Risk management

BASIC PRINCIPLES

As described in further detail in the annual financial statements, Intesa Sanpaolo Group policies relating to risk acceptance are defined by the Parent Company's Supervisory Board and Management Board. The Supervisory Board performs its activities through specific committees set up from among its members, including the Control Committee. The Management Board draws on the activities conducted by managerial committees, particularly the Group Risk Governance Committee. Both corporate bodies receive support from the Chief Risk Officer who reports directly to the Chief Executive Officer. The Chief Risk Officer is responsible for proposing the Risk Appetite Framework, setting the Group's risk management and compliance guidelines and policies in accordance with company strategies and objectives and coordinating and verifying the implementation of those guidelines and policies by the responsible units of the Group, including within the various corporate departments. The Chief Risk Officer ensures oversight of the Group's overall risk profile by establishing methods and monitoring exposure to the various types of risk.
The Parent Company is in charge of overall direction, management and control of risks. Group companies that generate credit and/or financial risks are assigned autonomy limits and each has its own control structure. A service agreement governs the risk control activities performed by the Parent Company's functions on behalf of the main subsidiaries. These functions report directly to the subsidiaries' Management Bodies.
The risk measurement and management tools contribute to 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 and is submitted quarterly to the Group Risk Governance Committee, the Management Board and the Control Committee, as part of the Group's Risks Tableau de Bord. Risk hedging, given the nature, frequency and potential impact of the risk, is based on a constant balance between mitigation/hedging action, control procedures/processes and capital protection measures.

BASEL 2 AND BASEL 3 REGULATIONS - THE INTERNAL PROJECT

The goal of the Basel 2 Project is the adoption of advanced approaches for credit and operational risks by the main Group companies.
The credit risk situation differs by portfolio:

- for the Corporate segment, authorisation has been obtained from the Supervisory Authority for the use of the AIRB approach on a scope that extends to the Parent Company, the network banks and Mediocredito Italiano (effective 31 December 2010; the FIRB approach had been in use since December 2008) and the foreign company Intesa Sanpaolo Bank Ireland Plc. (effective reporting as at 31 December 2011). Similar authorisation was requested for Banca Monte Parma, submitted to the Supervisory Authority in July 2013. The foreign bank VUB Banka obtained permission to use the FIRB approach effective from the report as at 31 December 2010. With effect from June 2012 permission was obtained to extend the AIRB approach to the subsidiary Banca IMI and for the adoption of rating models for the hedging of Specialised Lending exposures at Group Level, together with the use of internal LGD estimates for the Corporate segment in relation to the product companies Leasint and Mediofactoring (the FIRB approach had been in use since December 2008);
- for the Retail Mortgage segment, permission was granted for the use of the IRB approach effective June 2010, extended to the former Casse del Centro network banks effective the report as at 31 December 2011 and to VUB Banka with effect from the report as at 30 June 2012. Similar authorisation was requested for Banca Monte Parma, submitted to the Supervisory Authority in July 2013;
- authorisation for transition to the IRB approach was granted for the SME Retail segment effective from the December 2012 report, extending to a scope that includes the Parent Company, network banks and Mediocredito Italiano.

The Group is also proceeding with development of the IRB systems for the other segments and the extension of the scope of companies for their application in accordance with a plan presented to the Supervisory Authority.
With regard to Operational Risk, the Group obtained authorisation to use the Advanced Measurement Approaches (AMA – internal model) to determine the associated capital requirement for regulatory purposes, with effect from the report as at 31 December 2009. The scope of application of the advanced approaches is being progressively expanded in accordance with the roll out plan presented to the Management and to the Supervisory Authorities. For additional details see the section on operational risk.

In April 2013 the Group presented its Annual 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 approaches 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.

As regards developments in the set of regulations known as "Basel 3", the main changes regard the level and quality of capital of the banks, introduction of the leverage ratio (ratio of Core Tier I and Total Assets, including off balance sheet adjusted for the actual derivatives exposure), changes in the valuation of counterparty risk and the introduction of two new regulatory liquidity indicators (Liquidity Coverage Ratio and Net Stable Funding Ratio). Specifically, during the third quarter of 2013 an application for authorisation to use the internal counterparty risk model for regulatory purposes was submitted to the Bank of Italy in reference to the Parent Company Intesa Sanpaolo and Banca IMI.
In preparing to adopt the new rules envisaged by Basel 3, the Group has undertaken adequate project initiatives, expanding the objectives of the Basel 2 Project in order to improve the measurement systems and the related risk management systems.

CREDIT RISK

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

The Intesa Sanpaolo Group has developed a set of techniques and tools for credit risk measurement and management which ensures analytical control over the quality of loans to customers and financial institutions, and loans subject to country risk.
In particular, with respect to loans to customers, risk is measured using internal rating models which change according to the counterparty's operating segment.

Credit quality

Constant monitoring of the quality of the loan portfolio is also pursued through specific operating checks for all the phases of loan management.
The overall 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 pre-set rules, positions which are attributed a persistent high-risk rating are intercepted (manually or automatically) and classified to the following categories based on their risk profile: 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)

	30.09.2013			31.12.2012			Changes
	Gross exposure	Total adjustments	Net exposure	Gross exposure	Total adjustments	Net exposure	Net exposure
Doubtful loans	32,857	-20,036	12,821	28,362	-17,160	11,202	1,619
Substandard loans	17,033	-3,996	13,037	14,480	-2,985	11,495	1,542
Restructured loans	2,509	-325	2,184	3,587	-724	2,863	-679
Past due loans	3,104	-330	2,774	3,244	-332	2,912	-138
Non-performing loans	**55,503**	**-24,687**	**30,816**	**49,673**	**-21,201**	**28,472**	**2,344**
Performing loans	305,901	-2,413	303,488	333,989	-2,550	331,439	-27,951
Performing loans represented by securities	15,709	-342	15,367	17,108	-394	16,714	-1,347
Loans to customers	**377,113**	**-27,442**	**349,671**	**400,770**	**-24,145**	**376,625**	**-26,954**

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

The table above shows an increase for the first nine months of 2013 of non-performing loans, net of adjustments, by 2.3 million euro (+8.2%), compared to the end of the previous year. This trend led to a higher incidence of non-performing loans on total loans to customers, increasing from 7.6% to 8.8%. Coverage of non-performing loans came to approximately 44.5%, higher than the level at the end of 2012 (42.7%) and adequate to account for expected losses, also considering the guarantees securing the positions.
In particular, as at 30 September 2013, doubtful loans net of adjustments, reached 12.8 billion euro, up 14.5% since the start of the year. The impact on total loans was 3.7%, with a coverage ratio of 61%.
Compared to 31 December 2012 and again referring to net exposure, substandard loans increased 13.4% to 13,037 million euro. The growth is largely attributable to one position (Carlo Tassara) previously classified among restructured loans. Substandard loans as a proportion of total loans to customers therefore increased from 3.0% to 3.7%, and the coverage ratio, adequate for the risk intrinsic to this portfolio, was 23.5%, higher than the figure recorded at the end of the previous year.
Restructured loans stood at 2,184 million euro, down compared to the beginning of the year (23.7%), with a coverage ratio of 13% lower than the 20.2% of the previous year. In this case, too, the changes in absolute values and coverage ratios were attributable to the aforementioned position transferred to substandard loans.
Past due loans, net of impairment losses, recorded a decrease of 138 million euro (-4.7%) to 2,774 million euro from 2,912 million euro for the previous year. As a consequence, the percentage of this type of non-performing loans remained unchanged at 0.8% with respect to that recorded at the end of December. The coverage ratio rose to 10.6% from the previous figure of 10.2%.
Performing exposures decreased, from 331.4 billion euro in the previous year to 303.5 billion euro. In this context, the cumulated collective adjustments on these loans totalled 0.8% of the gross exposure to customers, a value that is unchanged compared to the figure recorded at the end of 2012.

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 4% of the Group's overall risk). In particular, the risk factors of the international subsidiaries' trading books were local government bonds and positions in 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.
Effective the report as at 30 September 2012, both banks have received authorisation from the Supervisory Authority to extend the scope of the model to specific risk on debt securities. The model was extended on the basis of the current methodological framework (a historical simulation in full evaluation), and required the integration of the Incremental Risk Charge into the calculation of the capital requirement for market risks.
The risk profiles validated are: (i) generic/specific on debt securities and on equities for Intesa Sanpaolo and Banca IMI, (ii) position risk on quotas of UCI underlying CPPI (Constant Proportion Portfolio Insurance) products for Banca IMI, (iii) position risk on dividend derivatives and (iv) position risk on commodities for Banca IMI, the only legal entity in the Group authorised to hold open positions in commodities.

The requirement for stressed VaR is included when determining capital absorption effective from 31 December 2011. The requirement derives from the determination of the VaR associated with a market stress period. This period was identified considering the following guidelines, on the basis of the indications presented in the Basel document "Revision to the Basel 2 market risk framework":
– the period must represent a stress scenario for the portfolio;
– the period must have a significant impact on the main risk factors for the portfolios of Intesa Sanpaolo and Banca IMI;
– the period must allow real historical series to be used for all portfolio risk factors.

In keeping with the historical simulation approach employed to calculate VaR, the latter point is a discriminating condition in the selection of the holding period. In fact, in order to ensure that the scenario adopted is effectively consistent and to avoid the use of driver or comparable factors, the historical period must ensure the effective availability of market data.
As at the date of preparation of this document, the period relevant to the measurement of stressed VaR had been set as 1 January to 31 December 2011 for both Banca IMI and Intesa Sanpaolo.

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 2013, market risks generated by Intesa Sanpaolo and Banca IMI decreased with respect to the averages for the second quarter of 2013. The average VaR for the period totalled 59 million euro.

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

(millions of euro)

	2013					2012			
	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	8.2	6.4	11.9	11.7	14.1	16.8	19.6	24.6	24.1
Banca IMI	39.3	31.1	49.6	50.8	59.0	65.7	49.5	55.3	72.9
Total	**59.0**	**37.8**	**47.6**	**62.5**	**73.2**	**82.5**	**69.1**	**79.9**	**97.0**

(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 the two companies are estimated using aggregate historical time-series and therefore do not correspond to the sum of the individual values in the column.

During the first nine months of 2013, market risks generated by Intesa Sanpaolo and Banca IMI decreased significantly with respect to the values for 2012.

(millions of euro)

	2013			2012		
	average 30.09	minimum 30.09	maximum 30.09	average 30.09	minimum 30.09	maximum 30.09
Intesa Sanpaolo	11.3	6.4	18.1	22.8	17.0	27.5
Banca IMI	49.6	31.1	74.2	59.2	41.7	92.1
Total	**61.0**	**37.8**	**88.5**	**82.0**	**63.5**	**115.4**

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

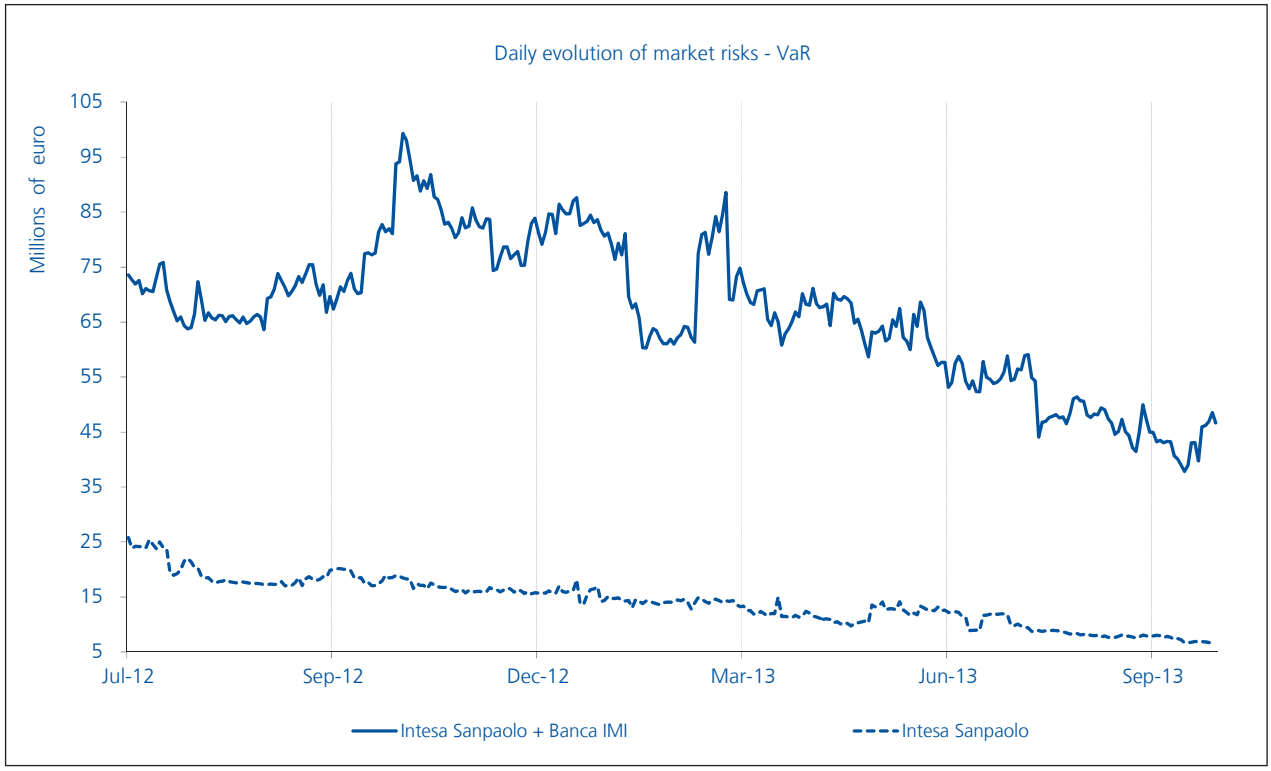
For Intesa Sanpaolo, the breakdown of risk profile in the third quarter of 2013 with regard to the various factors shows the prevalence of the hedge fund risk, which accounted for 35% of total VaR; for Banca IMI, credit spread risk was the most significant, representing 61% of total VaR.

Contribution of risk factors to total VaR[(a)]

3rd quarter 2013	Shares	Hedge funds	Rates	Credit spreads	Foreign exchange rates	Other parameters	Commodities
Intesa Sanpaolo	11%	35%	12%	35%	6%	1%	0%
Banca IMI	14%	0%	11%	61%	1%	9%	4%
Total	**15%**	**9%**	**12%**	**51%**	**3%**	**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 third quarter of 2013, 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. The downtrend in risks persists in the third quarter of 2013 due to the rolling effect of scenarios used to calculate the historical simulation and risk reduction for Italy. In September Banca IMI contributed to the slight increase in risks.



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 bullish scenario, that is a 5% increase in stock prices with a simultaneous 10% decrease in volatility would have led to a 16 million euro gain; the opposite scenario would have led to a -15 million euro loss;
– on interest rate exposures, a parallel +70 basis point shift (average) would have led to a 97 million euro loss, whereas a parallel shift in the euro curve with near zero rates would have led to potential gains of 124 million euro;
– on exposures sensitive to credit spread fluctuations, a 25 basis point widening in spreads would have led to a 94 million euro loss, approximately 3 million euro of which due to structured credit products (SCPs), whereas a 25 basis point tightening of the spreads would have led to a 95 million euro gain;
– on foreign exchange exposures, the portfolio would have recorded a 1 million euro loss if the Euro were to appreciate against the US dollar;
– lastly, on commodity exposures a 1 million euro loss would have been recorded in the event of a 50% increase in prices.

(millions of euro)

	EQUITY		INTEREST RATES		CREDIT SPREADS		FOREIGN EXCHANGE RATES		COMMODITY	
	volatility +10% and prices -5%	volatility -10% and prices +5%	+70bp	lower rate	-25bp	+25bp	-10%	+10%	-50%	+50%
Total	-15	16	-97	124	95	-94	6	-1	4	-1
of which SCP					*3*	*-3*				

Backtesting

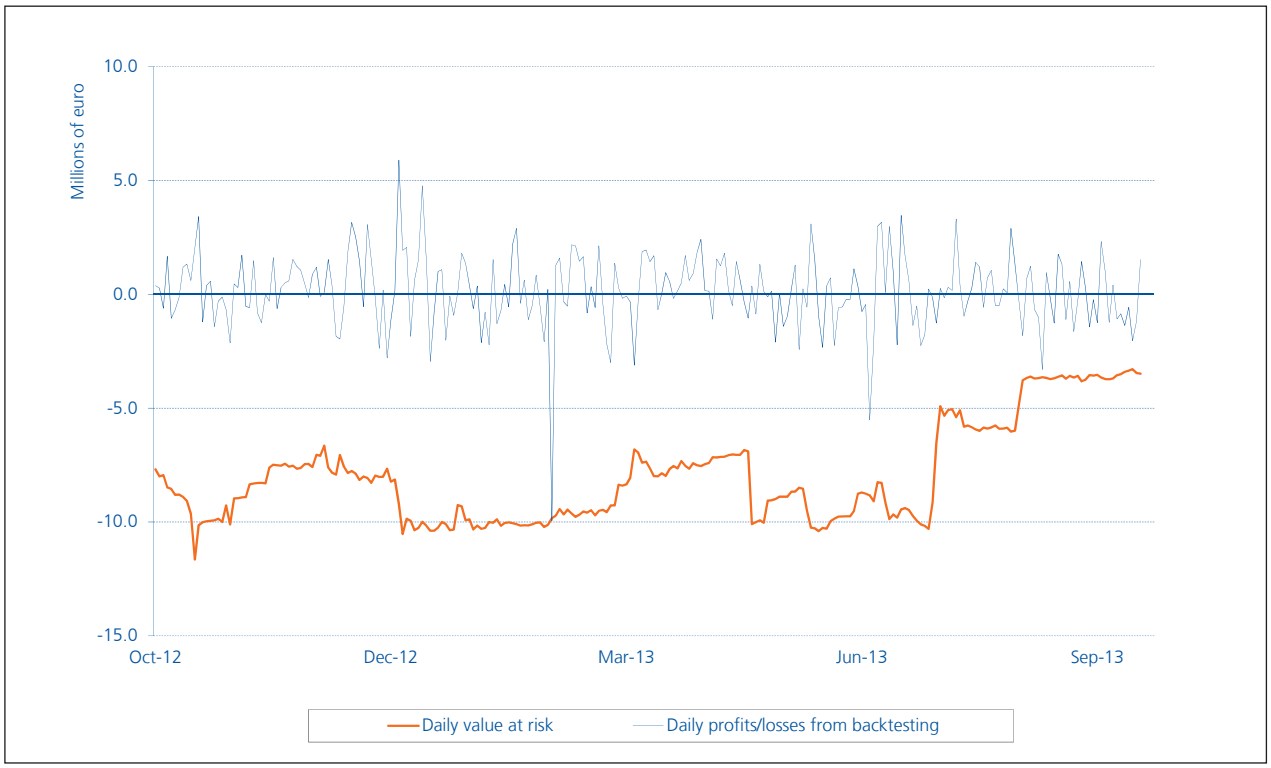
The effectiveness of the VaR calculation methods must be monitored daily via backtesting which, as concerns regulatory backtesting, compares:

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

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

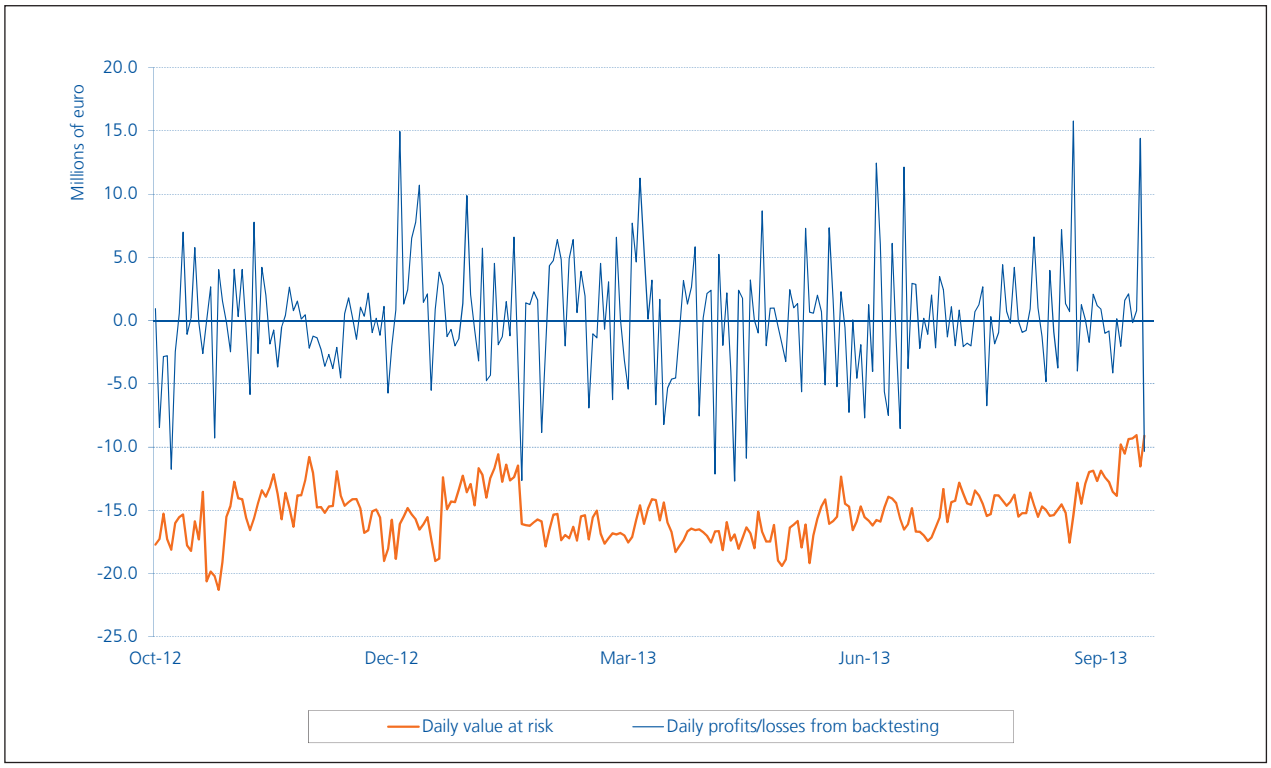
Backtesting in Intesa Sanpaolo

Over the last year, the sole backtesting exception for Intesa Sanpaolo related to events in the Italian sovereign debt crisis.



Backtesting in Banca IMI

Banca IMI's recent backtesting exception refers to the theoretical P&L figure and can be attributed to the fluctuations in financial sector spreads.



BANKING BOOK

Market risk originated by the banking book arises primarily in the Parent Company and in the other main Group companies involved in retail and corporate banking. The banking book also includes exposure to market risks deriving from the equity investments in 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. An update to the methodology aimed at sterilizing the credit spread impact, significantly increased during the recent financial crisis, was introduced from January 2013.
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 both variable rate funding, to the extent that the latter finances fixed-rate investments, and on variable rate investments to cover fixed-rate funding (macro cash flow hedges).
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 2013, interest rate risk generated by the Intesa Sanpaolo Group's banking book, measured through shift sensitivity analysis, registered an average value of 71 million euro settling at 102 million euro at the end of September, almost entirely concentrated on the euro currency; this figure compares with 386 million euro (17 million euro net of the aforementioned methodology updates) at the end of 2012.
Interest margin sensitivity – assuming a 100 basis point change in interest rates – amounted to 364 million euro at the end of September 2013 (270 million euro at the end of 2012).
Interest rate risk, measured in terms of VaR, averaged 39 million euro during the first nine months of 2013 (17 million euro at the end of 2012, net of the aforementioned methodology updates), with a minimum value of 27 million euro and a maximum value of 56 million euro. At the end of September 2013 VaR totalled 42 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 74 million euro in the first nine months of 2013 (81 million euro at the end of 2012), with a maximum value of 80 million euro and a minimum value of 65 million euro, confirmed in the final figures 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 47 million euro at the end of September 2013.

LIQUIDITY RISK

Liquidity risk is defined as the risk that the Bank may not be able to meet its payment obligations due to the inability to obtain funds on the market (funding liquidity risk) or liquidate its assets (market liquidity risk).
The arrangement of a suitable control and management system for that specific risk has a fundamental role in maintaining stability, not only at the level of each individual bank, but also of the market as a whole, given that imbalances within a single financial institution may have systemic repercussions. Such a system must be integrated into the overall risk management system and provide for incisive controls consistent with developments in the context of reference.
The "Guidelines for Group Liquidity Risk Management" approved by Intesa Sanpaolo's corporate bodies illustrate the tasks of the various corporate functions, the rules and the set of control and management processes aimed at ensuring prudent monitoring of liquidity risk, thereby preventing the emergence of crisis situations. The key principles underpinning the Liquidity Policy of the Intesa Sanpaolo Group are:
– the existence of liquidity management guidelines approved by senior management and clearly disseminated throughout the Group;
– the existence of an operating structure that works within set limits and of a control structure that is independent from the operating structure;
– the constant availability of an adequate amount of liquidity reserves in relation to the pre-determined liquidity risk tolerance threshold;

- the assessment of the impact of various scenarios, including stress testing scenarios, on the cash inflows and outflows over time and the quantitative and qualitative adequacy of liquidity reserves;
- the adoption of an internal fund transfer pricing system that accurately incorporates the cost/benefit of liquidity, on the basis of the Intesa Sanpaolo Group's funding conditions.

From an organisational standpoint, a detailed definition is prepared of the tasks assigned to the strategic and management supervision bodies and reports are presented to the senior management concerning certain important formalities such as the approval of measurement methods, the definition of the main assumptions underlying stress scenarios and the composition of warning indicators used to activate emergency plans.
The departments of the Parent Company that are in charge of ensuring the correct application of the Guidelines are, in particular, the Treasury Department, responsible for liquidity management, and the Risk Management Department, directly responsible for measuring liquidity risk on a consolidated basis.

With regard to liquidity risk measurement metrics and mitigation tools, in addition to defining the methodological system for measuring short-term and structural liquidity indicators, the Group also formalises the maximum tolerance threshold (risk appetite) for liquidity risk, the criteria for defining liquidity reserves and the rules and parameters for conducting stress tests.
The short-term Liquidity Policy is aimed at ensuring an adequate, balanced level of cash inflows and outflows with certain or estimated maturities included in 12 months' time horizon, in order to respond to periods of tension, including extended periods of tension, on different funding markets, also by establishing adequate liquidity reserves in the form of assets eligible for refinancing with Central Banks or liquid securities on private markets. To that end, and in keeping with the liquidity risk appetite, the system of limits consists of two short-term indicators for holding periods of one week (cumulative projected imbalance in wholesale operations) and of one month (Short Term Gap).
The cumulative projected wholesale imbalances indicator measures the Bank's independence from unsecured wholesale funding in the event of a freeze of the money market and aims to ensure financial autonomy, assuming the use on the market of only the highest quality liquidity reserves. The short-term gap indicator measures, for the various short-term time brackets, the ratio between availability of liquidity reserves and expected positive cash flows to expected and potential cash outflows, with reference to both on- and off-balance sheet captions. This indicator aims to ensure that the Bank maintains an adequate level of unencumbered liquidity reserves that may be converted into cash to meet expected and potential liquidity requirements. To that end, the behavioural coefficients and assumptions underlying the valuation of expected and potential cash flows incorporate cautionary and extremely prudential assumptions (such as: (i) the loss of a portion of customer demand deposits, (ii) unforeseen uses of undrawn committed credit and liquidity lines and (iii) an increase in market volatility for determining haircuts on liquidity reserves and estimating the potential future exposure associated with derivatives positions) effectively constituting an especially severe "base prudential scenario," with the adoption of run-off percentages for demand deposits more conservative than those identified by Basel 3 (LCR).

The aim of Intesa Sanpaolo Group's structural Liquidity Policy is to control and manage the risks deriving from the mismatch of the medium to long-term maturities of the assets and liabilities and involves the adoption of internal limits on maturities' transformations aimed at preventing the medium to long-term operations from giving rise to excessive imbalances to be financed in the short term.
The Guidelines also call for the periodic estimate of the liquidity position in an acute combined stress scenario (both firm specific and market related), with the definition of a target threshold for the 3-month stressed short-term gap, aiming at establishing an overall level of reserves suitable to face greater cash outflows during a period of time (3 months) adequate to take the required operating measures to restore the Group to balanced conditions. The acute stress scenario is determined by combining:

- a "firm-specific" stress scenario, relating to a liquidity crisis specific to the Bank, reflected in an accelerated withdrawal of funds by deposit-holders, a significant reduction in the realised value of assets due to the need for immediate liquidation of assets not eligible for refinancing through repurchase agreements, the activation of downgrade triggers and the need to repurchase own debt securities or honour extra-contractual obligations in order to attenuate reputational risk;
- a "market-related" stress scenario, representing a general market crisis extending to both the financial and industrial sectors, characterised by, for example: (i) failure to repay granted facilities to corporate customers; (ii) a sudden increase in uses of lines of credit and guarantees; and (iii) a significant increase in market volatility, with negative effects on the value of reserves or potential future exposure associated with positions in derivatives, resulting in larger haircuts and the need for additional guarantees.

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

In the first nine months of 2013, the Group's liquidity position remained within the risk limits provided for in the Group's Liquidity Policy both in terms of short-term and structural liquidity indicators.
The regulatory indicators envisaged by Basel 3 have also already been satisfied (LCR and NSFR > 100%), and have further improved following the regulatory revision of early January 2013. Adequate, timely information regarding the development of market conditions and the position of the Bank and/or Group was provided to company bodies and internal committees in order to ensure full awareness and manageability of the prevalent risk factors.
As at 30 September 2013, the Central Banks eligible liquidity reserves came to 124 billion euro (115 billion euro at the end of December 2012), of which 92 billion euro, net of haircut, was unencumbered (67 billion euro at the end of December 2012).

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.

FAIR VALUE MEASUREMENT OF FINANCIAL ASSETS AND LIABILITIES

General principles

This chapter summarises the criteria used by the Group to measure the fair value of financial instruments. As already illustrated in the criteria for the preparation of this Report, the application of IFRS 13 governing fair value measurement and related disclosure became mandatory from 1 January 2013.
The fair value is the price receivable for the sale of an asset or which would be paid to transfer a liability in a normal transaction between market operators (i.e. not as part of the compulsory liquidation or a below-cost sale) as at the measurement date. Fair value is a market measurement criterion that is not entity-specific.
An entity has to measure the fair value of an asset or liability by adopting the assumptions that would be used by market operators to determine the price of an asset or liability, presuming that the market operators act with a view to satisfying their own economic interest in the best way possible.

In determining the fair value of a financial instrument, IFRS 13 establishes a hierarchy of criteria based on the origin, type and quality of the information used in the calculation. The aim of this classification is to establish a hierarchy in terms of reliability of the fair value based on the level of discretion applied by companies, giving precedence to the use of market-observable parameters that reflect the assumptions that market operators would make in pricing the asset or liability. The hierarchy also aims to increase coherence and comparability in fair value measurements.
Three different levels of input are identified:

- Level 1: input represented by quoted prices (unadjusted) in active markets for identical assets or liabilities accessible by the entity as at the measurement date;
- Level 2: input other than quoted prices included in Level 1 that are directly or indirectly observable for the assets or liabilities to be measured;
- Level 3: input unobservable for the asset or liability.

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 the 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 (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 (level 3).
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:

- 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;
- 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;
- 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 series of adjustments adopted for the purpose of considering, in addition to model risk as described above, also other factors eligible to influence the valuation and essentially attributable to:

- high and/or complex risk profile;
- position illiquidity determined by temporary or structural market conditions;
- valuation difficulties due to the lack of liquid and observable market parameters.

For additional details on the Fair Value Policy and the fair value measurement criteria see the disclosure provided in the 2012 Annual Report and in the Half-yearly Report as at 30 June 2013.

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	30.09.2013			31.12.2012		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
1. Financial assets held for trading	17,811	34,996	530	12,143	50,579	824
2. Financial assets designated at fair value through profit or loss	33,818	3,344	474	31,944	4,537	406
3. Financial assets available for sale	95,733	4,664	2,572	89,445	5,264	2,500
4. Hedging derivatives	-	8,140	1	-	11,649	2
Total	**147,362**	**51,144**	**3,577**	**133,532**	**72,029**	**3,732**
1. Financial liabilities held for trading	5,519	34,632	366	5,335	46,200	660
2. Financial liabilities designated at fair value through profit or loss	-	30,027	-	-	27,047	-
3. Hedging derivatives	-	8,441	13	-	10,757	19
Total	**5,519**	**73,100**	**379**	**5,335**	**84,004**	**679**

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

As shown in the table, level 3 instruments, which allow for more discretion in fair value measurement, still account for a limited portion of the financial instruments portfolio, with percentages stable at approximately 2% for financial assets and down 0.5% (from 0.8% in December 2012) for financial liabilities.
At the level of value, there was a decrease in level 3 financial assets held for trading tied to the quotas of UCI held by the Parent Company. Approximately 73% of financial assets measured at fair value are determined based on market prices, and therefore without any discretion by the valuator.

The sensitivity analysis of complex credit derivatives also shows a 0.1 million euro decrease in fair value [3] 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).

[3] 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

The first nine months of 2013 saw a decline in the portfolio on risk positions classified as part of the loan portfolio. As regards the trading book, the increase in exposure during the reporting period is largely attributable to the purchase of ABSs by the subsidiary Banca IMI.
In the same period a positive contribution to profit of 76 million euro was recorded, of which 26 million euro from realised profits and 50 million euro from revaluation. This figure remained unchanged on the first nine months of last year, compared to 96 million euro as at 31 December 2012.

The risk exposure to structured credit products amounted to 2,022 million euro as at 30 September 2013 with respect to funded and unfunded ABSs/CDOs, compared to 2,247 million euro as at 31 December 2012, in addition to an exposure of 23 million euro with respect to structured packages (this position was 3 million euro as at 31 December 2012). The reduction in the exposure during the first nine months of 2013 was, in relation to financial assets held for trading, associated with the termination of two CDO funded structures included within the "Contagion Area" with a TruPS risk exposure of 54 million euro and of two unfunded Super Senior CDO positions recorded under "Other structured credit products" for 83 million euro. These decreases, however, were largely offset by the increase in risk exposure in European/US ABS/CDOs held by Banca IMI. With regard to the exposure in securities classified under the loan portfolio, on the other hand, a significant decrease was recorded, almost all of which attributable to the Parent Company loan portfolio and for the most part due to disposals.
Lastly, with regard to exposure in packages, the figure of 23 million euro recorded as at 30 September 2013 was entirely due to a substantial improvement in the creditworthiness of the counterparty which led to a positive fair value of the credit derivative.

In the summary tables provided below, table (a) sets out risk exposure and income statement captions (sum of realised charges and profits, write-downs and write-backs) as at 30 September 2013, compared with the corresponding values recorded as at 31 December 2012.
Table (b) sets out figures related to structured packages, normally made up of an asset (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 asset hedged.
Values expressed in USD as at 31 December 2012 were translated to euro at an exchange rate of 1.3194 euro per dollar, and as at 30 September 2013 at an exchange rate of 1.3505 euro per dollar.

Structured credit products: summary tables

a) Exposure in funded and unfunded ABSs/CDOs

(millions of euro)

Financial assets held for trading	**30.09.2013**		**31.12.2012**	
	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	**10**	**-1**	**9**	**-3**
Contagion area	**-16**	**6**	**33**	**65**
- Multisector CDOs[(1)]	-16	6	-21	18
- Alt-A	-	-	-	-
- TruPS	-	-	54	47
- Prime CMOs	-	-	-	-
Other structured credit products	**924**	**34**	**844**	**44**
- European/US ABS/CDOs	879	14	716	31
- Unfunded super senior CDOs	45	20	128	16
- Other unfunded positions	-	-	-	-3
Total	**918**	**39**	**886**	**106**
in addition to:				
Positions of funds		-		11
Total Financial assets held for trading	**918**	**39**	**886**	**117**

(millions of euro)

Loans	30.09.2013		31.12.2012	
	Risk exposure (**) (including write-downs and write-backs)	**Income Statement**	**Risk exposure** (**) (including write-downs and write-backs)	**Income Statement**
US subprime exposure	**2**	**-**	**3**	**-**
Contagion area	**31**	**3**	**43**	**1**
- Multisector CDOs	2	3	8	1
- Alt-A	20	-	23	-
- TruPS	-	-	-	-
- Prime CMOs	9	-	12	-
Other structured credit products	**1,071**	**-3**	**1,315**	**-1**
- Funded European/US ABS/CDOs	880	-7	1,017	-8
- Funded super senior CDOs	191	4	298	7
- Other Romulus funded securities	-	-	-	-
Total	**1,104**	**-**	**1,361**	**-**
in addition to:				
Positions of funds		-		
Total Loans	**1,104**	**-**	**1,361**	**-**
TOTAL	**2,022**	**39**	**2,247**	**117**

(*) 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 its fair value at the reclassification date, plus accrued interest calculated at the effective interest rate net of net value adjustments to the portfolio.

(1) The short position of the Multisector CDO segment was generated as a result of the closing of almost all the risk positions which had been included from the beginning, and the maintenance of derivatives on indices for the operational hedging of said positions. More specifically, these comprise 11 million euro in risk exposure hedged by 27 million euro in "short" operational positions.

b) Exposure in packages

(millions of euro)

	30.09.2013		31.12.2012	
	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	23	37	-	-21
Non monoline packages	-	-	3	-
TOTAL	**23**	**37**	**3**	**-21**

From an income statement perspective, structured credit products generated a net income of +76 million euro as at 30 September 2013 compared to +96 million euro for 2012.
The exposure in funded and unfunded ABSs/CDOs had an effect on "Profits (Losses) on trading – Caption 80" of 39 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" for +20 million euro, of which 18 million euro deriving from termination of the two structures mentioned previously and 2 million euro from revaluation of positions outstanding;
– European and US funded ABSs/CDOs (+14 million euro), entirely attributable to the subsidiary Banca IMI and including -3 million euro attributable to losses realised on the partial disposal of the trading book and +17 million from revaluation of positions outstanding;
– instruments included in the "Contagion Area" (+6 million euro) and particularly in the Multisector CDO segment;
– the contribution of the subprime exposure for -1 million euro.

The securities reclassified to the loan portfolio had an impact on the income statement of zero as at 30 September 2013. However, this result is the combination of the 12 million euro in profits realised on the sale of positions and 12 million in impairment losses on securities included in the portfolio.

The "Monoline risk" and "Non-monoline packages" made a positive contribution of 37 million euro to "Profits (Losses) on trading – caption 80" as at 30 September 2013, up strongly on the -21 million euro recorded at the end of 2012. The segment trend reflects the spread volatility for the counterparty on which this exposure is concentrated.

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 2013, bonds had been reclassified as loans in the amount of 890 million euro, compared to a fair value of 724 million euro. The corresponding benefit due to reclassification as at 30 September 2013 was 116 million euro (of which the effect on the income statement for the first nine months of 2013 came to 31 million euro), whereas the effect on equity that would have occurred had the securities not been transferred was 50 million euro.

In addition to the structured credits identified during the subprime crisis, the Group continues to invest in this type of security as part of its normal customer lending operations. In particular, securities were recorded in the loan portfolio of the conduit Duomo for a nominal value of 1,048 million euro, with underlyings originated in recent years, but not impacted by the 2007 crisis. As at 30 September 2013, there were no signs of impairment of the collateral of the structured products in question.

INFORMATION ON ACTIVITIES PERFORMED THROUGH SPECIAL PURPOSE ENTITIES (SPEs)

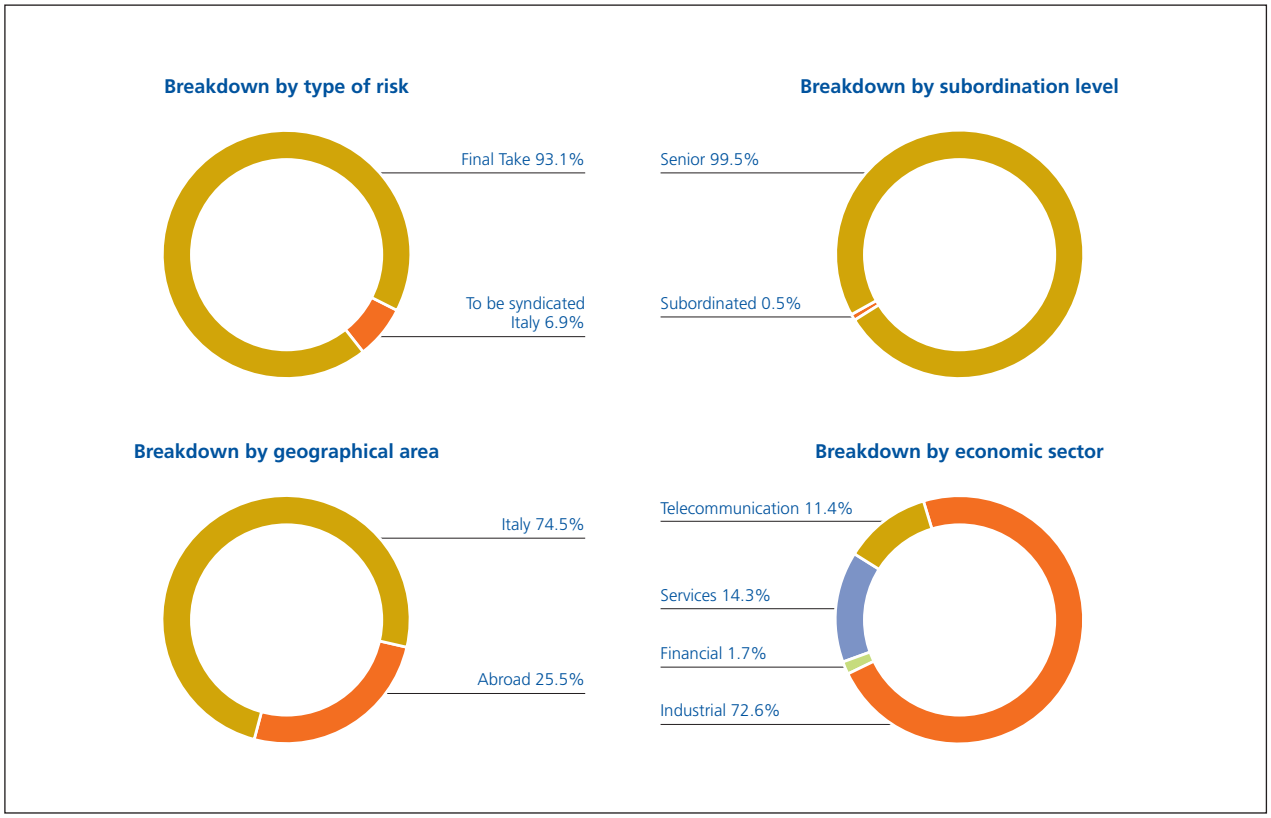
For the purpose of this analysis, legal entities established to pursue a specific, clearly defined and limited objective are considered Special Purpose Entities (raising funds on the market, acquiring/selling/managing assets both for asset securitisations, acquisition of funding through self-securitisations and the issue of covered bonds (CBs), 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 2012 financial statements.

For information concerning the categories of SPEs subject to disclosure, reference should be made to the 2012 Financial Statements and the Half-yearly Report as at 30 June 2013.
The only significant changes were in the Securitisation SPE segment. In particular:

– in July 2013 the vehicles Intesa Sec 2 S.r.l. and Adriano Finance S.r.l. were merged by incorporation into Intesa Sanpaolo;
– with regard to covered bond issues, during the third quarter of 2013 covered bonds (CBs) were issued under the programme secured by ISP CB Ipotecario backed by mortgage loans. The issue has a nominal value of 750 million euro, a 2.25% rate and a 5-year maturity. The bonds were placed with institutional investors. The bonds are listed on the Luxembourg Stock Exchange and rated A2 by Moody's.

LEVERAGED FINANCE TRANSACTIONS

Since there is no univocal and universally agreed-upon definition of leveraged finance transactions, Intesa Sanpaolo decided to include in this category the exposures (loans granted and disbursed in relation to structured financing operations, normally medium/long term) to legal entities in which the majority of share capital is held by private equity funds.
These are mainly positions in support of Leveraged Buy Out projects (therefore with high financial leverage), i.e. linked to the full or partial acquisition of companies through recourse to SPEs created for this purpose. After acquisition of the target company's shares/quotas package, these SPEs are normally merged into the target. The target companies generally have good economic prospects, stable cash flows in the medium term and low original leverage levels. Intesa Sanpaolo has financed entities of this type, as normal borrowers, without acting as sponsor.
None of these SPEs is consolidated, since the guarantees to support the transaction are solely instrumental for the granting of the financing and are never directed to the acquisition of direct or indirect control over the vehicle.
As at 30 September 2013, 128 transactions for a total amount granted of 3,420 million euro met the above definition.
These exposures are classified under the loans portfolio. They also include the portions of syndicated loans underwritten or under syndication. In line with disclosure requirements, breakdown of exposures by geographical area, economic sector and by level of subordination is set out below.



INFORMATION ON INVESTMENTS IN HEDGE FUNDS

The hedge fund portfolio as at 30 September 2013 totalled 704 million euro, compared to the 696 million euro recorded at the end of 2012. The slight decrease in the exposure reflects the combined effect of the net capital gains on positions outstanding at the end of the period and appreciation of the euro/dollar exchange rate.
As at the same date, there was an overall profit of 35 million euro, down slightly compared to the end of 2012 (53 million euro) and 30 September 2012 (43 million euro).

INFORMATION ON TRADING TRANSACTIONS IN DERIVATIVES WITH CUSTOMERS

Considering only relations with customers, as at 30 September 2013, the Intesa Sanpaolo Group, in relation to derivatives trading with retail customers, non-financial companies and public entities (therefore excluding banks, financial and insurance companies), presented a positive fair value, not having applied netting agreements, of 5,946 million euro (7,314 million euro as at 31 December 2012). The notional value of such derivatives totalled 56,292 million euro (55,865 million euro as at 31 December 2012). Please note that the positive fair value of structured contracts outstanding with the 10 customers with the highest exposures was 3,865 million euro (4,563 million euro as at 31 December 2012).
Conversely, negative fair value determined with the same criteria, for the same types of contracts and with the same counterparties, totalled 623 million euro as at 30 September 2013 (1,054 million euro as at 31 December 2012). The notional value of such derivatives totalled 18,817 million euro (15,701 million euro as at 31 December 2012).
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 2013, this led to a positive effect of 24 million euro being recorded under "Profits (losses) on trading" in the income statement.
As regards the means of calculation of the aforesaid Bilateral Credit Risk Adjustment and, in general, the various methodologies used in the determination of the fair value of financial instruments, see the specific paragraphs in this chapter.

OPERATIONAL RISK

Operational risk is defined as the risk of loss due to the inadequacy or failure of procedures, human resources and internal systems, or from external events. Operational risk includes legal risk, that is, the risk of losses deriving from non compliance or breach in law or regulations, in contractual, out-of-contract responsibilities from other liabilities; strategic and reputational risks are not included.
The Intesa Sanpaolo Group has for some time defined the overall operational risk management framework by setting up a Group policy and organisational processes for measuring, managing and controlling operational risk.
With regard to Operational Risk, the Group has adopted the Advanced Measurement Approaches (AMA – internal model) to determine the associated capital requirement for regulatory purposes:

- effective from 31 December 2009, for an initial set including the Organisational Units, 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 from 31 December 2010, for a second set of companies within the Corporate and Investment Banking Division, in addition to Setefi, the remaining banks of the Cassa di Risparmio di Firenze Group and PBZ Banka;
- effective from 31 December 2011, for a third set including Banca Infrastrutture Innovazione e Sviluppo. The full demerger of the Bank in favour of the Parent Company Intesa Sanpaolo and Leasint was completed in December 2012;
- effective from 30 June 2013, for a fourth scope including several companies of the Banca Fideuram group (Banca Fideuram, Fideuram Investimenti, Fideuram Gestions, Fideuram Asset Management Ireland and Sanpaolo Invest) and two international subsidiaries of VUB Banka (VUB Leasing and Consumer Finance Holding).

The remaining companies, currently using the Standardised approach (TSA), will migrate progressively to the Advanced Measurement Approaches starting from the end of 2014, based on the roll-out plan presented to the Management and Supervisory Authorities.

The control of the Group's operational risks 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 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 management of the Group's operational risk. This function is responsible for the definition, implementation, and monitoring of the methodological and organisational framework, as well as for the measurement of the risk profile, the verification of mitigation effectiveness and reporting to Top Management.
In compliance with current requirements, the individual Organisational Units are responsible for identifying, assessing, managing and mitigating risks. Specific officers and departments have been identified within these business units to be responsible for Operational Risk Management (structured collection of information relative to operational events, scenario analyses and evaluation of the business environment and internal control factors).

The Integrated self-assessment process, conducted on an annual basis, allows the Group to:

- identify, measure, monitor and mitigate operational risk through identification of the main operational problem issues and definition of the most appropriate mitigation actions;
- create significant synergies with the specialised functions of the Human Resources and Organisation Department that supervise the planning of operational processes and business continuity issues and with control functions (Compliance and Internal Auditing) that supervise specific regulations and issues (Legislative Decree 231/01, Law 262/05) or conduct tests of the effectiveness of controls of company processes.

The Self-assessment process identified a good overall level of control of operational risks and contributed to enhancing the diffusion of a business culture focused on the ongoing control of these risks.
The process of collecting data on operational events (in particular operational losses, obtained from both internal and external sources) provides significant information on the exposure. It also contributes to building knowledge and understanding of the exposure to operational risk, on the one hand, and assessing the effectiveness or potential weaknesses of the internal control system, on the other hand.
The internal model for calculating capital absorption is conceived in such a way as to combine all the main sources of quantitative (operational losses) and qualitative 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 (by 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 severe operational events.
Capital-at-risk is therefore identified as the minimum amount at Group level required to bear the maximum potential loss (worst case); Capital-at-risk is estimated using a Loss Distribution Approach model (actuarial statistical model to calculate the Value-at-risk of operational losses), applied on quantitative data and the results of the scenario analysis assuming a one-year estimation period, with a confidence level of 99.90%; the methodology also applies a corrective factor, which derives from the qualitative analyses of the risk level of the business environment, to take account of the effectiveness of internal controls in the various organizational units.

Operational risks are monitored by an integrated reporting system, which provides Management with support information 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 this process.

In addition the Group 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 third-party liability), which contributes to mitigating exposure to operational risk. At the end of June, in order to allow optimum use of the available operational risk transfer tools, pursuant to applicable regulations the Group stipulated an innovative insurance coverage policy (a second layer policy) known as Operational Risk Insurance Programme, which offers additional coverage to traditional (first layer) policies, significantly increasing the limit of liability, effectively transferring the risk of significant operational losses to the insurance market. The internal model's insurance mitigation component was approved by the Bank of Italy in June 2013 with immediate effect of its benefits on operations and on the capital requirements.

To determine its capital requirements, the Group employs a combination of the methods allowed under applicable regulations. The capital absorption resulting from this process amounts to 1,815 million euro as at 30 September 2013, unchanged compared to 30 June 2013.

Legal risks

Legal risks are thoroughly 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 and where the amount of the disbursement may be reliably estimated.
In the third quarter of 2013, no new significant legal procedures were commenced or important developments took place with respect to those underway. Reference should therefore be made to the Notes to the 2012 Financial Statements for a detailed description of litigation regarding anatocism, investment services and other significant proceedings and litigation, and to the information provided in the Half-Yearly Report as at 30 June 2013.

Tax litigation

With regard to pending tax litigation and the related risks and provisions, detailed information is provided in the Notes to the 2012 consolidated financial statements (Part E). Further information regarding developments in the first six months of the year is presented in the Half-yearly Report as at 30 June 2013.
In relation to the third quarter of 2013, September saw the completion of the Milan Guardia di Finanza tax inspection, with the same type of findings as for previous years in reference to capitalisation transactions involving the issue of preference shares through international subsidiaries (LLCs) resident in Delaware (USA) and loans granted abroad in the period 2010 to 2012, also referred to in the Half-Yearly Report 2013.
Furthermore, it is worth mentioning at this point that the Public Prosecutor's Office of Biella investigation into certain repurchase agreement transactions involving foreign bonds undertaken in 2006 and 2007 by Biverbanca (a member of the Intesa Group at the time of the disputed events), which were subject to settlement in December 2011, was concluded in the Bank's favour with issue by the First Instance Judge, based on the confirmatory opinion of the Public Prosecutor, of an order for the proceedings to be discharged due to groundlessness of the offence notification.

INSURANCE RISKS

Life business

The typical risks of the life insurance portfolio may be divided into three main categories: premium risks, actuarial and demographic risks and reserve risks.
Premium risks are managed initially during definition of the technical features and product pricing, and over the life of the instrument by means of periodic checks on sustainability and profitability (both at product level and at portfolio level, including liabilities).
Actuarial and demographic risks by means of systematic statistical analysis of the evolution of liabilities in its own contract portfolio, divided by risk type, and through simulations of expected profitability of the assets hedging technical reserves.
Reserve risk is guarded against 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 Investment Framework Resolution is the main control and monitoring instrument for market and credit risks.
The Resolution defines the goals and the operating limits that are needed to distinguish the investments in terms of eligible assets and asset allocation, breakdown by rating classes and credit risk, concentration risk by issuer and sector, market risks, in turn measured in terms of sensitivity to variations in risk factors and Value at Risk (VaR).

Investment portfolios

The investments of the insurance companies of Intesa Sanpaolo Group (Intesa Sanpaolo Vita, Intesa Sanpaolo Assicura, Intesa Sanpaolo Life, Fideuram Vita and Bentos Assicurazioni) are made with their free capital and to cover contractual obligations with customers. These refer to traditional revaluable life insurance policies, Index- and Unit-linked policies, pension funds and non-life policies.
As at 30 September 2013, the investment portfolios of Group companies, recorded at book value, amounted to 86,792 million euro. Of these, the part of 51,594 million euro relates to traditional revaluable life policies, the financial risk of which is shared with the policyholders by virtue of the mechanism whereby the returns on assets subject to segregated management are determined, non-life policies and free capital. The other component, whose risk is borne solely by the policyholders, consists of investments related to Index-linked policies, Unit-linked policies and pension funds and amounted to 35,198 million euro.

Considering the various types of risks, the analysis of investment portfolios, described below, concentrates on the assets held to cover traditional revaluable life policies, non-life policies and free capital.
In terms of breakdown by asset class, net of derivative financial instruments, 94.1% of assets, i.e. approximately 48,842 million euro, were bonds, whereas assets subject to equity risk represented 1.4% of the total and amounted to 699 million euro. The remainder (2,343 million euro) consisted of investments relating to UCI, Private Equity and Hedge Funds (4.5%).
The carrying value of derivatives came to approximately -290 million euro, almost entirely relating to hedging derivatives, with effective management derivatives[4] only amounting to around -53 million euro.

At the end of the first nine months of 2013, investments made with the free capital of Intesa Sanpaolo Vita and Fideuram Vita amounted to approximately 2,512 million euro at market value, and presented a risk in terms of VaR (99% confidence level, 10-day holding period) of approximately 91 million euro.
The modified duration of the bond portfolio, or the synthetic financial term of assets, is approximately 5.3 years. The reserves relating to the revaluable contracts under Separate Management have an average modified duration of approximately 5.7 years. The related portfolios of assets have a modified duration of around 4.4 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 2,455 million euro. On the basis of this hypothetical scenario, the value of hedging derivatives in the portfolio undergoes an approximate 111 million euro rise which partly offsets the corresponding loss on the bonds.
The distribution of the portfolio by rating class is as follows. AAA/AA bonds represented approximately 5.0% of total investments and A bonds approximately 4.5%. Low investment grade securities (BBB) were approximately 82.2% of the total and the portion of speculative grade or unrated was minimal (approximately 2.4%).
A considerable portion of the BBB area is made up of securities issued by the Republic of Italy.
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 73.5% of the total investments, while financial companies (mostly banks) contributed almost 16.2% of exposure and industrial securities made up approximately 4.4%.

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

At the end of the third quarter of 2013, 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 2,596 million euro, with 2,185 million euro due to government issuers and 411 million euro to corporate issuers (financial institutions and industrial companies).