
Risk management

MAIN RISKS AND UNCERTAINTIES

The macroeconomic scenario and the high volatility of the financial markets require constant monitoring of the factors that make it possible to pursue sustainable profitability: high liquidity, funding capacity, low leverage, adequate capital base, and prudent asset valuations.

Group liquidity remains high: as at 31 March 2017, both regulatory indicators envisaged by Basel 3 (LCR and NSFR), adopted also as internal liquidity risk measurement metrics, were well above the requirements for 2018. At the end of March, the Central Banks eligible liquidity reserves came to 156 billion euro (150 billion euro at the end of December 2016), of which 82 billion euro, net of haircut, was unencumbered (96 billion euro at the end of December 2016). The loan to deposit ratio at the end of March 2017, calculated as the ratio of loans to customers to direct deposits from banking business, came to 96%.

In terms of funding, the widespread branch network remains a stable, reliable source: 72% of direct deposits from banking business come from retail operations (277 billion euro). Moreover, during the quarter 1.25 billion euro in Additional Tier 1 instruments and 1 billion euro in senior Eurobonds were placed on the international markets.

With regard to the targeted refinancing operation TLTRO II, at the end of March 2017, the Group's participation amounted to 57 billion euro, equal to the maximum amount that can be requested (45 billion euro as at 31 December 2016).

The Intesa Sanpaolo Group leverage (6.4% as at 31 March 2017) continues to be at the top levels recorded in the sector.

The capital base also remains high. Own funds, risk weighted assets and the capital ratios at 31 March 2017 were calculated according to the harmonised rules and regulations for banks and investment companies contained in Directive 2013/36/EU (CRD IV) and in (EU) Regulation 575/2013 (CRR) of 26 June 2013, which have transposed the banking supervision standards defined by the Basel Committee (the Basel 3 Framework) to European Union laws, and on the basis of Bank of Italy Circulars 285, 286 and 154.

At the end of the quarter, total Own Funds came to 48,830 million euro, against risk-weighted assets of 281,530 million euro, which reflected primarily the credit and counterparty risk and, to a lesser extent, the operational and market risk.

The Total Capital Ratio stood at 17.3%, while the ratio of the Group's Tier 1 capital to its total risk-weighted assets (Tier 1 ratio) was 14.1%. The ratio of Common Equity Tier 1 capital (CET1) to risk-weighted assets (the Common Equity Tier 1 ratio) was 12.5%.

Common Equity Tier 1 capital does not include the net income for the year and, for consistency, the correlated dividend or the distribution of reserves proposed.

The Group's risk profile remained within the limits approved by the Risk Appetite Framework, consistent with the intention to continue to privilege commercial banking operations.

In relation to market risk, the Group's average risk profile during the first quarter of 2017 was approximately 85 million euro, compared to an average amount of approximately 105 million euro in the same period of 2016. The trend in the Group's VaR in the first three months of 2017 - mainly determined by Banca IMI - is described in greater detail later in this chapter.

The macroeconomic environment and the persisting financial market volatility heighten the complexity of assessing credit risk and measuring financial assets.

Intesa Sanpaolo has developed a set of instruments which ensure analytical control over the quality of loans to customers and financial institutions, and of exposures subject to country risk.

With regard to performing loans to customers, the "collective" adjustments, equal to 1,565 million euro, provide a coverage ratio of 0.5% (stable compared to the end of 2016).

The methods used to classify non-performing loans and to measure both non-performing and performing loans ensure that the impacts of the deteriorating economic environment on a debtor's position are promptly recognised. The economic crisis has called for constant review of the values of loans that had already shown problematic symptoms and of loans with no obvious signs of impairment. All categories of non-performing loans were assessed using the usual criteria of prudence, as highlighted by the substantial average coverage percentages for bad loans (60.4%) and unlikely to pay (27.5%).

Constant attention has been paid to the valuation of financial items. The majority of financial assets are measured at fair value, since classified as held for trading using the fair value option, under assets available for sale, or represented by hedging derivatives.

The fair value measurement of financial assets was carried out as follows: approximately 83% using level 1 inputs, around 15% using level 2 inputs and only close to 2% using level 3 inputs. Among the financial liabilities designated at fair value through profit and loss, most of the financial instruments (approximately 87%) were measured using the level 2 approach.

As regards the Intesa Sanpaolo Group's sovereign debt exposure, at the end of December exposure in securities to the Italian government amounted to a total of approximately 86 billion euro, in addition to receivables for approximately 14 billion euro.

The Group banks' exposure in securities amounted to approximately 35 billion euro, of which approximately 9.6 billion euro up to 3 years (approximately 27%), with a duration of 4.6 years. On the other hand, the duration of the insurance portfolio is longer, at 6.2 years, consistently with that of liabilities.

Investment levels in structured credit products and hedge funds remained low. The former generated a positive contribution of 8 million euro during the year. Also for the hedge funds, the economic result of the investments in this segment was positive and amounted to 5 million euro.

In volatile market environments, measuring the recoverable amount of intangible assets is also particularly delicate. However, with regard to intangible assets and goodwill, no problem issues were identified during the quarter – also in consideration of the short length of time since the last impairment test – requiring the remeasurement of their recoverable values. In particular, with regard to goodwill, the analyses conducted showed no significant changes to the main parameters and macroeconomic aggregates which could have an impact on the Group's expected cash flows and on the discounting rates thereof based on the models used to verify the retention of the recognition value of the intangible asset in the financial statements.

THE BASIC PRINCIPLES OF RISK MANAGEMENT

The Intesa Sanpaolo Group's risk acceptance policies are defined by the Board of Directors and the Management Control Committee, with management and control functions respectively. The Board of Directors carries out its activity through specific internal committees, among which 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 by 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 the Group might incur over a 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

In view of compliance with the reforms of the previous accord by the Basel Committee ("Basel 3"), the Intesa Sanpaolo 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.

With regard to credit risk, among the main changes please note the authorisations received from the ECB to use internal ratings-based approaches for the Public Sector Entities and Banks portfolios and use the new Corporate model for a scope extending to the Parent Company, the network banks in the Banca dei Territori Division and the main Italian and international Group companies.

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.

There were no changes in the scope of application of the internal models concerning counterparty risk for OTC derivatives and operational risk compared to 31 December 2016.

The annual Internal Capital Adequacy Assessment Process (ICAAP) Report, based on the extensive use of internal approaches for the measurement of risk, internal capital and total capital available, was approved and sent to the ECB in April 2017.

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 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 regard to loans to customers, risk measurement is performed by means of different internal rating models according to borrower segment (Corporate, Retail SME, Retail Mortgage, Other Retail, Sovereigns, Italian Public Sector Entities and Banks). These models make it possible to summarise the counterparty's credit quality in a value, the rating, which reflects the probability of default over a period of one year, adjusted on the basis of the average level of the economic cycle. These ratings are then made comparable with those awarded by rating agencies, by means of a uniform scale of reference.

Ratings and credit-risk mitigating factors (guarantees, loan types and covenants) play a key role in the loan granting and managing process.

On 9 March 2017, the Group received the authorisation from the ECB - effective after the 31 March 2017 - relating to the Banks and Public Sector Entities portfolios.

As regard the model for determining the probability of default for the Banks portfolio, the choice was made to differentiate between models for banks in mature economies and banks in emerging countries. In short, the model consists of a quantitative part and a qualitative part, differentiated according to mature and emerging countries, a country rating component representing systemic risk, a component relating to specific country risk for banks most closely correlated with country risk, and finally, a module (the "relationship manager's judgement") that allows the rating to be modified in certain conditions. The Loss Given Default (LGD) calculation model partly diverges from the models developed for the other segments as the estimation model used is based on the market price of debt instruments observed 30 days after the official date of default and relating to a sample of defaulted banks from all over the world, acquired from an external provider. The model is completed by an econometric estimate aimed at determining the most significant drivers, in accordance with the practice in use for the other models.

In the Public Sector Entities segment, the reference models have been differentiated according to the type of counterparty. Accordingly, default models have been developed for municipalities and provinces and shadow rating models for regions. An approach to extend the rating of the regulatory Entity (e.g.: Region) has been adopted for local healthcare authorities and other sector entities, with possible changes on the basis of financial statement assessments (notching). As regards the LGD estimate of the Public Sector Entities segment, the methodological framework is substantially similar to that used for the development of the LGD models of the already validated segments (Corporate, Retail SME, Retail Mortgage).

On 18 April 2017, the Group also received the authorisation from the ECB to use the new internal rating systems (PD) and LGD for the Corporate portfolio. With regard to the re-estimation of rating models, steps were taken, on the one hand, to broaden the information set used for counterparty evaluation and, on the other hand, efforts were made to simplify their framework and number. Finally, various measures have been adopted that are aimed at favouring a through-the-cycle profile of the probabilities of default produced by the models, consistently with the relational-type commercial approach adopted by the Group. With regard to the LGD, the most significant change is represented by the development of the model dedicated to non-performing loans. The scope of the authorisation also extends to the subsidiaries Intesa Sanpaolo Bank Ireland and Intesa Sanpaolo Bank Luxembourg. The Slovak subsidiary, Vseobecna Uverova Banka (VUB) uses this model only for counterparties with a turnover of more than 500 million euro.

On 31 March 2017, the Slovenian subsidiary, Banka Intesa Sanpaolo (formerly Banka Koper) received the authorisation from the ECB to use the internal rating systems (PD-FIRB) for the Corporate portfolio.

On 7 March 2017, the Slovak subsidiary, Vseobecna Uverova Banka (VUB) received the authorisation from the ECB to use the new internal rating model for the Retail Mortgage regulatory segment, valid from the Supervisory reporting as at 31 March 2017.

Credit quality

(millions of euro)

	31.03.2017			31.12.2016			Changes
	Gross exposure	Total adjustments	Net exposure	Gross exposure	Total adjustments	Net exposure	Net exposure
Bad loans	36,817	-22,249	14,568	37,834	-22,939	14,895	-327
Unlikely to pay	19,599	-5,384	14,215	19,745	-5,310	14,435	-220
Past due loans	568	-129	439	558	-121	437	2
Non-performing loans	56,984	-27,762	29,222	58,137	-28,370	29,767	-545
of which forborne	11,752	-3,672	8,080	11,727	-3,523	8,204	-124
Performing loans	325,549	-1,565	323,984	322,130	-1,607	320,523	3,461
of which forborne	7,851	-184	7,667	8,036	-208	7,828	-161
Performing loans represented by securities	13,665	-223	13,442	14,651	-228	14,423	-981
of which forborne	96	-1	95	97	-1	96	-1
Loans to customers	396,198	-29,550	366,648	394,918	-30,205	364,713	1,935

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

As at 31 March 2017, the Group's non-performing loans, net of adjustments, came to 29.2 billion euro, below the levels of the end of 2016 (-1.8%), and confirming the gradual decrease shown during the last year. Compared to the end of December 2016, there was also a decrease in non-performing assets as a percentage of total net loans to customers, down to 8% from 8.2% at the end of 2016.

In further detail, bad loans came to 14.6 billion euro, net of adjustments, at the end of the first quarter of 2017, down (-2.2%) from the beginning of the year, and represented 4% of total loans (4.1% at the end of 2016). During the same period, the coverage ratio stood at 60.4% (60.6% in December 2016). Loans included in the unlikely to pay category amounted to 14.2 billion euro, down by 1.5%, accounting for 3.9% of total loans to customers, with a coverage ratio of 27.5% (26.9% in December 2016). Past due loans amounted to 439 million euro, up 0.5% since the beginning of the year, with a coverage ratio which rose to 22.7%. 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 due to financial difficulty by the debtor) at the European level. Within the non-performing loan category, forborne exposures amounted to 8.1 billion euro, with an average coverage ratio of 31.2%, whereas those in the performing loan category were slightly lower (7.7 billion euro). The coverage ratio of performing loans was 0.5%.

MARKET RISKS

TRADING BOOK

During the first quarter of 2017, the market risks generated by Intesa Sanpaolo and Banca IMI increased compared to the average values of the fourth quarter of 2016. The average VaR for the period totalled 85.3 million euro compared to 75.6 million euro in the fourth quarter of 2016.

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

(millions of euro)

	average 1st quarter	2017 minimum 1st quarter	maximum 1st quarter	average 4th quarter	2016 average 3rd quarter	average 2nd quarter	average 1st quarter
Intesa Sanpaolo	11.5	10.1	12.5	11.7	11.5	11.5	14.9
Banca IMI	73.7	60.7	93.2	63.8	90.6	85.5	90.0
Total	85.3	72.1	104.8	75.6	102.2	97.0	104.9

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

In the first three months of 2017, the Group's average VaR was 85.3 million euro, down from 104.9 million euro in the same period of 2016.

(millions of euro)

	average 1st quarter	2017 minimum 1st quarter	maximum 1st quarter	average 1st quarter	2016 minimum 1st quarter	maximum 1st quarter
Intesa Sanpaolo	11.5	10.1	12.5	14.9	12.3	17.5
Banca IMI	73.7	60.7	93.2	90.0	64.8	115.0
Total	85.3	72.1	104.8	104.9	78.4	132.4

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

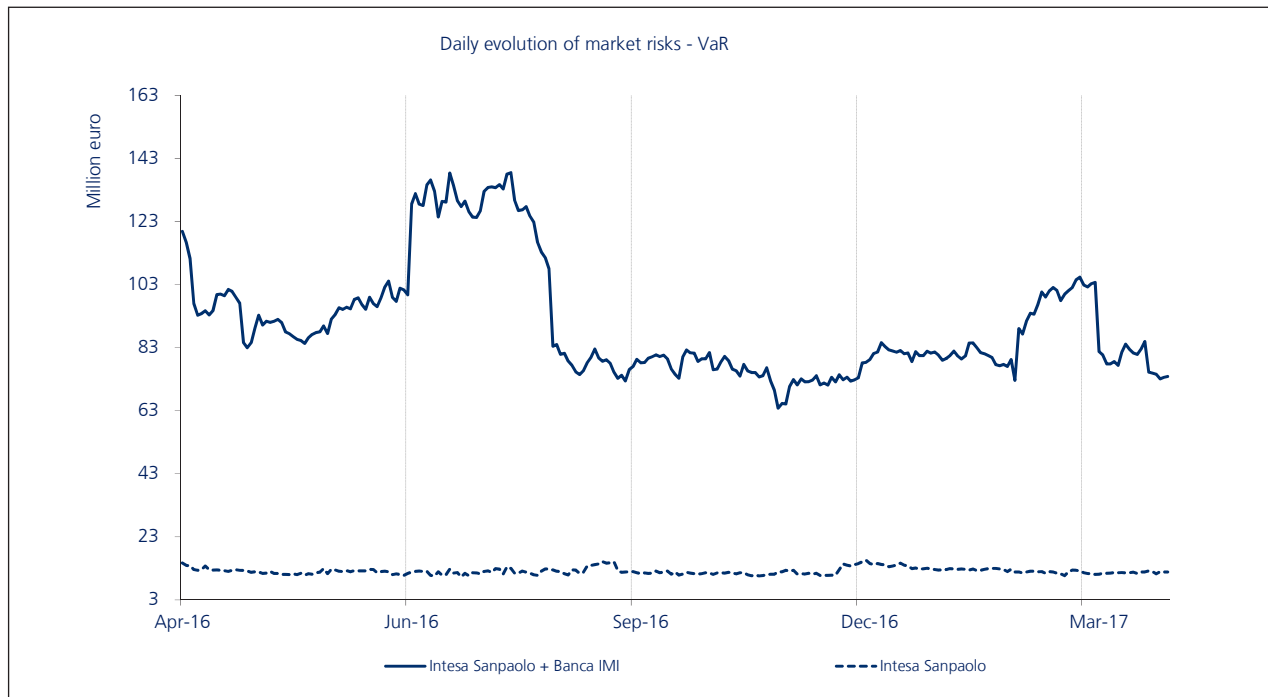
For Intesa Sanpaolo the breakdown of the risk profile in the first quarter of 2017, with regard to the various factors, shows the prevalence of the interest rate risk, which accounted for 32% of total VaR; for Banca IMI credit spread risk was the most significant, representing 76% of total VaR.

Contribution of risk factors to total VaR^(a)

1st quarter 2016	Shares	Hedge funds	Interest rates	Credit spreads	Foreign exchange rates	Other parameters	Commodities
Intesa Sanpaolo	5%	6%	32%	21%	33%	3%	0%
Banca IMI	7%	0%	8%	76%	1%	4%	4%
Total	6%	1%	12%	69%	5%	4%	3%

^(a) Each line in the table sets out the contribution of risk factors considering the overall VaR 100%, calculated as the average of daily estimates in the first quarter of 2017, broken down between Intesa Sanpaolo and Banca IMI and indicating the distribution of overall VaR.

The trend in VaR is mainly attributable to Banca IMI. During the first quarter of 2017 an increase in risks was recorded, due initially to a "scenario" effect (at the beginning of February a particularly volatile scenario was recorded for the credit spread risk factor) and subsequently to an increase in risks in the credit and equity sector. In the last month, the VaR recorded a decline due to the technical effect linked to the passage of time, whereby past scenarios, at the time volatile, assume, with the passing of days, a lower weighting in the calculation of risks.



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

(millions of euro)

	EQUITY		INTEREST RATES		CREDIT SPREADS		FOREIGN EXCHANGE RATES		COMMODITIES	
	Crash	Bullish	+40bp	lower rate	-25bp	+25bp	-10%	+10%	Crash	Bullish
Total	-2	34	5	-11	335	-327	15	-29	13	-18

In particular:

- for positions on equity markets, there would be a theoretical loss of 2 million euro in the event of a market crash (decline in prices of 15% on the European market and of 10% on the U.S. market and increase in volatility of 25%).
- for positions in interest rates, there would be a loss of 11 million euro in the event of a fall in rates.
- for positions in credit spreads, a widening of credit spreads of 25 bps would entail a loss of 327 million euro;
- for positions in foreign exchange, there would be losses in the event of a 10% increase in the EUR-USD exchange rate.
- finally, for positions in commodities, an increase in commodity prices of 20% (accompanied by a reduction in the price of gold of 15%) would entail a loss of 18 million euro.

Backtesting

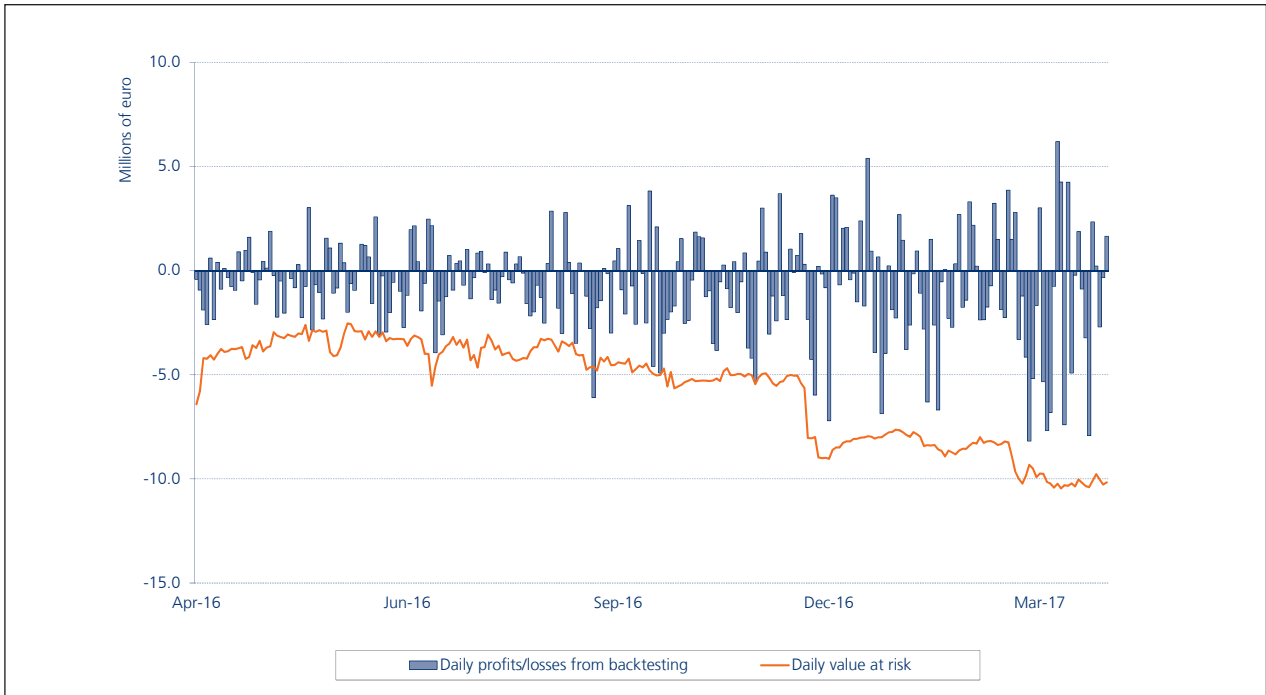
The effectiveness of the VaR calculation methods must be monitored daily via backtesting which, as concerns regulatory backtesting, compares:

- 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 revaluation 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.

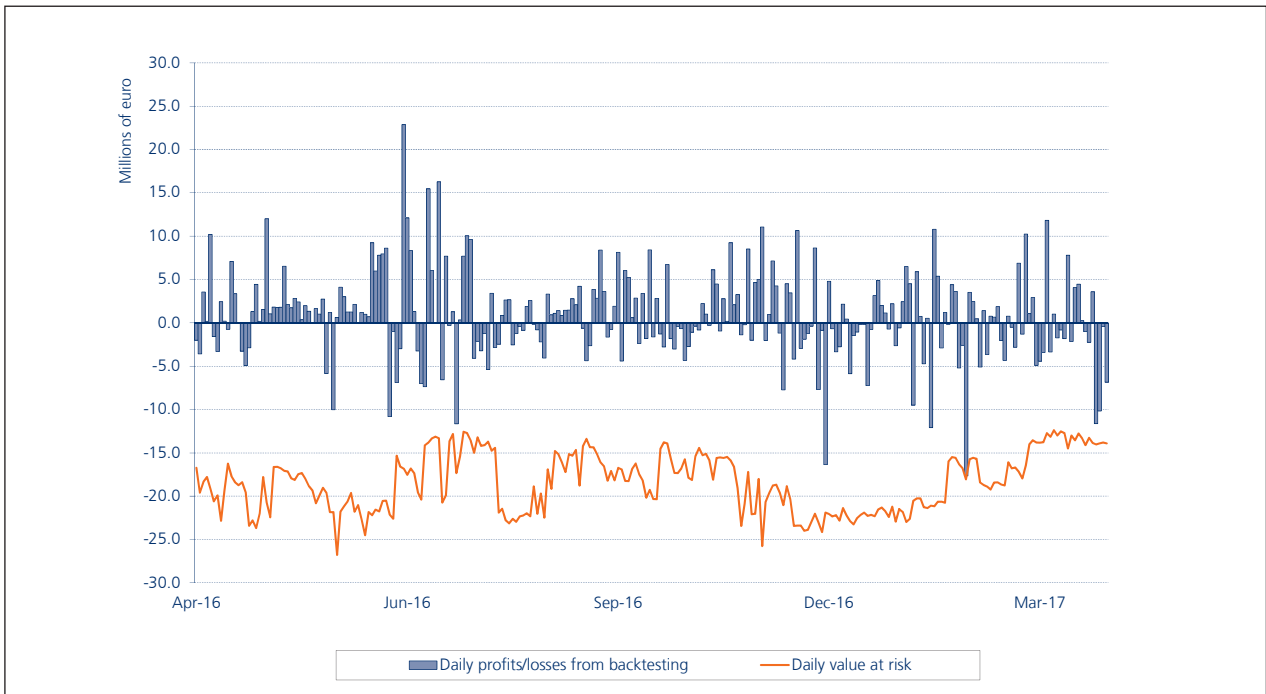
Backtesting in Intesa Sanpaolo

The effective backtesting exception of Intesa Sanpaolo relates to interest rate dynamics, with particular regard to the performance of cross currency swaps.



Backtesting in Banca IMI

In the last year, no backtesting exceptions have been found.



BANKING BOOK

In the first three months of 2017, interest rate risk generated by the Intesa Sanpaolo Group's banking book, measured through shift sensitivity analysis, recorded an average value of 1,086 million euro, settling at 1,167 million euro at the end of March 2017, almost entirely concentrated on the euro; this figure compares with 945 million euro at the end of 2016.

The sensitivity of net interest income – assuming a +100, +50 and -50 basis point change in interest rates – amounted to 1,142 million euro, 607 million euro and -716 million euro respectively, at the end of March 2017 (1,081 million euro, 571 million euro and -665 million euro at the end of 2016).

Interest rate risk, measured in terms of VaR, recorded an average of 141 million euro in the first three months of 2017 (117 million euro at the end of 2016), with a maximum value of 153 million euro and a minimum value of 123 million euro; this figure compares with an exact end-of-quarter value of 153 million euro. Price risk generated by minority stakes in listed companies, mostly held in the AFS (Available for Sale) category and measured in terms of VaR, recorded an average level of 142 million euro in the first three months of 2017 (161 million euro at the end of 2016), with a minimum value of 135 million euro and a maximum value of 146 million euro; the latter figure coincides with the value at the end of March.

Lastly, an analysis of banking book sensitivity to price risk, measuring the impact on Shareholders' Equity of a price shock on the above quoted assets recorded in the AFS category shows sensitivity to a 10% negative shock equal to 19 million euro at the end of March 2017.

LIQUIDITY RISK

In the first three months of 2017, the Group's liquidity position remained within the risk limits provided for in the Group's Liquidity Policy: both the LCR and NSFR indicators were largely respected, as they reached a level well above the phased-in requirements. As at 31 March 2017, the eligible liquidity reserves for the Central Banks, considering also the cash components, came to 156 billion euro (150 billion euro at the end of December 2016), of which 82 billion euro, net of haircut, was unencumbered (96 billion euro at the end of December 2016).

Also the stress tests, when considering the high availability of liquidity reserves (liquid or eligible), yielded results in excess of the target threshold for the Group, with a liquidity surplus capable of meeting extraordinary cash outflows for a period of more than 3 months.

Adequate and timely information regarding the development of market conditions and the position of the Bank and/or Group was provided to the corporate bodies and internal committees in order to ensure full awareness and manageability of the main risk factors.

INFORMATION ON FINANCIAL PRODUCTS

In line with the requests for utmost transparency made by supranational and national Supervisory Authorities, the following information is provided on the fair value measurement methods adopted, structured credit products, activities performed through Special Purpose Entities (SPE), leveraged finance transactions, hedge fund investments and transactions in derivatives with customers.

FAIR VALUE MEASUREMENT OF FINANCIAL ASSETS AND LIABILITIES

Fair value hierarchy

Financial assets / liabilities at fair value	31.03.2017			31.12.2016		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
(millions of euro)						
1. Financial assets held for trading	15,106	28,549	829	10,685	31,978	950
<i>of which: Equities</i>	764	-	-	885	-	-
<i>of which: quotas of UCI</i>	585	87	162	584	86	165
2. Financial assets designated at fair value through profit or loss	65,868	1,067	503	62,341	1,072	452
<i>of which: Equities</i>	1,413	-	-	1,295	-	-
<i>of which: quotas of UCI</i>	60,645	-	126	57,438	-	127
3. Financial assets available for sale	141,167	5,941	2,892	137,354	6,341	2,997
<i>of which: Equities</i>	2,315	2,446	888	1,765	2,728	970
<i>of which: quotas of UCI</i>	8,311	34	1,514	7,942	30	1,663
4. Hedging derivatives	-	5,600	18	-	6,241	20
5. Property and equipment	-	-	-	-	-	-
6. Intangible assets	-	-	-	-	-	-
Total	222,141	41,157	4,242	210,380	45,632	4,419
1. Financial liabilities held for trading	14,475	28,633	252	12,983	31,541	266
2. Financial liabilities designated at fair value through profit or loss	-	60,562	-	-	57,187	-
3. Hedging derivatives	-	8,357	4	-	9,024	4
Total	14,475	97,552	256	12,983	97,752	270

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: 1.6% for financial assets and 0.2% for financial liabilities.

Within the framework of level 3, more than 60% (2,690 million) refer to equities and quotas of UCI.

The reduction in level 3 financial assets available for sale is mainly due to the write-down of the investment in the Atlante fund net of the payment for the period.

Approximately 83% of financial assets measured at fair value are determined based on market prices, and therefore without any discretion by the valuator.

STRUCTURED CREDIT PRODUCTS

The risk exposure to structured credit products amounted to 2,354 million euro as at 31 March 2017 with respect to funded and unfunded ABSs/CDOs, compared to 2,471 million euro as at 31 December 2016, in addition to an exposure of 8 million euro with respect to structured packages, which compares with the 7 million euro as at 31 December 2016.

The strategy regarding the portfolio in question in 2017 focused on investments 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 decrease in exposure to funded and unfunded ABSs/CDOs designated at fair value (from 2,081 million euro in December 2016 to 2,014 million euro in March 2017) is attributable to sales and redemptions of ABSs by Banca IMI and of European ABSs/CDOs by the Parent Company, only partially offset by investments in ABSs of Banca IMI (part of which were classified to the available-for-sale portfolio) and to European ABSs/CDOs acquired by the Parent Company and classified to the trading portfolio.

Banca IMI's investments mainly consist of securities with underlying residential mortgages and CLOs with mainly AA ratings, which were more than offset by sales in the first three months of 2017. The Parent Company confirmed its transactions in European RMBS with mainly AAA ratings, aimed at seizing market opportunities with new investments.

With regard to the exposure represented by securities classified under the loan portfolio, on the other hand, a decrease was recorded (from 390 million euro at the end of December 2016 to 340 million euro at the end of March 2017), attributable to the sales that concerned the portfolio of Banca IMI and, to a lesser extent, the Parent Company.

The increase in the exposure of structured packages is attributable to valuation components of the period.

From the perspective of the income statement, a profit of 8 million euro was posted for the first three months of 2017, against the +13 million euro for 2016.

As at 31 March 2017 the "Profits (losses) on trading – caption 80" of the exposure to funded and unfunded ABSs/CDOs came to +8 million euro (+12 million euro in 2016), generated by the positions in funded European and U.S. ABSs/CDOs, while positions in multi-sector CDOs and U.S. subprime had a nil result.

The exposure to funded and unfunded ABSs/CDOs in securities classified by the subsidiary Banca IMI in the available-for-sale portfolio recorded a net increase in fair value of 2 million euro in 2017, accounted for in the specific Shareholders' Equity Reserve (from a reserve at the end of December 2016 of +5 million euro to a reserve of +7 million euro at the end of March 2017) and an impact on the income statement for sales made in the period of +1 million euro (+5 million euro in 2016). No value adjustments due to impairment were posted on the securities reclassified in the Loan portfolio in the first three months of 2017 (-6 million euro in 2016).

The "Monoline risk" and "Non-monoline packages" made a contribution to "Profits (Losses) on trading – caption 80" of -1 million euro as at 31 March 2017, compared with the +2 million euro profit recorded as at 31 December 2016.

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 (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) are considered Special Purpose Entities.

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 2016 financial statements.

During the first quarter of the year, within the framework of the multi-originator programme guaranteed by ISP OBG, the two series expiring in 2017 - the 9th and 10th series - were redeemed in advance in February, each for an amount of 1.375 billion euro.

Following these redemptions, the 23rd and 24th series of floating-rate securities were concurrently issued, for the same amounts, maturing in nine and ten years respectively. All the securities, which are listed on the Luxembourg Stock Exchange and rated A High by DBRS, were subscribed by the Parent Company and are eligible on the Eurosystem.

With reference to the covered bond issue programme guaranteed by ISP CB Pubblico, the 10th series was redeemed partially for an amount of 500 million euro.

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. After acquisition of the target company's shares/quotas package, these SPEs are normally merged into the target. The target companies generally have good economic prospects, stable cash flows in the medium term and low original leverage levels. Intesa Sanpaolo has financed entities of this type, as normal borrowers, without acting as sponsor.

None of these SPEs is consolidated, since the guarantees to support the transaction are solely instrumental for the granting of the financing and are never directed to the acquisition of direct or indirect control over the vehicle.

As at 31 March 2017, 110 transactions for a total amount granted of 2,941 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. Breakdown of exposures by geographical area shows prevalence of Italian exposures (approximately 71%) and of the industrial sector (79%). All the exposures included within the scope under examination are senior exposures.

INFORMATION ON INVESTMENTS IN HEDGE FUNDS

The hedge fund portfolio held for trading as at 31 March 2017 totalled 330 million euro, compared to 352 million euro recorded in December 2016, 80% of which were funds on the MAP platform.

The reduction of the portfolio is attributable to the distributions and redemptions that took place starting from the second quarter of last year and continuing at the beginning of this year, aimed at reducing the risk level of the exposure and also as a result of the obligation to comply with the instructions of the Volcker Rule on U.S. Funds.

In particular, the most significant redemptions in the first quarter concerned the MAP 5A Fund for 13.5 million dollars, and to a lesser extent the Eurizon Penghua Fund, the Mount Kellett 14th MAF Fund and the Marathon MAP9A Fund.

As at the same date, the economic result of the investments in this segment was positive, standing at 5 million euro, compared to the negative 48 million euro of "Profits (Losses) on trading – caption 80" in the first quarter of 2016, caused by severe turbulence on the markets. The 5 million euro profit is mainly attributable to specific "event-driven" situations and some macro and sectoral movements in the market.

Overall, the portfolio's strategy remains oriented towards benefiting from the occurrence of specific corporate events, largely independent of the general trend, and the reduction of risk through a general downwards revision of allocations of individual funds in response to continued market uncertainty.

INFORMATION ON TRADING TRANSACTIONS IN DERIVATIVES WITH CUSTOMERS

Considering relations with customers only, as at 31 March 2017, 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 7,007 million euro (7,532 million euro as at 31 December 2016). The notional value of these derivatives totalled 47,336 million euro (47,698 million euro as at 31 December 2016).

The positive fair value of the structured contracts in existence with the 10 customers with the highest exposures was 5,008 million euro.

Conversely, negative fair value determined with the same criteria, for the same types of contracts and with the same counterparties, totalled 1,683 million euro as at 31 March 2017 (1,971 million euro as at 31 December 2016). The notional value of these derivatives totalled 21,946 million euro (22,030 million euro as at 31 December 2016).

The fair value of derivative financial instruments entered into with customers was determined considering, as for all other OTC derivatives, the creditworthiness of the single counterparty ("Bilateral Credit Value Adjustment"). With regard to contracts outstanding as at 31 March 2017, this led to a positive effect of 3 million euro being recorded under "Profits (Losses) on trading" in the income statement.

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; compliance risk, for the economic sanctions and losses part, and model risk. Strategic and reputational risks, however, 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.

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 1,563 million euro as at 31 March 2017, unchanged compared to 31 December 2016.

Legal risks

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

During the quarter no new major litigations have been undertaken and there have been no significant developments with regard to those indicated in the Notes to the 2016 financial statements, which therefore should be consulted, with the exception of the continuation of the administrative and judicial proceedings against Banca IMI Securities Corp. of New York. The SEC (the U.S. financial market supervisory authority), as anticipated in the 2016 Annual Report, has launched an investigation concerning the dealings of certain brokers, including our subsidiary IMI Securities of New York, involving some particular financial instruments known as “ADRs” (depository receipts for shares issued by non-U.S. companies), transactions that were discontinued some time ago by our subsidiary.

In recent months, our cooperation with the Supervisory Authority has continued in order to focus on the operating procedures adopted by our subsidiary. The SEC’s analyses have ascertained alleged deficiencies in oversight obligations in the business area of pre-released ADRs, in response to which our subsidiary will submit counter-pleas and explanations in its defence to the SEC to mitigate the conclusions the Authority has reached.

Tax litigation

No significant developments were recorded during the first quarter of 2017.

With respect to the disputes concerning the recovery of registration tax on contributions of company assets and the subsequent sale of equity investments, reclassified by the tax authorities as transfer of a business unit, note should be taken of the favourable decision of the Regional Tax Commission of Milan, filed on the 20 February 2017. The dispute, for an amount of approximately 2 million euro, concerns a transaction that involved Cassa di Risparmio del Veneto, Cassa di Risparmio di Parma e Piacenza and Banca Popolare Friuladria.

The Bank has also lodged an appeal to the Court of Cassation in relation to an old dispute of the merged company Caripuglia S.p.A., relating to a notice of assessment concerning Irpeg (former corporation tax) and Ilor (former local tax on earnings) for the year 1982 (litigation value of 1.8 million euro). Following the unfavourable decision of the Central Tax Commission, in February 2017 the Revenue Agency paid the full assessed amount, plus interest (1.8 million euro in total) and the payment was prudently considered as final payment. Therefore, a possible favourable outcome of the proceedings before the Court of Cassation would result in a tax credit towards the Revenue Agency and an extraordinary income item.

As regards tax credit reimbursements, the Bari branch of the Revenue Agency has approved the reimbursements of the Irpeg and Ilor tax credits relating to the years 1985 and 1986, as well as from 1990 to 1994, for the total amount in principal of 42 million euro, plus accrued interest (37 million euro). In addition, the Piedmont Regional Office - Large Taxpayers Office, approved the Ires (corporate income tax) reimbursements for the tax periods from 2008 to 2010 and the Irap (regional tax on production) reimbursement for 2009, for an overall amount of 11.7 million euro.

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 main control and monitoring instrument for market and credit risks is represented by specific internal rules which define 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 changes 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 31 March 2017, the investment portfolios of Group companies, recorded at book value, amounted to 150,111 million euro. Of these, a part amounting to 83,898 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 66,214 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, 86.3% of assets, i.e. approximately 72,497 million euro, were bonds, whereas assets subject to equity risk represented 2.1% of the total and amounted to 1,803 million euro. The remainder (9,660 million euro) consisted of investments relating to UCI, Private Equity and Hedge Funds (11.5%).

The carrying value of derivatives came to approximately -63 million euro, entirely relating to effective management derivatives.¹ Hedging derivatives are currently not present in the portfolio.

At the end of the first three months of 2017, investments made with the free capital of Intesa Sanpaolo Vita and Fideuram Vita amounted to approximately 1,578 million euro at market value, and presented a risk in terms of VaR (99% confidence level, 10-day holding period) of approximately 45 million euro.

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 4,119 million euro.

The distribution of the portfolio by rating class is as follows. AAA/AA bonds represented approximately 4.5% of total investments and A bonds approximately 5.4%. Low investment grade securities (BBB) were approximately 87.3% of the total and the portion of speculative grade or unrated was minimal (approximately 2.8%).

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 75.8% of the total investments, while financial companies (mostly banks) contributed almost 13.2% of exposure and industrial securities made up approximately 11.0%.

At the end of the first quarter of 2017, 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 4,203 million euro, with 3,269 million euro due to government issuers and 935 million euro to corporate issuers (financial institutions and industrial companies).

¹ ISVAP Regulation 36 of 31 January 2011 on investments defines as "effective management derivatives" 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.