Risk management

BASIC PRINCIPLES

The Intesa Sanpaolo Group's risk acceptance policies are defined by the Board of Directors and the Management Control Committee, with management and control functions respectively. The Board of Directors carries out its activity through specific internal committees, among which mention should be made of the Risk Committee. The Corporate Bodies are assisted by the action of managerial committees, among which mention should be made of the Group Risk Governance Committee, as well as the support of the Chief Risk Officer, reporting directly to the Chief Executive Officer. The Chief Risk Officer is responsible for proposing the Risk Appetite Framework, setting the Group's risk management guidelines and policies in accordance with company strategies and objectives and coordinating and verifying the implementation of those guidelines and policies by the responsible units of the Group, including within the various corporate departments. The Chief Risk Officer ensures management of the Group's overall risk profile by establishing methods and monitoring exposure to the various types of risk and reporting the situation periodically to the corporate bodies.
The Parent Company is in charge of overall direction, management and control of risks. Group companies that generate credit and/or financial risks are assigned autonomy limits and each has its own control structure. A service agreement governs the risk control activities performed by the Parent Company's functions on behalf of the main subsidiaries. These functions report directly to the subsidiaries' Management Bodies.
The risk measurement and management tools contribute to defining a risk-monitoring framework at Group level, capable of assessing the risks assumed by the Group from a regulatory and economic point of view. The level of absorption of economic capital, defined as the maximum "unexpected" loss that could be borne by the Group over a period of one year, is a key measure for determining the Group's financial structure, risk appetite and for guiding operations, ensuring a balance between risks assumed and shareholder return. It is estimated on the basis of the current situation and also as a forecast, based on the Budget assumptions and projected economic scenario under ordinary and stress conditions. The assessment of capital is included in business reporting and is submitted quarterly to the Group Risk Governance Committee, the Risk Committee and the Board of Directors, as part of the Group's Risks Tableau de Bord. Risk hedging, given the nature, frequency and potential impact of the risk, is based on a constant balance between mitigation/hedging action, control procedures/processes and capital protection measures.

BASEL 3 REGULATIONS AND THE INTERNAL PROJECT

With effect from 1 January 2014, the reforms of the accords by the Basel Committee ("Basel 3") were implemented in the EU legal framework. Their aim is to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, improve risk management and governance, and strengthen banks' transparency and disclosures. In doing so, the Committee maintained the approach based on three Pillars, which was at the basis of the previous capital accord, known as "Basel 2", supplementing and strengthening it to increase the quantity and quality of intermediaries' available capital as well as introducing counter-cyclical regulatory instruments, provisions on liquidity risk management and financial leverage containment.
Therefore, the EU implemented "Basel 3" through two legislative acts:

- Regulation (EU) No. 575/2013 of 26 June 2013 (CRR), which governs the prudential supervision requirements of Pillar 1 and public disclosure requirements (Pillar 3);
- Directive 2013/36/EU of 26 June 2013 (CRD IV), which, among other things, deals with the access to the activity of credit institutions, freedom of establishment, freedom to provide services, supervisory review process, and additional equity reserves.

EU legislation is complemented by the provisions issued by the Bank of Italy and referring to Circular no. 285 of 17 December 2013, which contains the prudential supervision regulations applicable to banks and Italian banking groups. The provisions were reviewed and updated to adjust the internal regulations to include the new elements of the international regulatory framework, with special reference to the new regulatory and institutional structure of banking supervision of the European Union and to the needs detected while supervising banks and other intermediaries.

In order to comply with 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.
Additional information on own funds, which are now calculated according to the Basel 3 rules, and on capital ratios of the Group is provided in the section on balance sheet aggregates: Own funds and capital ratios, and in the document Basel 3 - Pillar 3.

With respect to credit risks, the Group received authorisation to use internal ratings-based approaches effective from the report as at 31 December 2008 on the Corporate portfolio for a scope extending to the Parent Company, network banks in the Banca dei Territori Division and the main Italian product companies.
Progressively, the scope of application has been gradually extended to include the SME Retail and Retail Mortgage portfolios, as well as other Italian and international Group companies, as shown in the following table.

Company	Corporate FIRB	Corporate AIRB LGD	SME Retail IRB LGD	Mortgage IRB LGD
Intesa Sanpaolo Banco di Napoli Cassa di Risparmio del Veneto Cassa di Risparmio in Bologna Cassa di Risparmio del Friuli Venezia Giulia Cassa dei Risparmi di Forlì e della Romagna Banca dell'Adriatico	Dec - 2008	Dec - 2010	Dec - 2012	Jun - 2010
Mediocredito Italiano				n.a.
Gruppo Cassa di Risparmio di Firenze	Dec - 2009	Dec - 2010	Dec - 2012	Jun - 2010
Cassa di Risparmio dell'Umbria	n.a.	Dec - 2010	Dec - 2012	Dec - 2011
Banca Prossima	n.a.	Dec - 2013	Dec - 2013	n.a.
Banca IMI	n.a.	Jun - 2012	n.a.	n.a.
Intesa Sanpaolo Bank Ireland	Mar - 2010	Dec - 2011	n.a.	n.a.
Vseobecna Uverova Banka	Dec - 2010	Jun - 2014	Jun - 2014	Jun - 2012

Dedicated rating approaches have been developed for the Banks and Public Entities Portfolio according to the type of counterparty to be assessed. This was the subject of a pre-validation inspection by the Supervisory Authority conducted in December 2013, followed by an additional validation visit in March 2015. In the same month an AIRB authorisation request was presented to the Supervisory Authority for this portfolio.
The Group is also proceeding with development of the IRB systems for the other segments and the extension of the scope of companies for their application in accordance with a plan presented to the Supervisory Authority.

For OTC derivatives, with reference to the Parent Company Intesa Sanpaolo and to Banca IMI, the Bank of Italy granted the authorisation to use the internal counterparty risk model for regulatory purposes, starting from the first quarter of 2014. For the Banks in the Banca dei Territori Division, an application for authorisation to use the internal model for regulatory purposes was submitted to the Supervisory Authority in 2015, while for management purposes, the advanced risk estimate measures were implemented in November 2014.
In 2015 an application for authorisation to use internal models for regulatory purposes was also submitted for Securities Financing Transactions (SFT - Repos and securities lending) products. For management purposes, the advanced risk measurement methods were implemented for SFT in May 2015.

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

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

In 2016, the Intesa Sanpaolo Group is once again involved in an EU-wide stress test conducted by the European Central Bank and the European Banking Authority on the financial statements of the main European banks as at 31 December 2015. As opposed to the previous year, the test will not involve an asset quality review (AQR), but only a simulation of the impact of negative macroeconomic scenarios on capital soundness (Stress Test).

As mentioned, as part of its adoption of Basel 3, the Group publishes information concerning capital adequacy, exposure to risks and the general characteristics of the systems aimed at identifying, monitoring and managing them in a document entitled "Basel 3 - Pillar 3" or simply "Pillar 3".
The document is published on the website (group.intesasanpaolo.com) on a quarterly basis.

CREDIT RISK

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

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

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

Credit quality

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

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

The category of non-performing loans also includes past due positions that cannot be considered mere delays in reimbursements, as established by the Bank of Italy.
Lastly, non-performing exposures also include the individual forborne exposures which comply with the definition of "Non-performing exposures with forbearance measures" envisaged by the EBA ITS (European Banking Authority - Implementing Technical Standards). The latter do not represent a separate category of non-performing assets, rather, they are an attribute of the above categories of non-performing assets.
The management process for such exposures, in close accordance with regulatory provisions concerning classification times and methods, is assisted by automatic mechanisms that ensure pre-established, autonomous and independent management procedures.

(millions of euro)

	31.03.2016			31.12.2015			Changes
	Gross exposure	Total adjustments	Net exposure	Gross exposure	Total adjustments	Net exposure	Net exposure
Bad loans	38,924	-23,801	15,123	39,150	-24,177	14,973	150
Unlikely to pay	22,588	-5,510	17,078	22,725	-5,634	17,091	-13
Past due loans	1,069	-188	881	1,239	-217	1,022	-141
Non-performing loans	**62,581**	**-29,499**	**33,082**	**63,114**	**-30,028**	**33,086**	**-4**
of which forborne	***11,180***	***-3,196***	***7,984***	***10,856***	***-3,151***	***7,705***	***279***
Performing loans	315,986	-1,961	314,025	305,558	-2,018	303,540	10,485
of which forborne	*7,517*	*-218*	*7,299*	*7,917*	*-218*	*7,699*	*-400*
Performing loans represented by securities	14,174	-246	13,928	13,633	-249	13,384	544
of which forborne	*122*	*-2*	*120*	*137*	*-2*	*135*	*-15*
Loans to customers	**392,741**	**-31,706**	**361,035**	**382,305**	**-32,295**	**350,010**	**11,025**

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

As at 31 March 2016, the Group's non-performing loans, net of adjustments, came to 33.1 billion euro, at the same levels of the end of 2015. While non-performing loans declined to 9.2% of total loans to customers, the NPL cash coverage ratio was 47.1%, down compared to 31 December 2015, following the consistent settlements made in the period on the positions with a higher coverage.
In further detail, bad loans came to 15.1 billion euro, net of adjustments, in the first quarter of 2016, up 1% from the beginning of the year, and represented 4.2% of total loans (4.3% at the end of 2015). During the same period, the coverage ratio was 61.1% (61.8% in December 2015). Loans included in the unlikely to pay category amounted to 17.1 billion euro and remained stable, accounting for 4.8% of total loans to customers, with a coverage ratio of 24.4%. Past due loans totalled 881 million euro, down 13.8% compared to the beginning of the year, with a coverage ratio of 17.6%. Forborne exposures are generated by forbearance measures for borrowers experiencing difficulty in meeting their financial obligations, according to the definition introduced by the European Banking Authority with the aim of harmonising the classification of non-performing loans at the European level: within the non-performing loan category, they amounted to 8 billion euro, with an average coverage ratio of 28.6%, whereas those in the performing loan category were slightly lower (7.3 billion euro). The coverage ratio of performing loans was 0.6% (0.7% net of loans represented by repurchase agreements).

MARKET RISKS

TRADING BOOK

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

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

Other Group subsidiaries hold smaller trading portfolios with a marginal risk (approximately less than 4% of the Group's overall risk). In particular, the risk factors of the international subsidiaries' trading books are local government bonds, positions in interest rates, and foreign exchange rates relating to linear pay-offs.
For some of the risk factors indicated above, the Supervisory Authority has validated the internal models for the reporting of the capital absorptions of both Intesa Sanpaolo and Banca IMI.
Effective from the report as at 30 September 2012, both banks have received authorisation from the Supervisory Authority to extend the scope of the model to specific risk on debt securities. The model was extended on the basis of the current methodological framework (a historical simulation in full evaluation), and required the integration of the Incremental Risk Charge into the calculation of the capital requirement for market risks.

Effective from June 2014, market risks are to be reported according to the internal model for capital requirements for the Parent Company's hedge fund portfolios (the full look-through approach).
The risk profiles validated are: (i) generic/specific on debt securities and on equities for Intesa Sanpaolo and Banca IMI, (ii) position risk on quotas of UCI underlying CPPI (Constant Proportion Portfolio Insurance) products for Banca IMI, (iii) position risk on dividend derivatives and (iv) position risk on commodities for Banca IMI, the only legal entity in the Group authorised to hold open positions in commodities.

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

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

In keeping with the historical simulation approach employed to calculate VaR, the latter point is a discriminating condition in the selection of the holding period. In fact, in order to ensure that the scenario adopted is effectively consistent and to avoid the use of driver or comparable factors, the historical period must ensure the effective availability of market data.
As at the date of preparation of this document, the period relevant to the measurement of stressed VaR had been set as 1 January to 31 December 2011 for Intesa Sanpaolo and as1 July 2011 to 30 June 2012 for Banca IMI.

The analysis of market risk profiles relative to the trading book uses various quantitative indicators and VaR is the most important. Since VaR is a synthetic indicator which does not fully identify all types of potential loss, risk management has been enriched with other measures, in particular simulation measures for the quantification of risks from illiquid parameters (dividends, correlation, ABS, hedge funds).
VaR estimates are calculated daily based on simulations of historical time-series, with a 99% confidence level and 1-day holding period.
The following paragraphs provide the estimates and evolution of VaR, defined as the sum of VaR and of the simulation on illiquid parameters, for the trading book of Intesa Sanpaolo and Banca IMI.

During the first quarter of 2016, the market risks generated by Intesa Sanpaolo and Banca IMI increased compared to the average values of the fourth quarter of 2015. The average VaR for the period totalled 105 million euro compared to 77 million euro of March 2015.

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

(millions of euro)

	2016 average 1st quarter	2016 minimum 1st quarter	2016 maximum 1st quarter	2015 average 4th quarter	2015 average 3rd quarter	2015 average 2nd quarter	2015 average 1st quarter
Intesa Sanpaolo	14.9	12.3	17.5	13.2	11.6	13.8	12.1
Banca IMI	90.0	64.8	115.0	85.0	104.7	71.1	64.6
Total	**104.9**	**78.4**	**132.4**	**98.3**	**116.3**	**84.9**	**76.7**

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

(millions of euro)

	2016 average 1st quarter	2016 minimum 1st quarter	2016 maximum 1st quarter	2015 average 1st quarter	2015 minimum 1st quarter	2015 maximum 1st quarter
Intesa Sanpaolo	14.9	12.3	17.5	12.1	6.0	18.5
Banca IMI	90.0	64.8	115.0	64.6	54.0	84.8
Total	**104.9**	**78.4**	**132.4**	**76.7**	**64.6**	**96.6**

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

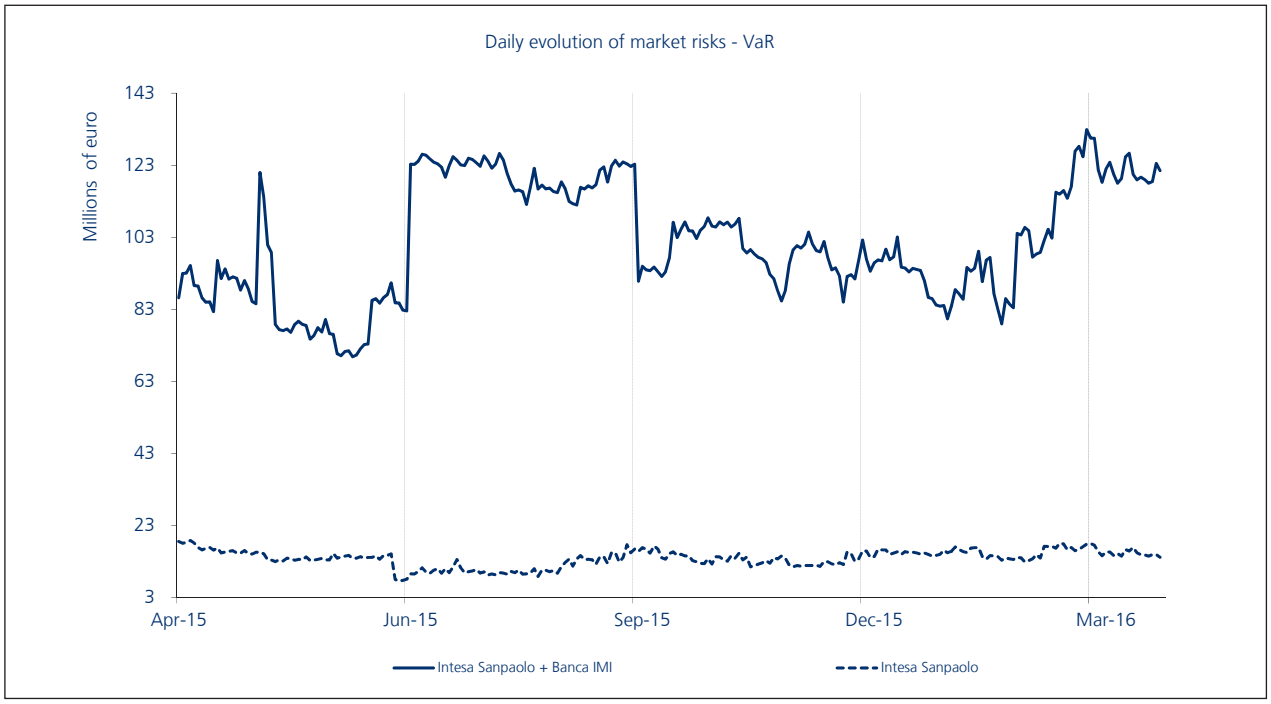
For Intesa Sanpaolo the breakdown of risk profile in the first quarter of 2016, with regard to the various factors, shows the prevalence of the risk generated by foreign exchange, which accounted for 29% of total VaR (primarily linked to hedge positions of banking book entries, excluding which, the component relating to equity risk is the main one); for Banca IMI, credit spread risk was the most significant, representing 74% of total VaR.

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

1st quarter 2016	Shares	Hedge funds	Interest rates	Credit spreads	Foreign exchange rates	Other parameters	Commodities
Intesa Sanpaolo	22%	14%	12%	20%	29%	3%	0%
Banca IMI	7%	0%	15%	74%	1%	2%	1%
Total	**9%**	**2%**	**14%**	**67%**	**5%**	**2%**	**1%**

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

During the first quarter of 2016, as shown in the chart below, the risks are up and the dynamic of the trend is mainly explained by Banca IMI.
In particular, at the beginning of February, scenarios of financial market volatility were recorded, which increased the VaR absorptions; an expansion of the portfolio was subsequently recorded (relating to the credit spread and equity risk factors assumed within the limits approved for 2016).



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

(millions of euro)

	EQUITY		INTEREST RATES		CREDIT SPREADS		FOREIGN EXCHANGE RATES		COMMODITIES	
	volatility +10% and prices -5%	volatility -10% and prices +5%	+40bp	lower rate	-25bp	+25bp	-10%	+10%	-50%	+50%
Total	-11	5	-137	81	338	-319	29	-18	36	-21

In particular:

- on stock market positions, a 5% decrease in stock prices with a resulting 10% increase in volatility would have led to a loss of approximately 11 million euro;
- on interest rate exposures, a rise of the curves of 40 basis points would have had a negative impact of 137 million euro, whereas a scenario with near zero rates would have led to potential gains;
- on exposures sensitive to credit spread fluctuations, a 25 basis point widening in spreads would have led to a 319 million euro loss;
- on foreign exchange exposures, were the Euro to appreciate against the US dollar by 10%, a loss of approximately 18 million euro would be recorded;
- lastly, on commodity exposures, gains would be recorded in case of a 50% decrease in prices; conversely, in case of an increase, the potential losses would be equal to 21 million euro.

Backtesting

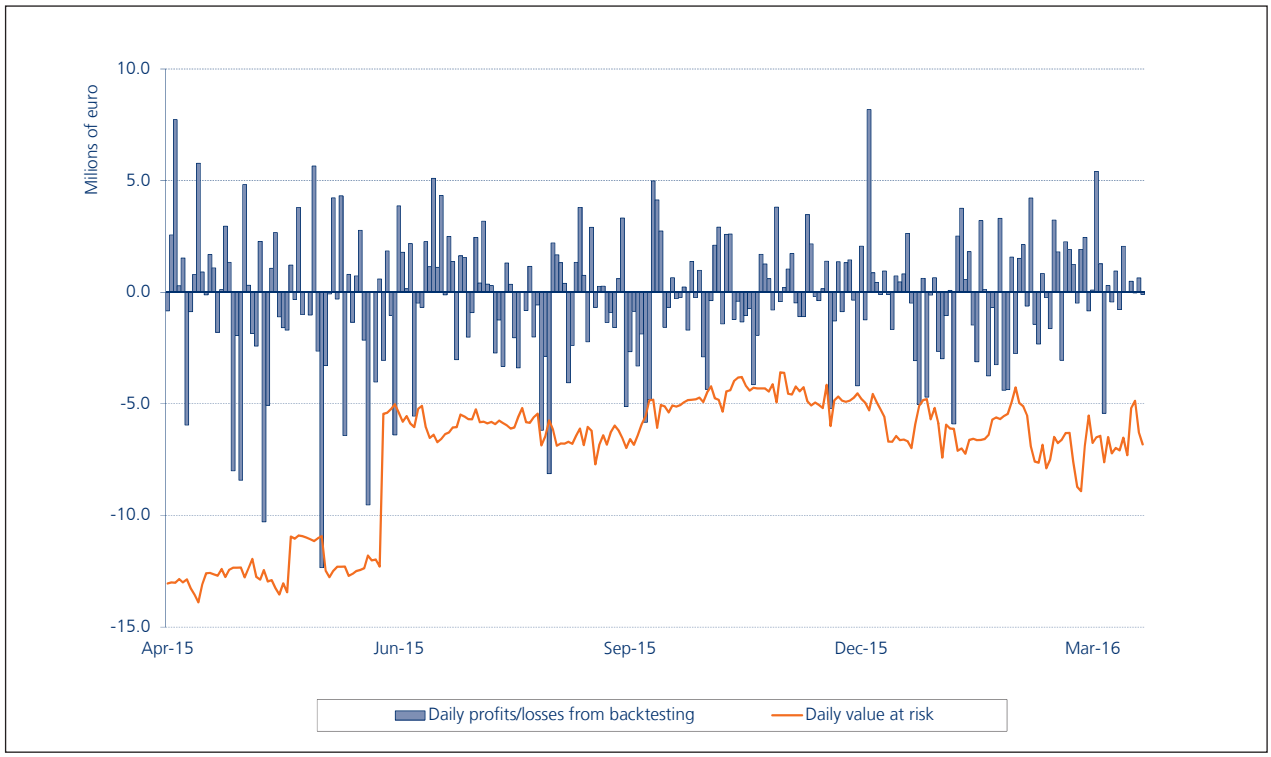
The effectiveness of the VaR calculation methods must be monitored daily via backtesting which, as concerns regulatory backtesting, compares:

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

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

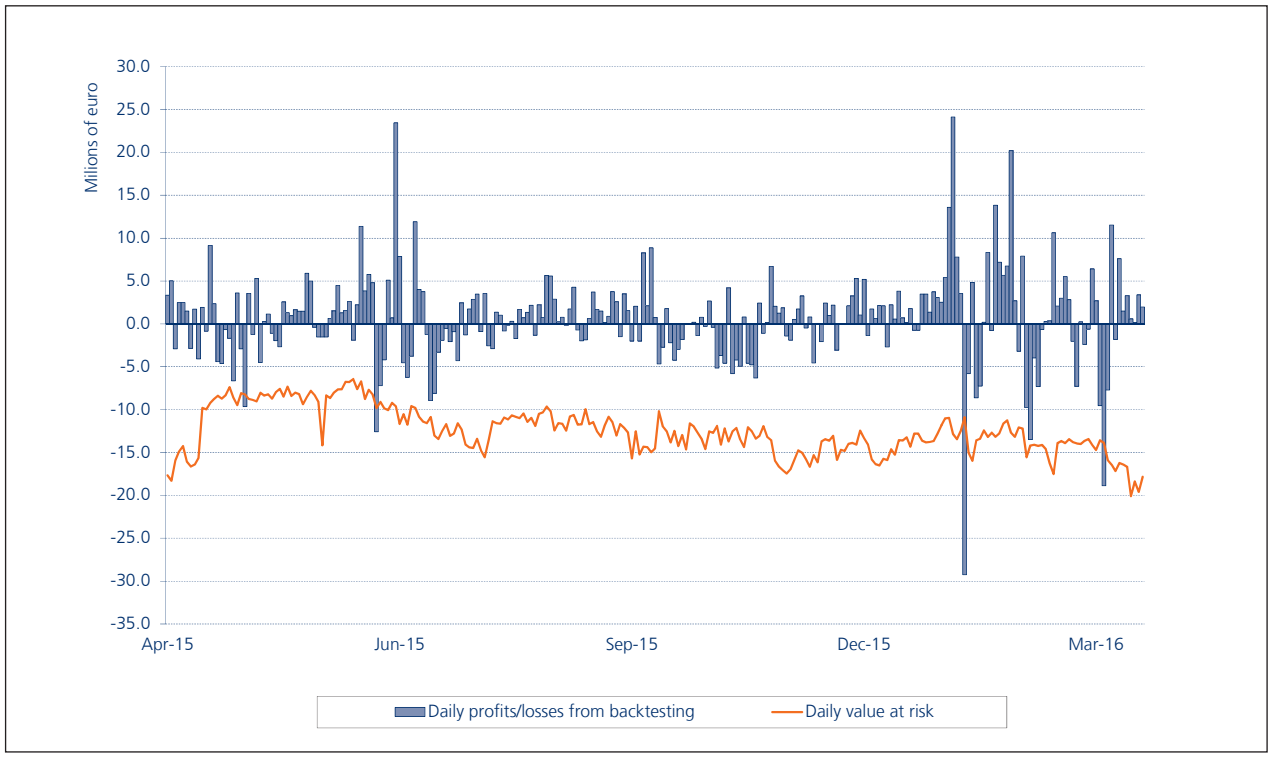
Backtesting in Intesa Sanpaolo

There were four backtesting exceptions during the last year linked to the effects of the Greek debt crisis, and to equity market volatility at the end of August 2015.



Backtesting in Banca IMI

The four backtesting exceptions of Banca IMI refer to the actual P&L data. The losses derive from the increased volatility as a result of the worsening of the Greek debt crisis and the volatility of the financial spreads recorded during the first quarter of 2016.



BANKING BOOK

Market risk originated by the banking book arises primarily in the Parent Company and in the other main Group companies involved in retail and corporate banking. The banking book also includes exposure to market risks deriving from the equity investments in listed companies not fully consolidated, mostly held by the Parent Company and by Equiter and IMI Investimenti.
The following methods are used to measure financial risks of the Group's banking book:

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

Value at Risk is calculated as the maximum potential loss in the portfolio's market value that could be recorded over a 10-day holding period with a 99% confidence level (parametric VaR).
The Shift sensitivity analysis quantifies the change in value of a financial portfolio resulting from adverse movements in the main risk factors (interest rate, foreign exchange, equity). For interest rate risk, an adverse movement is defined as a parallel and uniform shift of +100 basis points of the interest rate curve. The measurements include an estimate of the prepayment effect and of the risk originated by customer demand loans and deposits. Furthermore, interest margin sensitivity is measured by quantifying the impact on net interest income of a parallel and instantaneous shock in the interest rate curve of ±100 basis points, over a period of 12 months. This measure highlights the effect of variations in interest rates on the portfolio that is being measured, excluding assumptions on future changes in the mix of assets and liabilities and, therefore, it cannot be considered a forecast indicator of the future levels of the interest margin.

Hedging of interest rate risk is aimed at (i) protecting the banking book from variations in the fair value of loans and deposits due to movements in the interest rate curve or (ii) reducing the volatility of future cash flows related to a particular asset/liability. The main types of derivative contracts used are interest rate swaps (IRS), overnight index swaps (OIS), cross-currency swaps (CCS) and options on interest rates 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. On the basis of the carved-out version of IAS 39, fair-value hedging is also applied for the macro hedging of the stable portion of on demand deposits (core deposits) and on the already fixed portion of floating-rate loans.
Moreover, since the end of 2015 the Group has extended the use of macro hedging to a portion of fixed-rate loans, adopting an open-portfolio macro hedging model for a portion of fixed-rate loans according to a bottom-layer approach that, in accordance with the interest rate risk measurement method involving modelling of the prepayment phenomenon, is more closely correlated with risk management activity and asset dynamics.

Another hedging method used is the cash flow hedge, which has the purpose of stabilising interest flow on both 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 Financial and Market Risks Department is in charge of measuring the effectiveness of interest rate risk hedges for the purpose of hedge accounting.
In the first three months of 2016, interest rate risk generated by the Intesa Sanpaolo Group's banking book, measured through shift sensitivity analysis, registered an average value of 643 million euro, settling at 634 million euro at the end of March 2016, almost entirely concentrated on the euro currency; this figure compares with 547 million euro at the end of 2015.
Interest margin sensitivity – assuming a 100 basis point change in interest rates – amounted to 670 million euro at the end of March 2016 (535 million euro at the end of 2015).
Interest rate risk, measured in terms of VaR, recorded an average of 61 million euro in the first three months of 2016 (139 million euro at the end of 2015), with a maximum value of 74 million euro and a minimum value of 55 million euro; the latter figure coincides with the value at the end of March 2016. Price risk generated by minority stakes in listed companies, mostly held in the AFS (available for sale) category and measured in terms of VaR, recorded an average level of 27 million euro in the first three months of 2016 (the latter coinciding with the value at the end of 2015 with a minimum value of 24 million euro and a maximum value of 30 million euro; these figures compare with a value of 27 million euro at the end of March 2016.
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 4.2 million euro at the end of March 2016.

LIQUIDITY RISK

Liquidity risk is defined as the risk that the Bank may not be able to meet its payment obligations due to the inability to obtain funds on the market (funding liquidity risk) or liquidate its assets (market liquidity risk).
The arrangement of a suitable control and management system for that specific risk has a fundamental role in maintaining stability, not only at the level of each individual bank, but also of the market as a whole, given that imbalances within a single financial institution may have systemic repercussions. Such a system must be integrated into the overall risk management system and provide for incisive controls consistent with developments in the context of reference.
During 2016 the corporate bodies of Intesa Sanpaolo approved the update of the "Guidelines for Group Liquidity Risk Management", implementing the latest regulatory provisions. These Guidelines illustrate the tasks of the various company functions, the rules and the set of control and management processes aimed at ensuring prudent monitoring of liquidity risk, thereby preventing the emergence of crisis situations. The key principles underpinning the Liquidity Policy of the Intesa Sanpaolo Group are:

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

From an organisational standpoint, a detailed definition is prepared of the tasks assigned to the strategic and management supervision bodies and reports are presented to the senior management concerning certain important formalities such as the approval of measurement methods, the definition of the main assumptions underlying stress scenarios and the composition of early warning indicators used to activate emergency plans.
The departments of the Parent Company that are in charge of ensuring the correct application of the Guidelines are, in particular, the Treasury Department, the Planning and Active Value Management Head Office Department, responsible for liquidity management, and the Financial and Market Risks Department, directly responsible for measuring liquidity risk on a consolidated basis.
With regard to liquidity risk measurement metrics and mitigation tools, in addition to defining the methodological system for measuring short-term and structural liquidity indicators, the Group also formalises the maximum tolerance threshold (risk appetite) for liquidity risk, the criteria for defining liquidity reserves and the rules and parameters for conducting stress tests.
The short-term Liquidity Policy is aimed at ensuring an adequate, balanced level of cash inflows and outflows the timing of which is certain or estimated to fall within a period of 12 months, in order to respond to periods of tension, including extended periods, on the various funding sourcing markets, also by establishing adequate liquidity reserves in the form of liquid securities on private markets and securities eligible for refinancing with Central Banks. To that end, and in keeping with the liquidity risk appetite, the system of limits consists of two short-term indicators for holding periods of one week (cumulative projected imbalance in wholesale operations) and of one month (Liquidity Coverage Ratio) respectively.
The cumulative projected wholesale imbalances indicator measures the Bank's independence from unsecured wholesale funding in the event of a freeze of the money market and aims to ensure financial autonomy, assuming the use on the market of only the highest quality liquidity reserves. The Liquidity Coverage Ratio (LCR) is aimed at strengthening the short-term liquidity risk profile, ensuring a detention of sufficient unencumbered high quality liquid assets (HQLA) that can be easily and immediately converted into cash in the private markets to satisfy the short-term liquidity requirements (30 days) in a liquidity stress scenario. To this end, the Liquidity Coverage Ratio measures the ratio between: (i) the stock of HQLA and (ii) the total net cash outflows calculated according to the scenario parameters defined by the regulations. Delegated Regulation (EU) 2015/61 implies a gradual introduction of the regulatory framework of LCR according to the following schedule: from 1 October 2015 to 31 December 2015 = 60%; from 1 January to 31 December 2016 = 70%; from 1 January to 31 December 2017 = 80%; from 1 January 2018 = 100%.
The aim of the Intesa Sanpaolo Group's structural Liquidity Policy is to adopt the structural requirement provided for by the regulatory provisions of Basel 3: Net Stable Funding Ratio (NSFR). This indicator is aimed at promoting the increased use of stable funding, to prevent medium/long-term operations from giving rise to excessive imbalances to be financed in the short term. To this end, it sets a minimum "acceptable" amount of funding exceeding one year in relation to the needs originating from the characteristics of liquidity and residual duration of assets and off-balance sheet exposures. The NSFR's regulatory requirement is still subject to a period of observation: the European Commission is required to present a legislative proposal that will come into force from 2018.
The Guidelines for Group Liquidity Risk Management also envisage the time extension of the stress scenario for the LCR indicator, provided by the new regulatory framework, measuring, for up to 3 months, the effect of specific acute liquidity tensions (at bank level) combined with a widespread and general market crisis. The internal management guidelines also envisage a minimum limit on the LCR indicator up to 3 months, with the purpose of establishing an overall level of reserves covering greater cash outflows during a period of time that is adequate to implement the required operating measures to restore the Group to balanced conditions.
The Guidelines also establish methods for management of a potential liquidity crisis, defined as a situation of difficulty or inability of the Bank to meet its cash obligations falling due, without implementing procedures and/or employing instruments that, due to their intensity or manner of use, do not qualify as ordinary administration. By setting itself the objectives of safeguarding the Group's asset value and also guaranteeing the continuity of operations under conditions of extreme liquidity emergency, the Contingency Liquidity Plan ensures the identification of the early warning signals and their ongoing monitoring, the definition of procedures to be implemented in situations of liquidity stress, the immediate lines of action, and the intervention measures for the resolution of emergencies. The early warning indexes, aimed at spotting the signs of a potential liquidity strain, both systematic and specific, are monitored with daily frequency of the Financial and Market Risks Department.
In the first three months of 2016, the Group's liquidity position remained within the risk limits provided for in the Group's Liquidity Policy: both the LCR and NSFR indicators were largely respected, as they reached a level well above the phased-in

requirements. As at 31 March 2016, the eligible liquidity reserves for the Central Banks, considering cash components, came to 119 billion euro (117 billion euro at the end of December 2015), of which 76.6 billion euro, net of haircut, was unencumbered (78 billion euro at the end of December 2015).
Also the stress tests, when considering the high availability of liquidity reserves (liquid or eligible), yielded results in excess of the target threshold for the Group, with a liquidity surplus capable of meeting extraordinary cash outflows for a period of more than 3 months.
Adequate and timely information regarding the development of market conditions and the position of the Bank and/or Group was provided to the corporate bodies and internal committees in order to ensure full awareness and manageability of the main risk factors.

INFORMATION ON FINANCIAL PRODUCTS

In line with the requests for utmost transparency made by supranational and national Supervisory Authorities, the following information is provided on the fair value measurement methods adopted, structured credit products, activities performed through Special Purpose Entities (SPE), leveraged finance transactions, hedge fund 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. These criteria are substantially unchanged with respect to those illustrated in detail in the Annual Report 2015, to which reference is made for more information.

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

The fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants (i.e. not as part of the compulsory liquidation or a below-cost sale) as at the measurement date. Fair value is a market measurement criterion, not specifically referring to a single bank. This definition of fair value assumes that the bank is carrying out normal operations, without any intention of liquidating its assets, significantly reducing the level of operations or carrying out transactions at unfavourable conditions.
A bank has to measure the fair value of an asset or liability by adopting the assumptions that would be used by market participants when pricing an asset or liability, presuming that they act with a view to satisfying their own economic interest in the best way possible. Fair value measurement assumes that the sale of an asset or the transfer of a liability takes place in the principal active market for the asset or liability or, in the absence of a principal active market, in the most advantageous market for the asset or liability.

The Intesa Sanpaolo Group identifies the principal market for a financial asset or liability as the market in which it generally operates.
The Group considers a market 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 companies, Info Providers or authorised entities.
In the event of a significant reduction in the volume or level of operations compared to normal operations for the asset or liability (or for similar assets or liabilities) highlighted by a number of indicators (number of transactions, limited significance of market prices, significant increase in implicit liquidity risk, widening or increase of the bid-ask spread, reduction or total lack of market for new issuances, limited publicly-available information), analyses of the transactions or of the quoted prices are carried out.

Fair value hierarchy

The fair value of financial instruments is determined according to a hierarchy of criteria based on the origin, type and quality of inputs. In detail, this hierarchy assigns top priority to (unadjusted) quoted prices in active markets and less importance to unobservable inputs. As a consequence, three different hierarchical levels of fair value are identified:

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

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

For level 1 financial instruments, the current bid price is used for financial assets and the current ask price for financial liabilities, struck on the principal active market at the end 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 there exist no quotations on an active market or the market is not functioning regularly, that is when the market does not have a sufficient and continuous number of trades and bid-ask spreads and volatility are not sufficiently contained, the fair value of the financial instruments is mainly determined through the use of valuation techniques whose objective is the establishment of the price at which, in an orderly transaction, the asset is sold or the liability transferred between market participants, as at the measurement date, under current market conditions.
Such techniques include:

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

In the case of level 2 inputs, the valuation is based on prices or credit spreads derived from the official listing of instruments which are similar in terms of risk factors, using a given calculation methodology (valuation model). The use of this approach requires the identification of transactions on active markets in relation to instruments that, in terms of risk factors, are comparable with the instrument to be measured.

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

Valuation of financial instruments and Model Risk Management

The valuation process of financial instruments entails the following phases:

– Identification of the sources for valuation: for each asset class, the Fair Value Policy and Market Data Reference Guide establish the processes that are necessary to identify market parameters and the manner according to which such data must be extracted and used.
– Validation and processing of market data for periodic valuation: this stage consists of the accurate verification, at each accounting measurement date, of the market parameters used (verifying the integrity of data contained on the proprietary platform with respect to the source of contribution), reliability tests (consistency of each single figure with similar or comparable figures) and verification of concrete application means.
– Validation 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 valuation models used and at determining any adjustments necessary for measurement.
– Periodic monitoring of the consistency of the pricing models over time: the monitoring consists in checking the adherence to the market of the measurement model in order to promptly discover any gaps and start the necessary verifications and interventions.

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

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

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

In addition to the adjustments related to the above mentioned factors, also other types of adjustments ("Mark-to-Market Adjustment") relating to other factors that may influence the valuation are included. These factors essentially involve:

– high and/or complex risk profile;
– illiquidity of the posistions determined by temporary or structural market conditions or in relation to the amount of assets held (in case of excessive concentration);
– valuation difficulties due to the lack of liquid and observable market parameters.

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

Following the crisis of 2007, the market progressively introduced a series of adjustments linked to the credit and liquidity risk, with impacts on both the income statement and the capital, collectively shown as XVA. In line with market practices, in the past the Intesa Sanpaolo Group introduced the Credit/Debt Value Adjustment (bCVA), and, starting from 31 March 2016, it implemented the Funding Value Adjustment (FVA) for the valuation of OTC derivatives. The latter assessment component takes into

consideration the liquidity risk premium, connected to the costs of funding the cash flows generated by an OTC derivative portfolio (coupons, dividends, collateral, etc.). Like the bCVA, the FVA depends on the probability of default of the counterparties and considers any netting and collateralisation agreements (CSA).

Fair value hierarchy

The table below shows financial assets and liabilities designated at fair value through profit and loss broken down by fair value hierarchy levels.
Compared to the information provided in the 2015 financial statements, the Group did not amend the guidelines based on which level changes are carried out within the fair value hierarchy.

(millions of euro)

Financial assets / liabilities at fair value	31.03.2016			31.12.2015		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
1. Financial assets held for trading	18,139	35,714	933	17,994	32,546	1,057
2. Financial assets designated at fair value through profit or loss	52,723	1,109	648	51,847	1,200	616
3. Financial assets available for sale	133,217	7,351	2,316	120,876	8,208	2,318
4. Hedging derivatives	-	7,642	27	-	7,039	20
5. Property and equipment	-	-	-	-	-	-
6. Intangible assets	-	-	-	-	-	-
Total	**204,079**	**51,816**	**3,924**	**190,717**	**48,993**	**4,011**
1. Financial liabilities held for trading	14,406	34,243	287	11,217	31,972	333
2. Financial liabilities designated at fair value through profit or loss	-	48,031	-	-	47,022	-
3. Hedging derivatives	-	10,257	6	-	8,225	9
Total	**14,406**	**92,531**	**293**	**11,217**	**87,219**	**342**

Figures, 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, accounting for 1.5% for financial assets and 0.3% for financial liabilities, in line with the percentages of December 2015.
Approximately 78% of financial assets measured at fair value are determined based on market prices, and therefore without any discretion by the valuator.

The sensitivity analysis performed on level 3 structured credit products highlights a negative change in fair value, referring to complex credit derivatives, of 31,868 euro [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 collateral 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] The amount is shown net of the adjustments to valuations relating to the main input parameters which were already considered to determine the fair value of financial instruments (see paragraph "Fair value measurement of financial assets and liabilities" above).

STRUCTURED CREDIT PRODUCTS

The risk exposure to structured credit products reached 2,504 million euro as at 31 March 2016 with respect to funded and unfunded ABS/CDOs, compared to 2,429 million euro as at 31 December 2015, in addition to an exposure of 4 million euro with respect to structured packages, which compares with the 2 million euro as at 31 December 2015.
The strategy regarding the portfolio in question in 2016 focused on slightly increasing the trading book to exploit market opportunities, on the one hand, and on disposing of the portfolio hard hit by the financial crisis, which is now managed by Capital Light Bank, on the other.
Specifically, the rise in exposure in funded and unfunded ABS/CDOs designated at fair value (from 1,988 million euro in December 2015 to 2,060 million euro in March 2016) is attributable to higher investments in ABS by the subsidiary Banca IMI, part of which was classified to the available-for-sale portfolio, as well as to European ABS/CDOs acquired by the Parent Company and classified in the trading portfolio.
Banca IMI's investments mainly consist of securities with underlying residential mortgages and CLOs with mainly AA ratings. The Parent Company confirmed its transactions in European RMBS with mainly Aaa ratings, aimed at seizing market opportunities, with sales that are only partially offset by new investments.
With regard to the exposure represented by securities classified under the loan portfolio, on the other hand, a slight increase was recorded (from 441 million euro in December 2015 to 444 million euro in March 2016), attributable to the higher investments of Banca IMI, which are only partially offset by the sales that concerned the portfolio of the Parent Company.

From an income statement perspective, a result of -4 million euro was recorded in the first three months of 2016, compared to -1 million euro for 2015.
As at 31 March 2016, the "Profits (losses) on trading – caption 80" of the exposure in funded and unfunded ABS/CDOs reached -3 million euro, generated as the offsetting of:

- the negative effect of 1 million euro of funded European and US ABS/CDOs;
- the negative effect of 1 million euro of positions in Multisector CDOs;
- the negative effect of 1 million euro of US subprime exposures.

As regards the exposure to funded and unfunded ABS/CDOs, it should be noted that the securities classified by the subsidiary Banca IMI in the available-for-sale portfolio recorded a net decrease in fair value of around -3 million euro, accounted for in the specific Shareholders' Equity Reserve, and an impact on the income statement for sales made in the period of +2 million euro.

The securities reclassified to the loan portfolio had an impact of -3 million euro on the income statement as at 31 March 2016.
This result is attributable to the Parent Company, which posted negative adjustments due to the impairment of several securities in the portfolio.
The "Monoline risk" and "Non-monoline packages" made a nil contribution to "Profits (Losses) on trading – caption 80" as at 31 March 2016, compared with the nil contribution as at 31 December 2015.

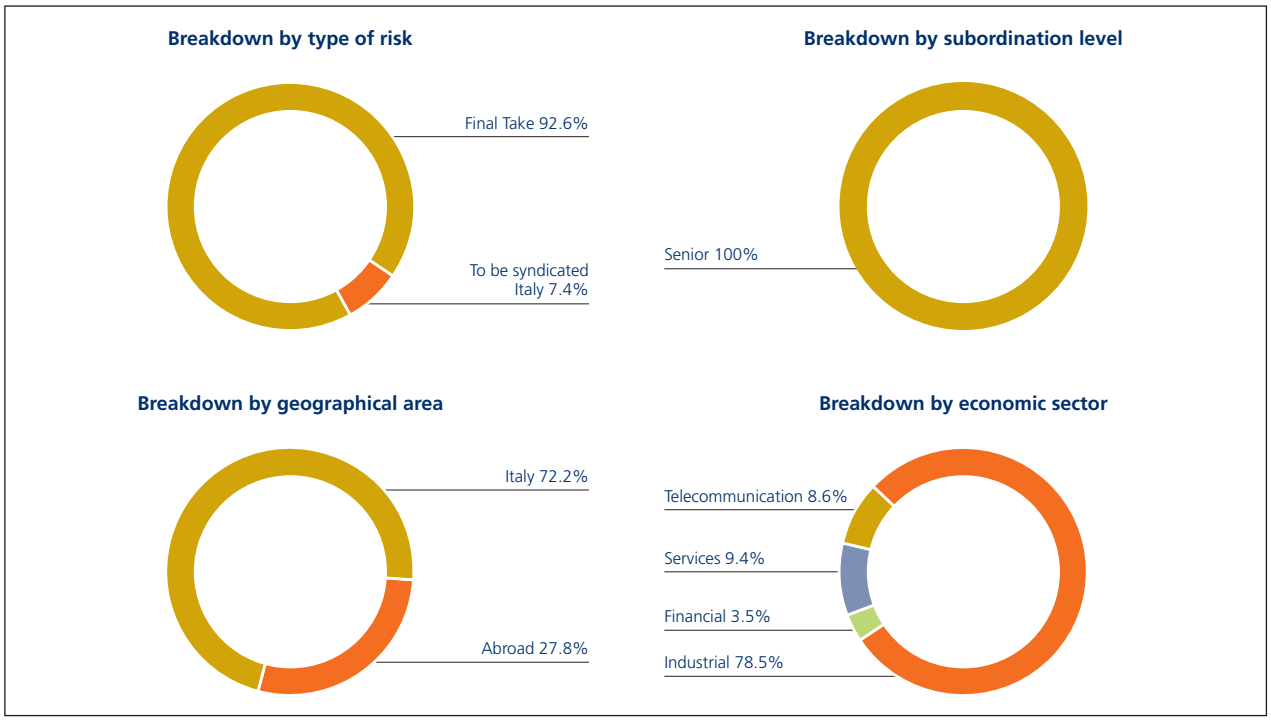
INFORMATION ON ACTIVITIES PERFORMED THROUGH SPECIAL PURPOSE ENTITIES (SPES)

For the purpose of this analysis, legal entities established to pursue a specific, clearly defined and limited objective are considered Special Purpose Entities (raising funds on the market, acquiring/selling/managing assets both for asset securitisations, acquisition of funding through self-securitisations and the issue of covered bonds (CB), developing and/or financing specific business initiatives, undertaking leveraged buy-out transactions, or managing credit risk inherent in an entity's portfolio).
The sponsor of the transaction is normally an entity which requests the structuring of a transaction that involves the SPE for the purpose of achieving certain objectives. In some cases the Bank is the sponsor and establishes a SPE to achieve one of the objectives cited above.
For the SPE categories identified as not consolidated structured entities, no amendments are recorded, compared to the information already provided in the 2015 financial statements, to the criteria based on which the Intesa Sanpaolo Group decides on whether to include the companies in the scope of consolidation.
In the first quarter of 2016 the Parent Company Intesa Sanpaolo issued some new Covered Bonds (CB) mainly backed by residential mortgages sold by Intesa Sanpaolo to the vehicle ISP CB Ipotecario. The issue is at a fixed rate of 0.625% and is addressed to professional investors and financial intermediaries. The bond is listed on the Luxembourg Stock Exchange, as well as traded over-the-counter, as is customary.
There were no significant changes to the other categories of SPEs subject to disclosure. Accordingly, reference should be made to the 2015 financial statements.

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 31 March 2016, 112 transactions for a total amount granted of 3,275 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 31 March 2016 totalled 651 million euro, compared to 758 million euro recorded in December 2015. The analysis of changes in the portfolio showed some distributions and redemptions, as well as a decrease in the value of the units underwritten and the repricing of the euro on the dollar, which affected the value of the positions denominated in that currency.
As at the same date, the economic result of the investments in this segment was negative for 48 million euro, compared to the positive 39 million euro of "Profits (Losses) on trading – caption 80" in the first quarter of 2015. The net losses of 48 million euro, recognised as at 31 March 2016, are almost entirely attributable to a deterioration in the listed NAV of some funds (47 million) and, to a minimum extent (1 million), to foreign exchange losses related to a breakeven position in foreign currency.
More specifically, the greatest losses were recorded on the Paulsen fund (14 million), which is heavily exposed to the healthcare sector, which was affected by idiosyncratic events and is at the centre of the US electoral campaign on the price of drugs, and on the Eurizon Penghua fund (6 million), focusing on the Asian equity market, and the Chinese one in particular; several losses also concerned the funds focused on Financials, where the indexes shrunk considerably.
There were no changes in the portfolio's overall strategy, which still remains prevalently geared towards benefiting from the implementation of specific corporate events, typically independent from the general market trend. Risk reduction is expected in any case, through a generalised downsizing of the allocations to the individual funds as a result of market uncertainty. The exposure to the Avenue fund was reduced already during the first quarter of 2016 through the distribution of 4.4 million dollars. Some funds that expressed an exposure to Asia and the American pharmaceutical sector were liquidated.

INFORMATION ON TRADING TRANSACTIONS IN DERIVATIVES WITH CUSTOMERS

Considering relations with customers only, as at 31 March 2016, the Intesa Sanpaolo Group, in relation to derivatives trading with retail customers, non-financial companies and public entities (therefore excluding banks, financial and insurance companies), presented a positive fair value, not having applied netting agreements, of 8,902 million euro (7,670 million euro as at 31 December 2015). The notional value of these derivatives totalled 48,673 million euro (45,855 million euro as at 31 December 2015).
The positive fair value of the structured contracts in existence with the 10 customers with the highest exposures was 5,999 million euro.
Conversely, negative fair value determined with the same criteria, for the same types of contracts and with the same counterparties, totalled 1,807 million euro as at 31 March 2016 (1,929 million euro as at 31 December 2015).
The notional value of these derivatives totalled 19,034 million euro (20,304 million euro as at 31 December 2015).

The fair value of derivative financial instruments entered into with customers was determined considering, as for all other OTC derivatives, the creditworthiness of the single counterparty ("Bilateral Credit Value Adjustment"). With regard to contracts outstanding as at 31 March 2016, this led to a negative effect of 18 million euro being recorded under "Profits (Losses) on trading" in the income statement.
With regard to the various methodologies used when determining the fair value of financial instruments, reference is made to the paragraphs specifically dedicated to this subject in this chapter.

OPERATIONAL RISK

Operational risk is defined as the risk of suffering losses due to inadequacy or failures of processes, human resources and internal systems, or as a result of external events. Operational risk includes legal risk, that is, the risk of losses deriving from breach of laws or regulations, contractual or out-of-contract liability or other disputes; ICT (Information and Communication Technology) risk and model risk. Strategic and reputational risks are not included.

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

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

The control of the Group's operational risk was attributed to the body with management function, which identifies risk management policies, and to the body with strategic supervision function, which is in charge of their approval and verification, as well as of the guarantee of the functionality, efficiency and effectiveness of the risk management and control system.
Moreover, the tasks of the Intesa Sanpaolo Group Internal Control Coordination and Operational Risk Committee include periodically reviewing the overall operational risk profile, authorising any corrective measures, coordinating and monitoring the effectiveness of the main mitigation activities and approving operational risk transfer strategies.

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

The Integrated Self-diagnosis process, conducted on an annual basis, allows to:
- identify, measure, monitor and mitigate operational risk through identification of the main operational problem issues and definition of the most appropriate mitigation actions;
- analyse exposure to ICT risk;
- create significant synergies with the other functions with control duties of the Personnel and Organisation Department that supervise the planning of operational processes and business continuity issues, with the Administrative and Financial Governance and with control functions (Compliance and Internal Auditing) that supervise specific regulations and issues (Legislative Decree 231/01, Law 262/05) or conduct tests of the effectiveness of controls of company processes.

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

The process of collecting data on operational events (in particular operational losses, obtained from both internal and external sources) provides significant information on the exposure. It also contributes to building knowledge and understanding of the exposure to operational risk, on the one hand, and assessing the effectiveness or potential weaknesses of the internal control system, on the other hand.
The internal model for calculating capital absorption is conceived in such a way as to combine all the main sources of quantitative (operational losses) and qualitative (Self-diagnosis) information.
The quantitative component is based on an analysis of historical data concerning internal events (recorded by organisational units, appropriately verified by the Head Office Department and managed by a dedicated IT system) and external events (by the Operational Riskdata eXchange Association).
The qualitative component (scenario analysis) focuses on the forward-looking assessment of the risk exposure of each unit and is based on the structured, organised collection of subjective estimates expressed directly by management (subsidiaries, Parent Company's business areas, the Corporate Centre) with the objective of assessing the potential economic impact of particularly severe operational events.
Capital-at-risk is therefore identified as the minimum amount at Group level required to bear the maximum potential loss (worst case); Capital-at-risk is estimated using a Loss Distribution Approach model (actuarial statistical model to calculate the Value-at-risk of operational losses), applied on quantitative data and the results of the scenario analysis assuming a one-year estimation period, with a confidence level of 99.90%; the methodology also applies a corrective factor, which derives from the qualitative analyses of the risk level of the business environment (Business Environment Assessment), to take into account the effectiveness of internal controls in the various organisational units.

Operational risks are monitored by an integrated reporting system, which provides management with support information for managing and/or mitigating the operational risk.
In order to support the operational risk management process on a continuous basis, a structured training programme was implemented for employees actively involved in this process.
In addition, the Group activated a traditional operational risk transfer policy (to protect against offences such as employee disloyalty, theft and damage, cash and valuables in transit losses, computer fraud, forgery, cyber crimes, earthquake and fire, and third-party liability), which contributes to mitigating exposure to operational risk. At the end of June 2013, in order to allow optimum use of the available operational risk transfer tools and to take advantage of the capital benefits, pursuant to applicable regulations the Group subscribed an insurance coverage policy named Operational Risk Insurance Programme, which offers

additional coverage to traditional policies, significantly increasing the limit of liability, transferring the risk of significant operational losses to the insurance market.
The internal model's insurance mitigation component was approved by the Bank of Italy in June 2013 with immediate effect of its benefits on operations and on the capital requirements.

To determine its capital requirements, the Group employs a combination of the methods allowed under applicable regulations. The capital absorption resulting from this process amounts to 1,652 million euro as at 31 March 2016, unchanged compared to 31 December 2015.

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

Legal risks

Legal risks are thoroughly analysed by the Parent Company and Group companies. Provisions are made to the allowances for risks and charges in the event of disputes for which it is probable that funds will be disbursed and where the amount of the disbursement may be reliably estimated. During the quarter there were some developments regarding the litigations towards the Viaggi del Ventaglio Group, which concluded with a judgement favourable to the Bank, the Elifani Group, whose judgement, which was also favourable to the Bank, was appealed, and Acotel Noverca, for which the Court rejected the preliminary counterparty motions. However, these developments did not lead to changes in the risk status of the abovementioned litigations. No particularly significant new litigations were started during the quarter.
Therefore, reference should be made to the Notes to the 2015 financial statements for a thorough description of the individual legal proceedings in place and pending lawsuits.

Tax litigation

With regard to pending tax litigation and the related risks and provisions, detailed information is provided in the Notes to the 2015 Financial Statements (Part E), to which reference is made. Described below are thus only the most important changes occurred in the first quarter of 2016.
On 22 March, by implementing the resolution of the Management Board of 23 February, Intesa Sanpaolo finalised a framework agreement with the Italian Revenue Agency to settle three important disputes regarding funding transactions through US vehicles and loans disbursed by Luxembourg companies of the Group, deriving from two reports on findings by the Guardia di Finanza, served in September 2013 and February 2015. Based on the agreement, the abovementioned litigations were settled with the payment of about 110 million plus interest (against a tax risk of 467 million).
During the quarter, the implementation of the framework agreements reached with the Italian Revenue Agency in 2015 for complete settlement of the charges concerning tax period 2005 was also completed. The agreement resulted in a reduction of the revenue authority's claim from the original 376 million euro (including tax, penalties and interest) to approximately 6 million euro (so-called "Castello Finance dispute"). On 5 February 2016 the settlement led the repayment of 107 million euro, previously disbursed on a preliminary basis by the bank and no longer due.
With respect to the dispute concerning the recovery of registration tax on contribution of company assets and the subsequent sale of equity investments, characterised by the tax authorities as transfer of a business unit, some favourable decisions for our Group were made by courts in the first and second instances during the quarter. In addition, at the end of the quarter the Bank was served another 3 assessment notices due to higher value of the business lines contributed, for a total of 2 million euro (plus interest).
On 29 March 2016, following the report on findings of 27 July 2015, the Italian Revenue Agency, Emilia Romagna Regional Department, notified the Bank an assessment notice for IRES 2011 of the merged company Neos Finance (value of the dispute about 1.8 million euro, including tax, penalties and interest). Analyses are underway to assess the need to define the context in advance, since this is a tax claim with effects of a primarily temporary nature.
On the tax dispute relating to the charge of illegal use of an offshore tax structure brought by the Italian tax authorities against the Luxembourg subsidiary Eurizon Capital S.A., no changes are recorded compared to the situation as at 31 December 2015.
Also considering the absence of significant changes compared to 31 December 2015, the Group's tax litigation risks are covered by adequate provisions to allowances for risks and charges.

INSURANCE RISKS

Life business

The typical risks of a life insurance portfolio may be divided into three main categories: premium risks, actuarial and demographic risks and reserve risks.
Premium risks are managed initially during definition of the technical features and product pricing, and over the life of the instrument by means of periodic checks on sustainability and profitability (both at product level and at portfolio level, including liabilities).
Actuarial and demographic risks are monitored by means of systematic statistical analysis of the evolution of liabilities in its own contract portfolio, divided by risk type, and through simulations of expected profitability of the assets hedging technical reserves.
Reserve risk is monitored through the exact calculation of mathematical reserves, with a series of detailed checks as well as overall verifications, by comparing results with the estimates produced on a monthly basis.
The mathematical reserves are calculated on almost the entire portfolio, on a contract-by-contract basis, and the methodology used to determine the reserves takes account of all the future commitments of the company.

Non-life business

The risks of the non-life insurance portfolio are essentially premium risk and reserve risk.
Premium risks are managed initially during definition of the technical features and product pricing and over the life of the instrument by means of periodic checks on sustainability and profitability (both at product level and at portfolio level, including liabilities).
Reserve risk is monitored through the exact calculation of technical reserves.

Financial risks

In line with the growing focus in the insurance sector on the issues of value, risk and capital in recent years, a series of initiatives has been launched with the objective of both strengthening risk governance and managing and controlling financial risks.
With reference to investment portfolios, set up both as coverage of obligations with the insured and in relation to free capital, the Investment Framework Resolution is the main control and monitoring instrument for market and credit risks.
The Resolution defines the goals and the operating limits that are needed to distinguish the investments in terms of eligible assets and asset allocation, breakdown by rating classes and credit risk, concentration risk by issuer and sector, and market risks, in turn measured in terms of sensitivity to variations in risk factors and Value at Risk (VaR).

Investment portfolios

The investments of the insurance companies of the Intesa Sanpaolo Group (Intesa Sanpaolo Vita, Intesa Sanpaolo Assicura, Intesa Sanpaolo Life and Fideuram Vita) are made with their free capital and to cover contractual obligations with customers. These refer to traditional revaluable life insurance policies, Index- and Unit-linked policies, pension funds and non-life policies.
As at 31 March 2016, the investment portfolios of Group companies, recorded at book value, amounted to 137,783 million euro. Of these, a part amounting to 84,386 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 53,397 million euro.

Considering the various types of risks, the analysis of investment portfolios, described below, concentrates on the assets held to cover traditional revaluable life policies, non-life policies and free capital.
In terms of breakdown by asset class, net of derivative financial instruments, 87.3% of assets, i.e. approximately 73,697 million euro, were bonds, whereas assets subject to equity risk represented 2.0% of the total and amounted to 1,723 million euro. The remainder (9,047 million euro) consisted of investments relating to UCI, Private Equity and Hedge Funds (10.7%).
The carrying value of derivatives came to approximately -82 million euro, entirely relating to effective management derivatives.[4]. Hedging derivatives are currently not present in the portfolio.

At the end of the three nine months of 2016, investments made with the free capital of Intesa Sanpaolo Vita and Fideuram Vita amounted to approximately 2,217 million euro at market value, and presented a risk in terms of VaR (99% confidence level, 10-day holding period) of approximately 68 million euro.
The modified duration of the bond portfolio, or the synthetic financial term of assets, is approximately 6.24 years. The reserves relating to the revaluable contracts under Separate Management have an average modified duration of approximately 6.42 years. The related portfolios of assets have a modified duration of around 5.85 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 4,318 million euro.
The distribution of the portfolio by rating class is as follows. AAA/AA bonds represented approximately 5.1% of total investments and A bonds approximately 4.8%. Low investment grade securities (BBB) were approximately 87.4% of the total and the portion of speculative grade or unrated was minimal (approximately 2.7%).
A considerable portion of the BBB area is made up of securities issued by the Italian Republic.
The analysis of the exposure in terms of the issuers/counterparties produced the following results: securities issued by Governments and Central Banks approximately made up 77.8% of the total investments, while financial companies (mostly banks) contributed almost 13.2% of exposure and industrial securities made up approximately 9.0%.

[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 first quarter of 2016, the fair value sensitivity of bonds to a change in issuer credit rating, intended as a market credit spread shock of +100 basis points, was 4,425 million euro, with 3,540 million euro due to government issuers and 885 million euro to corporate issuers (financial institutions and industrial companies).