1.4. OPERATIONAL RISK

QUALITATIVE INFORMATION

Operational risk is defined as the risk of suffering losses due to inadequacy or failures of processes, human resources and internal systems, or as a result of external events. Operational risks include legal risk, that is, the risk of losses deriving from breach of laws or regulations, contractual, out-of-contract responsibilities or other disputes; strategic and reputation risks are not included.

The Intesa Sanpaolo Group has defined the overall operational risk management framework by setting up a Group policy and organisational process for measuring, managing and controlling operational risk.

The control of operational risk was attributed to the Management Board, which identifies risk management policies, and to the Supervisory Board, which is in charge of their approval and verification, as well as of the guarantee of the functionality, efficiency and effectiveness of the risk management and controls system.

The Group's Operational Risk Committee (made up of the heads of the areas of the corporate centre and of the business areas that are more involved in operational risk management), has the task of periodically verifying the Group's overall operational risk profile, defining any corrective actions, coordinating and monitoring the effectiveness of the main mitigation activities and approving the operational risk management transfer strategies.

The Group has had a long centralised function within the Risk Management Department for managing of the Group's operational risks. This function is responsible for the definition, implementation, and monitoring of the methodological and organisational framework, as well as for the measurement of the risk profile, the verification of mitigation effectiveness and reporting to Top Management. In compliance with current requirements, the individual organisational units that participated in the process and to each of them was assigned the responsibility for the identification, assessment, management and mitigation of its operational risks. Specific officers and departments have been identified within these organisational units to be responsible for Operational Risk Management (collection and structured census of information relative to operational events, scenario analyses and evaluation of the business environment and internal control factors).

In 2008, the "integrated" Self-Assessment (SA) process was implemented at Group level for the first time. The objective of this process is to assess the exposure to Operational Risk at Organisational Unit and business process level, contributing to the model for the determination of the Group's exposure to Operational Risks, and to generate synergies with the information flows to the other corporate control and compliance functions.

This process was assigned to the decentralised functions responsible for the Operational Risk Management (ORMD) supported by the Operational Risk Management Department. Around 70 Group Companies were involved, 40% abroad and 60% in Italy. A total of over 450 Organisational Units were involved. The Operational Environment Assessment (OEA), conducted for the first time during the second half of the year, is the qualitative analysis of the current exposure to Operational Risks, performed by means of an assessment of the Risk Factors in terms of "significance" and "control" and aimed at identifying areas of vulnerability and any mitigation actions to address them, thus promoting "proactive" risk management (Risk Ownership). The Scenario Analysis (AS), already in use, on the other hand, is aimed at identifying the operational risks from a forward-looking perspective, measuring exposure in terms of frequency, average impact, and worst case scenario.

The Self-Assessment process identified a good overall level of control of operational risks and contributed to enhancing the dissemination of a business culture focused on the ongoing control of these risks.

The internal model for the calculation of capital absorption is designed to combine all the main quantitative (internal and external historical incurred loss data) and qualitative information sources (scenario analysis and operational environment assessment).

The quantitative component is based on the assessment of historical data on internal events (recorded by organisational units, verified by the central function and managed by a dedicated IT system) and external events (including participation in consortium initiatives such as "Database Italiano Perdite Operative" – Italian Operating Loss Database – managed by the Italian Banking Association and Operational Riskdata eXchange Association) applying actuarial techniques that entail the separate study of event frequency and impact and the subsequent formation, through Montecarlo simulations, determining the annual loss distribution curve and, consequently, obtaining a measurement of the associated risk.

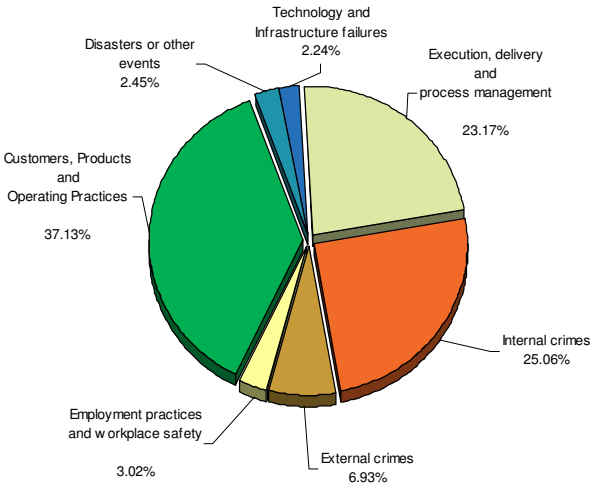
The qualitative component (scenario analyses) focuses on the forward-looking assessment of the risk exposure of each unit and is based on the structured, organised collection of subjective estimates expressed directly by Management (subsidiary companies, Parent Company's business areas, Corporate

Centre) with the objective of assessing the potential economic impact of particularly serious operational events; such assessments, processed with statistical-actuarial techniques, calculate an unexpected loss estimation which is subsequently integrated in the measurement obtained by the analysis of historical loss data.
Capital-at-Risk is therefore identified as the minimum amount at Group level, net of insurance cover, required to bear the maximum potential loss (worst loss); Capital-at-Risk is estimated using a Loss Distribution Approach model (actuarial statistical model to calculate the Value-at-Risk of operational losses), applied on quantitative and qualitative data assuming a one-year estimation period, with a confidence level of 99.96% (99.90% for regulatory measurement); the methodology also applies a corrective factor, which derives from the qualitative analyses of the risk of the evaluation of the business environment and internal control factors, to take account of the effectiveness of internal controls in the various organisational units.
The Intesa Sanpaolo Group has activated a traditional operational risk transfer policy (insurance) with the objective of mitigating the impact of any unexpected losses, and thus contributing to the reduction of the Capital at Risk.
Monitoring of operational risks is performed by an integrated reporting system, which provides management with the information necessary for the management and/or mitigation of the operational risk.
In order to support the operational risk management process on a continuous basis, during the year a structured training programme was defined for employees actively involved in the process for the management and mitigation of operational risk.
The EurizonVita insurance group adopts the recommendations from the banking Parent Company in relation to Operational Risks and is also assessing the adequacy of the entire process in the light of the specific, regulatory and non-regulatory, developments for insurance companies at international (ORX consortium- Insurance Sector), European (Solvency II) and at national level (ISVAP, COVIP, and ANIA).

QUANTITATIVE INFORMATION

The capital absorption for Operational Risks with the Standard Approach for the Group calculated a value of approximately 2.3 billion euro. The result obtained with the internal model was on similar levels; the Economic Capital absorbed by operational risks at Group level, with a 99.96% confidence level and diversified with the other risk types, totalled 2.1 billion euro. The breakdown of operational events by type is shown below.

Breakdown of Economic Capital referred to 2008



To cover the phenomena described above, the Intesa Sanpaolo Group took part in industry initiatives aimed at increasing transparency and continued interventions for improving processes and controls aimed at risk mitigation and loss containment.

Legal risks

Legal risks are analysed by the Parent Company and Group companies. Provisions are made to the Allowances for risks and charges, in the presence of legal obligations for which it is probable that funds will be disbursed to meet such obligations and where it is possible to make a reliable estimate of the disbursement.
The most complex legal procedures are described in the paragraphs below.

Litigation regarding anatocism

After March 1999, the Italian Court of Cassation changed its previous opinion and declared the quarterly capitalisation of interim interest payable on current accounts to be illegitimate, assuming that the relevant clauses in bank contracts do not integrate the contract with a "regulatory" standard practice, but rather with a "commercial" practice, and therefore, such clauses are not adequate to derogate from the prohibition of anatocism pursuant to Art. 1283 of the Italian Civil Code.
The subsequent Legislative Decree 342 of 1999 confirmed the legitimacy of capitalisation of interest on current accounts, as long as interest is calculated with the same frequency on deposits and loans. From April 2000 (date in which this regulation came into effect), quarterly capitalisation of both interest income and expense was applied to all current accounts. Therefore the dispute on this issue concerns only those contracts which were stipulated before the indicated date.
With the decision of the United Sections on 4 November 2004, the Court of Cassation again excluded the possibility that said use may be considered regulatory. Even though court decisions have generally complied with the ruling by the United Sections, the possibility of defending in court the lawfulness of the Bank's past conduct still exists since many judges in the reliquidation of the accounts apply the technical and accounting criteria proposed by banks which often decrease, even significantly, the restitutions request of account holders.
The overall number of pending cases is at an insignificant level in absolute terms, and is the subject of constant monitoring. The risks related to these disputes are covered by prudential allocations to the provisions for other risks and charges.

Litigation regarding bonds in default

Group policy on management of complaints on financial instruments sold sets out a case-by-case assessment, with particular attention paid to the suitability of the instruments with respect to the position of the single investor.
More specifically, for Parmalat bonds, Intesa Sanpaolo decided, in agreement with all the representative Consumer Associations at national level, to extend the free conciliation procedure - successfully applied for former Gruppo Intesa customers - to customers of the former SANPAOLO IMI Group who had bought Parmalat securities.
The extended procedure consequently involved all the approximately 27,000 customers of the former SanPaolo IMI Group who bought Parmalat bonds that were then converted into shares and warrants of the new Parmalat. Of these, around 16,600 took part in the procedure. The examination of the applications started in November 2008 and is due to be concluded by the end of 2009.
The assessments are based on the principle of fairness and are conducted by five joint committees organised on a regional basis.
The repayment proposals made to date as part of the conciliation have been in line with the related specific provisions made.
The customers of the former SANPAOLO IMI Group may also continue to use the support offered, for the exercise of reimbursement actions against the parties responsible for the default, by the Parmalatbond Clienti SANPAOLO IMI Committee: During 2008 two significant settlements were reached between the Committee and several counterparties as part of the actions for compensation brought by the Committee on behalf of the parties being represented by it. Through the first agreement, which has been almost completely fulfilled, the entitled parties were able to obtain an overall recovery of around 13 million euro. Through the second agreement, for which the acceptances by the interested parties are in the process of being gathered, if all the entitled parties were to accept the overall recovery would amount to around 36 million euro.
For the Argentina bonds, complaints are managed by the ordinary procedure in place for any other financial product, according to a case-by-case assessment of the individual positions. Like all other legal risk measurement procedures provisions are made on each occasion that are deemed to be consistent with the specific circumstances of each case.
The same criteria are applied to the assessments of claims relating to bonds issued by companies belonging to the Lehman Brothers Group whose default was declared on 15 September 2008.

The Cirio group default

In November 2002, the Cirio Group, one of the largest Italian groups operating in the agro-industrial sector, was declared insolvent in the repayment of a loan issued on the Euromarket. This event led to a cross default on all its existing issues. The bonds issued by the Cirio Group had a nominal value totalling approximately 1.25 billion euro. Both the former Gruppo Intesa and the former Sanpaolo IMI Group – like the other major banking groups – had granted loans to the Cirio group.

In April 2007, 10 companies of the Cirio group in Extraordinary Administration notified Intesa Sanpaolo and Banca Caboto, as well as five other banks, considered to be severally liable, of the filing of a claim for the reimbursement of alleged damages deriving from:

– the worsening of the default of the Cirio group, from the end of 1999 to 2003, favoured also by the issue in the 2000/2002 period of 6 bond issues; the damages thereof are quantified – adopting three different criteria – with the main criteria in 2,082 million euro and, with the control criteria, in 1,055 million euro or 421 million euro;
– the impossibility by the Extraordinary Administration procedures of undertaking bankruptcy repeal, for undetermined amounts, because the default of Cirio group companies was postponed in time;
– the payment of fees of 9.8 million euro for the placement of the various bond issues.

The Group considers these claims to be totally unfounded and it is confident that it will be able to oppose them on both the merits of the case and on the basis of the lack of capacity to act in court proceedings of the Extraordinary Administration bodies.

Equitalia Polis S.p.A. (former Gest Line S.p.A.) – Tax-collection litigation

With three different transactions, the first in September 2006, the second in December 2007 and the last in April 2008, the Bank, as part of the State's internalisation of tax-collection activities, sold to Equitalia S.p.A. (a company owned by Agenzia delle Entrate and INPS) the entire equity investment in Gest Line S.p.A., now Equitalia Polis, which performed tax-collection activities in the former Sanpaolo IMI Group.

Gest Line's alleged irregularities in performing tax-collection activities in the period from the late 80s and the early 90s led to drawn-out litigation with tax-collection authorities mostly referred to the concession in Bologna. At the time of disposal of the equity investment, the Bank released specific guarantees, in addition to those provided for by the law for the State's internalisation of tax-collection activities, which also cover liabilities deriving from the aforesaid litigation.

Gest Line adhered to the amnesty for administrative irregularities introduced by Law 311/04. However, as part of the pending litigation, doubts were raised by certain Tax-Collection Offices and Administrative Judges concerning the extension of the provisions of the aforesaid amnesty. The conversion of Law Decree 248/2007 provides a clarification on the interpretation of the amnesty which should positively affect the litigation, favouring its possible extinction.

However, despite this latest legislative intervention, there is still some uncertainty regarding the interpretation of the extension of the amnesty, whose application in cases brought before the courts has led to judgements that have not been unequivocal.

In any event, the related risks are covered by provisions considered to be adequate.

IMI/SIR dispute

The Management Board meeting of 25 July 2007 approved the Bank's acceptance of the proposal made by the Rovelli family for the settlement of the IMI – SIR dispute, through a payment to Intesa Sanpaolo of the overall amount of 200 million euro and the assignment by the heirs of Mr. Rovelli to the Bank, of tax credits from the Government Authorities amounting to around 144 million euro.

The fulfilment of this settlement is still underway. In the first half of 2008, a total of 67.8 million euro were credited and recorded under "other income". Subsequently, during the course of July, the Public Prosecutor of the Court of Monza authorised the transfer to the Bank of a further 59 million euro, which were recorded in the third quarter of last year.

The final tranche of around 73.2 million euro was due to be received at the end of 2008, however this did not take place due to difficulties encountered by the debtors in realising the financial assets.

The funds are expected to be received during 2009.

Banca Infrastrutture Innovazione e Sviluppo and Municipality of Taranto Dispute

B.I.I.S., as the successor to Banca OPI, is involved in a case pending before the Court of Taranto brought by the Municipality of Taranto in relation to the subscription in May 2004 by Banca OPI for a 250,000,000 euro bond issued by this Municipality. The judgement is due to be issued before the summer.
As things stand it has not been necessary to change the classification of the performing loan due from the Municipality of Taranto, or to make any provisions for risks and charges.

Other judicial and administrative proceedings

Please note that a criminal investigation is underway in the United States instigated by the District Prosecutor of New York and the Department of Justice aimed at verifying the methods used for the clearing through the United States of payments in dollars to/from countries embargoed by the US government in the years from 2001 to 2008.
The investigation involves the treatment of payment orders in dollars generally issued in the SWIFT interbank payments settled through US banks, and the alleged omission or alteration of the information relating to the originators and beneficiaries of these payments.
The Bank is cooperating in full with this investigation.
A parallel administrative proceeding is also underway, initiated in March 2007 by the US banking supervisory authorities that, having found certain weaknesses in 2006 in the anti-money laundering systems of the New York branch, requested a series of actions (already implemented) to strengthen the anti-money laundering procedures and an examination of the payment traffic of the first half of 2006 by an independent consultant to verify the existence of any violations of the local anti-money laundering and embargo regulations.
Based on the information available it is not currently possible to make any forecasts concerning the timescale for the completion or the outcome of these proceedings.

Tax litigation

The risks associated with tax litigation are covered by specific provisions for risks and charges.
With regard to the Parent Company, in 2008, a reimbursement of tax credits of around 307 million euro was received, with the consequent release of the corresponding precautionary provisions of around 31 million euro.
New disputes also arose for around 46 million euro, relating to issues of law involving the charge of the alleged failure to pay:

- stamp duty in relation to compulsory accounting figures, for a total of around 15 million euro, as tax, penalty and interest relating to the years 2005 and 2006;
- IRES and IRAP of around 31 million euro as tax, penalty and interest relating to the years 2003-2006, mainly referring to the significance of the repurchase agreements for the purposes of the calculation of the deduction of the write-down of receivables, together with other less significant items.

It is believed that both charges can be effectively opposed in judicial proceedings.
The outstanding tax litigation as at 31 December 2008 involving the other, Italian and international, companies of the Group included within the scope of consolidation, amounted to a total of 117 million euro, respectively attributable to 94 million euro for actions brought by the Financial Authorities – for capital, penalties and interest – and to 23 million euro for tax credits recorded in the financial statements.
The disputes involve 41 million euro relating to direct taxes, around 9 million euro for withholding tax, 30 million euro for VAT, and around 13 million euro for other taxation. With regard to the most significant disputes that arose in 2008, which generally involve issues of interpretation, the following should be noted in particular:

- Centro Leasing Banca, for a total of 17 million euro solely relating to 2003, due to a disputable reclassification of sale & lease back transactions as ordinary loans guaranteed by real estate, on the basis of the case-law principle of abuse of rights;
- Eurizon Vita, for a total of 15 million euro due to the recovery of VAT for the years 2003 and 2004 relating to the tax treatment applied to the provision of services associated with co-insurance;
- Banca Fideuram, for a total of around 12 million euro relating to direct taxes for the year 2003, due to the derecognition of the accrual principle relating to charges associated with the incentive scheme for financial planners.

Labour litigation

During the year the INPS of Turin confirmed a payment demand relating to the failure by Sanpaolo IMI to pay contributions to finance the involuntary unemployment for the period 1 November 2002 – 31 December 2006. This risk has been covered by a provision considered to be sufficient based on the probable outcome of the dispute.