Risk management

BASIC PRINCIPLES

Intesa Sanpaolo Group policies relating to risk acceptance are defined by the Parent Company's Management Bodies, the Supervisory Board and the Management Board, with support from specific Committees, particularly Control Committee and from the Group Risk Governance Committee and the Chief Risk Officer, who reports directly to the Chief Executive Officer.
The Parent Company is in charge of overall direction, management and control of risks, whereas Group companies that generate credit and/or financial risks operate within the assigned autonomy limits and have their own control structures. 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 together define 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 (Group Risks Tableau de Bord) and is submitted quarterly to the Group Risk Governance Committee, the Management Board and the Control Committee. 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 2 REGULATIONS AND THE INTERNAL PROJECT

As part of the Basel 2 Project, the goal of which is for the main Group companies to adopt advanced approaches relating to credit risks, the Supervisory Authority granted authorisation to make the transition from the FIRB approach (in use since December 2008) to the AIRB approach in the Corporate segment, effective the report as at 31 December 2010.
The scope of application of the AIRB approach extends to the Parent Company, the network banks, Banca Infrastrutture Innovazione e Sviluppo and Mediocredito Italiano. The release of specific LGD models is planned for the end of 2011 and will allow transition to the AIRB approach for the product companies (Leasint and Mediofactoring). The foreign bank VUB Banka obtained permission to use the FIRB approach effective the report as at 31 December 2010. An application for authorisation of direct transition to the AIRB approach was submitted in the third quarter of 2011 for Intesa Sanpaolo Bank Ireland Plc. The application for Banca IMI will be submitted in the fourth quarter.
In addition, recognition of the IRB approach for the Retail Mortgage segment was obtained in June 2010. The request for authorisation to extend the scope of application of the IRB approach to the network banks of the former Casse del Centro will be submitted during the fourth quarter 2011.
An application for authorisation of transition to the IRB approach for the SME Retail segment is expected to be submitted in the first half of 2012.
The development of rating models for the other segments and the extension of the scope of companies is proceeding according to the gradual roll-out plan for the advanced approaches presented to the Supervisory Authority.
With regard to operational risk, it should be noted that the Group was authorised, effective the report as at 31 December 2009, to use the Advanced AMA Approaches (internal model) to determine the associated capital requirement on an initial scope that included Organisational Units, the Banks and Companies of the Banca dei Territori Division (excluding network banks belonging to Cassa di Risparmio di Firenze Group, but including Casse del Centro), Leasint, Eurizon Capital and VUB Banka. Effective 31 December 2010, the Group was also authorised to extend the Advanced approaches to a second set of Organisational Units and Companies of the Corporate and Investment Banking Division, in addition to Setefi, to the remaining banks of the Cassa di Risparmio di Firenze Group and to PBZ Banka. The remaining companies, currently using the Standardised approach (TSA) or Basic Indicator Approach (BIA), will migrate progressively to the Advanced approaches starting from the end of 2011, based on the roll-out plan presented to the Management and Supervisory Authorities.
In 2011 the Group presented its Internal Capital Adequacy Assessment Process Report as a "class 1" banking group, according to Bank of Italy classification, based on the extensive use of internal methodologies for the measurement of risk, internal capital and total capital available.
As part of its adoption of Basel 2, 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 2 - Pillar 3" or simply "Pillar 3".
The document is published on the website (group.intesasanpaolo.com) each quarter, inasmuch as Intesa Sanpaolo is among the groups that have adopted validated internal approaches for credit, market and operational risk.

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 of lending operations consistent with the risk appetite and value creation;
- diversifying the portfolio, limiting the concentration of exposures on single counterparties/groups, single 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;

- privileging lending of a commercial nature or intended for new investments in production, provided that they are sustainable, over those of a merely financial nature;
- constantly monitoring relationships, through the use of both IT procedures and systematic surveillance of positions that show irregularities, with the aim of detecting any symptoms of performance 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 segment to which the counterparty belongs.

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 non-performing loan portfolio is subject to a specific management process which, inter alia, entails accurate monitoring through a predetermined 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. They allow timely assessments when any anomalies arise or persist and interact with processes and procedures for loan management and for credit risk control.
Within the Group, in accordance with preset rules, positions to which the synthetic risk indicator attributes a persistent high-risk rating are intercepted (manually or automatically) and included in a unique operational category based on their risk profile. In accordance with the Supervisory Authority instructions, they are classified in the following categories: doubtful loans, exposures to borrowers in default or in similar situations; substandard loans, exposures to borrowers in temporary difficulty, deemed likely to be settled in a reasonable period of time and exposures which satisfy the conditions objectively set by the Supervisory Authority ("objective substandard loans"), although they do not meet the requirements to be classified under doubtful loans; restructured loans, positions for which, due to the deterioration of the economic and financial position of the borrower, the bank (or pool of banks) agrees to modify the original contractual terms giving rise to a loss. Lastly, non-performing loans also include past due positions that cannot be considered mere delays in reimbursements, as established by the Bank of Italy.

(millions of euro)

	30.09.2011			31.12.2010			Changes
	Gross exposure	Total adjustments	Net exposure	Gross exposure	Total adjustments	Net exposure	Net exposure
Doubtful loans	23,295	-14,968	8,327	20,666	-13,272	7,394	933
Substandard loans	11,698	-2,429	9,269	11,337	-2,371	8,966	303
Restructured loans	3,791	-325	3,466	3,637	-299	3,338	128
Past due loans	1,295	-146	1,149	1,694	-154	1,540	-391
Non-performing loans	**40,079**	**-17,868**	**22,211**	**37,334**	**-16,096**	**21,238**	**973**
Performing loans	342,916	-2,407	340,509	342,062	-2,495	339,567	942
Performing loans represented by securities	19,188	-716	18,472	18,504	-482	18,022	450
Loans to customers	**402,183**	**-20,991**	**381,192**	**397,900**	**-19,073**	**378,827**	**2,365**

Figures restated where required by international accounting standards and, where necessary, considering the changes in the scope of consolidation and discontinued operations.

The above table indicates an increase in non-performing loans during the first nine months of 2011, net of adjustments of 973 million euro (+4.6%), compared to the end of the prior year. This trend led to a higher incidence of non-performing loans on total loans to customers, increasing from 5.6% to 5.8%. Coverage of non-performing loans came to approximately 45%, a level higher than that recorded at the end of 2010 (43%) and deemed adequate to account for expected losses, considering the guarantees that secure the positions.
In particular, as at 30 September 2011, doubtful loans net of adjustments totalled 8,327 million euro, with a 933 million euro rise (+12.6%) from the beginning of the year; the incidence on total loans to customers was 2.2%, with a coverage ratio of more than 64%.
Compared to 31 December 2010, substandard loans underwent a more moderate increase (+3.4%) than doubtful loans, totalling 9,269 million euro. The incidence of substandard loans on total loans to customers was 2.4%, and the coverage ratio, adequate against the risk intrinsic to this portfolio, was 21%.
Restructured loans, totalling 3,466 million euro, increased 3.8% from the beginning of the year, while the coverage ratio increased to 8.6% from 8.2% at the end of 2010. Past due loans amounted to 1,149 million euro, down by 25% compared to the end of December and showing a coverage ratio of 11%.
Performing exposures increased from 340 billion euro to 341 billion euro. In this context, the cumulated collective adjustments on these loans totalled 0.7% of the gross exposure to customers, a value that is essentially unchanged compared to the figure recorded at the end of 2010.

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.

A number of the other Group subsidiaries hold smaller trading portfolios with a marginal risk (around 3% of the Group's overall risk). In particular, the risk factors of the international subsidiaries' trading books were interest rates and foreign exchange rates, both 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.
In particular, the validated risk profiles for market risks are: (i) generic on debt securities and generic/specific on equities for Intesa Sanpaolo and Banca IMI, (ii) position risk on quotas of funds underlying CPPI (Constant Proportion Portfolio Insurance) products for Banca IMI, (iii) optional risk and specific risk for the CDS portfolio for Intesa Sanpaolo, (iv) position risk on dividend derivatives, (v) position risk on commodities for Banca IMI, the only legal entity in the Group authorised to hold open positions in commodities.

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, 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.
In the third quarter of 2011, market risks generated by Intesa Sanpaolo and Banca IMI increased with respect to the averages for the second quarter of 2011. The average VaR for the period totalled 66.7 million euro.

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

(millions of euro)

	2011					2010			
	average 3rd quarter	minimum 3rd quarter	maximum 3rd quarter	average 2nd quarter	average 1st quarter	average 4th quarter	average 3rd quarter	average 2nd quarter	average 1st quarter
Intesa Sanpaolo	21,4	16.0	26,5	15,3	18,7	22,3	27,6	27,0	19,5
Banca IMI	45,3	21,4	56,5	21,1	17,4	14,5	15,8	13,9	11,7
Total	**66,7**	**38,2**	**82,3**	**36,4**	**36,1**	**36,8**	**43,4**	**40,9**	**31,3**

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

During the first nine months of 2011, market risks generated by Intesa Sanpaolo and Banca IMI increased with respect to the values for 2010. The average VaR for 2011 totalled 46.6 million euro.

(millions of euro)

	2011			2010		
	average 30.09	minimum 30.09	maximum 30.09	average 30.09	minimum 30.09	maximum 30.09
Intesa Sanpaolo	18,5	14,0	26,5	24,7	17,7	32,2
Banca IMI	28,1	13,6	56,5	13,8	8,9	19,5
Total	**46,6**	**30,8**	**82,3**	**38,5**	**27,6**	**49,9**

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

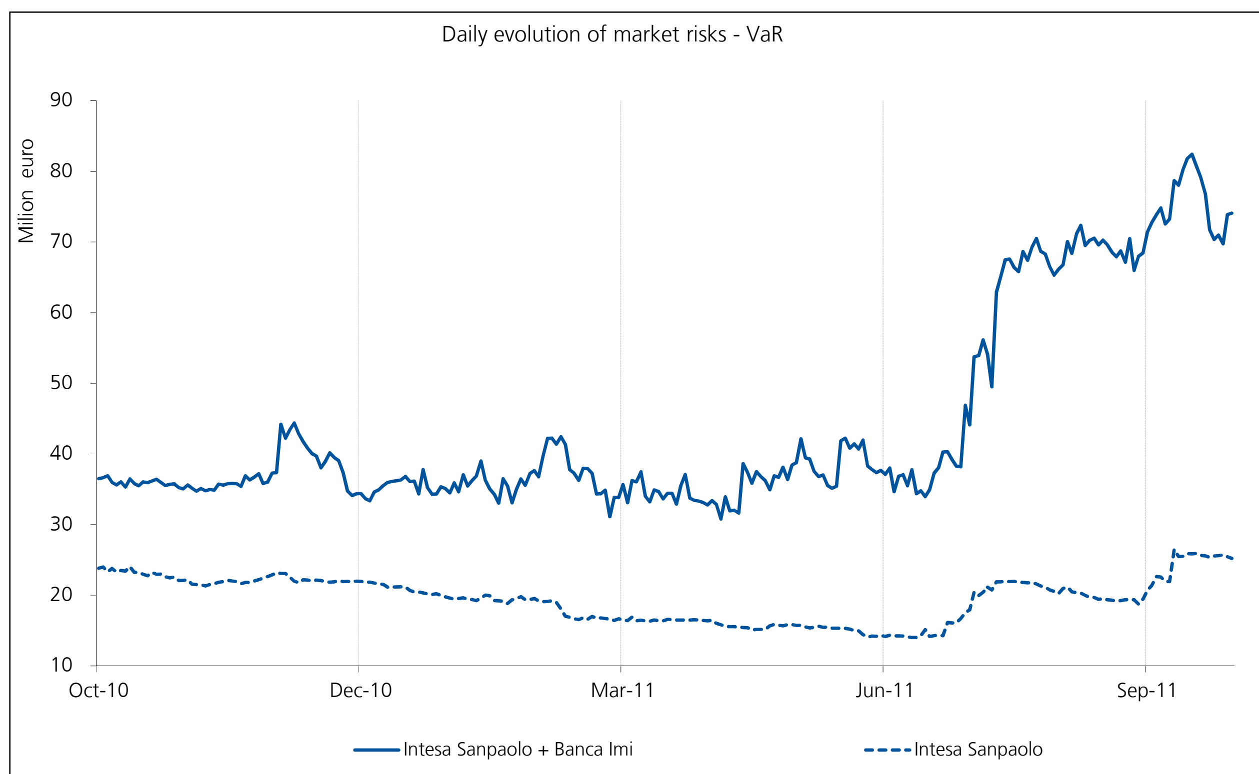
For Intesa Sanpaolo the breakdown of risk profile in the third quarter of 2011 with regard to the various factors shows the prevalence of the hedge fund risk, which accounted for 41% of total VaR; for Banca IMI credit spread risk was the most significant, representing 76% of total VaR.

Contribution of risk factors to overall VaR [a]

3rd quarter 2011	Shares	Hedge funds	Rates	Credit spreads	Foreign exchange rates	Other parameters	Comodities
Intesa Sanpaolo	0%	41%	11%	36%	3%	9%	0%
Banca IMI	6%	0%	7%	76%	1%	6%	4%
Total	**4%**	**13%**	**9%**	**63%**	**1%**	**7%**	**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 first half of 2011, broken down between Intesa Sanpaolo and Banca IMI and indicating the distribution of overall capital at risk.

VaR in the last twelve months is set out below. VaR increased during the course of third quarter 2011. Performance was impacted by the increase in the volatility of spreads in the Italian government sector and, particularly for Banca IMI, by purchases made in this sector in order to take advantage of market opportunities.



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, foreign exchange rates and commodity prices at the end of September is summarised as follows:

- on stock market positions, a bearish scenario, that is a 5% decrease in stock prices with a simultaneous 10% increase in volatility would have led to a 4 million euro loss;
- on interest rate exposures, a parallel +25 basis point shift in the yield curve would have led to a 17 million euro loss, whereas a parallel -25 basis point shift would have led to a 15 million euro gain;
- on exposures sensitive to credit spread fluctuations, a 25 basis point widening in spreads would have led to a 85 million euro loss, 6 million euro of which due to structured credit products (SCPs), whereas a 25 basis point tightening of the spreads would have led to a 86 million euro gain, 6 million euro of which due to SCPs;
- on foreign exchange exposures (main position on Euro/USD), the portfolio would have recorded a 9 million euro gain in the event of exchange depreciation (-10%). The negative effect in case of foreign exchange appreciation (+10%) would have been 8 million euro;
- lastly, on commodity exposures a 5 million euro loss would have been recorded in the event of a 50% decrease in prices.

(millions of euro)

	EQUITY		INTEREST RATES		CREDIT SPREADS		FOREIGN EXCHANGE RATES		COMMODITY	
	volatility +10% and prices -5%	volatility -10% and prices +5%	-25bp	+25bp	-25bp	+25bp	-10%	+10%	-50%	+50%
Total	-4	4	15	-17	86	-85	9	-8	-5	5
of which SCP					6	-6				

BANKING BOOK

Market risk originated by the banking book arises primarily in the Parent Company and in the other main Group companies that carry out retail and corporate banking. The banking book also includes exposure to market risks deriving from the equity investments in quoted companies not fully consolidated, mostly held by the Parent Company and by Equiter, IMI Investimenti and Private Equity International.
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).
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 being measured, excluding assumptions on future changes in the mix of assets and liabilities and, therefore, it cannot be considered a predictor 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 stipulated 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. In addition, macro-hedging is carried out on the stable portion of on demand deposits and in order to hedge against fair value changes intrinsic to the instalments under accrual generated by floating rate operations. The Group is exposed to this risk in the period from the date on which the rate is set and the interest payment date.
Another hedging method used is the cash flow hedge which has the purpose of stabilising interest flow on variable rate funding to the extent that the latter finances fixed-rate investments (macro cash flow hedge). In other cases, micro cash flow hedges are applied to specific assets or liabilities (micro cash flow hedge).
The Risk Management 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 2011, interest rate risk generated by the Intesa Sanpaolo Group's banking book, measured through shift sensitivity analysis, registered an average value of 269 million euro settling at 477 million euro at the end of September, almost entirely concentrated on the euro currency; this figure compares with 426 million euro at the end of 2010.
Interest margin sensitivity – in the event of a 100 basis point rise in interest rates – amounted to 255 million euro (-227 million euro in the event of reduction) at the end of September 2011; these values record a slight increase compared to the 2010 year-end figures amounting to +163 million euro and -166 million euro, respectively, in the event of an increase/decrease in interest rates.
Interest rate risk, measured in terms of VaR, averaged 93 million euro in the first nine months of 2011 (98 million euro at the end of 2010) and reached a value of 131 million euro at the end of September, with a peak value of 142 million euro and a minimum value 67 million euro. 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 85 million euro (86 million euro at the end of 2010) in the first nine months of 2011, with minimum and peak values of 71 million euro and 101 million euro respectively, which is also the value 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 -64 million euro at the end of September 2011.

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 investments and transactions in derivatives with customers.

DETERMINATION OF THE FAIR VALUE 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 unchanged with respect to those adopted for the previous year financial statements. For more details, reference should be made to the description included in the Annual Report 2010.
Fair value is the amount for which an asset may be exchanged or a liability settled between knowledgeable, willing counterparties in an arm's length transaction. Underlying the definition of fair value is an assumption that an entity is a going concern without any need to liquidate or curtail materially the scale of its operations or to undertake a transaction on adverse terms. Fair value reflects the credit quality of the instrument since it incorporates counterparty risk.
The fair value of financial instruments is determined through the use of prices obtained from financial markets in the case of instruments quoted on active markets or via internal valuation techniques for other financial instruments.
A market is regarded as active if quoted prices, representing actual and regularly occurring market transactions considering a normal reference period, are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency.
When no quote 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-offer 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 of a hypothetical arm's length transaction, motivated by normal business considerations, as at the measurement date. Such techniques include:

– reference to market values indirectly connected to the instrument to be valued and deduced from products with the same risk profile (Comparable Approach);
– valuations performed using – even partially – inputs not identified from parameters observed on the market, which are estimated also by way of assumptions made by the valuator (Mark-to-Model).

The choice between the aforesaid methodologies is not optional, since they must be applied according to a hierarchy: absolute priority is attributed to effective market quotes (level 1) for valuation of assets and liabilities or for similar assets and liabilities measured using valuation techniques based on market-observable parameters other than financial instruments quotes (Comparable Approach - level 2) and a lower priority to assets and liabilities whose fair value is determined using valuation techniques based on non-observable and, therefore, more discretional inputs (Mark-to-Model Approach - level 3).
The following instruments are considered quoted on an active market (level 1): equities quoted on a regulated market, bonds quoted on the EuroMTS circuit and those for which it is possible to continuously derive from the main price contribution international platforms at least three bid and ask prices, mutual funds, spot exchange rates, derivatives for which quotes are available on an active market (for example, futures and exchange traded options). Lastly, hedge funds for which the fund administrator provides the NAV (Net Asset Value) with the frequency established in the subscription contract, are considered as quoted on an active market, provided that no adjustments are required for the valuation of the liquidity or counterparty risks of the underlying assets. Conversely, all other financial instruments, which do not fall in the categories described above, are not considered quoted on an active market.
For financial instruments quoted on active markets, the current bid price is used for financial assets and the current asking price for financial liabilities, obtained on the most advantageous available 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 prices can be derived on active markets, the fair value of financial instruments is determined using the Comparable Approach (level 2) which uses measurement models based on market parameters. In this case, the valuation is not based on the price of the same financial instrument to be measured, but on prices or credit spreads derived from official quotes of instruments which are similar in terms of risk factors, using a given calculation methodology (pricing 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. The calculation methodologies used in the comparable approach reproduce prices of financial instruments quoted on active markets (model calibration) and do not contain discretional parameters – parameters for which values may not be inferred from quotes of financial instruments present on active markets or fixed at levels capable of reproducing quotes on active markets – that significantly influence the final valuation.
The fair value of bonds without official quotes expressed by an active market is determined through the use of an appropriate credit spread which is estimated starting from contributed and liquid financial instruments with similar characteristics. Credit spread sources are contributed and liquid securities of the same issuer, credit default swaps on the same reference entity, contributed and liquid securities issued by an issuer with the same rating and belonging to the same sector. The different seniority of the security to be priced relatively to the issuer's debt structure is also considered.
Similarly, with respect to financial liabilities designated at fair value through profit and loss, the credit spread of the Intesa Sanpaolo Group is determined and measured based on the bonds issued by the Parent Company, with regular, periodic coupons, maturity beyond one year and quoted on an active market in compliance with IAS/IFRS. The implicit credit rating is determined on the basis of market quotes and subsequently adjusted through interpolation models which generate credit spread curves by type of coupon, maturity and subordination level.
In consideration of their number and complexity, a systematic reference framework has been developed for derivatives which represents the common elements (calculation algorithms, processing models, market data used, basic assumptions of the model) that are used to measure all categories of derivatives.

Interest rate, foreign exchange, equity, inflation and commodity derivatives, if not traded on regulated markets, are Over The Counter (OTC) instruments, which are bilaterally exchanged with market counterparties and are valued through specific pricing models, fed by input parameters (such as yield, foreign exchange and volatility curves) observed on the market.
Moreover, when determining fair value, the credit quality of the counterparty is also considered. Fair value considers counterparty credit risk and future exposures of the contract through the so-called Credit Risk Adjustment (CRA).
With respect to structured credit products, in the case of ABS, if significant prices are not available, valuation techniques consider parameters which may be presumed from the market (Comparable Approach), such as spreads presumed from new issuers and/or collected from the major investment banks, further strengthened by a qualitative analysis relative to the performance of the underlying asset presumed from periodic investor reports and subject to backtesting with actual sale prices.
Financial instruments for which fair value is determined using the comparable approach also include equities measured based on direct transactions, that is significant transactions on the stock registered in a time frame considered to be sufficiently short with respect to measurement date and in constant market conditions, using, therefore, the so-called "relative" valuation models based on multipliers. Multipliers are used under the comparable companies' or comparable transactions' approach. In the former case, reference is made to a sample of comparable listed companies, therefore the stock prices from which the multiples to measure the investment are deducted. In the latter case, reference is made to the trading prices of the market related to comparable companies registered in a time frame considered to be sufficiently short with respect to measurement date and in constant market conditions.
Finally, loans also fall under the financial instruments whose fair value is determined using the comparable approach. In particular, for medium- and long-term assets and liabilities measurement is carried out by discounting future cash flows. This is based on the discount rate adjustment approach, in which the risk factors connected to the granting of loans are taken into consideration in the rate used to discount future cash flows.
The calculation of the fair value of certain types of financial instruments is based on valuation models which consider parameters not directly observable on the market, therefore implying estimates and assumptions on the part of the valuator (level 3). In particular, the valuation of the financial instrument uses a calculation methodology which is based on specific assumptions of:

- the development of future cash-flows, which may be affected by future events that may be attributed probabilities presumed from past experience or on the basis of the assumed behaviour;
- the level of specific input parameters not quoted on active markets, for which information acquired from prices and spreads observed on the market is in any case preferred. Where this is not available, past data on the specific risk of the underlying asset or specialised reports are used (e.g. reports prepared by Rating agencies or primary market players).

The following are measured under the Mark-to-Model Approach:

- debt securities and complex credit derivatives (CDOs) included among structured credit products and credit derivatives on index tranches;
- hedge funds not included in level 1;
- shareholding and other equities measured using models based on discounted cash flows;
- other loans, of a smaller amount, classified in the available-for-sale portfolio;
- derivative transactions relating to securitisations and equity-risk structured options.

The fair value of debt securities and complex credit derivatives (funded and unfunded CDOs) is determined based on a quantitative model which estimates losses on collateral with a simulation of the relevant cash flows which uses copula functions. The most significant factors considered in the simulation – for each collateral – are the risk-neutral probability of default derived from market spreads, recovery rates, the correlation between the value of collaterals present in the structure and the expected residual life of the contract. In order to incorporate high market dislocation and intense market illiquidity phenomena in valuations, a series of corrections have been prepared for valuations referred to the main input parameters. On the basis of this valuation, a Qualitative Credit Review is provided for and entails an accurate analysis of credit aspects referred to the specific structure of the ABS/CDO and to the collateral present. This is to identify any present or future weaknesses which emerge from the characteristics of the underlying assets, which could have been missed by rating agencies and as such not fully considered in the valuations described in the previous point. The results of this analysis, condensed in certain objective elements (such as Past Due, Weighted Average Delinquency, etc.), are summarised in an indicator representing credit quality on which downgrades depend, so as to proceed to a consistent adjustment in the valuation. Finally, for this class of products, management has the possibility to decide a further adjustment which must be based on prices observed from counterparties and on expert opinions.
With respect to credit derivatives on index tranches, off-the-run series are valued at level 3 when no reliable and verifiable quotes are available from the Risk Management Department. Fair value is determined based on the quotes of series being issued, adjusted to reflect the different underlying.
The fair value of hedge funds is determined by reducing the operating NAV provided by the Fund Administrator, by an amount deriving from an individual measurement process of the counterparty risk (being the risk associated with the credit quality of the fund's prime brokers[1]) and the liquidity risk (which occurs when the assets in which the fund is invested become so illiquid that they cast doubts as to the validity of the valuation process).
Equities to which the "relative" models indicated with respect to level 2 are not applied are valued using "absolute" valuation models. In particular, these models are based on flows which substantially anticipate the measurement of the security value by estimating the cash flows it can generate over time, discounted using a rate that is in line with the risk level of the instrument, equity models or equity-income models.

The valuation technique defined for a financial instrument is adopted over time and is modified only following significant changes in market conditions or the subjective conditions related to the issuer of the financial instrument.
The valuation process of financial instruments ("Fair Value Policy") entails the following phases:

[1] The Prime Broker is an international financial intermediary that operates as agent in the settlement process, carrying out the financial transactions ordered by the hedge fund's manager with the utmost confidentiality. The Prime Broker also acts as the fund's lender, providing credit lines and securities lending for short selling, and directly obtaining guarantees in respect of the financing granted to the fund. The Prime Broker also provides risk management services, monitoring the hedge fund's risk exposure to ensure conditions of financial stability. Other services provided by the Prime Broker are holding and deposit of the fund's cash and securities, handling of the netting and settlement process, and recording of all market transactions.

- identification of the sources for measurements: for each asset class, the Market Data Reference Guide establishes 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 measurements: this stage consists of the accurate verification 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. In particular:
  - reference categories are established for the various types of market parameters;
  - the reference requirements governing the identification of official revaluation sources are set;
  - the fixing conditions of official figures are established;
  - the data certification conditions are established;
- certification of pricing models and Model Risk Assessment: this phase is aimed at verifying the consistency and the adherence of the various measurement techniques used with current market practice, at highlighting any critical aspects in the pricing models used and at determining any adjustments necessary for measurement. The validation process is particularly important at the start of activities in a new financial instrument which requires the development of further pricing models, and when the Bank decides to use a new model to measure payoffs previously managed with models deemed to be less adequate. All models used for the measurement must be submitted to an internal certification process which involves various competent structures or independent companies in highly complex or particularly critical cases;
- monitoring consistency of pricing models over time: periodical monitoring of the adherence to the market of the pricing model in order to discover any gaps promptly and start the necessary verifications and interventions.

The fair value policy also provides for adjustments to reflect the model risk and other uncertainties relating to valuation. In particular, model risk is represented by the possibility that the valuation of a complex instrument is materially influenced by the model chosen. Indeed, it is possible that models using price elementary instruments with the same quality may give rise to different prices for exotic instruments. In these cases, where possible, alternative models are compared, and where necessary, model inputs are subjected to stress tests, thus obtaining useful elements to quantify fair value adjustments, expressed in terms of measurable financial indicators (vega, delta, correlation shift), and periodically reviewed. These fair value adjustments, due to model risks, are part of a Mark to Market Adjustment Policy adopted for the purpose of considering, in addition to model risk described above, also other factors eligible to influence valuation and essentially attributable to:

- 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) and
- valuation difficulties due to the lack of liquid and observable market parameters.

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	30.09.2011			31.12.2010		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
1. Financial assets held for trading	15,360	53,319	1,255	24,683	45,791	1,471
2. Financial assets designated at fair value through profit or loss	28,882	6,071	259	28,746	6,576	228
3. Financial assets available for sale	63,687	5,580	1,683	54,309	5,655	1,871
4. Hedging derivatives	-	9,057	1	-	7,370	3
Total	**107,929**	**74,027**	**3,198**	**107,738**	**65,392**	**3,573**
1. Financial liabilities held for trading	4,312	48,789	851	4,015	40,214	815
2. Financial liabilities designated at fair value through profit or loss	3,757	19,801	-	3,722	22,422	-
3. Hedging derivatives	-	8,037	5	-	5,888	-
Total	**8,069**	**76,627**	**856**	**7,737**	**68,524**	**815**

Figures restated where required by international accounting standards and, where necessary, considering the changes in the scope of consolidation and discontinued operations.

As shown, level 3 instruments, which have more discretion in fair value measurement, still account for a limited portion of the financial instruments portfolio and the relevant balances were slightly down on those at 2010 year end. Conversely, approximately 60% of the financial assets measured at fair value are determined based on market prices (no discretion).

The increase in level 1 financial assets available for sale was attributable to the purchase of quoted bonds, offset by the reduction in financial assets held for trading and in line with reallocation of the securities portfolio, particularly with respect to sovereign issuers.

The level 2 financial assets held for trading showed an increase predominantly linked to the change in fair values, both positive and negative, of derivatives, resulting from changes in the market parameters impacting the underlying instruments of these contracts. The increase in "Hedging derivatives" under both assets and liabilities was due to growth in the notional amounts of the derivatives linked to these transactions.

The sensitivity analysis of level 3 financial assets and liabilities shows a 21 million euro[2] decrease in fair value due 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).

[2] This amount is shown net of adjustments to valuations relating to the main input parameters which were already considered to determine the fair value of financial instruments.

STRUCTURED CREDIT PRODUCTS

During the first nine months of 2011, the total risk exposure to structured credit products fell considerably following the repayment of certain assets held in portfolio. This drop can be ascribed to the portfolio management strategy focused on gradually reducing exposure to the portion held in assets originated in the United States, and at the same time repositioning towards Asset Backed products with European underlying, particularly assets originated in Italy. However, third quarter 2011 showed a decline in the contribution to profit/loss, predominantly due to increased provisions on a position with respect to a monoline. The impact on the income statement dropped from +45 million euro as at 30 June 2011 to +26 million euro as at 30 September 2011, for a 19 million euro decline in contribution.

The overall risk exposure of structured credit products decreased from 3,715 million euro as at 31 December 2010 to 2,834 million euro as at 30 September 2011, in addition to an exposure of 33 million euro in connection with structured packages (87 million euro as at 31 December 2010). The considerable decrease in exposure in the first nine months of 2011 is due to the total/partial repayment of assets held in portfolio. In particular, the first nine months of 2011 saw the settlement of two unfunded positions included in the "Other structured credit products – unfunded Super Senior CDOs" aggregate for a notional value of approximately 500 million euro and the reduction of several funded positions included in the loans portfolio due to amortization.
As at 30 September 2011, 12% of the outstanding positions was affected by a reduction in creditworthiness. The increase over the 4% as at 31 December 2010 can be attributed to unfunded positions originated in the United States, in addition to the third quarter increase in downgrades of funded positions originated in Europe. The situation of the structured credit product portfolio at the end of the first nine months of 2011 is described by the following indicators:

- 73% of exposure was Investment Grade, compared to 80% as at 31 December 2010: this decrease is due to the closure of unfunded positions with an AA/A rating, in addition to the progressive deterioration of the portfolio due to the overall performance of the market;
- 38% had an AAA rating;
- 27% had a BBB rating or less, compared to 20% as at 31 December 2010;
- 11% of the exposure had a pre-2005 vintage[3];
- 35% has a 2005 vintage;
- only 10% of the exposure related to the US Residential segment, and 20% to the US Non-Residential segment;
- the remaining exposure (70% of the total) is 66% European.

In terms of underlying contract types, slightly less than half the exposure consisted of CLOs (27%) and CDOs (22%); the rest was almost entirely made up of ABSs (13%, down due to the closure of certain unfunded positions) and RMBSs (32%), with CMBSs representing 6% of the total.
As concerns valuation methods, of "long" positions, approximately 38% are measured using the mark-to-model (100% of unfunded positions, 28% of funded positions, 100% of the monoline risk and the non-monoline "packages"), 53% with the comparable approach (62% of funded positions) and 9% are measured using effective market quotes (10% of funded positions). Of the "short" positions, 70% are measured using the mark-to-model (100% of unfunded positions and 100% of positions of funds) and 30% are measured using effective market quotes (100% of CMBX-CDS hedges).
In the summary tables below, table (a) illustrates risk exposure as at 30 September 2011 and income statement captions (the sum of realized charges and profits, write-downs and write-backs) for the first nine months of the year, compared with the corresponding values recorded as at 31 December 2010.
Table (b) sets out figures related to structured packages, normally made up of a security whose credit risk is entirely hedged by a specific credit default swap. Risk exposure in the table refers to the protection seller and not to the issuer of the security hedged.
Values expressed in USD as at 31 December 2010 were translated at an exchange rate of 1.3362 euro per dollar, and as at 30 September 2011 at an exchange rate of 1.3503 euro per dollar.

[3] Date of generation of the collateral underlying the securitisation. It is an important factor in the assessment of the risk of the mortgages underlying securitisations since, especially in the US, the phenomenon of mortgages granted to entities with inadequate income and with low prior assessment of documentation became significant as of 2005.

Structured credit products: summary tables

a) Exposure in funded and unfunded ABS/CDOs

(millions of euro)

Financial assets held for trading	**30.09.2011**		**31.12.2010**	
	Risk exposure (*) (including write-downs and write-backs)	**Income Statement** Profits (Losses) on trading	**Risk exposure** (*) (including write-downs and write-backs)	**Income Statement** Profits (Losses) on trading
US subprime exposure	**24**	**4**	**24**	**1**
Contagion area	**143**	**6**	**140**	**19**
- Multisector CDOs	77	-	61	-4
- Alt-A	-	-	-	-
- TruPS	66	6	79	23
- Prime CMOs	-	-	-	-
Other structured credit products	**776**	**18**	**1,298**	**40**
- European/US ABS/CDOs	626	4	607	3
- Unfunded super senior CDOs	161	8	672	26
- Other unfunded positions	-11	6	19	11
Total	**943**	**28**	**1,462**	**60**
in addition to:				
Positions of funds	-	-5	-	16
Total Financial assets held for trading	**943**	**23**	**1,462**	**76**

(millions of euro)

Loans	**30.09.2011**		**31.12.2010**	
	Risk exposure (**) (including write-downs and write-backs)	**Income Statement**	**Risk exposure** (**) (including write-downs and write-backs)	**Income Statement**
US subprime exposure	**3**	**-**	**3**	**-**
Contagion area	**66**	**-**	**89**	**-**
- Multisector CDOs	10	-	15	-
- Alt-A	37	-	49	-
- TruPS	-	-	-	-
- Prime CMOs	19	-	25	-
Other structured credit products	**1,822**	**9**	**2,161**	**7**
- Funded European/US ABS/CDOs	1,284	-4	1,253	3
- Funded super senior CDOs	521	13	777	8
- Other Romulus funded securities	17	-	131	-4
Total	**1,891**	**9**	**2,253**	**7**
in addition to:				
Positions of funds	-	-	-	-
Total Loans	**1,891**	**9**	**2,253**	**7**
TOTAL	**2,834**	**32**	**3,715**	**83**

(*) The column "Risk exposure" sets out: for securities, fair value; for derivatives, the nominal value of the contract, net of write-downs and write-backs recorded at reference date. Such amounts correspond, for "long" positions, to the maximum potential loss (in the event of a 100% default and a recovery rate of 0). For "short" positions, vice versa, they indicate the maximum potential gain (in the same scenario in terms of default and recovery levels).

(**) For assets reclassified to loans, exposure to risk is provided by the carrying amount of the security, equal to fair value at the reclassification date, plus accrued interest calculated at the effective interest rate net of net value adjustments to the portfolio.

b) Exposure in packages

(millions of euro)

	30.09.2011		31.12.2010	
	Credit exposure to monoline insurers (CDS fair value post write-down for CRA)	**Income Statement** Profits (Losses) on trading	**Credit exposure to monoline insurers** (CDS fair value post write-down for CRA)	**Income Statement** Profits (Losses) on trading
Monoline risk	12	-7	17	19
Non monoline packages	21	1	70	1
TOTAL	**33**	**-6**	**87**	**20**

From an income statement perspective, structured credit products generated a net income of +26 million euro as at 30 September 2011 compared to 103 million euro for 2010.
The exposure in funded and unfunded ABSs/CDOs had an effect on "Profits (Losses) on trading – Caption 80" of +23 million euro. The profit on this segment was a result of the effects of:
- unfunded Super Senior CDO positions included in "Other structured credit products" (+8 million euro as at 30 September 2011); the profit in this segment was positive, despite a reduction in third quarter 2011, due to a widening of the spreads of European issuers;
- European and US funded ABSs/CDOs (+4 million euro) and other unfunded positions (+6 million euro), also included in the area "Other structured credit products";
- the US Subprime exposure (+4 million euro), entirely attributable to unfunded positions included in the segment;
- instruments included in the "Contagion area"; in particular the TruPS recorded a positive 6 million euro result and the Multisector CDO positions made a negative contribution of 5 million euro, due to the negative results of the positions in funds attributable to this sector.

The securities reclassified to the loan portfolio showed an overall impact on the income statement of 9 million euro as at 30 September 2011. This figure was made up of the following:
- 3 million euro loss from the impairment of a security included in the portfolio of the Romulus vehicle;
- 1 million euro loss from the impairment of ABSs issued by European parties;
- 13 million euro gain from the market sale of positions in reclassified debt securities, including 6 million euro attributable to the subsidiary Banca IMI and 7 million euro to the Parent Company.

As at 30 September 2011 the loan portfolio contained ABSs issued by parties resident in EU countries in situations of financial difficulty (known as "PIGS"). In particular, these consist of:
- 155 million euro in nominal value of securities issued by parties resident in Spain; as at 30 September 2011 these securities had a book value of 141 million euro and a fair value of 103 million euro;
- 38 million euro in nominal value of securities issued by parties resident in Portugal; as at 30 September 2011 these securities had a book value of 34 million euro and a fair value of 22 million euro;
- 13 million euro in nominal value of securities issued by parties resident in Greece; as at 30 September 2011 these securities had a book value of 12 million euro and a fair value of 8 million euro;
- 2 million euro in nominal value of securities issued by parties resident in Ireland; as at 30 September 2011 these securities had a book value of 1 million euro and a fair value of 1 million euro.

The "Monoline risk" and "Non-monoline packages" made a positive contribution of 6 million euro as at 30 September 2011, compared to +20 million euro recorded at the end of 2010. The heavy penalization during third quarter 2011 (-15 million) was due to worsening of the creditworthiness of the monoline counterparty, with which a protection bought credit derivative was stipulated, requiring an increase in the provision percentage.
It should be noted that the "Structured credit products" aggregate was identified in 2007, immediately following the outbreak of the "subprime phenomenon" and, in disclosure to the market, has been kept essentially constant.
As at 30 September 2011, the aggregate included bonds reclassified as loans, which are summarized in the tables below.

(millions of euro)

	Nominal value	Risk exposure (*) (including write-downs and write-backs)	Fair value as at 30.09.2011	Benefit from the reclassification as at 30.09.2011	Effect on Shareholders' Equity
Reclassified securities:					
- from financial assets available for sale to loans	161	160	50		110
- from financial assets held for trading to loans	1,641	1,543	1,340	203	
Total Securities reclassified to loans	**1,802**	**1,703**	**1,390**	**203**	**110**
Securities classified under loans from inception	192	188			
Total securities classified under loans from inception	**192**	**188**			
TOTAL LOANS	**1,994**	**1,891**	**1,390**	**203**	**110**

(*) For assets reclassified to loans, exposure to risk is provided by the carrying amount of the security, equal to fair value at the reclassification date, plus accrued interest calculated at the effective interest rate net of net value adjustments to the portfolio.

(millions of euro)

Negative economic effect without reclassification for 2008	-299
Negative economic effect without reclassification for 2009	-7
Positive economic effect without reclassification for 2010	117
Negative economic effect without reclassification for 2011	-14
BENEFIT FROM THE RECLASSIFICATION AS AT 30.09.2011	**-203**

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, 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. There have not been any changes in the consolidation criteria compared to those reported in the 2010 financial statements.

Funding SPEs

These are entities established abroad to raise funds on specific markets. The SPEs issue financial instruments, guaranteed by Intesa Sanpaolo, and transfer the funds raised to the Parent Company.
Changes compared to the situation reported as at 31 December 2010 included exercising of the call option on the hybrid instrument issued by IntesaBCI Preferred Capital Co. LLC for 500 million euro in July 2011.
Therefore, within the category in question, the Intesa Funding LLC vehicle is still outstanding as at 30 September 2011, while the process to cease the IntesaBCI Preferred Capital Co. LLC vehicle has been initiated.

SPEs for insurance products

These are entities (UCITS) established for the purpose of investing internal funds of unit-linked and index-linked products of the Group's insurance companies. The latter retain the majority of the risks and rewards of the companies in question and, as a consequence, are consolidated pursuant to IAS 27/SIC 12.
There were no significant changes in this segment compared to the situation reported as at 31 December 2010.

Securitisation SPEs

These are funding SPEs that enable an entity to raise funds through the securitisation of part of its assets. In particular, this involves the spin-off of a package of balance sheet assets (generally loans) and its subsequent transfer to a vehicle which, to finance the purchase, issues securities later placed on the market or through a private placement. The funds raised in this way are reversed to the seller, whereas the commitments to the subscribers are met using the cash funds generated by the loans sold.
SPEs of this type, which are part of the scope of consolidation as at 30 September 2011, are the same reported in the financial statements as at 31 December 2010. With particular reference to the vehicle Adriano Finance S.r.l., note the early termination of the Series 2 self-securitisation in May 2011, completed on retrocession of the mortgage portfolio to the Parent Company Intesa Sanpaolo and full repayment of the subordinated loan granted for 50 million euro and of the Class A notes. The Class B notes were partly redeemed, given the lower value of the mortgage portfolio as at the date of settlement.

The securitised assets of vehicles in this category are represented by performing mortgages, non-performing mortgages and lease-related performing mortgages. For the Augusto, Colombo and Diocleziano vehicles the assets were made up of land financing or receivables for public works.
With regard, on the other hand, to the vehicles ISP CB Pubblico S.r.l. and ISP CB Ipotecario S.r.l., SPE used to support the covered bond issue programme, there were three covered bond issues during the first nine months of 2011:

– the first, for an amount of 1.5 billion euro, was issued under the Issue Programme for a maximum amount of 10 billion euro backed by public sector loans sold by Banca Infrastrutture Innovazione e Sviluppo to ISP CB Pubblico S.r.l.. This issue, which was completed in January and has a 10-year maturity, is targeted at institutional investors and financial intermediaries and is listed on the Luxembourg Stock Exchange;
– the second, for an amount of 2.4 billion euro, was issued, like the first, under the Issue Programme for a maximum amount of 10 billion euro backed by performing public sector loans sold by BIIS to ISP CB Pubblico S.r.l.. The bonds issued, with a floating rate linked to the 6-month Euribor plus spread, were fully subscribed by BIIS, which allocated them as collateral for its funding at the European Central Bank, through transactions carried out via the Parent Company;
– the third, for an amount of 2.5 billion euro, was issued under the Issue Programme for a maximum amount of 20 billion euro backed by triple-A-rated securitised securities (RMBS), with underlying composed of Italian residential mortgage loans originated by Intesa Sanpaolo, which were sold by the latter to the vehicle ISP CB Ipotecario S.r.l.. This issue, which was completed in February and has a maturity of 5.5 years, is targeted at institutional investors and institutional financial intermediaries and is listed on the Luxembourg Stock Exchange.

Regarding the ISP CB Ipotecario S.r.l. vehicle, with effect from 27 June 2011 in economic terms, the Parent Company Intesa Sanpaolo sold a portfolio of residential mortgages to the vehicle at a sale price of 2,319 million euro, paid to the transferor through a subordinated loan disbursed for that amount in July.
As also already noted in the financial statements as at 31 December 2010, Intesa Sanpaolo controls, pursuant to SIC 12, the vehicles Romulus Funding Corporation and Duomo Funding Plc.. Compared to the situation described at the end of 2010:

– there was a sale at fair value to Intesa Sanpaolo, completed at the beginning of March 2011, of part of the securities held by Romulus that were included within the scope of structured credit products. At the end of the first nine months of the year, these securities had a nominal value of 128 million euro and were recognised in the consolidated financial statements with a book value of 122 million euro. One of these securities was subject to impairment losses, during 2011, amounting to 3 million euro, which were recognised under "Net adjustments to loans – caption 130";
– regarding the liquidity lines granted to the Romulus vehicle, a decrease in the loan facility from 294 million euro (as at 31 December 2010) to 89 million euro, bringing the amount used to a nil value; there was also a reduction in the liquidity lines granted by Intesa Sanpaolo to the Duomo vehicle, from 2,165 million euro in loan facilities at the end of December 2010 to 1,640 million euro at the end of September 2011;
– the decrease in the amount of the letter of credit granted to the vehicle by ISP from 78 million euro to 40 million euro.

The self-securitizations carried out through the vehicle SPQR II S.r.l. were closed ahead of the due date during the first nine months of 2011, through the sale to Banca Infrastrutture Innovazione e Sviluppo of the entire portfolios underlying the CBO 1 and CBO 2 securitizations and redemption of the senior and junior bonds issued, which were entirely held by BIIS. Subsequently, BIIS sold the securities repurchased to the vehicle ISP CB Pubblico S.r.l. to proceed with the second of the three covered bond issues reported above.

Financial Engineering SPEs

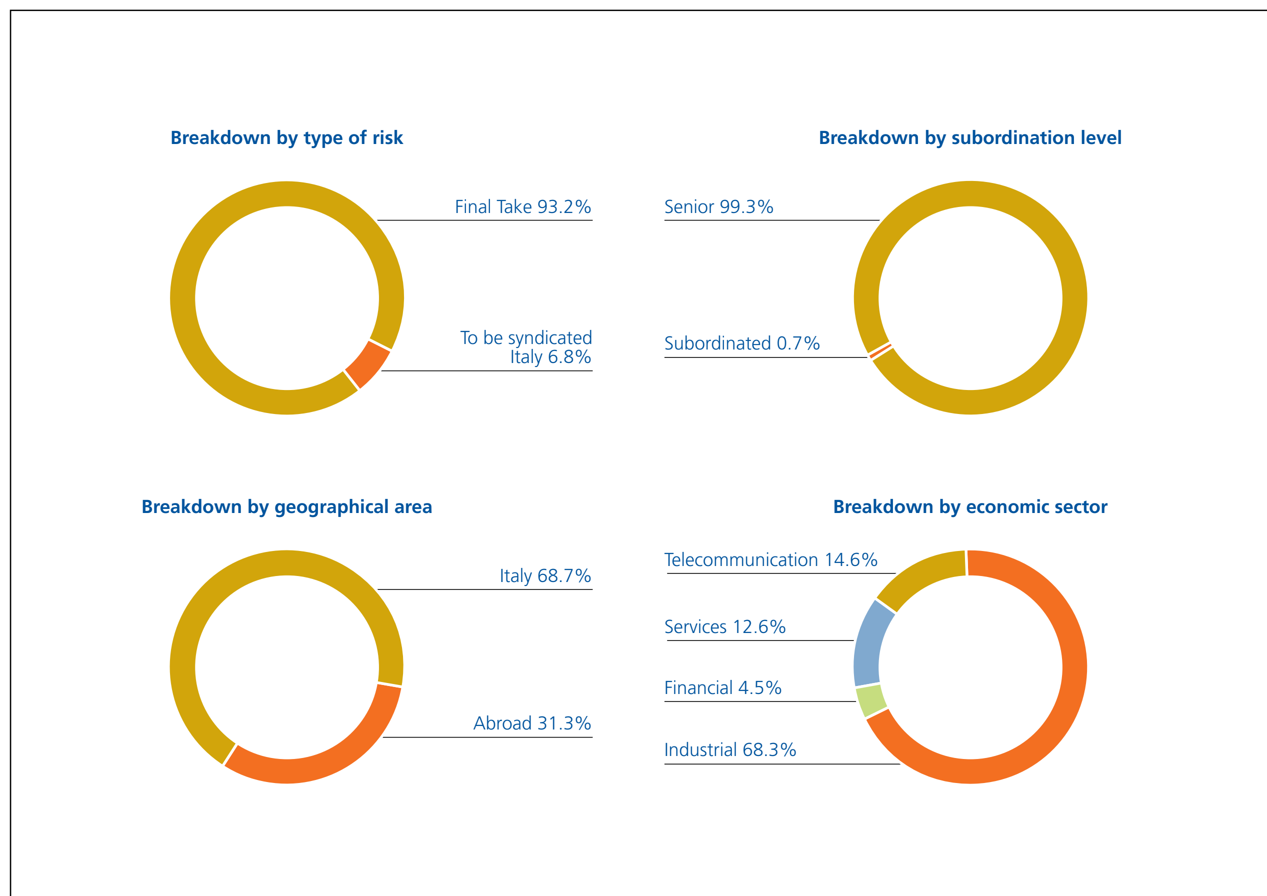
These SPEs carry out investment and funding transactions that achieve better risk/return combinations than those generated by standard transactions, through special structures aimed at optimising accounting, tax and/or regulatory aspects. These structures have been set up to respond to the needs of primary customers and provide solutions that offer financing at competitive interest rates and investments with higher returns.
As at 30 September 2011, the situation of the only vehicle of this kind controlled by Intesa Sanpaolo, Intesa Investimenti S.p.A., was exactly that described as at 31 December 2010. The Lunar Funding vehicle is still included in the scope of consolidation.

Other unconsolidated Special Purpose Entities

With regard to the other unconsolidated SPEs (Project Financing, Asset Backed and Credit Derivatives) reference should be made to the Financial statements as at 31 December 2010. For the Asset Backed SPEs in which the Group has the majority of voting rights, held by just one international subsidiary, total assets fell to 45 million euro (76 million euro in December 2010). In fact, almost all the SPEs in this category were merged by incorporation into the subsidiary holding the related equity investments.
For operations involving the vehicles used for Leveraged & Acquisition Finance transactions a description is provided in the sections below.

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, 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 part acquisition of companies through recourse to SPEs created for this purpose. After acquisition of the target company's securities 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 2011, 116 transactions for a total amount granted of 4,330 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.



DISCLOSURE ON INVESTMENTS IN HEDGE FUNDS

The hedge fund portfolio as at 30 September 2011 totalled 664 million euro, compared to the 814 million euro recorded at the end of 2010. The decrease is partly due to management and valuation of the portfolio and partly to revaluation of the foreign currency positions. As at the same date, there was an overall loss of 98 million euro, compared to the 44 million euro profit recorded in the third quarter 2010 and 84 million euro profit at the end of the previous year.
The 98 million euro net loss recognised as at 30 September 2011 under "Profits (Losses) on trading – caption 80" included:

- 3 million euro in net losses for the first nine months of the year on trading of funds (including -1 million euro in the structured credit products disclosure);
- 96 million euro from net write-downs of positions outstanding at the end of September 2011 (including -4 million euro in the structured credit products disclosure);
- 1 million euro from other net income.

Net capital losses on the final residual amount (-96 million euro) were spread across 47 positions, 19 of which with capital gains (8 million euro) and 28 with capital losses (-104 million euro).
The figures for the end of September should be considered in light of the negative contingent economic scenario, which arose during the first half of the year and worsened during third quarter, resulting in further weakening, especially in the financial and energy sectors, which until the end of last year had recorded excellent performances. In fact, a comparison of the results for this quarter with those for the same period in 2010 shows that the negative portfolio performance is mainly attributable to the positions that had invested in the aforementioned sectors and which have suffered strong capital losses.

INFORMATION ON TRADING TRANSACTIONS IN DERIVATIVES WITH CUSTOMERS

Considering only relations with customers, as at 30 September 2011, the Intesa Sanpaolo Group presented, in relation to derivatives trading with retail customers, non-financial companies and public entities (therefore excluding banks, financial and insurance companies), a positive fair value, not having applied netting agreements, of 3,816 million euro (3,268 million euro as at 31 December 2010). The notional value of such derivatives totaled 55,134 million euro (45,875 million euro as at 31 December 2010). Please note that the fair value of contracts outstanding with the 10 customers with the highest exposures was 1,546 million euro (1,472 million euro as at 31 December 2010).
Conversely, the negative fair value determined with the same criteria, for the same types of contracts and with the same counterparties, totaled 1,050 million euro as at 30 September 2011 (552 million as at 31 December 2010). The notional value of such derivatives totaled 18,638 million euro (13,157 million euro as at 31 December 2010).
The fair value of derivative financial instruments stipulated with customers was determined considering, as for all other OTC derivatives, the creditworthiness of the single counterparty ("Credit Risk Adjustment"). With regard to contracts outstanding as at 30 September 2011, this led to a negative effect of 55 million euro being recorded under “Profits (Losses) on trading” in the income statement.
Adjustments are recorded, for every single contract, on the market value determined using the risk free curves.

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, 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.
As already noted, effective from the report at 31 December 2009, the Group was authorised by the Supervisory Authority to use the Advanced Measurement Approaches (AMA – internal model) to determine capital requirements for operational risk on an initial scope that included the Organisational Units, Banks and Companies of the Banca dei Territori Division (excluding the network banks belonging to Cassa di Risparmio di Firenze Group, but including the Casse del Centro banks), Leasint, Eurizon Capital and VUB Banka. Effective 31 December 2010, the Group was also authorised to extend the Advanced approaches to a second set of Organisational Units and Companies of the Corporate and Investment Banking Division, in addition to Setefi, to the remaining banks of the Cassa di Risparmio di Firenze Group and to PBZ Banka. The remaining companies, currently using the Standardised approach (TSA) or Basic Indicator Approach (BIA), will migrate progressively to the Advanced approaches starting from the end of 2011, based on the roll-out plan presented to the Management and Supervisory Authorities.
The control of operational risk was attributed to the Management Board, which identifies risk management policies, and to the Supervisory Board, which is responsible for the approval and supervision of the policies and for their functionality in terms of the 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 will have 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, has allowed 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;
- 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 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 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 (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, 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, a structured training programme was fully implemented for employees actively involved in the process of managing and mitigating operational risk.
In addition, the Group has activated a traditional operational risk transfer policy (to protect against offences such as employee disloyalty, theft and theft damage, cash and valuables in transit losses, computer fraud, forgery, earthquake and fire, and professional liability), which contributes to mitigating exposure to operational risk, although it does not have an impact in terms of capital requirements, as the insurance mitigation component of the internal model has not yet been submitted for regulatory approval.

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 approximately 2,180 million euro as at 30 September 2011 (2,174 million euro as at 31 December 2010).

Legal risks

Legal risks have been thoroughly and individually analysed by the Parent Company and Group companies. Provisions have been made to the Allowances for risks and charges when there are legal obligations that are likely to result in a financial outlay and where the amount of the disbursement may be reliably estimated.
During the first nine months of 2011, no new significant legal procedures were commenced or important developments took place with respect to those underway.
Reference should be made to the Notes to the 2010 consolidated financial statements for a detailed description of litigation regarding anatocism and bonds in default, the insolvency of the Cirio Group, the tax-collection litigation with former Gest Line, the litigation between Banca Infrastrutture Innovazione e Sviluppo and the Municipality of Taranto, the class actions by Codacons and Altroconsumo, the Angelo Rizzoli litigation, the Allegra Finanz AG litigation, other judicial and administrative proceedings at the New York branch in relation to alleged embargo violations and labour litigation.

Tax litigation

The Notes to the 2010 consolidated financial statements (Part E) provide extensive information on pending tax litigation and the related risks and provisions. On that occasion, particular reference was made to the assessment notice served upon Intesa Sanpaolo regarding the 2005 tax year, amongst other things including the alleged "misuse of a right" on structured financing transactions involving the shares of companies listed in Italy, amounting to a total of 377 million euro in IRES, IRAP, withholding tax, penalties and interest. The Bank appealed against this demand before the relevant Provincial Tax Committee.
Furthermore, the Explanatory notes to the Half-yearly Report as at 30 June 2011 indicated that:
1) in May of this year the Tax Police of the Milan Guardia di Finanza began a tax inspection into Intesa Sanpaolo with regard to any transactions of this kind executed in 2006 and later years (this inspection is still in progress) and
2) during the first half of 2011 the same Tax Police squad issued reports of findings against Intesa Sanpaolo and other companies in (or formerly of) the Group in relation to transactions under repurchase agreement in foreign bonds completed in the period 2006 to 2009, which generated credits for taxes prepaid in other countries and which the inspectors believe were not due as a result of alleged misuse of a right. The tax benefit challenged totals approximately 119 million euro, of which 72 million euro for Intesa Sanpaolo and 47 million euro referring to other companies in (or formerly of) the Group and for which the Bank has issued waiver of liability in the related disposal documents.
No specific provision has been allocated in relation to the tax demands as the expected result of any litigation that might arise is currently viewed as positive.
No significant charges were made against the Group after 30 June 2011.

INSURANCE RISKS

Life business

The typical risks of a life insurance portfolio can be divided into three main categories: premium risk, actuarial and demographic risks 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 the sustainability and profitability (both at product level and at portfolio level, including liabilities).

Actuarial and demographic risks are guarded against by a regular statistical analysis of the evolution of liabilities, divided by type of risks and through simulations of expected profitability on the assets which cover technical reserves.

Reserve risk is managed 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 guarded against 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 Finance Policy is the main control and monitoring instrument for market and credit risks.

The Policy 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, market risks, in turn measured in terms of sensitivity to variations in risk factors and Value at Risk on a 1-year holding period.

Investment portfolios

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

As at 30 September 2011, the investment portfolios of Group companies, recorded at book value, amounted to 76,662 million euro; of these, the share regarding traditional revaluable life policies, non-life policies and free capital (Class C portfolio or portfolio at risk) amounted to 44,336 million euro, while the other component (Class D portfolio or portfolio with total risk retained by the insured) mostly comprised investments related to pension funds, Index- and Unit-linked policies and totalled 32,326 million euro.

Considering the various types of risks, the analysis of investment portfolios, described below, concentrates on the assets included in the "portfolio at-risk".

In terms of breakdown by asset class, net of derivative positions, 93.8% of assets, i.e. approximately 41,821 million euro, were bonds, while assets subject to equity risk represented 1.9% of the total and amounted to 821 million euro. The remaining part (1,934 million euro) consisted of investments relating to UCI, Private Equity and Hedge Funds (4.3%).

The carrying value of derivatives came to approximately -240 million euro, almost entirely relating to hedging derivatives, with effective management derivatives[4] only amounting to around -17 million euro.

At the end of the first nine months of 2011, investments of Intesa Sanpaolo Vita, Eurizon Vita, Sud Polo Vita, CentroVita and Fideuram Vita free capital amounted to approximately 2,365 million euro at market value, and presented a risk in terms of VaR (99% confidence level, 10-day holding period) equal to approximately 77 million euro.

The modified duration of the bond portfolio, or the synthetic financial term of assets, is approximately 5.2 years. The reserves relating to the revaluable contracts under Separate Management have an average modified duration of approximately 6.2 years. The related portfolios of assets have a modified duration of around 4.8 years.

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 2,039 million euro. On the basis of this hypothetical scenario, the value of hedging derivatives in the portfolio undergoes an approximate 115 million euro rise which partly offsets the corresponding loss on the bonds.

The investment portfolio had a high credit rating. AAA/AA bonds represented approximately 79.1% of total investments and single A bonds approximately 9.6%. Low investment grade securities (BBB) were approximately 3.9% of the total and the portion of speculative grade or unrated was minimal (approximately 1.2%).

[4] ISVAP Regulation 36 of 31/01/2011 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.

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 71.8% of the total investments, while financial companies (mostly banks) contributed almost 17.8% of exposure and industrial securities made up approximately 4.2%.
As at the end of the third quarter of 2011, 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 2,269 million euro, 1,855 million euro due to government issuers and 414 million euro to corporate issuers (financial and industrial companies).