information;
- a check over the main items and specific entries inherent in the formation of the consolidated financial statements;
- a system of controls over the data contained in the Reporting Package (i.e. certification of the data in conformity with the instructions provided by the Bank, controls on the reconciliation of intergroup accounts);
- the correct execution of the consolidation adjustments.

The Bank, as the Parent Company, in conformity with existing laws and regulatory provisions, sets out the guidelines for the preparation of the financial statements in the interests of the stability of the Group and in order to ensure a unitary direction for the entrepreneurial strategy and the overall operations of the same. The accounting policies of the Group establish the general principles and rules issued by the Group, in order to achieve – with regard to the recognition, classification, measurement and derecognition of the various items in the assets and liabilities, as well as the recognition of revenues and costs as set forth in International Financial Reporting Standards (“IAS/IFRS”) – the application of homogeneous accounting principles and interpretations, which must be applied by each Entity that draws up the accounting documents used for the preparation of consolidated financial statements of the Group (Reporting Package).

Furthermore, the principles and rules contained in the accounting policies of the Group also form a guideline for the preparation of the individual financial statements, when these are prepared in accordance with IAS/IFRS, and the preparation of the consolidated financial statements of the Entities responsible for the consolidation of their subsidiaries, when such financial statements are drawn up in accordance with IAS/IFRS.

Each Subsidiary entity and the Entities responsible for the consolidation of their subsidiaries are required to prepare and certify the Reporting Package, drawn up in accordance with IAS/IFRS, and consistent with the accounting policies of the Group adopted by the Parent Company and with the applicable technical instructions.

Specifically, for purposes of the certification of their data, each Subsidiary entity/Entities responsible for the consolidation of their subsidiaries must introduce the necessary internal entries, in order for the Reporting Package, the local statutory financial statements and the relative reconciliation to be approved on the part of the strategic supervisory body of each Entity.

The purpose of the method used by the Bank is that of providing the corporate bodies of the Group, at the consolidated level, an effective instrument for managing and monitoring the ICS, the essential elements of which can be described as follows:

- **control environment:** makes it possible to reflect the importance of the internal control culture in the company's organization, defined by executives with particular regard for integrity and ethical values, philosophy and style of management, organizational structure, attribution of authority and responsibility, personnel management policies and competences of these same personnel;
- **risk assessment:** allows an assessment of the risks that could have an effect on achieving corporate objectives, employing methods for the identification and analysis of risks;
- **information and communication:** permits information flows between various corporate structures to be managed correctly, so that all the subjects belonging to the structure properly execute their activities;
- **control activities:** aggregate of activities that enable the correct management of risks, in order to achieve the fixed corporate objectives;
- **monitoring:** allows the reliability of the implemented ICS to be verified continually.

The theoretical model underpinning the integrated ICS is represented, within its specific dimensions of analysis, by:

- a) **process level controls:** aimed at verifying the presence of an efficient ICS over the processes considered, which guarantee the correct formation of the accounting data. Therefore, the reliability of the financial information is guaranteed by the presence of a first- and second-level structured ICS, with regard to the individual companies, which is necessary for the assessment of the adequacy and the effective and continuing application of the above processes;
- b) **company level controls:** directed to verifying the existence of an ICS at the company level which reduces the risk of error and/or behavior that is not correct for purposes of financial reporting;
- c) **ICT process controls:** geared to assessing the adequacy of the rules for governing technological infrastructure and the applications concerning sensitive processes.