
Risk management

BASIC PRINCIPLES

The Intesa Sanpaolo Group's risk acceptance policies are defined by the Board of Directors and the Management Control Committee, with management and control functions respectively. The Board of Directors carries out its activity through specific internal committees, among which the Risk Committee. The Corporate Bodies are assisted by the action of managerial committees, among which mention should be made of the Group Risk Governance Committee, as well as the support of the Chief Risk Officer, reporting directly to the Chief Executive Officer.

The Chief Risk Officer is responsible for proposing the Risk Appetite Framework, setting the Group's risk management guidelines and policies in accordance with company strategies and objectives and coordinating and verifying the implementation of those guidelines and policies by the responsible units of the Group, including within the various corporate departments. The Chief Risk Officer ensures management of the Group's overall risk profile by establishing methods and monitoring exposure to the various types of risk and reporting the situation periodically to the corporate bodies.

The Parent Company is in charge of overall direction, management and control of risks. Group companies that generate credit and/or financial risks are assigned autonomy limits and each has its own control structure. A service agreement governs the risk control activities performed by the Parent Company's functions on behalf of the main subsidiaries. These functions report directly to the subsidiaries' Management Bodies.

The risk measurement and management tools contribute to defining a risk-monitoring framework at Group level, capable of assessing the risks assumed by the Group from a regulatory and economic point of view. The level of absorption of economic capital, defined as the maximum "unexpected" loss that could be borne by the Group over a period of one year, is a key measure for determining the Group's financial structure, risk appetite and for guiding operations, ensuring a balance between risks assumed and shareholder returns. It is estimated on the basis of the current situation and also as a forecast, based on the Budget assumptions and projected economic scenario under ordinary and stress conditions. The assessment of capital is included in business reporting and is submitted quarterly to the Group Risk Governance Committee, the Risk Committee and the Board of Directors, as part of the Group's Risks Tableau de Bord. Risk hedging, given the nature, frequency and potential impact of the risk, is based on a constant balance between mitigation/hedging action, control procedures/processes and capital protection measures.

BASEL 3 REGULATIONS AND THE INTERNAL PROJECT

In view of compliance with the reforms of the previous accord by the Basel Committee ("Basel 3"), the Intesa Sanpaolo Group has undertaken adequate project initiatives, expanding the objectives of the Basel 2 Project in order to improve the measurement systems and the related risk management systems.

With respect to credit risks, the Group received authorisation to use internal ratings-based approaches effective from the report as at 31 December 2008 on the Corporate portfolio for a scope extending to the Parent Company, network banks in the Banca dei Territori Division and the main Italian product companies.

Progressively, the scope of application has been gradually extended to include the SME Retail and Retail Mortgage portfolios, as well as other Italian and international Group companies.

Dedicated rating approaches have been developed for the Banks and Public Entities Portfolio according to the type of counterparty to be assessed. This was the subject of a pre-validation inspection by the Supervisory Authority conducted in December 2013, followed by an additional validation visit in March 2015. In the same month an AIRB authorisation request was presented to the Supervisory Authority for this portfolio.

The Group is also proceeding with development of the IRB systems for the other segments and the extension of the scope of companies for their application in accordance with a plan presented to the Supervisory Authority.

For OTC derivatives, with reference to the Parent Company Intesa Sanpaolo and to Banca IMI, the Bank of Italy granted the authorisation to use the internal counterparty risk model for regulatory purposes, starting from the first quarter of 2014. For the Banks in the Banca dei Territori Division, an application for authorisation to use the internal model for regulatory purposes was submitted to the Supervisory Authority in 2015, while for management purposes, the advanced risk estimate measures were implemented in November 2014.

In 2015 an application for authorisation to use internal models for regulatory purposes was also submitted for Securities Financing Transactions (SFT - Repos and securities lending) products. For management purposes, the advanced risk measurement methods were implemented for SFT in May 2015.

With regard to Operational Risk, the Group obtained authorisation to use the Advanced Measurement Approach (AMA – internal model) to determine the associated capital requirement for regulatory purposes, with effect from the report as at 31 December 2009.

There were no changes in the scope of application of the models compared to 31 December 2015.

The adequacy of the internal control system for risks is also illustrated in the annual Internal Capital Adequacy Assessment Process Report, based on the extensive use of internal approaches for the measurement of risks and for the calculation of internal capital and total capital available. The document was approved and sent to the Supervisor in April 2016.

The Intesa Sanpaolo Group participated in the 2016 EU-wide stress test, the exercise conducted by the European Banking Authority on the financial statements of European banks as at 31 December 2015.

The test consisted of the simulation of the impact of two scenarios – baseline and adverse – and covers a time horizon of three years (2016-2018). The 2016 EU-wide stress test provides crucial information as part of the prudential review process of 2016. The results thus allowed the competent authorities to assess banks' ability to comply with the established minimum and additional own funds requirements in stress scenarios based on shared methodology and assumptions.

Intesa Sanpaolo acknowledges the results of the 2016 EU-wide stress test announced by the EBA on 29 July 2016, which were extremely positive for the Group. The Common Equity Tier 1 ratio (CET1 ratio) resulting from the stress test for 2018, the final year considered in the exercise, was 12.8% for Intesa Sanpaolo in the baseline scenario and 10.2% in the adverse scenario, compared to the starting-point figure of 13% recorded as at 31 December 2015, and includes a 50 basis-point reduction - in both scenarios - for the transition from the calculation criteria applicable in 2015 to those in force for 2018.

As part of its adoption of Basel 3, the Group publishes information concerning capital adequacy, exposure to risks and the general characteristics of the systems aimed at identifying, monitoring and managing them in a document entitled "Basel 3 - Pillar 3" or simply "Pillar 3".

The document is published on the website (group.intesasanpaolo.com) on a quarterly basis.

CREDIT RISK

The Group's strategies, powers and rules for the granting and managing of loans are aimed at:

- achieving the goal of sustainable growth consistent with the Group's risk appetite and value creation objectives, whilst guaranteeing and improving the quality of its lending operations;
- diversifying the portfolio, limiting the concentration of exposures to counterparties/groups, economic sectors or geographical areas;
- efficiently selecting economic groups and individual borrowers through a thorough analysis of their creditworthiness aimed at limiting the risk of insolvency and mitigating potentially associated losses;
- given the current economic climate, favouring lending business aimed at supporting the real economy and production system and at developing relationships with customers;
- constantly monitoring relationships and the related exposures, through the use of both IT procedures and systematic surveillance of positions that show irregularities with the aim of detecting any symptoms of deterioration in a timely manner.

The Intesa Sanpaolo Group has developed a set of techniques and tools for credit risk measurement and management which ensures analytical control over the quality of loans to customers and financial institutions, and loans subject to country risk.

In particular, with respect to loans to customers, risk is measured using internal rating models which change according to the counterparty's operating segment.

Credit quality

Constant monitoring of the quality of the loan portfolio is also pursued through specific operating checks for all the phases of loan management.

The overall watch-list and non-performing loan portfolio is subject to a specific management process which, inter alia, entails accurate monitoring through a control system and periodic managerial reporting. In particular, this activity is performed using measurement methods and performance controls that allow the production of synthetic risk indicators. The quality of the loan portfolio is pursued through specific operating checks for all the phases of loan management, through the use of both IT procedures and systematic supervision of positions with the aim of detecting any symptoms of difficulty and promote corrective measures to prevent possible deterioration of credit risk.

Positions are detected and automatically entered in the credit management processes by way of daily and monthly checks using objective risk indicators that allow timely assessments when any anomalies arise or persist and interact with processes and procedures for loan management and monitoring.

Within the Group, in accordance with pre-set rules, positions which are attributed a persistent high-risk rating are intercepted (manually or automatically) and classified to the following categories based on their risk profile, in accordance with the regulatory provisions on credit quality:

- Bad loans: the set of "on-" and "off-balance sheet" exposures towards borrowers in default or similar situations;
- Unlikely to pay: "on-" and "off-balance sheet" exposures which the bank, based on its opinion, deems unlikely to be completely (as principal and/or interest) repaid by the borrowers without the implementation of actions such as enforcement of guarantees. This assessment is irrespective of the presence of any amounts (or instalments) due and unpaid.

The category of non-performing loans also includes past due positions that cannot be considered mere delays in reimbursements, as established by the Bank of Italy.

Lastly, non-performing exposures also include the individual forbore exposures which comply with the definition of "Non-performing exposures with forbearance measures" envisaged by the EBA ITS (European Banking Authority - Implementing Technical Standards), which are not a separate category of non-performing assets, but rather a sub-category. Similarly, exposures characterised by "forbearance measures" are also included among performing loans.

The management process for such exposures, in close accordance with regulatory provisions concerning classification times and methods, is assisted by automatic mechanisms that ensure pre-established, autonomous and independent management procedures.

	30.09.2016			31.12.2015			Changes
	Gross exposure	Total adjustments	Net exposure	Gross exposure	Total adjustments	Net exposure	Net exposure
Bad loans	38,028	-23,014	15,014	39,150	-24,177	14,973	41
Unlikely to pay	20,981	-5,501	15,480	22,725	-5,634	17,091	-1,611
Past due loans	686	-136	550	1,239	-217	1,022	-472
Non-performing loans	59,695	-28,651	31,044	63,114	-30,028	33,086	-2,042
of which forbore	11,502	-3,433	8,069	10,856	-3,151	7,705	364
Performing loans	321,209	-1,933	319,276	302,875	-2,012	300,863	18,413
of which forbore	8,049	-258	7,791	7,917	-218	7,699	92
Performing loans represented by securities	14,750	-234	14,516	13,633	-249	13,384	1,132
of which forbore	92	-	92	137	-2	135	-43
Loans to customers	395,654	-30,818	364,836	379,622	-32,289	347,333	17,503

Figures restated, where necessary, considering the changes in the scope of consolidation and discontinued operations.

As at 30 September 2016, the Group's non-performing loans, net of adjustments, came to 31 billion euro, below the levels of the end of 2015 (-6.2%), continuing the gradual decline witnessed in the previous quarters of the current year. Compared to the end

of December 2015, there was a significant decrease in non-performing assets as a percentage of total loans to customers (to 8.5%).

In further detail, bad loans came to 15 billion euro, net of adjustments, in the first nine months of 2016, slightly up (+0.3%) from the beginning of the year, and represented 4.1% of total loans (4.3% at the end of 2015). During the same period, the coverage ratio was 60.5% (61.8% in December 2015). Loans included in the unlikely to pay category amounted to 15.5 billion euro, down by 9.4%, accounting for 4.2% of total loans to customers, with a coverage ratio of 26.2%. Past due loans totalled 550 million euro, down 46.2% compared to the beginning of the year, with a coverage ratio of 19.8%. Forborne exposures are generated by forbearance measures for borrowers experiencing difficulty in meeting their financial obligations, according to the definition introduced by the European Banking Authority with the aim of harmonising the classification of the definitions of non-performing loans and forbearance practices (renegotiation due to financial difficulty by the debtor) at the European level: within the non-performing loan category, they amounted to 8.1 billion euro, with an average coverage ratio of 29.8%, whereas those in the performing loan category were slightly lower (7.8 billion euro).

The coverage ratio of performing loans was 0.6%.

MARKET RISKS

TRADING BOOK

The quantification of trading risks is based on daily and periodic VaR of the trading portfolios of Intesa Sanpaolo and Banca IMI, which represent the main portion of the Group's market risks, to adverse market movements of the following risk factors:

- interest rates;
- equities and market indexes;
- investment funds;
- foreign exchange rates;
- implied volatilities;
- spreads in credit default swaps (CDSs);
- spreads in bond issues;
- correlation instruments;
- dividend derivatives;
- asset-backed securities (ABSs);
- commodities.

Other Group subsidiaries hold smaller trading portfolios with a marginal risk (around 2% of the Group's overall risk). In particular, the risk factors of the international subsidiaries' trading books are local government bonds, positions in interest rates, and foreign exchange rates relating to linear pay-offs.

For some of the risk factors indicated above, the Supervisory Authority has validated the internal models for the reporting of the capital absorptions of both Intesa Sanpaolo and Banca IMI.

Effective from the report as at 30 September 2012, both banks have received authorisation from the Supervisory Authority to extend the scope of the model to specific risk on debt securities. The model was extended on the basis of the current methodological framework (a historical simulation in full evaluation), and required the integration of the Incremental Risk Charge into the calculation of the capital requirement for market risks.

Effective from June 2014, market risks are to be reported according to the internal model for capital requirements for the Parent Company's hedge fund portfolios (the full look-through approach).

The risk profiles validated are: (i) generic/specific on debt securities and on equities for Intesa Sanpaolo and Banca IMI, (ii) position risk on quotas of UCI underlying CPPI (Constant Proportion Portfolio Insurance) products for Banca IMI, (iii) position risk on dividend derivatives and (iv) position risk on commodities for Banca IMI, the only legal entity in the Group authorised to hold open positions in commodities.

The requirement for stressed VaR is included when determining capital absorption effective from 31 December 2011. The requirement derives from the determination of the VaR associated with a market stress period. This period was identified considering the following guidelines, on the basis of the indications presented in the Basel document "Revision to the Basel 2 market risk framework":

- the period must represent a stress scenario for the portfolio;
- the period must have a significant impact on the main risk factors for the portfolios of Intesa Sanpaolo and Banca IMI;
- the period must allow real historical series to be used for all portfolio risk factors.

In keeping with the historical simulation approach employed to calculate VaR, the latter point is a discriminating condition in the selection of the holding period. In fact, in order to ensure that the scenario adopted is effectively consistent and to avoid the use of driver or comparable factors, the historical period must ensure the effective availability of market data.

As at the date of preparation of this document, the period relevant to the measurement of stressed VaR had been set as 1 January to 31 December 2011 for Intesa Sanpaolo and as 1 July 2011 to 30 June 2012 for Banca IMI.

The analysis of market risk profiles relative to the trading book uses various quantitative indicators and VaR is the most important. Since VaR is a synthetic indicator which does not fully identify all types of potential loss, risk management has been enriched with other measures, in particular simulation measures for the quantification of risks from illiquid parameters (dividends, correlation, ABS, hedge funds).

VaR estimates are calculated daily based on simulations of historical time-series, with a 99% confidence level and 1-day holding period.

The following paragraphs provide the estimates and evolution of VaR, defined as the sum of VaR and of the simulation on illiquid parameters, for the trading book of Intesa Sanpaolo and Banca IMI.

During the third quarter of 2016, the market risks generated by Intesa Sanpaolo and Banca IMI increased compared to the average values of the second quarter of 2016. The average VaR for the period totalled 102.2 million euro compared to 97 million euro in the second quarter of 2016.

Daily VaR of the trading book for Intesa Sanpaolo and Banca IMI^(a)

(millions of euro)

	average 3 rd quarter	minimum 3 rd quarter	2016 maximum 3 rd quarter	average 2 nd quarter	average 1 st quarter	average 4 th quarter	2015 average 3 rd quarter	average 2 nd quarter	average 1 st quarter
Intesa Sanpaolo	11.5	9.8	14.6	11.5	14.9	13.2	11.6	13.8	12.1
Banca IMI	90.6	60.1	125.6	85.5	90.0	85.0	104.7	71.1	64.6
Total	102.2	71.9	137.9	97.0	104.9	98.3	116.3	84.9	76.7

^(a) Each line in the table sets out past estimates of daily VaR calculated on the quarterly historical time-series respectively of Intesa Sanpaolo and Banca IMI; minimum and maximum values for the two companies are estimated using aggregate historical time-series and therefore do not correspond to the sum of the individual values in the column.

In the first nine months of 2016, the Group's average VaR was 101.3 million euro, up from 93.1 million euro in the same period of 2015.

(millions of euro)

	average 30.09	2016 minimum 30.09	maximum 30.09	average 30.09	2015 minimum 30.09	maximum 30.09
Intesa Sanpaolo	12.6	9.8	17.5	12.5	6.0	18.5
Banca IMI	88.7	60.1	125.6	80.6	54.0	116.3
Total	101.3	71.9	137.9	93.1	64.5	125.7

^(a) Each line in the table sets out past estimates of daily VaR calculated on the historical time-series of the first nine months of the year respectively of Intesa Sanpaolo and Banca IMI; minimum and maximum values for the two companies are estimated using aggregate historical time-series and therefore do not correspond to the sum of the individual values in the column.

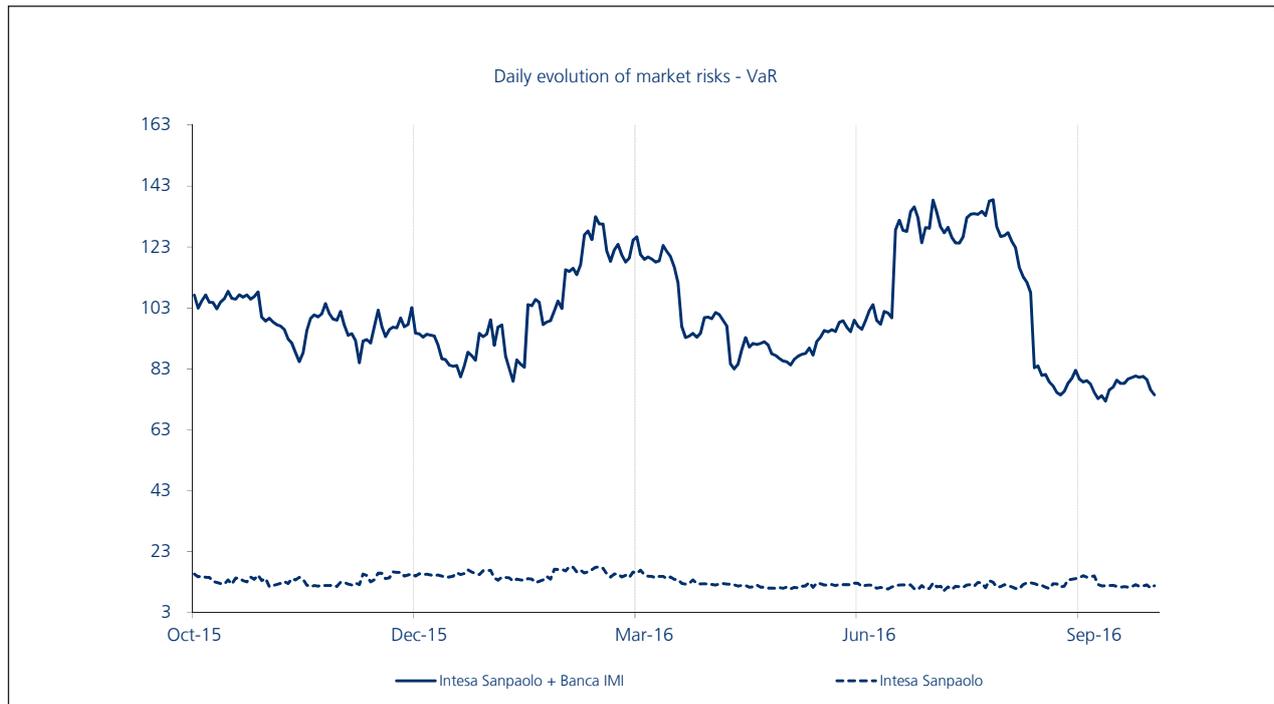
For Intesa Sanpaolo the breakdown of the risk profile in the third quarter of 2016, with regard to the various factors, shows the prevalence of the risk generated by foreign exchange, which accounted for 47% of total VaR (primarily linked to hedge positions of banking book entries, excluding which, the component relating to credit spread risk is the main one); for Banca IMI, credit spread risk was the most significant, representing 83% of total VaR.

Contribution of risk factors to total VaR^(a)

3rd quarter 2016	Shares	Hedge funds	Interest rates	Credit spreads	Foreign exchange rates	Other parameters	Commodities
Intesa Sanpaolo	8%	10%	13%	19%	47%	3%	0%
Banca IMI	3%	0%	8%	83%	1%	2%	3%
Total	4%	1%	8%	77%	5%	2%	3%

^(a) Each line in the table sets out the contribution of risk factors considering 100% the overall capital at risk, calculated as the average of daily estimates in the third quarter of 2016, broken down between Intesa Sanpaolo and Banca IMI and indicating the distribution of overall capital at risk.

The trend in VaR is mainly attributable to Banca IMI. In the second quarter of 2016, a decrease in VaR was initially recorded as a result of sales and exiting scenarios of volatility; then, subsequently, from mid-May onwards, the measures recorded a slight increase as a result of purchases of government securities (within the limits approved for 2016). On 24 June 2016, in correspondence to the outcome of the referendum in the UK (Leave victory), volatility of credit spreads was then recorded on the markets accompanied by lower interest rates and share prices. The new scenario generated an increase in the Group's VaR, which at the end of the period recorded a peak of 134 million euro. Risk measures continued to be contained within the assigned limits. During the third quarter, in addition to further exclusions of volatile scenarios, there was also a decrease in positions in government and financial securities.



Risk control with regard to the trading activity of Intesa Sanpaolo and Banca IMI also uses scenario analyses and stress tests. The impact on the income statement of selected scenarios relating to the evolution of stock prices, interest rates, credit spreads and foreign exchange rates as at the end of September is summarised in the following table: The shocks applied to the portfolio were updated by the Financial and Market Risks Department.

(millions of euro)

	EQUITY		INTEREST RATES		CREDIT SPREADS		FOREIGN EXCHANGE RATES		COMMODITIES	
	Crash	Bullish	+40bp	lower rate	-25bp	+25bp	-10%	+10%	Crash	Bullish
Total	-3	30	-49	32	236	-227	26	-25	15	-5

In particular:

- for positions on equity markets, there would be a theoretical loss of 3 million euro in the event of a market crash (decline in prices of 15% on the European market and of 10% on the U.S. market and increase in volatility of 25%);
- for positions in interest rates, there would be a loss of 49 million euro in the event of an increase in rate curves of 40 basis points;
- for positions in credit spreads, a widening of credit spreads of 25 bps would entail a loss of 227 million euro;
- for positions in foreign exchange, there would be losses in the event of a 10% increase in the EUR-USD exchange rate;
- finally, for positions in commodities, an increase in commodity prices of 20% (accompanied by a reduction in the price of gold of 15%) would entail a loss of 5 million euro.

Backtesting

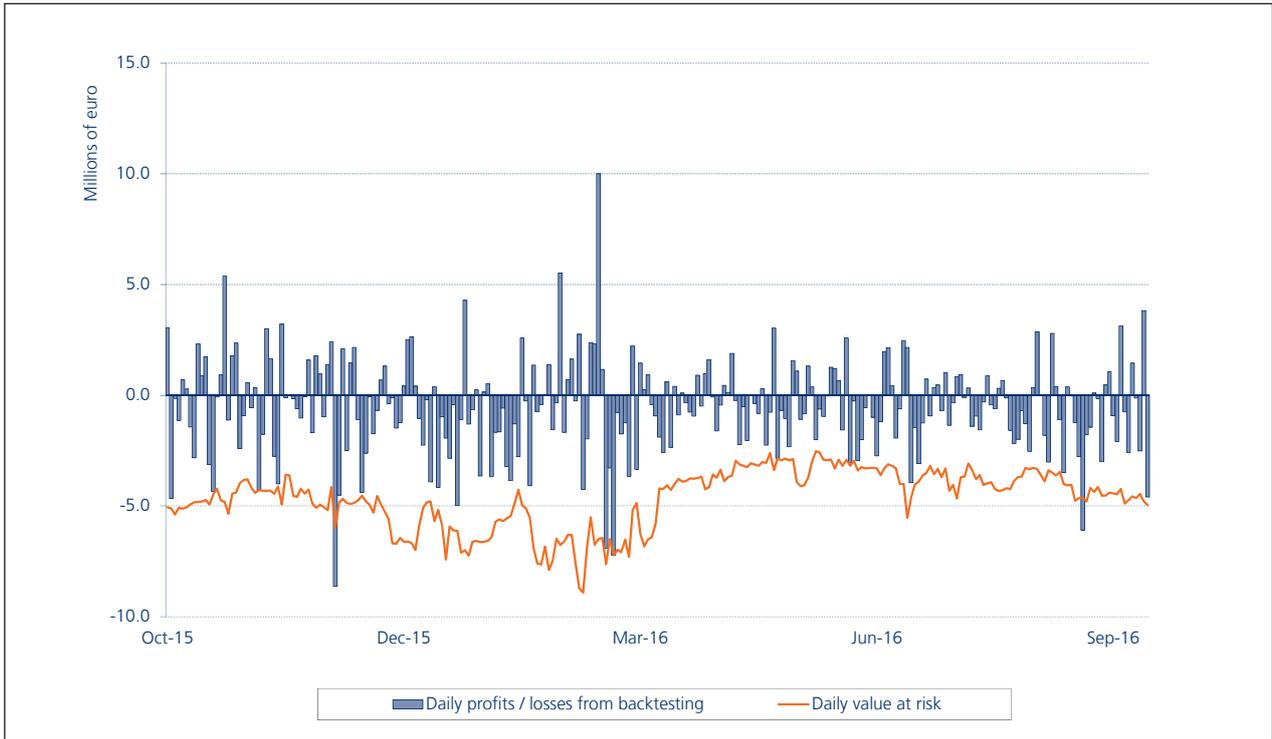
The effectiveness of the VaR calculation methods must be monitored daily via backtesting which, as concerns regulatory backtesting, compares:

- the daily estimates of value at risk;
- the daily profits/losses based on backtesting which are determined using actual daily profits and losses achieved by individual desks, net of components which are not considered in backtesting such as commissions and intraday activities.

Backtesting allows verification of the model’s capability of correctly seizing, from a statistical viewpoint, the variability in the daily valuation of trading positions, covering an observation period of one year (approximately 250 estimates). Any critical situations relative to the adequacy of the Internal Model are represented by situations in which daily profits/losses based on backtesting highlight more than three occasions, in the year of observation, in which the daily loss is higher than the value at risk estimate. Current regulations require that backtesting is performed by taking into consideration both the actual P&L series recorded and the theoretical series. The latter is based on valuation of the portfolio value through the use of pricing models adopted for the VaR measurement calculation. The number of significant backtesting exceptions is determined as the maximum between those for actual P&L and theoretical P&L.

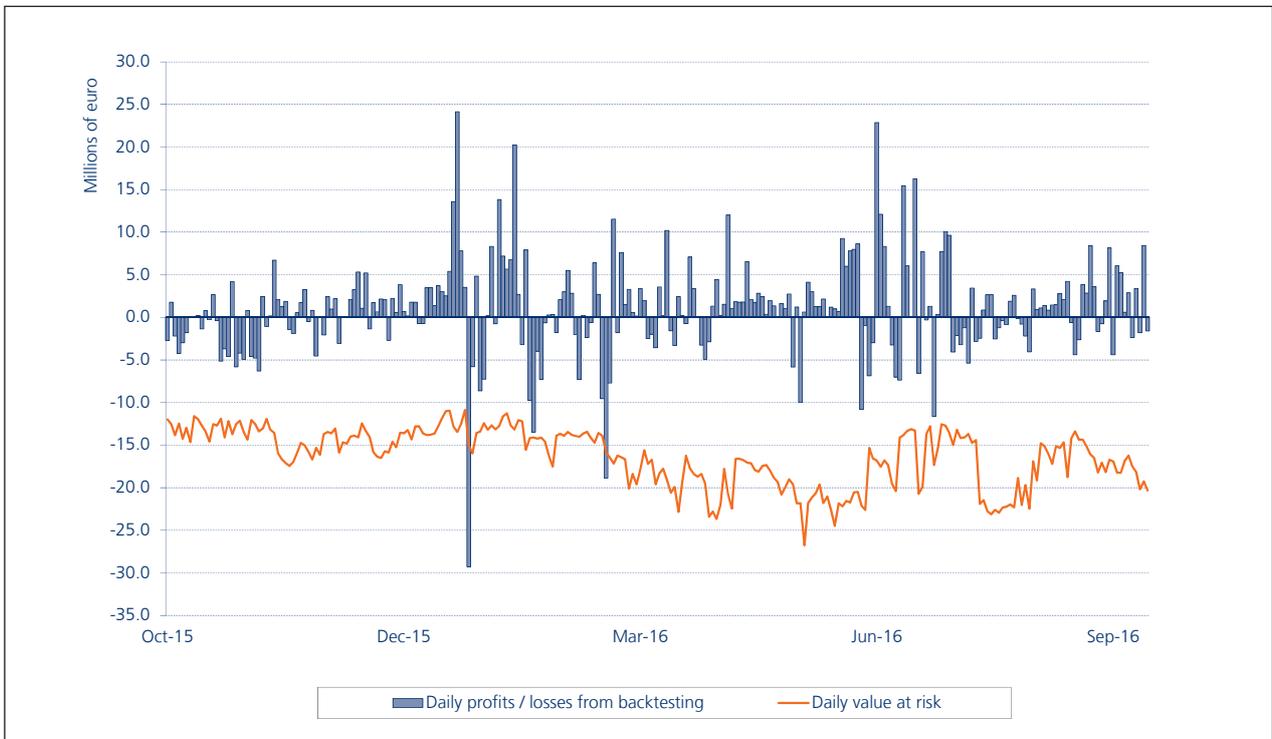
Backtesting in Intesa Sanpaolo

In the past year, there have been two effective backtesting exceptions tied to interest rate movements.



Backtesting in Banca IMI

Banca IMI's two backtesting exceptions are to be attributed to the increase in volatility of financial spreads recorded during the first quarter of 2016.



BANKING BOOK

Market risk originated by the banking book arises primarily in the Parent Company and in the other main Group companies involved in retail and corporate banking. The banking book also includes exposure to market risks deriving from the equity investments in listed companies not fully consolidated, mostly held by the Parent Company and IMI Investimenti.

The following methods are used to measure financial risks of the Group's banking book:

- Value at Risk (VaR);
- Sensitivity Analysis.

Value at Risk is calculated as the maximum potential loss in the portfolio's market value that could be recorded over a 10-day holding period with a 99% confidence level (parametric VaR).

The Shift sensitivity analysis quantifies the change in value of a financial portfolio resulting from adverse movements in the main risk factors (interest rate, foreign exchange, equity). For interest rate risk, an adverse movement is defined as a parallel and uniform shift of +100 basis points of the interest rate curve. The measurements include an estimate of the prepayment effect and of the risk originated by customer demand loans and deposits. Furthermore, interest margin sensitivity is measured by quantifying the impact on net interest income of a parallel and instantaneous shock in the interest rate curve of ± 100 basis points, over a period of 12 months. This measure highlights the effect of variations in interest rates on the portfolio that is being measured, excluding assumptions on future changes in the mix of assets and liabilities and, therefore, it cannot be considered a forecast indicator of the future levels of the interest margin.

Hedging of interest rate risk is aimed at (i) protecting the banking book from variations in the fair value of loans and deposits due to movements in the interest rate curve or (ii) reducing the volatility of future cash flows related to a particular asset/liability. The main types of derivative contracts used are interest rate swaps (IRS), overnight index swaps (OIS), cross-currency swaps (CCS) and options on interest rates entered into with third parties or with other Group companies. The latter, in turn, cover risk in the market so that the hedging transactions meet the criteria to qualify as IAS-compliant for consolidated financial statements.

Hedging activities performed by the Intesa Sanpaolo Group are recorded using various hedge accounting methods. A first method refers to the fair value hedge of specifically identified assets or liabilities (micro hedging), mainly consisting of bonds issued or acquired by Group companies and loans to customers. On the basis of the carved-out version of IAS 39, fair-value hedging is also applied for the macro hedging of the stable portion of demand deposits (core deposits) and on the already fixed portion of floating-rate loans.

Moreover, since the end of 2015 the Group has extended the use of macro hedging to a portion of fixed-rate loans, adopting an open-portfolio macro hedging model for a portion of fixed-rate loans according to a bottom-layer approach that, in accordance with the interest rate risk measurement method involving modelling of the prepayment phenomenon, is more closely correlated with risk management activity and asset dynamics.

Another hedging method used is the cash flow hedge, which has the purpose of stabilising interest flow on both floating-rate funding, to the extent that the latter finances fixed-rate investments, and on floating-rate investments to cover fixed-rate funding (macro cash flow hedges).

The Financial and Market Risks Department is in charge of measuring the effectiveness of interest rate risk hedges for the purpose of hedge accounting.

In the first nine months of 2016, interest rate risk generated by the Intesa Sanpaolo Group's banking book, measured through shift sensitivity analysis, recorded an average value of 885 million euro settling at 1,153 million euro at the end of September 2016, almost entirely concentrated on the euro currency; this figure compares with 547 million euro at the end of 2015.

Interest margin sensitivity – assuming a 100 basis point change in interest rates – amounted to 1,010 million euro at the end of September 2015 (535 million euro at the end of 2015).

Interest rate risk, measured in terms of VaR, recorded an average of 66 million euro in the first nine months of 2016 (139 million euro at the end of 2015), with a maximum value of 85 million euro and a minimum value of 40 million euro; that figure is compared to the value of 68 million euro at the end of September 2016. Price risk generated by minority stakes in listed companies, mostly held in the AFS (available for sale) category and measured in terms of VaR, recorded an average level of 83 million euro in the first nine months of 2016 (27 million euro at the end of 2015), with a minimum value of 16 million euro and a maximum value of 146 million euro; that figure compares with a value of 132 million euro at the end of September.

Lastly, an analysis of banking book sensitivity to price risk, measuring the impact on Shareholders' Equity of a price shock on the above quoted assets recorded in the AFS category shows sensitivity to a 10% negative shock equal to 6.6 million euro at the end of September 2016.

LIQUIDITY RISK

Liquidity risk is defined as the risk that the Bank may not be able to meet its payment obligations due to the inability to obtain funds on the market (funding liquidity risk) or liquidate its assets (market liquidity risk).

The arrangement of a suitable control and management system for that specific risk has a fundamental role in maintaining stability, not only at the level of each individual bank, but also of the market as a whole, given that imbalances within a single financial institution may have systemic repercussions. Such a system must be integrated into the overall risk management system and provide for incisive controls consistent with developments in the context of reference.

During 2016 the corporate bodies of Intesa Sanpaolo approved the update of the “Guidelines for Group Liquidity Risk Management”, implementing the latest regulatory provisions. These Guidelines illustrate the tasks of the various company functions, the rules and the set of control and management processes aimed at ensuring prudent monitoring of liquidity risk, thereby preventing the emergence of crisis situations. The key principles underpinning the Liquidity Policy of the Intesa Sanpaolo Group are:

- the existence of liquidity management guidelines approved by senior management and clearly disseminated throughout the Bank;
- the existence of an operating structure that works within set limits and of a control structure that is independent from the operating structure;
- the constant availability of adequate liquidity reserves in relation to the pre-determined liquidity risk tolerance threshold;
- the assessment of the impact of various scenarios, including stress testing scenarios, on the cash inflows and outflows over time and the quantitative and qualitative adequacy of liquidity reserves;
- the adoption of an internal fund transfer pricing system that accurately incorporates the cost/benefit of liquidity, on the basis of the Intesa Sanpaolo Group’s funding conditions.

From an organisational standpoint, a detailed definition is prepared of the tasks assigned to the strategic and management supervision bodies and reports are presented to the senior management concerning certain important formalities such as the approval of measurement methods, the definition of the main assumptions underlying stress scenarios and the composition of early warning indicators used to activate emergency plans.

The departments of the Parent Company that are in charge of ensuring the correct application of the Guidelines are, in particular, the Treasury Head Office Department, the Planning and Active Value Management Head Office Department, responsible for liquidity management, and the Financial and Market Risks Head Office Department, directly responsible for measuring liquidity risk on a consolidated basis.

With regard to liquidity risk measurement metrics and mitigation tools, in addition to defining the methodological system for measuring short-term and structural liquidity indicators, the Group also formalises the maximum tolerance threshold (risk appetite) for liquidity risk, the criteria for defining liquidity reserves and the rules and parameters for conducting stress tests.

The short-term Liquidity Policy is aimed at ensuring an adequate, balanced level of cash inflows and outflows the timing of which is certain or estimated to fall within a period of 12 months, in order to respond to periods of tension, including extended periods, on the various funding sourcing markets, also by establishing adequate liquidity reserves in the form of liquid securities on private markets and securities eligible for refinancing with Central Banks. To that end, and in keeping with the liquidity risk appetite, the system of limits consists of two short-term indicators for holding periods of one week (cumulative projected imbalance in wholesale operations) and of one month (Liquidity Coverage Ratio) respectively.

The cumulative projected wholesale imbalances indicator measures the Bank’s independence from unsecured wholesale funding in the event of a freeze of the money market and aims to ensure financial autonomy, assuming the use on the market of only the highest quality liquidity reserves. The Liquidity Coverage Ratio (LCR) is aimed at strengthening the short-term liquidity risk profile, ensuring the holding of sufficient unencumbered high quality liquid assets (HQLA) that can be easily and immediately converted into cash in the private markets to satisfy the short-term liquidity requirements (30 days) in a liquidity stress scenario. To this end, the Liquidity Coverage Ratio measures the ratio between: (i) the stock of HQLA and (ii) the total net cash outflows calculated according to the scenario parameters defined by the regulations. Delegated Regulation (EU) 2015/61 calls for a gradual introduction of the regulatory framework of LCR according to the following schedule: from 1 October 2015 to 31 December 2015 = 60%; from 1 January to 31 December 2016 = 70%; from 1 January to 31 December 2017 = 80%; from 1 January 2018 = 100%.

The aim of the Intesa Sanpaolo Group’s structural Liquidity Policy is to adopt the structural requirement provided for by the regulatory provisions of Basel 3: Net Stable Funding Ratio (NSFR). This indicator is aimed at promoting the increased use of stable funding, to prevent medium/long-term operations from giving rise to excessive imbalances to be financed in the short term. To this end, it sets a minimum “acceptable” amount of funding exceeding one year in relation to the needs originating from the characteristics of liquidity and residual duration of assets and off-balance sheet exposures. The NSFR’s regulatory requirement is still subject to a period of observation: the European Commission is required to present a legislative proposal that will come into force from 2018.

The Guidelines for Group Liquidity Risk Management also envisage the time extension of the stress scenario for the LCR indicator, provided by the new regulatory framework, measuring, for up to 3 months, the effect of specific acute liquidity tensions (at bank level) combined with a widespread and general market crisis. The internal management guidelines also envisage a minimum limit on the LCR indicator up to 3 months, with the purpose of establishing an overall level of reserves covering greater cash outflows during a period of time that is adequate to implement the required operating measures to restore the Group to balanced conditions.

The Guidelines also establish methods for management of a potential liquidity crisis, defined as a situation of difficulty or inability of the Bank to meet its cash obligations falling due, without implementing procedures and/or employing instruments that, due to their intensity or manner of use, do not qualify as ordinary administration. By setting itself the objectives of safeguarding the Group’s asset value and also guaranteeing the continuity of operations under conditions of extreme liquidity emergency, the Contingency Liquidity Plan ensures the identification of the early warning signals and their ongoing monitoring, the definition of procedures to be implemented in situations of liquidity stress, the immediate lines of action, and the intervention measures for the resolution of emergencies. The early warning indexes, aimed at spotting the signs of a potential liquidity strain, both systematic and specific, are monitored with daily frequency by the Financial and Market Risks Department.

In the first nine months of 2016, the Group’s liquidity position remained within the risk limits provided for in the Group’s Liquidity Policy: both the LCR and NSFR indicators were largely respected, as they reached a level well above the phased-in requirements.

As at 30 September 2016, the eligible liquidity reserves for the Central Banks, considering cash components, came to 127 billion euro (117 billion euro at the end of December 2015), of which 76 billion euro, net of haircut, was unencumbered (78 billion euro at the end of December 2015).

Also the stress tests, when considering the high availability of liquidity reserves (liquid or eligible), yielded results in excess of the target threshold for the Group, with a liquidity surplus capable of meeting extraordinary cash outflows for a period of more than 3 months.

Adequate and timely information regarding the development of market conditions and the position of the Bank and/or Group was provided to the corporate bodies and internal committees in order to ensure full awareness and manageability of the main risk factors.

INFORMATION ON FINANCIAL PRODUCTS

In line with the requests for utmost transparency made by supranational and national Supervisory Authorities, the following information is provided on the fair value measurement methods adopted, structured credit products, activities performed through Special Purpose Entities (SPE), leveraged finance transactions, hedge fund portfolios and transactions in derivatives with customers.

FAIR VALUE MEASUREMENT OF FINANCIAL ASSETS AND LIABILITIES

General principles

This chapter summarises the criteria used by the Group to measure the fair value of financial instruments. These criteria are substantially unchanged with respect to those illustrated in detail in the Annual Report 2015, to which reference is made for more information.

The Intesa Sanpaolo Group governs and defines the fair value measurement of financial instruments through the Group's Fair Value Policy, prepared by the Financial and Market Risks Department and also applied to the Parent Company and to all consolidated subsidiaries.

The fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants (i.e. not as part of the compulsory liquidation or a below-cost sale) as at the measurement date. Fair value is a market measurement criterion, not specifically referring to a single bank. Underlying the definition of fair value is the assumption that the Bank is carrying out normal operations, without any intention of liquidating its assets, significantly reducing the level of operations or carrying out transactions at unfavourable conditions.

A bank has to measure the fair value of an asset or liability by adopting the assumptions that would be used by market participants when pricing an asset or liability, presuming that they act with a view to satisfying their own economic interest in the best way possible. Measurement at fair value presumes that the asset is sold or the liability transferred:

- a. in the principal active market for the asset or liability;
- b. in the absence of a major active market, in the most advantageous market for the asset or liability.

The Group considers a market to be active when transactions in an asset or liability occur with sufficient frequency and volume to provide useful information for determining price on an ongoing basis. An instrument is considered listed on an active market if prices reflecting normal market transactions are promptly and regularly available from stock exchanges, brokers, intermediaries, principal-to-principal markets, listing services or authorised entities and such prices are representative of effective, regular market transactions.

The Intesa Sanpaolo Group considers the principal market of a financial asset or liability to be the market in which the Group generally operates.

In the event of a significant reduction in the volume or level of operations compared to normal operations for the asset or liability (or for similar assets or liabilities) highlighted by a number of indicators (number of transactions, limited significance of market prices, significant increase in implicit premiums for liquidity risk, expansion or increase of the bid-ask spread, reduction or total lack of market for new issues, limited publicly-available information), analyses of the transactions or of the quoted prices are carried out.

Fair value hierarchy

IFRS 13 establishes a fair value hierarchy in which inputs to fair value measurement techniques are divided into three levels. That hierarchy assigns top priority to (unadjusted) quoted prices on active markets for identical assets or liabilities (level 1 data) and the lowest priority to unobservable inputs (level 3 data). In particular:

- Fair value level 1 applies when an instrument is measured directly on the basis of (unadjusted) quoted prices on active markets for identical assets or liabilities to which the entity has access on the measurement date.
- Fair value level 2 applies when a price has not been found on an active market and the instrument is measured according to valuation techniques, on the basis of observable market parameters, or of the use of parameters that are not observable but are supported and confirmed by market evidence, such as prices, spreads or other inputs (the comparable approach).
- Fair value level 3 applies when fair value is measured using various inputs, not all of which are directly drawn from observable market parameters, and which thus entail estimates and assumptions by the valuator.

If various inputs are used to measure the fair value of an asset or liability, classification in the hierarchy is determined on the basis of the lowest-level input used in measurement. When assigning a level in the fair value hierarchy, priority is given to the inputs of the valuation techniques rather than the valuation techniques themselves.

The document "Fair Value Hierarchy Rules" defines, with regard to the respective financial instrument valuation models/inputs, the basic rules that market inputs must comply with in order to be classified as Level 2, and the significance thresholds which, when overrun, result in the assignment of Level 3.

For level 1 financial instruments, the current bid price is used for financial assets and the current ask price for financial liabilities, struck on the principal active market at the close of the reference period.

For financial instruments with a scarcely significant bid-ask spread or for financial assets and liabilities with offsetting market risks, mid-market prices are used (again referred to the last day of the reference period) instead of the bid or ask price.

When no listing on an active market exists or the market is not functioning regularly, that is when the market does not have a sufficient and continuous number of trades, and bid-ask spreads and volatility that are not sufficiently contained, the fair value of the financial instruments is mainly determined through the use of valuation techniques whose objective is the establishment of the price at which, in an orderly transaction, the asset is sold or the liability transferred between market participants, as at the measurement date, under current market conditions.

Such techniques include:

- the use of market values that are indirectly linked to the instrument to be measured, deriving from products with the same risk profile (level 2 inputs);
- valuations performed using – in whole or in part but primarily – inputs not identified from parameters observed on the market, for which estimates and assumptions made by the valuator are used (level 3 inputs).

In case of level 2 inputs, the valuation is based on prices or credit spreads presumed from the official listing of instruments which are similar in terms of risk factors, using a given calculation methodology (valuation model). The use of this approach requires the

identification of transactions on active markets in relation to instruments that, in terms of risk factors, are comparable with the instrument to be measured.

In case of instruments classified as level 3, the calculation of the fair value of certain types of financial instruments is based on valuation models based on specific hypotheses regarding the development of future cash-flows, which consider input parameters not directly observable on the market, therefore implying estimates and assumptions on the part of the valuator.

Valuation of financial instruments and Model Risk Management

The valuation process of financial instruments entails the following phases:

- Identification of the measurement sources: for each asset class, the Fair Value Policy and Market Data Reference Guide establish the processes necessary to identify market parameters and the means according to which such data must be extracted and used.
- Certification and treatment of market data for periodic measurements: this stage consists of the accurate verification, at each accounting measurement date, of the market parameters used (verifying the integrity of data contained on the proprietary platform with respect to the source of contribution), reliability tests (consistency of each single figure with similar or comparable figures) and verification of concrete application means.
- Certification of valuation models and Model Risk Assessment: this phase is aimed at verifying the consistency with and the adherence to current market practice of the various measurement techniques used, at highlighting any critical aspects in the valuation models used and at determining any adjustments necessary for measurement.
- Periodic monitoring of the consistency of the measurement models over time: the monitoring consists in checking the adherence to the market of the measurement model in order to promptly discover any gaps and start the necessary verifications and interventions.

In general, Model Risk is represented by the possibility that the price of a financial instrument is materially influenced by the valuation approach chosen. In the case of complex financial instruments, for which there is no standard valuation method in the market, or during periods when new valuation methods are being established in the market, it is possible that different methods may consistently value the elementary instruments of reference, but provide differing valuations for exotic instruments. The model risk is monitored through a series of analyses and checks carried out at different stages, aimed at certifying the various valuation methods used by the Parent Company (“Model Validation”), at regularly monitoring the performance of the models in operation to promptly identify any deviation from the market (“Model Risk Monitoring”) and at identifying any adjustments to be made to the valuations (“Model Risk Adjustment”, see the section below “Adjustments adopted to reflect model risk and other uncertainties related to the valuation”).

Adjustments adopted to reflect model risk and other uncertainties related to the valuation

If problems are found by the Model Validation process or the Model Risk Monitoring process in the calculation of the fair value of particular financial instruments, the appropriate Mark-to-Market Adjustments to be made to the valuations are identified. These adjustments are regularly reviewed, also considering market trends, or the introduction of new liquid instruments, different calculation methodologies and, in general, methodological advances which may also lead to significant changes in selected models and their implementation.

In addition to the adjustments relating to the abovementioned factors, also other types of adjustments (“Mark-to-Market Adjustment”) relating to other factors capable of influencing the valuation are included. These factors essentially involve:

- high and/or complex risk profile;
- position illiquidity determined by temporary or structural market conditions or in relation to the entity of exchange values held (in case of excessive concentration);
- valuation difficulties due to the lack of liquid and observable market parameters.

The management of the Mark-to-Market Adjustment process is formalised with appropriate calculation methodologies on the basis of the different configurations of the points set out above. Calculation of the adjustments depends on the dynamics of the factors indicated above and is disciplined by the Financial and Market Risks Head Office Department. For new products, the decision to apply Mark-to-Market Adjustment processes is taken during the process for the approval of new products, upon the proposal of the Financial and Market Risks Head Office Department.

Following the crisis of 2007, the market progressively introduced a series of adjustments linked to the credit and liquidity risk, with impacts on both the income statement and the capital, collectively shown as XVA. In line with market practices, in the past the Intesa Sanpaolo Group introduced the Credit/Debt Value Adjustment (bcVA), and, starting from 31 March 2016, it implemented the Funding Value Adjustment (FVA) in the valuation of OTC derivatives. The latter assessment component takes into consideration the liquidity risk premium, connected to the costs of funding the cash flows generated by an OTC derivative portfolio (coupons, dividends, collateral, etc.). Like the bcVA, the FVA depends on the probability of default of the counterparties and considers any netting and collateralisation agreements (CSA).

Fair value hierarchy

The table below shows financial assets and liabilities designated at fair value through profit and loss broken down by fair value hierarchy levels.

(millions of euro)

Financial assets / liabilities at fair value	30.09.2016			31.12.2015		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
1. Financial assets held for trading	14,138	35,215	879	17,994	32,546	1,057
2. Financial assets designated at fair value through profit or loss	59,734	1,151	453	51,847	1,200	616
3. Financial assets available for sale	136,843	7,004	3,038	120,864	8,152	2,318
4. Hedging derivatives	-	7,382	26	-	7,039	20
5. Property and equipment	-	-	-	-	-	-
6. Intangible assets	-	-	-	-	-	-
Total	210,715	50,752	4,396	190,705	48,937	4,011
1. Financial liabilities held for trading	12,935	34,964	244	11,217	31,972	333
2. Financial liabilities designated at fair value through profit or loss	-	54,373	-	-	47,022	-
3. Hedging derivatives	-	10,949	2	-	8,228	6
Total	12,935	100,286	246	11,217	87,222	339

Figures restated, where necessary, considering the changes in the scope of consolidation and discontinued operations.

As shown in the table, level 3 instruments, which allow for more discretion in fair value measurement, still account for a limited portion of the financial instruments portfolio: 1.7% for financial assets and 0.2% for financial liabilities.

The growth of level 3 financial assets available for sale is primarily due to the investment in the Atlante fund (504 million euro) and the contribution (60 million euro) paid into the Voluntary Scheme established within the framework of the National Interbank Deposit Guarantee Fund, representing the ISP Group's share of the recapitalisation of CR Cesena.

Approximately 79% of financial assets measured at fair value are determined based on market prices, and therefore without any discretion by the valuator.

The sensitivity analysis performed on level 3 structured credit products highlights a negative change in fair value of 139,581¹ euro, referring to complex credit derivatives, when the following parameters change:

- risk-neutral probability of default derived from market spreads (10%);
- recovery rate (from 5% to 25%, based on the type of risk of the underlying product);
- correlation between the value of collaterals present in the structure (from 25% to 80%, based on the type of risk of the underlying product);
- expected residual life of the contract (one-year increase over the expected term).

¹This amount is shown net of the adjustments to valuations relating to the main input parameters which were already considered to measure the fair value of financial instruments (see paragraph "Fair value measurement" above).

STRUCTURED CREDIT PRODUCTS

The risk exposure to structured credit products reached 2,363 million euro as at 30 September 2016 with respect to funded and unfunded ABS/CDOs, compared to 2,429 million euro as at 31 December 2015, in addition to an exposure of 1 million euro with respect to structured packages, which compares with the 2 million euro as at 31 December 2015.

The strategy regarding the portfolio in question in 2016 focused on investments to exploit market opportunities, on the one hand, and on disposing of the portfolio hard hit by the financial crisis, which is now managed by Capital Light Bank, on the other.

The decrease in exposure to funded and unfunded ABS/CDOs designated at fair value (from 1,988 million euro in December 2015 to 1,981 million euro in September 2016) is attributable to sales and redemptions of ABS by Banca IMI and of European ABS/CDOs by the Parent Company, only partially offset by investments in ABS of Banca IMI (part of which were classified to the available-for-sale portfolio) and to European ABS/CDOs acquired by the Parent Company and classified to the trading portfolio.

Banca IMI's investments mainly consist of securities with underlying residential mortgages and CLOs with mainly AA ratings. The Parent Company confirmed its transactions in European RMBS with mainly Aaa ratings, aimed at seizing market opportunities, with sales that are only partially offset by new investments.

With regard to the exposure represented by securities classified under the loan portfolio, on the other hand, a decrease was recorded (from 441 million euro in December 2015 to 382 million euro in September 2016), attributable to the sales and redemptions that concerned the portfolio of the Parent Company and Banca IMI, only partially offset by minor higher investments. The decrease in the exposure of structured packages is attributable to expiries during the period.

From an income statement perspective, a result of 11 million euro was recorded in the first nine months of 2016, compared to -1 million euro for 2015.

As at 30 September 2016 the "Profits (losses) on trading – caption 80" of the exposure to funded and unfunded ABS/CDOs came to +11 million euro (-1 million euro in 2015), generated by the positions in funded European and U.S. ABS/CDOs, while positions in U.S. subprime and Multisector CDOs had a nil result (+1 million in 2015).

The exposure to funded and unfunded ABS/CDOs in securities classified by the subsidiary Banca IMI in the available-for-sale portfolio recorded a net increase in fair value of 5 million euro, accounted for in the specific Shareholders' Equity Reserve, and an impact on the income statement for sales made in the period of +4 million euro. The securities reclassified in the Loan portfolio recorded an impact of -5 million euro as at 30 September 2016, to be attributed to the Parent Company, which posted negative adjustments due to the impairment of several securities in the portfolio (-1 million euro in 2015).

The "Monoline risk" and "Non-monoline packages" made a contribution to "Profits (Losses) on trading – caption 80" of +1 million euro as at 30 September 2016, compared with the nil contribution as at 31 December 2015.

INFORMATION ON ACTIVITIES PERFORMED THROUGH SPECIAL PURPOSE ENTITIES (SPES)

For the purpose of this analysis, legal entities established to pursue a specific, clearly defined and limited objective are considered Special Purpose Entities (raising funds on the market, acquiring/selling/managing assets both for asset securitisations, acquisition of funding through self-securitisations and the issue of covered bonds, developing and/or financing specific business initiatives, undertaking leveraged buy-out transactions, or managing credit risk inherent in an entity's portfolio).

The sponsor of the transaction is normally an entity which requests the structuring of a transaction that involves the SPE for the purpose of achieving certain objectives. In some cases, the Bank is the sponsor and establishes a SPE to achieve one of the objectives cited above.

For the SPE categories identified as not consolidated structured entities, no amendments are recorded to the criteria based on which the Intesa Sanpaolo Group decides on whether to include the companies in the scope of consolidation, compared to the information already provided in the 2015 financial statements.

In issuance in the third quarter, within the framework of the bank covered bond programme guaranteed by ISP CB Ipotecario, a variable-rate bond was issued for 1.25 billion euro, maturing in four years, listed on the Luxembourg Stock Exchange, rated Aa2 by Moody's, subscribed by the Parent Company and eligible with the Eurosystem.

Under the multi-originator issuance programme guaranteed by ISP OBG, two variable-rate bonds were issued for 1.75 billion euro each, maturing in eight and nine years, respectively, listed on the Luxembourg Stock Exchange and rated A High by DBRS. The securities were subscribed by the Parent Company and are also eligible with the Eurosystem.

LEVERAGED FINANCE TRANSACTIONS

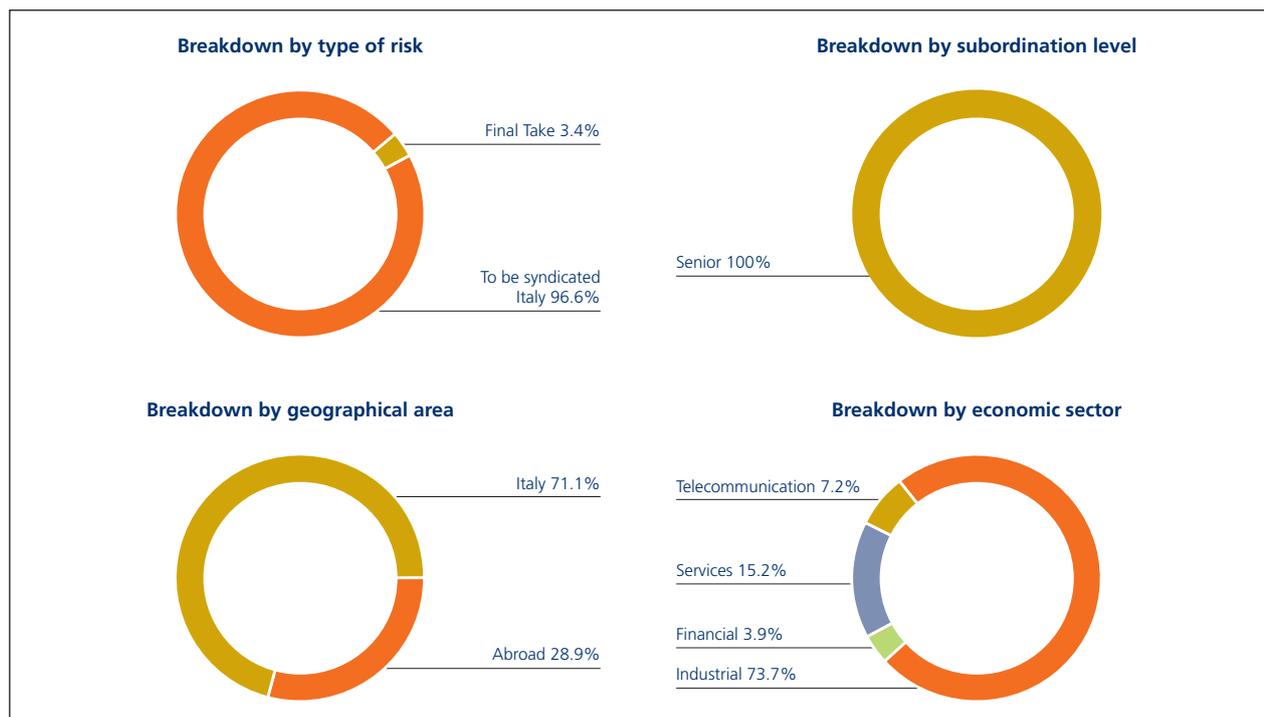
Since there is no univocal and universally agreed-upon definition of leveraged finance transactions, Intesa Sanpaolo decided to include in this category the exposures (loans granted and disbursed in relation to structured financing operations, normally medium/long term) to legal entities, in which the majority of share capital is held by private equity funds.

These are mainly positions in support of Leveraged Buy Out projects (therefore with high financial leverage), i.e. linked to the full or partial acquisition of companies through recourse to SPEs created for this purpose. After acquisition of the target company's shares/quotas package, these SPEs are normally merged into the target. The target companies generally have good economic prospects, stable cash flows in the medium term and low original leverage levels. Intesa Sanpaolo has financed entities of this type, as normal borrowers, without acting as sponsor.

None of these SPEs is consolidated, since the guarantees to support the transaction are solely instrumental for the granting of the financing and are never directed to the acquisition of direct or indirect control over the vehicle.

As at 30 September 2016, 109 transactions for a total amount granted of 3,319 million euro met the above definition.

These exposures are classified under the loans portfolio. They also include the portions of syndicated loans underwritten or under syndication. In line with disclosure requirements, breakdown of exposures by geographical area, economic sector and by level of subordination is set out below.



INFORMATION ON INVESTMENTS IN HEDGE FUNDS

The hedge fund portfolio held for trading as at 30 September 2016, totalled 448 million euro, compared to 758 million euro recorded in December 2015. The reduction in the portfolio is mainly due to the decrease in the value of the units underwritten during the first quarter, and to the significant distributions and redemptions in the second quarter, which continued in the third quarter, for the purpose of reducing risk levels.

As at the same date, the economic result of the investments in this segment was negative for -42 million euro (-44 million euro at 30 June 2016), compared to the positive 8 million euro of "Profits (Losses) on trading – caption 80" in the third quarter of 2015. The 42-million-euro net loss recorded at 30 September 2016 is almost entirely attributable to a decline in the NAV of several funds witnessed in the first quarter.

More specifically, the greatest losses were recorded on the Paulson fund (16 million euro), which is heavily exposed to the healthcare sector, which was affected by idiosyncratic events and is at the centre of the US electoral campaign on the price of drugs, and on the Eurizon Penghua fund (4 million euro), focusing on the Asian equity market, and the Chinese one in particular; several losses also concerned funds on the Map 12, Map 10 and Map 6 platforms, focused on financials and the Italian banking system.

The portfolio's overall strategy remains oriented towards benefiting from the occurrence of specific corporate events, largely independent of the general trend, and the reduction of risk through a general downwards revision of individual funds in response to market uncertainty. Portfolio adjustments continued in the third quarter. In particular, the period saw distributions by the Map 14 fund of 2 million euro, the liquidation of the Map 13 fund for approximately 10 million euro and a further reduction of the exposure to the Chinese equity market, of approximately 2 million euro, through the fund Penghua Equity China.

INFORMATION ON TRADING TRANSACTIONS IN DERIVATIVES WITH CUSTOMERS

Considering relations with customers only, as at 30 September 2016, the Intesa Sanpaolo Group, in relation to derivatives trading with retail customers, non-financial companies and public entities (therefore excluding banks, financial and insurance companies), presented a positive fair value, not having applied netting agreements, of 8,946 million euro (7,670 million euro as at 31 December 2015). The notional value of these derivatives totalled 49,544 million euro (45,855 million euro as at 31 December 2015). The positive fair value of the structured contracts in existence with the 10 customers with the highest exposures was 6,150 million euro.

Conversely, negative fair value determined with the same criteria, for the same types of contracts and with the same counterparties, totalled 1,826 million euro as at 30 September 2016 (1,929 million euro as at 31 December 2015). The notional value of those derivatives was 18,308 million euro (20,304 million euro as at 31 December 2015).

The fair value of derivative financial instruments entered into with customers was determined considering, as for all other OTC derivatives, the creditworthiness of the single counterparty ("Bilateral Credit Value Adjustment"). With regard to contracts outstanding as at 30 September 2016, this led to a negative effect of 17 million euro being recorded under "Profits (Losses) on trading" in the income statement.

As regards the means of calculation, for the various methodologies used in the determination of the fair value of financial instruments, see the specific paragraphs in this chapter.

Please note that contracts made up of combinations of several elementary derivative instruments have been considered "structured" and that the aforesaid figures do not include fair value of derivatives embedded in structured bond issues as well as the relative hedges agreed by the Group.

OPERATIONAL RISK

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 risk includes legal risk, that is, the risk of losses deriving from breach of laws or regulations, contractual or out-of-contract liability or other disputes, ICT (Information and Communication Technology) risk and model risk. Strategic and reputational risks are not included.

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

With regard to operational risk, on 31 December 2009, the Group adopted the Advanced Measurement Approach (AMA - internal model), in partial use with the standardised (TSA) and basic approaches (BIA) to determine the associated capital requirement for regulatory purposes. The AMA approach was adopted by the leading banks and companies in the Banca dei Territori, Corporate and Investment Banking, Private Banking and Asset Management Divisions, by the Intesa Sanpaolo Group Services consortium, by VUB Banka (including Consumer Financial Holding and VUB Leasing) and PBZ Banka.

The control of the Group's operational risk was attributed to the Board of Directors, which identifies risk management policies, and to the Management Control Committee, 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 control system.

Moreover, the tasks of the Intesa Sanpaolo Group Internal Control Coordination and Operational Risk Committee include periodically reviewing the overall operational risk profile, authorising any corrective measures, coordinating and monitoring the effectiveness of the main mitigation activities and approving operational risk transfer strategies.

The Group has a centralised function within the Enterprise Risk Management Department for management of the Group's operational risk. 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 are responsible for identifying, assessing, managing and mitigating risks. Specific officers and departments have been identified within these business units to be responsible for Operational Risk Management (structured collection of information relative to operational events, scenario analyses and evaluation of the business environment and internal control factors).

The Self-diagnosis process, conducted on an annual basis, allows the Group to:

- identify, measure, monitor and mitigate operational risk through identification of the main operational problem issues and definition of the most appropriate mitigation actions;
- analyse exposure to ICT risk;
- create significant synergies with the Information Security and Business Continuity Sub-department, which supervises the planning of operational processes and business continuity issues, with Administrative and Financial Governance and with control functions (Compliance and Internal Auditing) that supervise specific regulations and issues (Legislative Decree 231/01, Law 262/05) or conduct tests of the effectiveness of controls of company processes.

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

The process of collecting data on operational events (in particular operational losses, obtained from both internal and external sources) provides significant information on the exposure. It also contributes to building knowledge and understanding of the exposure to operational risk, on the one hand, and assessing the effectiveness or potential weaknesses of the internal control system, on the other hand. The internal model for calculating capital absorption is conceived in such a way as to combine all the main sources of quantitative (operational losses) and qualitative (Self-diagnosis) information.

The quantitative component is based on an analysis of historical data concerning internal events (recorded by the organisational units, appropriately verified by the Head Office Department and managed by a dedicated IT system) and external events (by the Operational Riskdata eXchange Association).

The qualitative component (scenario analysis) 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 (subsidiaries, Parent Company's business areas, the Corporate Centre) with the objective of assessing the potential economic impact of particularly severe operational events.

Capital-at-risk is therefore identified as the minimum amount at Group level required to bear the maximum potential loss (worst case); 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 data and the results of the scenario analysis assuming a one-year estimation period, with a confidence level of 99.90%; the methodology also applies a corrective factor, which derives from the qualitative analyses of the risk level of the business environment (Business Environment Evaluation), to take into account the effectiveness of internal controls in the various organisational units.

Operational risks are monitored by an integrated reporting system, which provides management with support information for managing and/or mitigating the operational risk.

In order to support the operational risk management process on a continuous basis, a structured training programme was implemented for employees actively involved in this process.

In addition, the Group activated a traditional operational risk transfer policy (to protect against offences such as employee disloyalty, theft and damage, cash and valuables in transit losses, computer fraud, forgery, cyber-crimes, earthquake and fire, and third-party liability), which contributes to mitigating exposure to operational risk. At the end of June 2013, in order to allow optimum use of the available operational risk transfer tools and to take advantage of the capital benefits, pursuant to applicable regulations the Group subscribed an insurance coverage policy named Operational Risk Insurance Programme, which offers additional coverage to traditional policies, significantly increasing the limit of liability, transferring the risk of significant operational losses to the insurance market.

The internal model's insurance mitigation component was approved by the Bank of Italy in June 2013 with immediate effect of its benefits on operations and on the capital requirements.

To determine its capital requirements, the Group employs a combination of the methods allowed under applicable regulations. The capital absorption resulting from this process amounts to 1,689 million euro as at 30 September 2016, up by 37 million euro compared to 31 December 2015 (1,652 million euro).

In addition, with respect to risks relating to real property and infrastructure, with the aim of containing the impacts of phenomena such as catastrophic environmental events, situations of international crisis, and social protest events, the Group may activate its business continuity solutions.

Legal risks

Legal risks are thoroughly analysed by the Parent Company and Group companies. Provisions are made to the Allowances for risks and charges in the event of litigations for which it is probable that funds will be disbursed and where the amount of the disbursement may be reliably estimated.

As at 30 September 2016 a total of about 17,000 disputes were pending (excluding Risanamento S.p.A., which is not subject to management and coordination by Intesa Sanpaolo) with a total remedy sought of 6.9 billion euro and provisions of about 785 million euro. Of these disputes, approximately 1.6 billion euro regarded claims concerning loan positions, 1.3 billion euro regarded civil and administrative disputes, 0.9 billion euro regarded anatocism, 0.5 billion euro regarded bankruptcy revocatory actions and 0.6 billion euro regarded insolvency compensation.

No particularly significant disputes arose in the third quarter. The following is a discussion of the main developments during the period relating to the disputes disclosed in the notes to the 2015 Financial Statements and the Half-yearly Report as at 30 June 2016, to which reference should be made for a description of the disputes in question.

Angelo Rizzo lawsuit – The judgment whereby in April 2016 the Court of Appeal upheld the decision of the first instance, which was favourable to Intesa Sanpaolo, was not appealed before the Court of Cassation and thus became final.

I Viaggi del Ventaglio Group lawsuit - The judgment (filed in February 2016) of the first instance of the suit brought by the Ventaglio International Bankruptcy trustee, which rejected all of the claims made on the merits, was appealed. The first hearing is scheduled for January 2017.

Alis Holding lawsuit – Negotiations between the parties to reach a settlement continue. The hearing on the admission of evidence submitted by the parties was continued until 24 January 2017.

IMI/SIR lawsuit - At the end of the first hearing of 19 July 2016, the Court of Appeal, by order filed on 25 July 2016, stayed the enforcement of the judgment of the first instance for the amount exceeding 130 million euro, in addition to accessory amounts and expenses, and continued the case for the entry of pleadings at the hearing of 12 June 2018. As a result of the order, the unfavourable appealed judgment remains immediately enforceable up to that limit. Intesa Sanpaolo is therefore entitled, in the absence of spontaneous compliance by the obligated parties, to proceed with enforced collection of the claim in question.

Administrative proceedings involving the New York Branch

During the first nine months of the year, the discussions with the Fed and the New York State Department for Financial Services (DFS) - the financial services supervisory body of the State of New York – regarding the proceedings, launched in 2007, concerning the status of anti-money laundering controls at the New York Branch and the methods used for clearing payments in US dollars continued. In particular, in recent weeks, following completion of the analysis conducted by an independent consultant, the process of reviewing the evidence with DFS begun, and it is currently not possible to predict the outcome of the discussions.

Tax litigation

The Group's tax litigation risks are covered by adequate provisions to allowances for risks and charges.

As at 30 September 2016 the Parent Company had 305 pending litigation proceedings (319 as at 30 June 2016) for a total amount of 302 million euro (338 million euro as at 30 June 2016), calculated considering proceedings in both administrative and judicial venues at various instances. The actual risks at issue in such litigation have been quantified at 91 million euro as at 30 September 2016 (in line with 30 June 2016 and 31 December 2015, net of litigation being settled).

The following is an account of the most significant developments in the third quarter in the ongoing tax litigation and the related risks and provisions disclosed in the notes to the Half-yearly Report as at 30 June 2016.

The most significant aspect relates to recoveries of registry tax on company contributions and the subsequent sale of equity investments, which the revenue authorities have treated as transfers of business units. In this framework, eleven disputes are currently pending, for a total of 59.5 million euro of additional taxes, in addition to interest of 11.2 million euro, without the application of penalties. Six cases (for a total value of 48.3 million euro, plus interest) are currently pending before the Court of Cassation, five by appeal by the revenue authorities and one by appeal by the Bank. The risks associated with litigation have been adequately assessed on the basis of the recent negative case law of the higher courts and, the recurring discrepancies between the cases in which Intesa Sanpaolo is involved and the contractual schemes considered previously by Italy's Supreme Court and the joint and several liability with various counterparties involved in the transactions.

In respect of those same contributions, the Italian Revenue Agency has assessed a greater value of the companies than indicated in the purchase and sale agreements for the equity interests, also for the purposes of registry tax. In this context, there are two pending disputes with a total value of approximately 32.5 million euro, in which the risk of an unfavourable outcome is considered remote.

On 30 June 2016 Intesa Sanpaolo was served a payment notice of 1.7 million euro for tax periods 1986 and 1988, by way of administrative penalties due as a result of the unfavourable conclusion of the litigation against the IRPEG and ILOR tax assessment notices for those same years. The notice was appealed before the Tax Commission, on the basis of arguments according to which the unfavourable judgment is void due to the prior resolution of the dispute pursuant to the old amnesty law no. 413 of 1991 and another trial, prior to that invoked by the revenue authority, which resulted in a favourable outcome for the Bank for those same years.

In addition, four cases of litigation with a total value of approximately 22.2 million euro (taxes, interest and penalties) were brought to a positive conclusion. The cases concerned registry tax paid on certain rulings of the judicial authority rendered in favour of a number of financial institutions in respect of pool loans to the Costanzo Group. The judgments of the Provincial Tax Commission of Catania, which acknowledged that the Bank was not liable for the tax claimed, became definitive when they failed to be appealed by the Revenue Agency within the allotted terms.

The assessment concerning tax period 2011 served on 29 March 2016 on the merged company Neos Finance was resolved by tax settlement proposal on 3 August 2016. The claim, concerning IRES and penalties of about 1.8 million euro, in addition to interest, concerned the determination criteria of the threshold under which the impairment of loans could be immediately deducted. In particular, citing the letter of Art. 106, paragraph 3, of the Combined Tax Regulations, the Agency denied that receivables subject to insurance cover contracted by customers should also be included in the immediately deductible 0.30% base amount. Since the effects of the tax claim were strictly temporary, as it concerned an issue of timing only, the effective amount of penalties and interest was 0.4 million euro.

Within the framework of the resolution of all litigation concerning tax period 2005, which entailed the reduction of the revenue authority's claims from 376 million euro to approximately 6 million euro, the quarter also saw the final conclusion - without any outlay by the Bank - of the case concerning IRES (total amount of tax, penalties and interest of approximately 13 million euro) relating to the disputed non-deductibility of losses deriving from the assignment without recourse of non-performing receivables to Castello Finance S.r.l. (a vehicle controlled by Fortress and Merrill Lynch) by Banca Intesa, Intesa Gestione Crediti and Mediocredito, on the basis of the alleged lack of "certain, precise elements" required by the legislation of reference. This result was reached through cancellation in an internal review process, by the Lombardy Regional Department, on the basis of a concurring opinion by the Central Assessment Department, of the above charge concerning losses on the assignment of receivables, on the assumption that the Bank had nonetheless discharged its evidentiary obligations according to the practice that was established in the course of the proceedings (i.e., Circular No. 26/E of 1 August 2013), which expressly considered as transactions capable of generating deductible losses on receivables those undertaken with supervised bank and financial counterparties who are in any event independent of both the assignor and assigned debtor. Following settlement before the court, the Provincial Tax Commission ruled that the case should be dropped. The risk of liabilities in this dispute had been deemed remote, and thus no provision had been recognised.

As regards the tax audits under way at Intesa Sanpaolo, worthy of note are those being conducted by the local tax authorities on the international branches of London and Frankfurt, currently with no findings.

The following is an account of the salient events during the quarter concerning the other Group companies, as compared to the situation as at 30 June 2016, amounting to total claims of 743 million euro and provisions of 44 million euro.

In the tax dispute of greatest amount (alone accounting for 530 million euro), concerning the charge of illegal use of an offshore tax structure brought by the Italian tax authorities against the Luxembourg subsidiary Eurizon Capital S.A., the Large Taxpayers Office of the Lombardy Regional Department of the Revenue Agency, in consultation with the Luxembourg company and Eurizon Capital SGR, served a questionnaire on the latter concerning tax periods 2011, 2012, 2013 and 2014 with the aim of inquiring further into the relationships between the two companies. Eurizon Capital SGR responded in a timely manner.

Discussions continued with the Italian Revenue Agency, Emilia Romagna Regional Office, to settle the claims concerning the tax treatment by Group banks based in the region (Cariromagna, Carisbo and the merged Banca Monte Parma) of the losses related to the transfer of loans to customers out of the performing category, subject to lump-sum write-downs, to positions subject to individual impairment testing, as a consequence of their involvement in insolvency procedures.

In audit-related developments, Banca CR Firenze received a request for clarification, for the years 2011 to 2013, concerning the VAT deductibility regime applied to purchases of goods and services by the merged Immobiliare Nuova Sede s.r.l., the builder of a property complex intended for use as the Bank's new headquarters. The Revenue Agency is believed to be considering charges of abuse of the law, on the assumption that, had the Bank undertaken the construction directly, it would not have been able to deduct the VAT paid on the construction costs. The Bank has provided all of the requested documentation and, in an extensive illustrative brief, believes that it has proved that there are no factual or legal grounds for a case for abuse of the law. At present, no assessment notices have been served.

For Intesa Sanpaolo Group Services, the general audit by the Guardia di Finanza, which began on 26 November 2015, continued, concerning IRES, IRAP, VAT, other indirect taxes and labour regulations for the 2013 tax period and following. Clarification has been requested concerning the transfer prices applied with Group counterparties residing abroad, and the Company has submitted a thorough brief illustrating the criteria adopted.

For Banca IMI, the inspection by the Guardia di Finanza, Milan Tax Police Squad, conducted on 10 May 2016, concluded with an auditors' report served on 20 July 2016. The audit, which concerns tax periods 2011 and 2012, relates to transactions on regulated markets in securities and single stock futures, reclassified by the tax authorities as repurchase agreements. After having redetermined the tax treatment for the purposes of income taxes and withholdings accordingly, the auditors charged the Bank with: i) for 2011, total unpaid withholding taxes of 11.2 million euro (on presumed manufactured dividends implicit in the transactions of 41.5 million euro) and a greater tax base for IRAP purposes of 19.5 million euro; and ii) for 2012, total unpaid withholdings of 18.5 million euro (on presumed "manufactured dividends" of 68.5 million euro) and a greater tax base for IRAP purposes of 32.2 million euro. The unpaid withholdings (a total of 30 million euro for the two years) were calculated by assuming categorically that the recipients of the manufactured dividends all resided in countries with privileged tax regimes and thus that the rate of 27% should apply to the dividends paid, instead of the 1.375% applicable to cases in which the recipients are companies residing in the European Union (as is instead the case in most of the situations considered). If this latter argument were to be upheld, as occurred (in the tax settlement procedure) in the disputes involving previous tax periods, the unpaid withholdings would be reduced to 1.5 million euro. The greater IRAP due would come to approximately 2.8 million euro (on a greater total tax base of 51.7 million euro). The above amounts are not inclusive of penalties and interest. If the Revenue Agency serves the assessment notices, the Bank will consider the appropriate initiatives to reach a settlement through alternative dispute resolution mechanisms.

On 29 July 2016, HMRC concluded its audit of Banca IMI's London branch, which resulted in charges of approximately 350,000 GBP (0.38 million euro), presumably subject to recovery in Italy as a foreign tax credit.

On 22 January 2016, the Italian Revenue Agency began a general audit of Casse del Veneto relating to the 2013 tax period. The audit process continued during the quarter, and on 21 September 2016 the audit was extended to tax periods 2011, 2012

and 2014 (as limited to the 50,000,000 euro lower tier 2 subordinated loan, 28 September 2007 - 28 September 2017, callable 28 September 2013, granted by Intesa Sanpaolo Bank Ireland PLC). No charges had been brought as at 30 September. On 6 September 2016, the Turin Revenue Agency began a general audit of Oldequiter S.p.A. (formerly Equiter S.p.A.) concerning, IRES, IRAP, VAT and withholdings in tax period 2012.

Also considering the absence of significant changes compared to 30 June 2016, the Group's tax litigation risks are deemed covered by adequate provisions to allowances for risks and charges.

INSURANCE RISKS

Life business

The typical risks of a life insurance portfolio may be divided into three main categories: premium risks, actuarial and demographic risks and reserve risks.

Premium risks are managed initially during definition of the technical features and product pricing, and over the life of the instrument by means of periodic checks on sustainability and profitability (both at product level and at portfolio level, including liabilities).

Actuarial and demographic risks are monitored by means of systematic statistical analysis of the evolution of liabilities in its own contract portfolio, divided by risk type, and through simulations of expected profitability of the assets hedging technical reserves.

Reserve risk is monitored through the exact calculation of mathematical reserves, with a series of detailed checks as well as overall verifications, by comparing results with the estimates produced on a monthly basis.

The mathematical reserves are calculated on almost the entire portfolio, on a contract-by-contract basis, and the methodology used to determine the reserves takes account of all the future commitments of the company.

Non-life business

The risks of the non-life insurance portfolio are essentially premium risk and reserve risk.

Premium risks are managed initially during definition of the technical features and product pricing and over the life of the instrument by means of periodic checks on sustainability and profitability (both at product level and at portfolio level, including liabilities).

Reserve risk is monitored through the exact calculation of technical reserves.

Financial risks

In line with the growing focus in the insurance sector on the issues of value, risk and capital in recent years, a series of initiatives has been launched with the objective of both strengthening risk governance and managing and controlling financial risks.

With reference to investment portfolios, set up both as coverage of obligations with the insured and in relation to free capital, the Investment Framework Resolution is the main control and monitoring instrument for market and credit risks.

The Resolution defines the goals and the operating limits that are needed to distinguish the investments in terms of eligible assets and asset allocation, breakdown by rating classes and credit risk, concentration risk by issuer and sector, and market risks, in turn measured in terms of sensitivity to variations in risk factors and Value at Risk (VaR).

Investment portfolios

The investments of the insurance companies of Intesa Sanpaolo Group (Intesa Sanpaolo Vita, Intesa Sanpaolo Assicura, Intesa Sanpaolo Life and Fideuram Vita) are made with their free capital and to cover contractual obligations with customers. These refer to traditional revaluable life insurance policies, Index- and Unit-linked policies, pension funds and non-life policies.

As at 30 September 2016, the investment portfolios of Group companies, recorded at book value, amounted to 146,278 million euro. Of these, a part amounting to 86,387 million euro relates to traditional revaluable life policies - the financial risk of which is shared with the policyholders by virtue of the mechanism whereby the returns on assets subject to segregated management are determined - non-life policies and free capital. The other component, whose risk is borne solely by the policyholders, consists of investments related to Index-linked policies, Unit-linked policies and pension funds and amounted to 59,891 million euro.

Considering the various types of risks, the analysis of investment portfolios, described below, concentrates on the assets held to cover traditional revaluable life policies, non-life policies and free capital.

In terms of breakdown by asset class, net of derivative financial instruments, 87.4% of assets, i.e. approximately 75,634 million euro, were bonds, whereas assets subject to equity risk represented 2.0% of the total and amounted to 1,706 million euro. The remainder (9,155 million euro) consisted of investments relating to UCI, Private Equity and Hedge Funds (10.6%).

The carrying value of derivatives came to approximately -108 million euro, entirely relating to effective management derivatives.² Hedging derivatives are currently not present in the portfolio.

At the end of the first nine months of 2016, investments made with the free capital of Intesa Sanpaolo Vita and Fideuram Vita amounted to approximately 1,637 million euro at market value, and presented a risk in terms of VaR (99% confidence level, 10-day holding period) of approximately 52 million euro.

The breakdown of the bond portfolio in terms of fair value sensitivity to interest rate changes showed that a +100 basis points parallel shift in the curve leads to a decrease of approximately 4,471 million euro.

The distribution of the portfolio by rating class is as follows. AAA/AA bonds represented approximately 4.8% of total investments and A bonds approximately 5.2%. Low investment grade securities (BBB) were approximately 87.3% of the total and the portion of speculative grade or unrated was minimal (approximately 2.7%).

A considerable portion of the BBB area is made up of securities issued by the Italian Republic.

The analysis of the exposure in terms of the issuers/counterparties produced the following results: securities issued by Governments and Central Banks approximately made up 76.6% of the total investments, while financial companies (mostly banks) contributed almost 13.2% of exposure and industrial securities made up approximately 10.2%.

At the end of the third quarter of 2016, the fair value sensitivity of bonds to a change in issuer credit rating, intended as a market credit spread shock of +100 basis points, was 4,565 million euro, with 3,578 million euro due to government issuers and 987 million euro to corporate issuers (financial institutions and industrial companies).

² ISVAP Regulation 36 of 31 January 2011 on investments defines "effective management derivatives" as all derivatives aimed at achieving pre-established investment objectives in a faster, easier, more economical or more flexible manner than would have been possible acting on the underlying assets.