1.4. BANKING GROUP – OPERATIONAL RISK

QUALITATIVE INFORMATION

A. General aspects, operational risk management processes and measurement methods

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/out-of-contract responsibilities or other disputes; strategic and reputation 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.
Effective from the report at 31 December 2009, the Group was authorised by the Supervisory Authority to use the Advanced Measurement Approach (AMA) internal model to determine capital requirements for operational risk on an initial scope that includes the Banks and Companies of the Banca dei Territori Division (with the exception of Banca CR Firenze but including Casse del Centro banks), Leasint, Eurizon Capital and VUB Banka. The remaining Companies, which currently employ the Standardised approach, will gradually migrate to the Advanced approach beginning in 2010.
The control of operational risk was attributed to the Management Board, which identifies risk management policies, and to the Supervisory Board, which is in charge of their approval and verification, as well as of the guarantee of the functionality, efficiency and effectiveness of the risk management and control system.
The tasks of the Group Compliance and Operational Risk Committee include periodically reviewing the Group's 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 Risk Management Department for the 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 (collection and structured census of information relative to operational events, scenario analyses and evaluation of the business environment and internal control factors).

The Integrated Self-Assessment process, which has been conducted on an annual basis since 2008, has allowed the Group to:
- identify, measure, monitor and mitigate operational risk; and
- create significant synergies with the specialised functions of the Organisation and Security Department that supervise the planning of operational processes and business continuity issues and with control functions (Compliance and Audit) that supervise specific regulations and issues (Legislative Decree 231/05, Law 262/05) or conduct tests of the effectiveness of controls of company processes.

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

The internal model for calculating capital absorption is conceived in such a way as to combine all the main sources of quantitative and qualitative information (self-assessment).
The quantitative component is based on an analysis of historical data concerning internal events (recorded by organisational units, appropriately verified by the central function and managed by a dedicated IT system) and external events (from the Operational Riskdata eXchange Association).
The qualitative component (scenario analyses) focuses on the forward-looking assessment of the risk exposure of each unit and is based on the structured, organised collection of subjective estimates expressed directly by management (subsidiaries, Parent Company's business areas, the Corporate Centre) with the objective of assessing the potential economic impact of particularly serious operational events.
Capital-at-risk is therefore identified as the minimum amount at Group level required to bear the maximum potential loss (worst loss); Capital-at-risk is estimated using a Loss Distribution Approach model (actuarial statistical model to calculate the Value-at-risk of operational losses), applied on quantitative 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 and internal control factors, to take account of the effectiveness of internal controls in the various organisational units.

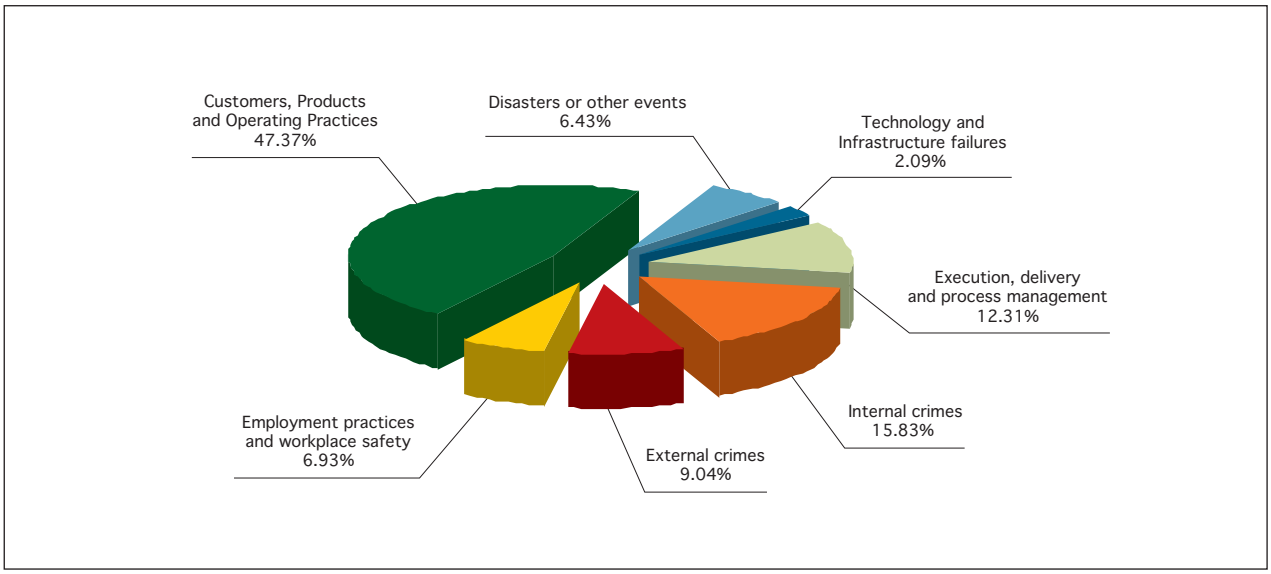
Operational risks are monitored by an integrated reporting system, which provides management with the information necessary for the management and/or mitigation of the operational risk.
In order to support the operational risk management process on a continuous basis, during the year a structured training programme was fully implemented for employees actively involved in the process of managing and mitigating operational risk.

QUANTITATIVE INFORMATION

To determine its capital requirements, the Group employs a combination of the methods foreseen under applicable regulations. The capital absorption resulting from this process amounts to approximately 2,249 million euro.

There follows an illustration of the breakdown of capital requirement by type of operational event.

Breakdown of capital requirement by type of operational event



Legal risks

Legal risks are thoroughly and individually analysed by the Parent Company and Group companies. Provisions are made to the Allowances for risks and charges when there are legal obligations for which it is probable that funds will be disbursed to meet such obligations and where the amount of the disbursement may be reliably estimated.
The most complex legal procedures are described in the paragraphs below.

Litigation regarding anatocism

After March 1999, the Italian Court of Cassation reversed its stance and found the quarterly capitalisation of interim interest payable on current accounts to be unlawful, assuming that the relevant clauses in bank contracts do not integrate the contract with a "regulatory" standard practice, but rather with a "commercial" practice, and therefore, such clauses are not adequate to derogate from the prohibition of anatocism pursuant to Art. 1283 of the Italian Civil Code.
The subsequent Legislative Decree 342 of 1999 confirmed the legitimacy of capitalisation of interest on current accounts, as long as interest is calculated with the same frequency on deposits and loans. From April 2000 (the date on which this regulation came into effect), quarterly capitalisation of both interest income and expense was applied to all current accounts.
Therefore the dispute on this issue concerns only those contracts which were stipulated before the indicated date.
In the judgment of the United Sections of 4 November 2004, the Court of Cassation again excluded the possibility that said use may be considered regulatory for the period prior to 2000. Although case law of the first and second instances has adhered to this latter ruling, it is still possible to dispute the claims advanced by counterparties, inasmuch as many judges, when re-determining interest due, apply proper technical accounting principles that often result in a significant decrease in the claims for restitution put forward by account holders.
The overall number of pending cases is at an insignificant level in absolute terms, and is the subject of constant monitoring. The risks related to these disputes are covered by prudential provisions to the allowances for risks and charges.

Litigation regarding bonds in default

Group policy on management of complaints on financial instruments sold sets out a case-by-case assessment, with particular attention paid to the suitability of the instruments with respect to the position of the single investor.
On the subject of Parmalat bonds in particular, Intesa Sanpaolo decided, in agreement with all of the associations representing consumers at the national level, to extend the same mediation procedure successfully applied to former Banca Intesa Group customers to former Sanpaolo IMI Group customers who had purchased these securities.
The extended procedure consequently involved all the approximately 27,000 customers of the former Sanpaolo IMI Group who bought Parmalat bonds that were then converted into shares and warrants of the new Parmalat. Approximately 16,800 customers, approximately 4,500 of whom belong to the Banche dei Territori network, elected to participate in the procedure. The examination of claims will be completed during the first four months of 2010. The evaluation process is based on the principle of fairness and is conducted by five committees organised at a regional level. Committees are equally divided into a representative of the Bank and a representative of the consumer association chosen by the customer from among those that elected to participate in the initiative.

Former Sanpaolo IMI Group customers also benefit from the support offered by the Sanpaolo IMI Customer Parmalatbond Committee. The Committee's mission is to provide free protection for the rights to compensation of participants, including by filing a civil claim in the pending trials of those responsible for the default. The results of these initiatives include three important settlements reached by the Committee and the parties against whom civil claims were brought in the trials. These settlements resulted in the availability of a total of 83.5 million euro, most of which has already been distributed to participants. A fourth settlement was added recently. Participants are currently being sought and an additional amount of approximately 15 million is expected to be recovered.
For the Argentina bonds, complaints are managed by the ordinary procedure in place for any other financial product, according to a case-by-case assessment of the individual positions. As in other legal risk assessment procedures, provisions are authorised on an individual basis after reviewing the specific circumstances that apply to particular cases.
The same criteria are applied to the assessments of claims relating to bonds issued by companies belonging to the Lehman Brothers Group whose default was declared in September 2008.
As part of a system-wide initiative, the Intesa Sanpaolo Group is overseeing the establishment of proof of debt in the insolvency procedures pending in various foreign countries for its customers who hold the aforementioned bonds, at no cost to its customers.
With respect to the related litigation, the first judgments handed down against Group Banks in 2009 rejected the claims for compensation put forward by customers on the grounds that the banks could not be held liable.

The Cirio Group default

In November 2002, the Cirio Group, one of the largest Italian groups operating in the agro-industrial sector, was declared insolvent in the repayment of a loan issued on the Euromarket. This event led to a cross default on all its existing issues. The bonds issued by the Cirio Group had a nominal value totalling approximately 1.25 billion euro. Both the former Intesa Group and the former Sanpaolo IMI Group – like the other major banking groups – had granted loans to the Cirio Group.
In April 2007, 10 companies of the Cirio Group in Extraordinary Administration notified Intesa Sanpaolo and Banca Caboto, as well as five other banks, considered to be severally liable, of the filing of a claim for the reimbursement of alleged damages deriving from:

- the worsening of the default of the Cirio group, from the end of 1999 to 2003, favoured also by the issue in the 2000/2002 period of 6 bond issues; the damages thereof are quantified – adopting three different criteria – with the main criteria in 2,082 million euro and, with the control criteria, in 1,055 million euro or 421 million euro;
- the impossibility by the Extraordinary Administration procedures of undertaking bankruptcy repeal, for undetermined amounts, in the event that the default of Cirio group companies was not postponed in time;
- the payment of fees of 9.8 million euro for the placement of the various bond issues.

In a judgment filed on 3 November 2009, the Court of Rome found the Cirio Group's claims to be unfounded on the merits and therefore rejected said claims on the grounds of a lack of a causal relationship between the actions of the banks named defendants in the suit and the claimed damage event.
In February 2010 the claimants appealed this judgment.

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

With three different transactions, the first in September 2006, the second in December 2007 and the last in April 2008, the Bank, as part of the State's internalisation of tax-collection activities, sold to Equitalia S.p.A. (a company owned by Agenzia delle Entrate – internal revenue service – and INPS) the entire share capital of Gest Line S.p.A., now Equitalia Polis, which performed tax-collection activities in the former Sanpaolo IMI Group.
Gest Line's alleged irregularities in performing tax-collection activities in the period from the late 80s and the early 90s led to drawn-out litigation with tax-collection authorities mostly referred to the concession in Bologna. At the time of disposal of the equity investment, the Bank released specific guarantees, in addition to those provided for by the law for the State's internalisation of tax-collection activities, which also cover liabilities deriving from the aforesaid litigation.
Gest Line adhered to the amnesty for administrative irregularities introduced by Law 311/04. However, as part of the pending litigation, doubts were raised by certain Tax-Collection Offices and Administrative Judges concerning the extension of the provisions of the aforesaid amnesty. The conversion of Law Decree 248/2007 provides a clarification on the interpretation of the amnesty which should positively affect the litigation, favouring its possible extinction.
However, despite this clarification from lawmakers, there are still uncertainties surrounding the interpretation of the extension of the amnesty. In detail, although the case law of the Central Sections of the Court of Auditors has recently taken the position that the amnesty does not extend to judgments of liability for lost tax revenue, the same Sections are still considering the effects of this ruling in suits brought by claimants concerning the non-payment or release of assessed amounts found to be irrecoverable during debt recovery action.
In any event, the related risks are covered by adequate provisions.

Banca Infrastrutture Innovazione e Sviluppo and Municipality of Taranto Dispute

Banca Infrastrutture Innovazione e Sviluppo, as the successor to Banca OPI, was involved in a case pending before the Court of Taranto brought by the Municipality of Taranto in relation to the subscription in May 2004 by Banca OPI for a 250 million euro bond issued by this Municipality.
In its judgement of 27 April 2009, the Court declared the invalidity of the operation, ordering the Bank to reimburse, with interest, the partial repayments of the loan made by the Municipality of Taranto. The latter was ordered to reimburse, with interest, the loan granted. Lastly, the Court ordered compensation in favour of the Municipality, to be calculated by separate proceedings.

Both parties appealed against the judgement. Moreover, the Bank requested the stay of enforcement of the judgement and brought a case for negative clearance.
According to the legal firms assisting BIIS, there are valid grounds to believe that the first level judgement will be modified.
In February 2010, the insolvency procedure entity for the Municipality of Taranto informed BIIS that the Municipality's debt to the Bank for the repayment of the 250 million euro bond had been added to "the insolvency procedures' list of debts". The fact that the Municipality's debt to the Bank has been included in the insolvency procedure's "list of debts" instead of in the "rebalanced financial statements" does not, in and of itself, have consequences for the Bank's right to repayment of its loan to the Municipality and, accordingly, on the position's risk profile. The Bank intends to appeal the decision before the competent judicial authority.

Class action by Codacons

On 5 January 2010, Codacons, acting on behalf of a single account holder, served Intesa Sanpaolo with a writ of summons for a class action suit in accordance with art. 140-*bis* of Legislative Decree 206/2005 (Consumer Code).
The suit, brought before the Court of Turin, seeks a finding that the new fee structure introduced by the Bank to replace the overdraft charges is unlawful and, accordingly, a sentence ordering the Bank to provide compensation for the alleged damages, which may also be determined on an equitable basis, suffered by the claimant (who has quantified them at 1,250 euro) and all other customers in the same class who elect to participate in the initiative.
In light of the analyses conducted, the suit appears to be without foundation both with respect to admissibility requirements and the merits. Accordingly, it was not deemed appropriate to make provisions. However, the Bank reserves the right to make further inquiries into the matter if, contrary to its current opinion, the Court finds that the suit meets the admissibility requirements at the preliminary level.

Angelo Rizzoli litigation

In September 2009, Angelo Rizzoli filed against Intesa Sanpaolo (as the successor of the former Banco Ambrosiano) and four other parties seeking a finding of nullity for the transactions undertaken between 1977 and 1984 alleged to have resulted in a detrimental loss of the control that he would otherwise have exercised over Rizzoli Editore S.p.A. and claiming compensation in an amount ranging from 650 to 724 million euro according to entirely subjective damage quantification criteria.
Rizzoli's claims, in addition to being without foundation on the merits due to the lack of a breach of the provision that prohibits preferential collateral rights argued to have occurred in the transactions whereby Rizzoli Editore S.p.A. was transferred, are also inadmissible at a preliminary procedural level, as held by the Bank in its motion of appearance, on the grounds that the Milan Court of Appeal had already decided the matter in its judgment of 1996, which has become res judicata, as well as that Rizzoli lacked an interest to sue due to prescription of claims for compensation or restitution and usucaption by third parties.

Other judicial and administrative proceedings

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

Tax litigation

Overall tax litigation risks are covered by adequate provisions to Allowances for risks and charges.
With respect to the Parent Company, during 2009 there were no new disputes of particular relevance and a refund of tax credits of approximately 137 million euro was obtained.
New tax credits were also recognised on the submission of applications for refunds of IRES pursuant to art. 6, paragraph 1, of Law Decree 185/08, converted into Law 2/09, which established that 10% of IRAP is deductible, effective retroactively for tax periods 2004 to 2007. These refund applications were reflected by a total of approximately 62 million euro in tax credits (approximately 35 million euro of which is claimed by the Parent Company, 22 million euro by companies participating in the national tax consolidation programme, and 5 million euro by other Group companies not participating in the national tax consolidation programme) recognised in the income statements of the Parent Company and other entitled companies by decreasing the amount of "taxes on income", resulting in an overall benefit at the consolidated level of like amount.

The outstanding tax litigation as at 31 December 2009 involving the other Italian and international companies of the Group included within the scope of consolidation amounted to a total of 572 million euro, consisting of 549 million euro for actions brought by the Financial Authorities – for taxes, penalties and interest – and to 23 million euro for tax credits

recorded in the financial statements.
The most significant disputes that arose in 2009 revolve around interpretative issues; the charges brought in this connection appear largely groundless. These include:

- a total of approximately 211 million euro claimed from Intesa Investimenti by way of IRES, IRAP, penalties and interest for 2004, 2005 and 2006 due to the reclassification of foreign dividends collected by the company;
- approximately 105 million euro claimed from Banca IMI by way of income taxes, withholdings, penalties and interest involving both the merged Banca IMI, for tax years 2004 to 2006, and the former Banca Caboto, for tax years 2004 to 2006, chiefly relating to equity dividend transactions and other issues associated with core capital market and investment banking operations;
- approximately 45 million euro claimed from Centro Leasing Banca by way of IRES, IRAP, VAT, penalties and interest for tax years 2004 to 2007 due to the reclassification of sale and lease-back transactions as ordinary loans secured by real property on the basis of the case law principle of misuse of a right. A similar charge for tax year 2003 was rejected in its entirety by the Provincial Tax Committee of Florence;
- approximately 38 million euro claimed from Banca Fideuram by way of direct taxes, penalties and interest following the extension to years 2004 to 2006 of the finding that the accrual requirement had not been met for expenses associated with the incentive plan for financial advisors;
- approximately 30 million euro claimed from Leasint by way of IRES, IRAP, VAT, penalties and interest for tax years 2005 to 2008, primarily as a result of the reclassification of a contribution and subsequent disposal of the investment as a simple disposal of a business unit and the finding that negative income components associated with the purchase of leased property was not deductible;
- approximately 17 million euro claimed from Banca Infrastrutture Innovazione e Sviluppo by way of IRES, IRAP, penalties and interest for tax years 2007 and 2008 under two charges, the first of which involves the long-term nature of the expenses incurred to incorporate Banca OPI, and the second of which involves the write-down of unlisted bonds.

The affected companies responded to the assessments served on them by initiating the litigation process before the competent tax courts to secure findings in favour of their arguments.
In a few cases of limited significance, or in which there was evidence of a likely negative outcome, it was decided to apply for the settlement procedure and pay reduced penalties.
There is no tax litigation involving foreign companies in which material amounts are at issue.
The only exception is Brazil, specifically the disposal of the investment in Sudameris Brasil. The ongoing tax litigation in Brazil is complex, in part due to recent provisions of law that would allow for it to be settled through an amnesty, for which application has been made with respect to the cases in which there was the greatest risk of a negative outcome. In addition, the risks associated with this litigation are covered by adequate provisions.

Labour litigation

During the previous year, the INPS of Turin confirmed a payment demand relating to the failure by Sanpaolo IMI to pay contributions to finance involuntary unemployment for the period 1 November 2002 – 31 December 2006. This risk has been covered by a provision considered to be sufficient based on the probable outcome of the dispute.
In general, all labour litigation is covered by provisions adequate to meet any outlays.