Risk management

BASIC PRINCIPLES

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

BASEL 3 REGULATIONS AND THE INTERNAL PROJECT

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.
Information on own funds, which are 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.
There were no changes in the scope of application compared to 31 December 2015.

<table>
<tr><th>Company</th><th>Corporate
FIRB</th><th>Corporate
AIRB LGD</th><th>SME Retail
IRB LGD</th><th>Mortgage
IRB LGD</th></tr>
<tr><td>Intesa Sanpaolo</td><td rowspan="7">Dec - 2008</td><td rowspan="7">Dec - 2010</td><td rowspan="7">Dec - 2012</td><td rowspan="6">Jun - 2010</td></tr>
<tr><td>Banco di Napoli</td></tr>
<tr><td>Cassa di Risparmio del Veneto</td></tr>
<tr><td>Cassa di Risparmio in Bologna</td></tr>
<tr><td>Cassa di Risparmio del Friuli Venezia Giulia</td></tr>
<tr><td>Cassa dei Risparmi di Forlì e della Romagna</td></tr>
<tr><td>Mediocredito Italiano</td><td>n.a.</td></tr>
<tr><td>Gruppo Cassa di Risparmio di Firenze</td><td>Dec - 2009</td><td>Dec - 2010</td><td>Dec - 2012</td><td>Jun - 2010</td></tr>
<tr><td>Casse di Risparmio dell'Umbria</td><td>n.a.</td><td>Dec - 2010</td><td>Dec - 2012</td><td>Dec - 2011</td></tr>
<tr><td>Banca Prossima</td><td>n.a.</td><td>Dec - 2013</td><td>Dec - 2013</td><td>n.a.</td></tr>
<tr><td>Banca IMI</td><td>n.a.</td><td>Jun - 2012</td><td>n.a.</td><td>n.a.</td></tr>
<tr><td>Intesa Sanpaolo Bank Ireland</td><td>Mar - 2010</td><td>Dec - 2011</td><td>n.a.</td><td>n.a.</td></tr>
<tr><td>Vseobecna Uverova Banka</td><td>Dec - 2010</td><td>Jun - 2014</td><td>Jun - 2014</td><td>Jun - 2012</td></tr>
</table>

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.

The Intesa Sanpaolo Group participated in the 2016 EU-wide stress test, the exercise conducted by the European Banking Authority on the financial statements of European banks as at 31 December 2015.
The test consisted of the simulation of the impact of two scenarios – baseline and adverse – and covers a time horizon of three years (2016-2018). The 2016 EU-wide stress test provides crucial information as part of the prudential review process of 2016. The results thus allowed the competent authorities to assess banks' ability to comply with the established minimum and additional own funds requirements in stress scenarios based on shared methodology and assumptions.
Intesa Sanpaolo acknowledges the results of the 2016 EU-wide stress test announced by the EBA on 29 July 2016, which were extremely positive for the Group. The Common Equity Tier 1 ratio (CET1 ratio) for Intesa Sanpaolo that emerged from the stress test for 2018, the final year of the simulation, came to 12.8% in the baseline scenario and 10.2% in the adverse scenario, compared to the starting point of 13% recorded as at 31 December 2015. This includes a reduction of 50 one-hundredths of a point – in both scenarios – for the move from the calculation criteria in force for 2015 to those in force for 2018.

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. The quality of the loan portfolio is pursued through specific operating checks for all the phases of loan management, through the use of both IT procedures and systematic supervision of positions with the aim of detecting any symptoms of difficulty and promote corrective measures to prevent possible deterioration of credit risk.

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

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

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

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

Lastly, non-performing exposures also include the individual 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 constitute a separate category of non-performing assets. Rather, they constitute a subset of both the previous categories of "Non-performing exposures with forbearance measures" and of the performing assets "Other forborne exposures", depending on the level of risk of the exposure when renegotiation occurs or as a consequence thereof.

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)

	30.06.2016			31.12.2015			Changes
	Gross exposure	Total adjustments	Net exposure	Gross exposure	Total adjustments	Net exposure	Net exposure
Bad loans	38,570	-23,411	15,159	39,150	-24,177	14,973	186
Unlikely to pay	21,993	-5,433	16,560	22,725	-5,634	17,091	-531
Past due loans	777	-144	633	1,239	-217	1,022	-389
Non-performing loans	**61,340**	**-28,988**	**32,352**	**63,114**	**-30,028**	**33,086**	**-734**
of which forborne	***11,642***	***-3,375***	***8,267***	***10,856***	***-3,151***	***7,705***	***562***
Performing loans	315,187	-1,954	313,233	302,875	-2,012	300,863	12,370
of which forborne	*7,506*	*-225*	*7,281*	*7,917*	*-218*	*7,699*	*-418*
Performing loans represented by securities	14,894	-239	14,655	13,633	-249	13,384	1,271
of which forborne	*118*	-	*118*	*137*	*-2*	*135*	*-17*
Loans to customers	**391,421**	**-31,181**	**360,240**	**379,622**	**-32,289**	**347,333**	**12,907**

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

As at 30 June 2016, the Group's non-performing loans, net of adjustments, came to 32.4 billion euro, below the levels of 2015 (-2.2%). While non-performing loans decreased as a percentage of total loans to customers at 9%, the non-performing assets coverage ratio was 47.3%.
In further detail, bad loans came to 15.2 billion euro, net of adjustments, in the first half of 2016, up 1.2% 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 60.7% (61.8% in December 2015). Loans included in the unlikely to pay category amounted to 16.6 billion euro, down by 3.1%, accounting for 4.6% of total loans to customers, with a coverage ratio of 24.7%. Past due loans totalled 633 million euro, down 38.1% compared to the beginning of the year, with a coverage ratio of 18.5%. Forborne exposures are generated by forbearance measures for borrowers experiencing difficulty in meeting their financial obligations, according to the definition introduced by the European Banking Authority with the aim of harmonising the classification of the definitions of non-performing loans and forbearance practices (renegotiation for the borrower's financial difficulties) at the European level. Within the non-performing loan category, forborne exposures amounted to 8.3 billion euro, with an average coverage ratio of 29%, whereas those in the performing loan category were slightly lower (7.3 billion euro).
The coverage ratio of performing loans was 0.6%.

MARKET RISKS

TRADING BOOK

The quantification of trading risks is based on daily and periodic VaR of the trading portfolios of Intesa Sanpaolo and Banca IMI, which represent the main portion of the Group's market risks, to adverse market movements of the following risk factors:
- interest rates;
- equities and market indexes;
- investment funds;
- foreign exchange rates;
- implied volatilities;
- spreads in credit default swaps (CDSs);
- spreads in bond issues;
- correlation instruments;
- dividend derivatives;
- asset-backed securities (ABSs);
- commodities.

Other Group subsidiaries hold smaller trading portfolios with a marginal risk (around 1% of the Group's overall risk). In particular, the risk factors of the international subsidiaries' trading books are local government bonds, positions in interest rates, and foreign exchange rates relating to linear pay-offs.
For some of the risk factors indicated above, the Supervisory Authority has validated the internal models for the reporting of the capital absorptions of both Intesa Sanpaolo and Banca IMI.
Effective from the report as at 30 September 2012, both banks have received authorisation from the Supervisory Authority to extend the scope of the model to specific risk on debt securities. The model was extended on the basis of the current methodological framework (a historical simulation in full evaluation), and required the integration of the Incremental Risk Charge into the calculation of the capital requirement for market risks.

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

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

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

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

In the second quarter of 2016, market risks generated by Intesa Sanpaolo and Banca IMI decreased, compared to the averages for the first quarter of 2016. The average VaR for the period totalled 97 million euro, compared to 105 million euro in March 2016.

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

(millions of euro)

	2016				2015			
	average 2nd quarter	minimum 2nd quarter	maximum 2nd quarter	average 1st quarter	average 4th quarter	average 3rd quarter	average 2nd quarter	average 1st quarter
Intesa Sanpaolo	11.5	10.2	14.1	14.9	13.2	11.6	13.8	12.1
Banca IMI	85.5	70.8	122.4	90.0	85.0	104.7	71.1	64.6
Total	**97.0**	**82.4**	**134.0**	**104.9**	**98.3**	**116.3**	**84.9**	**76.7**

[(a)] Each line in the table sets out past estimates of daily VaR calculated on the 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.

Compared to the previous year, the risk measures were up in the first half: for 2016 the average Group VaR is 101 million euro. In 2015 the average was approximately 81 million euro.

(millions of euro)

	2016			2015		
	average 1st half	minimum 1st half	maximum 1st half	average 1st half	minimum 1st half	maximum 1st half
Intesa Sanpaolo	13.2	10.2	17.5	12.9	6.0	18.5
Banca IMI	87.7	64.8	122.4	67.9	54.0	113.6
Total	**100.9**	**78.4**	**134.0**	**80.8**	**64.5**	**122.7**

[(a)] Each line in the table sets out past estimates of daily VaR calculated on the historical time-series of the first six 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.

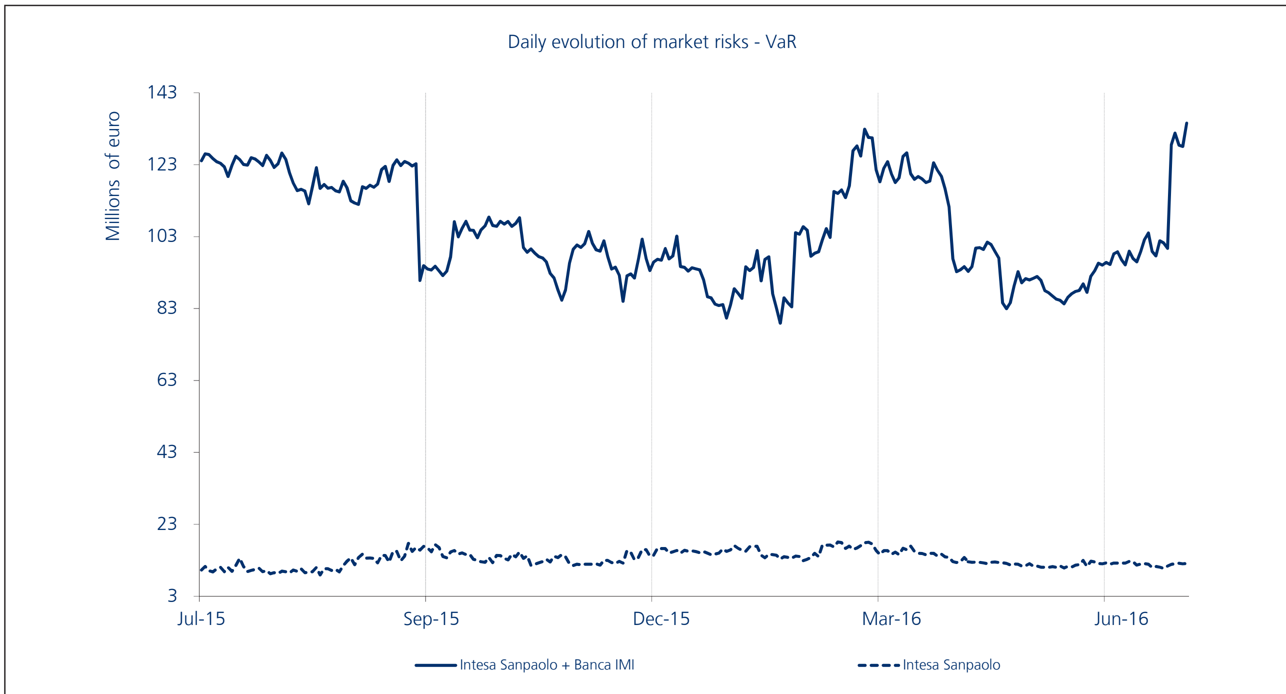
For Intesa Sanpaolo, the breakdown of risk profile in the second quarter of 2016, with regard to the various factors, shows the prevalence of the risk generated by foreign exchange, which accounted for 45% of total VaR (primarily linked to hedge positions of banking book entries, excluding which, the component relating to interest rate risk is the main one); for Banca IMI, credit spread risk was the most significant, representing 82% of total VaR.

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

2nd quarter 2016	Shares	Hedge funds	Interest rates	Credit spreads	Foreign exchange rates	Other parameters	Commodities
Intesa Sanpaolo	5%	12%	18%	16%	45%	3%	0%
Banca IMI	5%	0%	8%	82%	1%	2%	2%
Total	**6%**	**1%**	**15%**	**69%**	**5%**	**2%**	**2%**

[(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 second quarter of 2016, broken down between Intesa Sanpaolo and Banca IMI and indicating the distribution of overall capital at risk.

The trend of VaR is mainly due to Banca IMI. The second quarter of 2016 first saw a reduction in the VaR due to sales and the exit from volatility scenarios, and then, starting in mid-May, the measures recorded slight growth as a result of purchases of government bonds (taken on within the limits approved for 2016). On 24 June, following the outcome of the referendum in the UK (with the "leave" winning) the markets recorded volatility in credit spreads companied by the decrease in interest rates and share prices. The new scenario generated an increase in Group VaR, which recorded a peak of 134 million euro at the end of the period. However, risk measures remained contained within the assigned limits, and in the first few days of July, showed a slight decrease.



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 June is summarised in the table below.

(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	-3	8	-36	87	311	-299	27	-22	29	-16

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 3 million euro;
– on interest rate exposures, a rise of the curves of 40 basis points would have had a negative impact of 36 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 299 million euro loss;
– on foreign exchange exposures, were the Euro to appreciate against the US dollar by 10%, a loss of approximately 22 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 16 million euro.

Backtesting

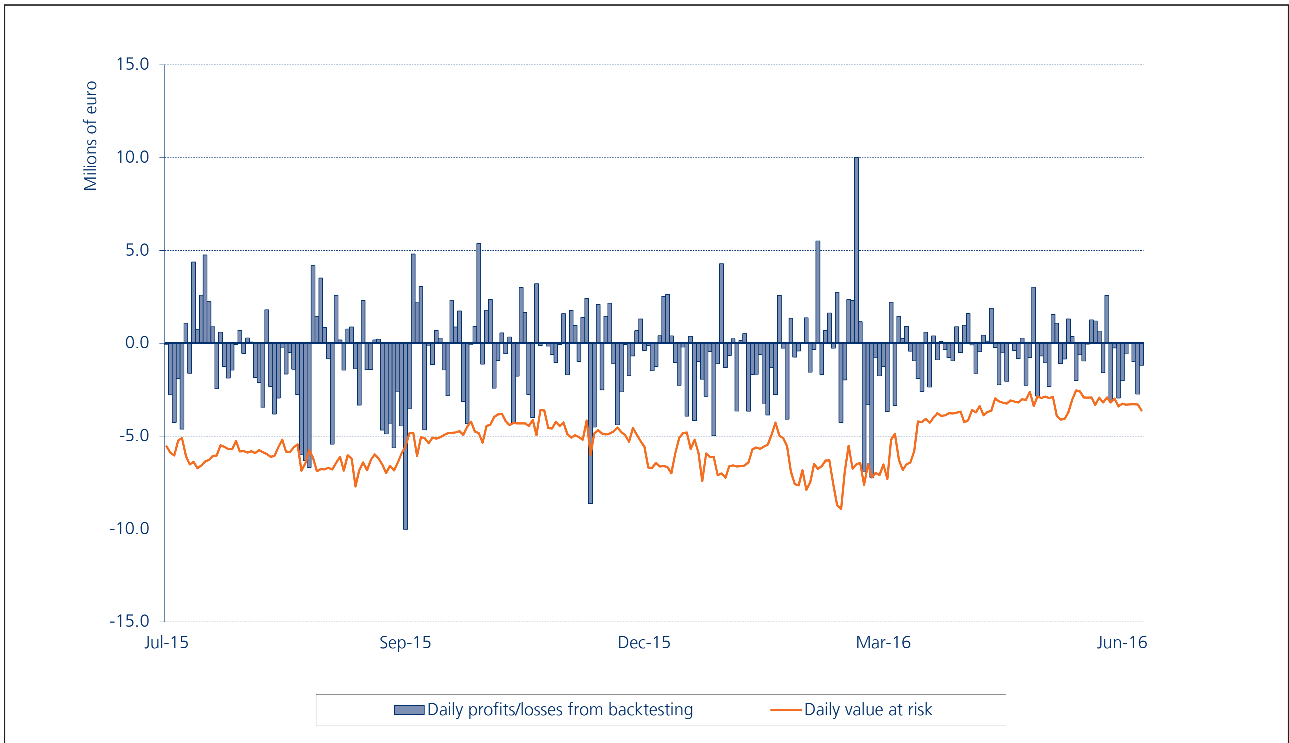
The effectiveness of the VaR calculation methods must be monitored daily via backtesting which, as concerns regulatory backtesting, compares:

– 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.

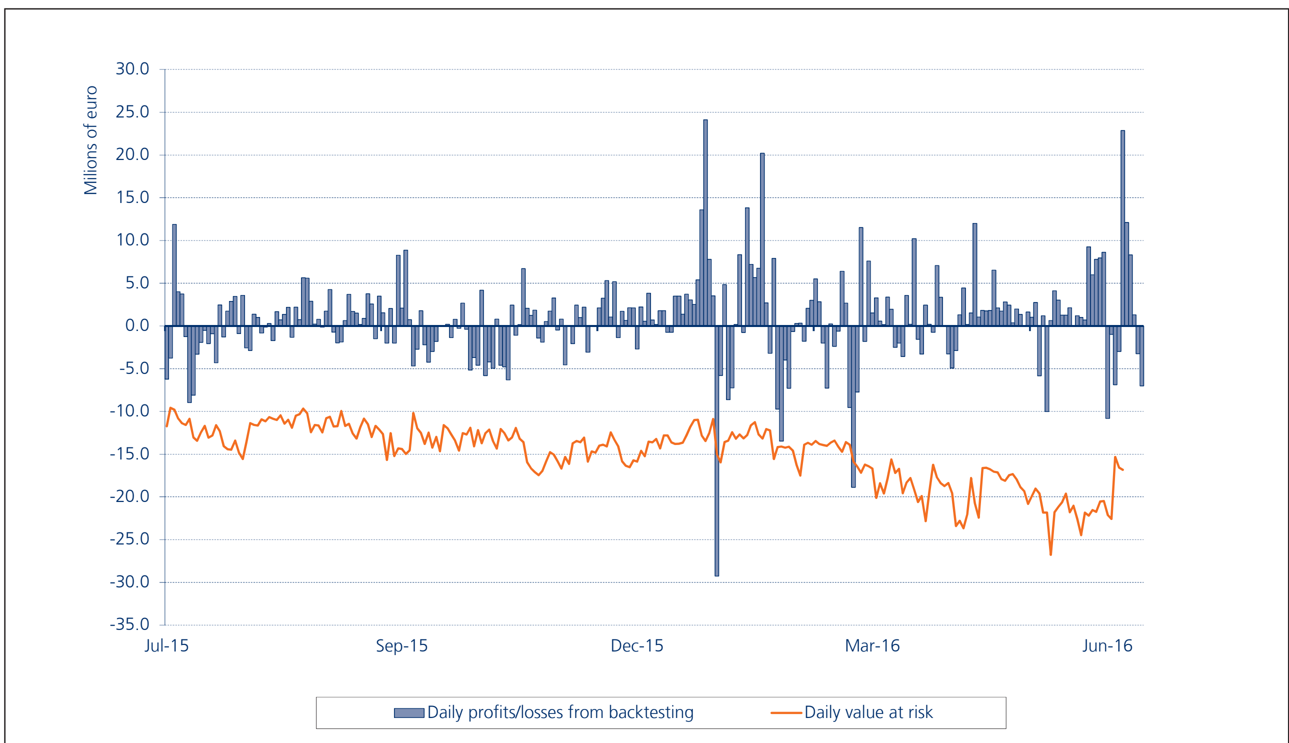
Backtesting in Intesa Sanpaolo

There were three 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

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



BANKING BOOK

Market risk originated by the banking book arises primarily in the Parent Company and in the other main Group companies involved in retail and corporate banking. The banking book also includes exposure to market risks deriving from the equity investments in listed companies not fully consolidated, mostly held by the Parent Company and by 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 macrohedging of the stable portion of on demand deposits (core deposits) and on the already fixed portion of variable-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 six 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 768 million euro, settling at 1,100 million euro at the end of June 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 642 million euro at the end of June 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 six months of 2016 (139 million euro at the end of 2015), with a maximum value of 85 million euro and a minimum value of 40 million euro; the latter figure coincides with the value at the end of June 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 59 million euro in the first six months of 2016 (27 million euro at the end of 2015), with a minimum value of 16 million euro and a maximum value of 146 million euro; the latter figure coincides with the value at the end of June 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 a sensitivity to a 10% negative shock equal to 6.8 million euro at the end of June 2016.

LIQUIDITY RISK

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

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

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

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

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

The departments of the Parent Company that are in charge of ensuring the correct application of the Guidelines are, in particular, the Treasury Head Office Department, the Planning and Active Value Management Head Office Department, responsible for liquidity management, and the Financial and Market Risks Head Office Department (DCRFM), 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 six months of 2016 the Group's liquidity position remained largely within the limits provided for in the Group's Liquidity Policy in force: both indicators (LCR and NSFR) were largely exceeded, already reaching a level above the limits under normal

conditions. As at 30 June 2016, the eligible liquidity reserves for the Central Banks, considering cash components, came to 130 billion euro (117 billion euro at the end of December 2015), of which 69 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 assets and transactions in derivatives with customers.

FAIR VALUE MEASUREMENT OF FINANCIAL ASSETS AND LIABILITIES

General principles

This chapter summarises the criteria used by the Group to measure the fair value of financial instruments. These criteria are substantially unchanged with respect to those illustrated in detail in the Annual Report 2015, to which reference is made for more information.
The Intesa Sanpaolo Group governs and defines the fair value measurement of financial instruments through the Group's Fair Value Policy, prepared by the Financial and Market Risks Department and also applied to the Parent Company and to all consolidated subsidiaries.
The fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants (i.e. not as part of the compulsory liquidation or a below-cost sale) as at the measurement date. Fair value is a market measurement criterion, not specifically referring to a single bank. 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 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, pricing service 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 premiums for liquidity risk, expansion or increase of the bid-ask spread, reduction or total lack of market for new issues, limited publicly-available information), analyses of the transactions or of the quoted prices are carried out.

Fair value hierarchy

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 quoted prices (unadjusted) in active markets for identical assets or liabilities accessible by the entity as at the measurement date;
- livello 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 close of the reference period.
For financial instruments with a scarcely significant bid-ask spread or for financial assets and liabilities with offsetting market risks, mid-market prices are used (again referred to the last day of the reference period) instead of the bid or ask price.
When no quotation on an active market exists or the market is not functioning regularly, that is when the market does not have a sufficient and continuous number of trades, and bid-ask spreads and volatility that are not sufficiently contained, the fair value of the financial instruments is mainly determined through the use of valuation techniques whose objective is the establishment of the price at which, in an orderly transaction, the asset is sold or the liability transferred between market participants, as at the measurement date, under current market conditions.
Such techniques include:
- the use of market values that are indirectly linked to the instrument to be measured, deriving from products with the same risk profile (level 2 inputs);

- valuations performed using – in whole or in part but primarily – inputs not identified from parameters observed on the market, for which estimates and assumptions made by the valuator are used (level 3 inputs).

In the case of level 2 inputs, the valuation is based on prices or credit spreads presumed from the official listing of instruments which are similar in terms of risk factors, using a given calculation methodology (valuation model). The use of this approach requires the identification of transactions on active markets in relation to instruments that, in terms of risk factors, are comparable with the instrument to be measured.
In 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 measurements: for each asset class, the Fair Value Policy and the Market Data Reference Guide establish the processes necessary to identify market parameters and the means according to which such data must be extracted and used;
- Certification and treatment of market data for periodic measurements: this stage consists of the accurate verification, at each accounting assessment date, of the market parameters used (verifying the integrity of data contained on the proprietary platform with respect to the source of contribution), reliability tests (consistency of each single figure with similar or comparable figures) and verification of concrete application means.
- Certification of valuation models and Model Risk Assessment: this phase is aimed at verifying the consistency 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 valuation models over time: monitoring consists of verifying the adherence to the market of the valuation model in order to discover any gaps promptly and start the necessary verifications and interventions.

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

Adjustments adopted to reflect model risk and other uncertainties related to the valuation
If problems are found by the Model Validation process or the Model Risk Monitoring process in the calculation of the fair value of particular financial instruments, the appropriate Mark-to-Market Adjustments to be made to the valuations are identified. These adjustments are regularly reviewed, also considering market trends, or the introduction of new liquid instruments, different calculation methodologies and, in general, methodological advances which may also lead to significant changes in selected models and their implementation.
In addition to the adjustments relating to the abovementioned factors, also other types of adjustments ("Mark-to-Market Adjustment") relating to other factors capable of influencing the valuation are included. These factors essentially involve:

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

The management of the Mark-to-Market Adjustment process is formalised with appropriate calculation methodologies on the basis of the different configurations of the points set out above. Calculation of the adjustments depends on the dynamics of the factors indicated above and is disciplined by the Financial and Market Risks Department. For new products, the decision to apply Mark-to-Market Adjustment processes is taken during the process for the approval of new products, upon the proposal of the Financial and Market Risks Department.
Following the crisis of 2007, the market progressively introduced a series of adjustments linked to the credit and liquidity risk, with impacts on both the income statement and the capital, collectively shown as XVA. In line with market practices, in the past the Intesa Sanpaolo Group introduced the Credit/Debt Value Adjustment (bCVA), and, starting from 31 March 2016, it implemented the Funding Value Adjustment (FVA) in the valuation of OTC derivatives. The latter assessment component takes into consideration the liquidity risk premium, connected to the costs of funding the cash flows generated by an OTC derivative portfolio (coupons, dividends, collateral, etc.). Like the bCVA, the FVA depends on the probability of default of the counterparties and considers any netting and collateralisation agreements (CSA).

Fair value hierarchy

Assets and liabilities measured at fair value on a recurring basis: fair value by level

(millions of euro)

Financial assets / liabilities at fair value	**30.06.2016**			**31.12.2015**		
	Level 1	**Level 2**	**Level 3**	**Level 1**	**Level 2**	**Level 3**
1. Financial assets held for trading	15,241	36,374	884	17,994	32,546	1,057
2. Financial assets designated at fair value through profit or loss	56,341	946	661	51,847	1,200	616
3. Financial assets available for sale	142,299	7,259	2,907	120,864	8,152	2,318
4. Hedging derivatives	-	8,019	29	-	7,039	20
5. Property and equipment	-	-	-	-	-	-
6. Intangible assets	-	-	-	-	-	-
Total	**213,881**	**52,598**	**4,481**	**190,705**	**48,937**	**4,011**
1. Financial liabilities held for trading	13,654	35,426	260	11,217	31,972	333
2. Financial liabilities designated at fair value through profit or loss	-	51,360	-	-	47,022	-
3. Hedging derivatives	-	11,315	2	-	8,228	6
Total	**13,654**	**98,101**	**262**	**11,217**	**87,222**	**339**

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

As shown in the table, level 3 instruments, which allow for more discretion in fair value measurement, still account for a limited portion of the financial instruments portfolio, accounting for 1.7% for financial assets and 0.2% for financial liabilities.
Approximately 79% of financial assets measured at fair value are determined based on market prices, and therefore without any discretion by the valuator.

In addition to the transfers relating to financial assets and liabilities measured at level 3 as detailed below, note that the following transfers were made during the first half of 2016:

– from level 1 to level 2:
  financial assets held for trading for 143 million euro (book value as at 30 June 2016);
  financial assets designated at fair value through profit and loss for 6 million euro (book value as at 30 June 2016);
  financial assets available for sale for 91 million euro (book value as at 30 June 2016);
  financial liabilities held for trading for 17 million euro (book value as at 30 June 2016).
– from level 2 to level 1:
  financial assets held for trading for 343 million euro (book value as at 30 June 2016);
  financial assets designated at fair value through profit and loss for 63 million euro (book value as at 30 June 2016);
  financial assets available for sale for 355 million euro (book value as at 30 June 2016);
  financial liabilities held for trading for 1,027 million euro (book value as at 30 June 2016).

Transfers between fair value levels derive from the evolution of the observability of prices or market data used to measure the instruments and the significance of the unobservable inputs.
The transition from level 1 to level 2 occurs where an active market for that instrument no longer exists, a situation verified by analysing the reliability and reciprocal consistence of the prices available according to the Group Fair Value Policy. Conversely, securities that are subject to mark-to-model measurement using observable inputs on the market – classified, therefore, as level 2 – are transferred to level 1 when the existence of an active market is identified.

Half-yearly changes in assets designated at fair value on a recurring basis (level 3)

(millions of euro)

	Financial assets held for trading	Financial assets designated at fair value through profit or loss	Financial assets available for sale	Hedging derivatives	Property and equipment	Intangible assets
1. Initial amount	**1,057**	**616**	**2,318**	**20**	**-**	**-**
2. Increases	**208**	**78**	**954**	**9**	**-**	**-**
2.1 Purchases	141	33	818	-	-	-
2.2 Gains recognised in:	31	9	77	9	-	-
2.2.1 Income statement	*31*	*9*	*22*	*9*	-	-
- of which capital gains	*30*	*9*	*13*	*9*	-	-
2.2.2 Shareholders' equity	*X*	*X*	*55*	-	-	-
2.3 Transfers from other levels	30	36	12	-	-	-
2.4 Other increases	6	-	47	-	-	-
3. Decreases	**-381**	**-33**	**-365**	**-**	**-**	**-**
3.1 Sales	-115	-1	-102	-	-	-
3.2 Reimbursements	-51	-21	-49	-	-	-
3.3 Losses recognized in:	-134	-4	-138	-	-	-
3.3.1 Income statement	*-134*	*-4*	*-30*	-	-	-
- of which capital losses	*-115*	*-4*	*-30*	-	-	-
3.3.2 Shareholders' equity	*X*	*X*	*-108*	-	-	-
3.4 Transfers to other levels	-75	-	-10	-	-	-
3.5 Other decreases	-6	-7	-66	-	-	-
4. Final amount	**884**	**661**	**2,907**	**29**	**-**	**-**

"Transfers from other levels" of "Financial assets held for trading" are mainly due to derivative contracts with a positive fair value.

Half-yearly changes in liabilities designated at fair value on a recurring basis (level 3)

(millions of euro)

	Financial liabilities held for trading	Financial liabilities designated at fair value through profit or loss	Hedging derivatives
1. Initial amount	**333**	**-**	**6**
2. Increases	**9**	**-**	**-**
2.1 Issues	-	-	-
2.2 Losses recognised in:	3	-	-
2.2.1 Income statement	*3*	-	-
- of which capital losses	*3*	-	-
2.2.2 Shareholders' equity	*X*	*X*	-
2.3 Transfers from other levels	-	-	-
2.4 Other increases	6	-	-
3. Decreases	**-82**	**-**	**-4**
3.1 Reimbursements	-	-	-
3.2 Repurchases	-	-	-
3.3 Gains recognised in:	-75	-	-4
3.3.1 Income statement	*-75*	-	*-4*
- of which capital gains	*-74*	-	*-4*
3.3.2 Shareholders' equity	*X*	*X*	-
3.4 Transfers to other levels	-7	-	-
3.5 Other decreases	-	-	-
4. Final amount	**260**	**-**	**2**

"Financial liabilities held for trading" refer to derivative contracts with a negative fair value.

Assets and liabilities not measured at fair value or measured at fair value on a non-recurring basis: fair value by level

(millions of euro)

Assets/liabilities not measured at fair value or measured at fair value on a non-recurring basis	30.06.2016		31.12.2015	
	Book value	Fair value	Book value	Fair value
1. Investments held to maturity	1,246	1,318	1,386	1,453
2. Due from banks	36,879	36,800	34,445	34,374
3. Loans to customers	360,240	372,724	347,333	357,749
4. Investment property	93	120	357	383
5. Non-current assets held for sale and discontinued operations	966	971	3,431	3,434
Total	**399,424**	**411,933**	**386,952**	**397,393**
1. Due to banks	67,656	67,554	59,327	59,140
2. Due to customers	271,722	272,467	255,275	255,829
3. Securities issued	107,921	108,428	110,144	112,128
4. Liabilities associated with non-current assets	336	357	116	116
Totale	**447,635**	**448,806**	**424,862**	**427,213**

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

Sensitivity analysis for financial assets and liabilities measured at level 3

As required by IFRS 13, for the financial assets and liabilities measured at level 3 the following table lists the effects of a change in one or more non-observable parameters used in the valuation techniques adopted to determine the fair value.

Financial assets/liabilities	Non-observable parameters	Sensitivity (thousands of euro)	Change in non-observable parameter
Held for trading and available for sale securities	Credit spread	-107	1 bp
Held for trading and available for sale securities	Correlation	6	1%
Held for trading and available for sale securities	CPR	-115	-1%
Held for trading and available for sale securities	Recovery rate	-148	-1%
OTC Derivatives - Equity	Historical volatility for the underlying Euro Class S.p.a.	-282	10%
OTC Derivatives - Interest rate	Correlation for spread options between swap rates	-1,414	0.10
OTC Derivatives - Equity	Correlation between underlying equity baskets	-211	0.10
Derivati OTC - Interest rate	Swaption volatility in JPY	-222	10%

The sensitivity analysis performed on level 3 structured credit products highlights a negative change in fair value, referring to complex credit derivatives, of 170,786 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).

Information on "Day one profit/loss"

Under IAS 39, financial instruments shall be initially recognised at fair value. The fair value of a financial instrument on initial recognition is normally the "transaction price", i.e. the fair value of the consideration given or received in relation to, respectively, financial assets and liabilities.

The fact that, upon initial recognition, the fair value of a financial instrument coincides with the transaction price is always intuitively verifiable in the case of transactions falling under level 1 of the fair value hierarchy. Also in the case of level 2, which is based on quotes that can be derived indirectly from the market (Comparable Approach), the fair value and the price often coincide upon initial recognition. Any differences between the price and the fair value are usually allocated to the so-called commercial margins, which are taken to the income statement when the financial instrument is initially measured.

Conversely, with respect to level 3 instruments, which have more discretion in fair value measurement, no definite reference benchmark is available to compare the transaction price with. For the same reason, the calculation of any commercial margin to be taken to the income statement is also difficult. In this event, the instrument is always initially recognised at the transaction cost. Subsequent measurement shall not include the difference between cost and fair value identified upon initial recognition (also defined as Day-One-Profit - DOP).

[3] This 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 previous paragraph "Fair value measurement").

This difference shall be recognised in the income statement only when it arises from changes of the factors over which market participants base their valuations when fixing prices (including the time effect). Where the instrument has a definite maturity and no model is available to monitor the changes to the factors over which prices are based, the DOP can be recognised in the income statement systematically over the life of such instrument.
When a level 3 instrument is reclassified to level 2, the residual deferred Day-One-Profits are recognised in the income statement. Similarly, in the event of "on the book" transactions falling under the Bank's investing activities, the Day-One-Profits earned on level 3 transactions (including in the above "on the book" management) are taken to the income statement when the Group entity (the investment bank) carries out transactions which substantially eliminate the risks of the level 3 instrument which generated the DOP.
The above regulation applies only to those instruments which fall in one of the classes which can be recognised at fair value through profit and loss (Fair Value Option and Trading Book). Indeed, only for the latter, the difference between the transaction price and the fair value would be taken to the income statement upon initial recognition.
The following table shows the DOP amount trend deferred in the balance sheet, indicating the portion taken to the income statement.

(millions of euro)

1. Initial amount	**1**
2. Increases	**-**
2.1 New transactions	-
3. Decreases	**-**
3.1 Releases to the income statement	-
4. Final amount	**1**

STRUCTURED CREDIT PRODUCTS

The risk exposure to structured credit products amounted to 2,521 million euro as at 30 June 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.
The rise in exposure in funded and unfunded ABS/CDOs designated at fair value (from 1,988 million euro in December 2015 to 2,099 million euro in June 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 decrease was recorded (from 441 million euro in December 2015 to 422 million euro in June 2016), attributable to the sales that concerned the portfolio of the Parent Company and Banca IMI, only partially offset by higher investments.
The decrease in the exposure of structured packages is attributable to expiries during the period.
From an income statement perspective, a result of -2 million euro was recorded in the first half of 2016, compared to -1 million euro for 2015.
As at 30 June 2016 the "Profits (losses) on trading – caption 80" of the exposure to funded and unfunded ABS/CDO came to -1 million euro (-1 million euro in 2015), generated by the positions in Multisector CDOs, while positions in funded European and US ABS/CDOs and in US subprime had a nil result.
The exposure to funded and unfunded ABS/CDOs in securities classified by the subsidiary Banca IMI in the available-for-sale portfolio recorded a net increase in fair value of less than 1 million euro, accounted for in the specific Shareholders' Equity Reserve, and an impact on the income statement for sales made in the period of +3 million euro. The securities reclassified in the Loan portfolio recorded an impact of -7 million euro as at 30 June 2016, to be attributed to the Parent Company, which posted negative adjustments due to the impairment of several securities in the portfolio (-1 million euro in 2015).
The "Monoline risk" and "Non-monoline packages" made a contribution to "Profits (Losses) on trading – caption 80" of +3 million euro as at 30 June 2016, compared with the nil contribution as at 31 December 2015.

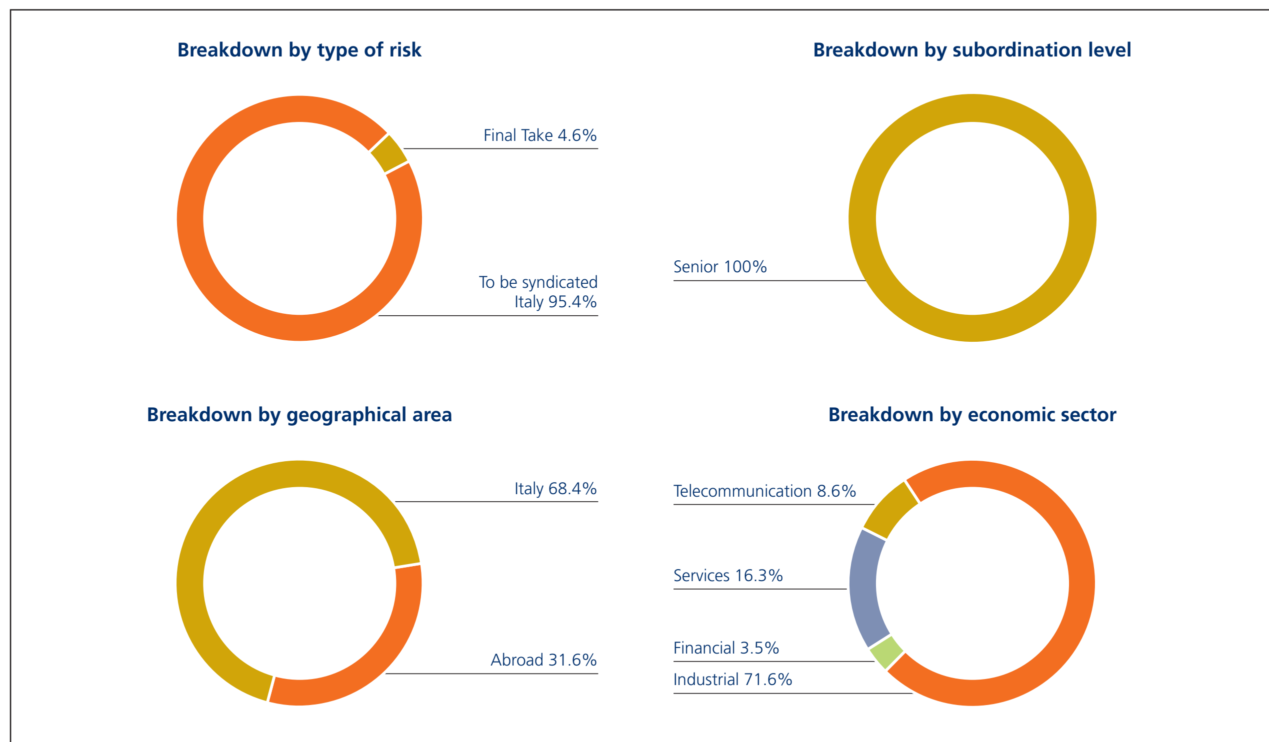
INFORMATION ON ACTIVITIES PERFORMED THROUGH SPECIAL PURPOSE ENTITIES (SPEs)

For the purpose of this analysis, legal entities established to pursue a specific, clearly defined and limited objective are considered Special Purpose Entities (raising funds on the market, acquiring/selling/managing assets both for asset securitisations, acquisition of funding through self-securitisations and the issue of covered bonds, developing and/or financing specific business initiatives, undertaking leveraged buy-out transactions, or managing credit risk inherent in an entity's portfolio).
The sponsor of the transaction is normally an entity which requests the structuring of a transaction that involves the SPE for the purpose of achieving certain objectives. In some cases the Bank is the sponsor and establishes a SPE to achieve one of the objectives cited above.
For the SPE categories identified as not consolidated structured entities, no amendments are recorded to the criteria based on which the Intesa Sanpaolo Group decides on whether to include the companies in the scope of consolidation, compared to the information already provided in the 2015 financial statements.

In the first half 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 for funding or self-securitisations 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 30 June 2016, 111 transactions for a total amount granted of 3,280 million euro met the above definition.
These exposures are classified under the loans portfolio. They also include the portions of syndicated loans underwritten or under syndication. In line with disclosure requirements, breakdown of exposures by geographical area, economic sector and by level of subordination is set out below.



INFORMATION ON INVESTMENTS IN HEDGE FUNDS

The hedge fund portfolio, held for trading, totalled 502 million euro as at 30 June 2016 compared to 758 million euro recorded in December 2015. The reduction in the portfolio is mainly due to the decrease in the value of the units underwritten during the first quarter, and to the significant distributions and redemptions in the second quarter, for the purpose of reducing risk levels.
As at the same date, the economic result of the investments in this segment was negative for 44 million euro (with a positive contribution of 4 million euro in the second quarter and a negative contribution of 48 million euro in the first quarter), compared to a positive 51 million euro which, vice versa, concerned "Profits (losses) on trading – caption 80" in the first half of 2015. The net losses of 44 million euro recognised as at 30 June 2016 are almost entirely attributable to a deterioration in the listed NAV of some funds recognised in the first quarter. More specifically, the greatest losses were recorded on the Paulson fund (16 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 (5 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, and reducing risks through a generalised downsizing of the allocations to the individual funds as a result of market uncertainty. During the second quarter of 2016, the main reductions concerned the funds Psam Master (MAP5), by 39 million euro, Paulson (MAP15) by 21 million euro,

Halcyon (MAP21) by 17 million USD and Avenue by 16 million euro. At the end of the half year, further returns were under way of approximately 90 million euro, which had not yet been carried out as at 30 June 2016.

INFORMATION ON TRADING TRANSACTIONS IN DERIVATIVES WITH CUSTOMERS

Considering relations with customers only, as at 30 June 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 8,980 million euro (7,670 million euro as at 31 December 2015). The notional value of these derivatives totalled 49,805 million euro (45,855 million euro as at 31 December 2015). Of these, the notional value of plain vanilla contracts was 46,306 million euro (42,521 million euro as at 31 December 2015), while that of structured contracts was 3,499 million euro (3,334 million euro as at 31 December 2015).

Please note that the positive fair value of contracts outstanding with the 10 customers with the highest exposures came to 6,097 million euro (5,161 million euro as at 31 December 2015), of which 567 million euro (493 million euro as at 31 December 2015) referred to structured contracts.

Conversely, the negative fair value referring to total contracts outstanding, determined with the same criteria, for the same types of contracts and with the same counterparties, totalled 2,004 million euro as at 30 June 2016 (1,929 million euro as at 31 December 2015). The notional value of these derivatives totalled 19,782 million euro (20,304 million euro as at 31 December 2015). Of these, the notional value of plain vanilla contracts was 17,378 million euro (17,999 million euro as at 31 December 2015), while that of structured contracts was 2,404 million euro (2,305 million euro as at 31 December 2015).

The fair value of derivative financial instruments entered into with customers was determined considering, as for all other OTC derivatives, the creditworthiness of the single counterparty ("Bilateral Credit Value Adjustment"). With regard to contracts outstanding as at 30 June 2016, this led to a negative effect of 25 million euro being recorded under “Profits (Losses) on trading” in the income statement.

As regards the methodologies used in determining the fair value of financial instruments, see the specific paragraphs in this chapter.

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

OPERATIONAL RISK

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

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

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

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

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

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

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

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

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

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

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

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

Legal risks

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

As at 30 June 2016, a total of about 17,000 disputes were pending (excluding Risanamento S.p.A., which is not subject to management and coordination by Intesa Sanpaolo) with a total remedy sought of 7.7 billion and provisions of almost 800 million euro. Of these disputes, approximately 1.6 billion euro regarded claims concerning loan positions, 2 billion euro regarded civil and administrative disputes, 0.9 billion euro regarded anatocism, 0.6 billion regarded bankruptcy revocatory actions and 0.6 billion euro regarded insolvency compensation.

During the first six months of 2016 no new significant legal procedures were initiated. The changes regarding the disputes referred to in the Notes to the 2015 financial statements are stated below. Reference should be made to said Notes for a more detailed description thereof.

Angelo Rizzoli Lawsuit - In April 2016 the Court of Appeal confirmed the first instance judgment in favour of Intesa Sanpaolo. Considering the favourable outcome of the first two instances of the proceedings, no provisions were allocated.

Mazzucco Group Lawsuit - The Court of Appeal postponed the deadlines for the proceedings to May 2017 for the decision on the case.

Fondazione Monte Paschi di Siena Lawsuit - As a result of the order of 23 February 2016 through which the Court of Siena accepted the claim of lack of jurisdiction raised by the Ministry for the Economy and Finance and ordered the lawsuit to be transferred to the Court of Florence, the Foundation reinstated the lawsuit. The first hearing is scheduled for 7 December 2016.

Acotel Group / Noverca Lawsuit - With measure dated 31 March 2016 the judge rejected the preliminary motions of the parties and set the hearing for the presentation of conclusions and discussion for 21 September 2016.
Specifically considering the non-admission of the court-appointed expert's report requested by the counterparty and the judge's decision to issue the ruling on conclusion of the discussion, the assessment of the case as risk-free currently stands.

I Viaggi del Ventaglio Group Lawsuits - The first instance proceedings of the lawsuit initiated in December 2011 by the bankruptcy trustee of Ventaglio International and by two of its subsidiaries, against Intesa Sanpaolo and another bank, was settled by way of judgment filed in February 2016, which rejected all the claims made on their merits, declaring them groundless both in fact and under law.
In May 2016 a new out-of-court formal notice was received, through which the bankruptcy trustee of I Viaggi del Ventaglio Resorts Ventaglio Real Estate S.r.l. claimed damages of 12 million euro. The notice concerns the same facts already attributed to the Bank in the lawsuit initiated by the bankruptcy trustee of Ventaglio International and, also on the basis of the outcome of said lawsuit, it is deemed that the claim lacks grounds.

Elifani Group Lawsuits - The judgment of the Court of Appeal of November 2015, upholding the judgment of the first instance favourable to Intesa Sanpaolo, was appealed before the Court of Cassation.

Alberto Tambelli Lawsuit - Unexpectedly, on 7 July 2016 the judgment of the Court of Appeal was published which, while rejecting most of the claims for damages formulated by Mr Tambelli, deemed that the damage concerning lost earnings resulting from the fact that Mr Tambelli was unable to make other investments should be compensated, due to the unavailability since 1994 of the amount which was the subject matter of the first instance sentencing of 2004. Though affirming that Mr Tambelli did not prove said damages, the Court ruled to accept the existence thereof and determine the damages based on the Court's mere assessment. The Court (which did not order any court-appointed expert's report) autonomously calculated the damages based on the profitability data of the equity and bond market recorded in the decade from the time the damages arose and the time the amounts settled by the first instance judge were collected (1994-2004). The Court thus calculated hypothetical income of approximately 20 million euro and deemed it "fair and reasonable to sentence the Bank to return to Mr Tambelli, as an increase in equity that could have been earned by using the amount made unavailable (lost earning), the total, comprehensive amount of 13,000,000.00 euro (including interest and revaluation), equal to around two-thirds of the total of the investments illustrated above".
The judgment is flawed in various aspects, which will be pointed out in the appeal to the Court of Cassation and the application to suspend the enforceability of the decision. Furthermore, the quantification of the damages made by the Court also has significant defects, both in the criteria used and in the mathematical calculation made.

Alis Holding Lawsuit
Assessments are under way concerning the possibility of an amicable settlement, also considering the high value of the demand for compensation and the risks that, though in a scenario favourable to the Bank, are inevitably related to the continuation of such complex lawsuits. The Judge, having been informed by the parties that negotiations are under way, postponed the lawsuit to 27 September 2016 to rule on the preliminary motions, whose outcome is generally additionally uncertain.

Administrative proceedings involving the New York Branch
During the half year, the discussions with the FED and the New York State Department for Financial Services - the financial services supervisory body of the State of New York – regarding the proceedings, launched in 2007, concerning the status of anti-money laundering controls at the New York Branch and the methods used for clearing payments in US dollars continued. The proceedings are under way and it is not possible to predict their outcome.

Potrošac Dispute
The conversion into Euro required by the law issued in September 2015 was completed in the initial months of 2016. The resulting costs, equal to approximately 171 million euro, were covered using the provisions allocated to the financial statements.
Said law decreased customers' interest in individual disputes, which dropped from 365 to 292 due to waiver of the lawsuits.

Tax litigation

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

The Parent Company has 319 pending litigation proceedings (303 as at 31 December 2015) for a total amount of 338 million euro (847 million euro as at 31 December 2015), calculated considering proceedings in both administrative and judicial venues at various instances. As regards those situations, actual risk was quantified at 91 million euro (229 million euro at the end of 2015, of which 135 million euro relating to litigation being settled).

At the Group's other Italian companies included in the scope of consolidation (with the exclusion of Risanamento S.p.A., not subject to management and coordination by Intesa Sanpaolo), tax litigation totalled 203 million euro as at 30 June 2016 (217 million euro at the end of 2015), covered by specific provisions of 35 million euro (27 million euro at the end of 2015).

Tax disputes involving international subsidiaries, totalling 540 million euro (537 million euro at the end of 2015), are covered by allowances of 10 million euro (figure unchanged on 2015) and are almost exclusively comprised of the charge of illegal use of an offshore tax structure brought by the Italian tax authorities against the Luxembourg subsidiary Eurizon Capital S.A. (530 million euro, including interest accrued).

For Intesa Sanpaolo, the following situations are worth noting in the first half 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 deriving from two reports on findings by the Guardia di Finanza, served in September 2013 and February 2015, previously illustrated in detail in the 2015 Annual Report. Based on the agreement, the above-mentioned disputes, which present a total tax risk (only for taxes and penalties) that varies from a minimum of 530 million euro to a maximum of 866 million euro and represented approximately 60% of Intesa Sanpaolo's litigation, were settled through the payment of a total of 125 million euro, by way of principal and interest (equal to 23.6% of the minimum risk and 14.4% of the maximum risk, respectively).

During the first quarter, the implementation of the framework agreements reached with the Italian Revenue Agency in 2015 for complete settlement of the charges concerning the 2005 tax period 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 to a reimbursement 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 decisions were made by courts in the first and second instances during the half year, almost all favourable for the Group.
Furthermore, an additional assessment notice was served to the Bank due to higher value of the business units contributed, for a total of 2.1 million euro (plus interest), which was challenged before the competent Tax Commission.

On 29 March 2016, following the report on findings dated 27 July 2015, the Italian Revenue Agency, Emilia Romagna Regional Office, served the Bank with an assessment notice for the 2011 tax period of the merged company Neos Finance. The claim, concerning IRES and penalties of about 1.8 million euro, in addition to interest, concerns the determination criteria of the threshold under which the impairment of loans could be immediately deducted. Negotiations are under way with the Italian Revenue Agency in order to resolve the dispute through a tax settlement proposal.

The judgment of the Regional Tax Commission of Lombardy, filed on 9 June 2016, concluded the dispute concerning the refund of excess withholding paid on interest, premiums and other income on certificates of deposits and registered deposits of customers (for an amount of about 129 million euro, plus interest), stated in the annual income tax returns for 1998. The judgment merely declared the appeal that gave rise to the proceedings as inadmissible, disavowing the existence of a measure refusing the refund that can be autonomously challenged, without, however, ruling on the merits of the dispute. The Bank will not challenge the decision of the Regional Tax Commission due to lack of interest, as it has received indirect confirmation of the enforceability of the claim pending the statute of limitations.

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

Turning to the other Group companies, discussions were held with the Italian Revenue Agency, Emilia Romagna Regional Office, to settle the claims concerning the tax treatment by Group banks based in the region (Cariromagna, Carisbo and the merged Banca Monte Parma) of the losses related to the transfer of loans to customers out of the performing category, subject to lump-sum write-downs, to positions subject to individual impairment testing, as a consequence of their involvement in insolvency procedures. As conditions favourable to settlement did not occur, Carisbo and Cariromagna have challenged the notices of assessment served for 2010 before the competent Tax Commission (value of the disputes of 20 million euro and 15 million euro, respectively, for IRES, interest and penalties). For Cariromagna, the dispute challenging the notice of assessment for 2011 is also pending before the Tax Commission (value of the dispute of 3 million euro for IRES, interest and penalties). However, the notice of assessment for 2012 still has to be served for Cariromagna and the notices for 2011 and 2012 for Carisbo. In any event, attempts are under way to reach a settlement, as the Regulatory Head Office of the Italian Revenue Agency has been involved to provide an answer on the merits. The economic effect of the disputes would be limited to penalties and interest, as the findings are based on an issue of jurisdiction.

For Banco di Napoli, the report on findings served by the Italian Revenue Agency, Campania Regional Office on 21 December 2015, concerning IRES and IRAP for the 2011 tax period has been settled (actual charge of 0.25 million euro, for interest on higher taxes verified and reduced penalties).

For Mediocredito Italiano, on 29 June 2016, the Italian Revenue Agency, Lombardy Regional Office, Large Taxpayers Office served a report on findings relating to a tax audit launched on 9 April 2014 concerning direct taxes, IRAP, VAT and obligations of the tax collection agents relating to the 2011 tax period. The audit concluded without any findings against the Company.

For Intesa Sanpaolo Group Services, the general audit by the Guardia di Finanza, which began on 26 November 2015, continued, concerning IRES, IRAP, VAT, other indirect taxes and labour regulations for the 2013 tax period and following.

For Banca IMI, an inspection was conducted by the Italian Revenue Agency, which sent a questionnaire for the 2013 tax period and an inspection was launched, on 10 May 2016, by the Guardia di Finanza - Milan Tax Police squad for the years 2011 and 2012 regarding income taxes and withholdings specifically regarding arbitrage operations on securities and single stock future transactions reported by another Department of the Guardia di Finanza.

Moreover, on 22 January 2016, the Italian Revenue Agency began a general audit at Cassa di Risparmio del Veneto relating to the 2013 tax period.

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. However, the contacts with the fiscal authorities continue aimed at the recognition of the correctness of the Company's conduct, as it always acted in compliance with Italian rules and the treaty for the avoidance of double taxation between Italy and Luxembourg.

In the criminal tax area, during the first half of 2016, no situations arose that were worthy of mention, except for two judicial notices pursuant to art. 415-bis of the Italian Code of Criminal Procedure, to a top manager of the merged company Neos Finance, charging the crime of filing untrue tax returns (pursuant to art. 4 of Italian Legislative Decree no. 74/2000) in connection with the findings for the tax periods from 2010 to 2012 relating to the threshold for immediate deductibility of impairment of loans.

INSURANCE RISKS

Life business

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

Non-life business

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

Financial risks

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

Investment portfolios

The investments of the insurance companies of Intesa Sanpaolo Group (Intesa Sanpaolo Vita, Intesa Sanpaolo Assicura, Intesa Sanpaolo Life and Fideuram Vita) are made with their free capital and to cover contractual obligations with customers. These refer to traditional revaluable life insurance policies, Index- and Unit-linked policies, pension funds and non-life policies.
As at 30 June 2016, the investment portfolios of Group companies, recorded at book value, amounted to 143,062 million euro. Of these, a part amounting to 86,291 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 56,771 million euro.

Considering the various types of risks, the analysis of investment portfolios, described below, concentrates on the assets held to cover traditional revaluable life policies, non-life policies and free capital.
In terms of breakdown by asset class, net of derivative financial instruments, 87.4% of assets, i.e. approximately 75,468 million euro, were bonds, whereas assets subject to equity risk represented 1.9% of the total and amounted to 1,657 million euro. The remainder (9,253 million euro) consisted of investments relating to UCI, Private Equity and Hedge Funds (10.7%).
The carrying value of derivatives came to approximately -86 million euro, entirely relating to effective management derivatives.[4].
Hedging derivatives are currently not present in the portfolio.

At the end of the first six months of 2016, investments made with the free capital of Intesa Sanpaolo Vita and Fideuram Vita amounted to approximately 2,009 million euro at market value, and presented a risk in terms of VaR (99% confidence level, 10-day holding period) of approximately 67 million euro.
The modified duration of the bond portfolio, or the synthetic financial term of assets, is approximately 6.29 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 5.90 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 4,434 million euro.
The distribution of the portfolio by rating class is as follows. AAA/AA bonds represented approximately 4.7% of total investments and A bonds approximately 5.2%. Low investment grade securities (BBB) were approximately 87.3% of the total and the portion of speculative grade or unrated was minimal (approximately 2.7%).
A considerable portion of the BBB area is made up of securities issued by the Italian Republic.
The analysis of the exposure in terms of the issuers/counterparties produced the following results: securities issued by Governments and Central Banks approximately made up 76.9% of the total investments, while financial companies (mostly banks) contributed almost 13.2% of exposure and industrial securities made up approximately 9.8%.

[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 half 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 4,543 million euro, with 3,572 million euro due to government issuers and 971 million euro to corporate issuers (financial institutions and industrial companies).