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 30 June 2018, both regulatory indicators LCR and NSFR, also adopted as internal liquidity risk measurement metrics, were well above fully phased-in requirements established by Regulation 575/2013 and Directive 2013/36/EU. At the end of June, the Central Banks eligible liquidity reserves came to 163 billion euro (171 billion euro at the end of December 2017), of which 79 billion euro, net of haircut, was unencumbered (98 billion euro at the end of December 2017).
The loan to deposit ratio at the end of June 2018, calculated as the ratio of loans to customers to direct deposits from banking business, is 93%.
In terms of funding, the widespread branch network remains a stable, reliable source: 74% of direct deposits from banking business come from retail operations (318 billion euro). In addition, 2.5 billion USD of unsecured senior bonds, 46.6 billion Yen of unsecured senior bonds, 1.25 billion euro of unsecured senior bonds and 1 billion euro of covered bonds were placed during the half year.
With regard to the targeted refinancing operation TLTRO II, at the end of June 2018, the Group's participation amounted to 61 billion euro.
The Intesa Sanpaolo Group's leverage ratio was 6.2% as at 30 June 2018.
The capital base also remains high. Own funds, risk weighted assets and the capital ratios at 30 June 2018 are 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 first half, Own Funds – taking account of the transitional treatment adopted to mitigate the impact of IFRS 9 – came to 48,337 million euro, against risk-weighted assets of 282,383 million euro, which primarily reflected credit and counterparty risk and, to a lesser extent, operational and market risk.
The Total Capital Ratio stood at 17.1%, while the ratio of the Group's Tier 1 capital to its total risk-weighted assets (Tier 1 ratio) was 14.6%. The ratio of Common Equity Tier 1 capital (CET1) to risk-weighted assets (the Common Equity Tier 1 ratio) was 12.8%.
Having met the regulatory requirements for its inclusion pursuant to article 26(2) of the CRR, the Common Equity Tier 1 Capital as at 30 June 2018 took account of the figure of 15% of the net income for the period (net of foreseeable costs), in consideration of the payout ratio established for 2018 in the dividend policy of the 2018-2021 Business Plan.
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 six months of 2018 was approximately 55 million euro, compared to an average amount of approximately 78 million euro in the same period of 2017. The trend in the Group's VaR in the first six months - mainly determined by Banca IMI - is described in greater detail later in this chapter.
The macroeconomic environment and the 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 2,160 million euro, provide a coverage ratio of 0.6%, which is sufficient for the intrinsic risk of the Stage 1 and Stage 2 portfolios.
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 (67.1%) and unlikely to pay positions (35.2%).
Constant attention has been paid to the valuation of financial items. The majority of the financial assets are measured at fair value or are represented by hedging derivatives.
Excluding the insurance segment whose financial assets are almost all measured using level 1 inputs, the fair value measurement of the remaining financial assets measured at fair value through profit and loss was carried out as follows: around 61% using level 1 inputs, around 31% using level 2 inputs and only around 8% using level 3 inputs.
Investment levels in structured credit products and hedge funds remained low. The structured credit products generated a positive contribution of 7 million euro during the period, whereas the hedge funds generated a loss of 6 million euro over the six months, as described in more detail in the specific paragraphs of this chapter.

In volatile market environments, measuring the recoverable amount of intangible assets is also particularly delicate. No problematic issues requiring the remeasurement of the recoverable values of intangible assets and goodwill were identified during the period. In particular, with regard to goodwill, no events occurred that could lead to the conclusion that the forecast cash flows of the 2018-2021 Business Plan, used for the impairment test as at 31 December 2017, were no longer relevant, also considering the short time period that has elapsed since the analyses carried out at that time. In addition, 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 carrying amount of the intangible asset in the financial statements. Indeed, even though the cash flow discounting rate for the explicit forecast horizon rose slightly, it did not exceed the limits identified by the sensitivity analyses carried out during the impairment testing as at 31 December 2017,
On the other hand, for the intangible assets with finite useful lives, no critical factors were considered to have arisen regarding the stability of the intangible value, thanks to both the increase in insurance reserves and in volumes of assets under management (AUM).

THE BASIC PRINCIPLES OF RISK MANAGEMENT

The policies relating to risk taking and the processes for the management of the risk that the Group is or could be exposed to are defined by Board of Directors of Intesa Sanpaolo as the Parent Company, with the support of the Risks Committee. The Management Control Committee, which is the body with control functions, supervises the adequacy, efficiency, functionality and reliability of the risk management process and of the Risk Appetite Framework.
The Managing Director and CEO has the power to submit proposals for the adoption of resolutions concerning the risk system and implements all the resolutions of the Board of Directors, with particular reference to the implementation of the strategic guidelines, the RAF and the risk governance policies.
The Corporate Bodies also benefit from the action of some Management Committees on risk management. These Committees, which include the Steering Committee, operate in compliance with the primary responsibilities of the Corporate Bodies regarding internal control system and the prerogatives of corporate control functions, and in particular the risk control function.

Without prejudice to the powers of the corporate bodies, the Chief Risk Officer is responsible for: (i) governing the macro-process of definition, approval, control and implementation of the Group's Risk Appetite Framework with the support of the other corporate functions involved; (ii) setting the Group’s risk management guidelines and policies in accordance with the company's strategies and objectives; (iii) coordinating and verifying the implementation of those guidelines and policies by the responsible units of the Group, including within the various corporate departments; (iv) ensuring the 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 performs a guidance and coordination role with respect to the Group companies, aimed at ensuring effective and efficient risk management at Group level, exercising responsibility in setting the guidelines and methodological rules for the risk management process, and pursuing, in particular, integrated information at Group level to the Bodies of the Parent Company, with regard to the completeness, adequacy, functioning and reliability of internal control system. For the corporate control functions in particular, there are two different types of models within the Group: (i) the centralised management model based on the centralisation of the activities at the Parent Company and (ii) the decentralised management model that involves the presence of locally established corporate control functions that conduct their activities under the direction and coordination of the same corporate control functions of the Parent Company, to which they report in functional terms.
Irrespective of the control model adopted within their company, the corporate bodies of the Group companies are aware of the choices made by the Parent Company and are responsible for the implementation, within their respective organisations, of the control strategies and policies pursued and promoting their integration within the Group controls.
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. The assessment of capital is included in business reporting and is submitted quarterly to the Steering 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 risks, there have been no changes with respect to the situation as at 31 December 2017, except for the extension in June 2018 of the Group’s Banks and Public Sector Entities and Corporate internal models to the acquired portfolio of Banca Nuova.

The development and application of IRB systems for the other segments and the extension of the scope of companies is proceeding according to the Group’s Basel 3 roll-out plan.

The situation as at 30 June 2018 is shown in the following table:

<table>
<tr><th>Company</th><th>Corporate
FIRB</th><th>Corporate
AIRB LGD</th><th>Corporate
EAD</th><th>Retail Mortgage
IRB LGD</th><th>SME Retail
IRB LGD</th><th>Banks and Public Entities
IRB</th><th>Banking Book Equity
IRB</th></tr>
<tr><td>Intesa Sanpaolo</td><td rowspan="6">Dec - 2008</td><td rowspan="7">Dec - 2010</td><td rowspan="7">Sep - 2017</td><td rowspan="7">Jun - 2010</td><td rowspan="7">Dec - 2012</td><td rowspan="7">Jun - 2017</td><td rowspan="7">Jun - 2017</td></tr>
<tr><td>Banco di Napoli</td></tr>
<tr><td>Cassa di Risparmio del Veneto</td></tr>
<tr><td>Cassa di Risparmio di 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>Gruppo Cassa di Risparmio di Firenze</td><td>Dec - 2009</td></tr>
<tr><td>Mediocredito Italiano</td><td>Dec - 2008</td><td>Dec - 2010</td><td>Sep - 2017</td><td>n.a.</td><td>Dec - 2012</td><td>Jun - 2017</td><td>n.a</td></tr>
<tr><td>Banca Prossima</td><td>n.a.</td><td>Dec - 2013</td><td>Sep - 2017</td><td>n.a.</td><td>Dec - 2013</td><td>Jun - 2017</td><td>n.a</td></tr>
<tr><td>Banca IMI</td><td>n.a.</td><td>Jun - 2012</td><td>Sep - 2017</td><td>n.a.</td><td>n.a.</td><td>Jun - 2017</td><td>n.a</td></tr>
<tr><td>IMI Investimenti</td><td>n.a.</td><td>n.a.</td><td>n.a.</td><td>n.a.</td><td>n.a.</td><td>n.a</td><td>Jun - 2017</td></tr>
<tr><td>Intesa Sanpaolo Bank Ireland</td><td>Mar - 2010</td><td>Dec - 2011</td><td>Sep - 2017</td><td>n.a.</td><td>n.a.</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>n.a.</td><td>Jun - 2012</td><td>Jun - 2014</td><td>n.a</td><td>n.a</td></tr>
<tr><td>Banka Intesa Sanpaolo d.d.</td><td>Mar - 2017</td><td>n.a.</td><td>n.a.</td><td>n.a.</td><td>n.a.</td><td>n.a</td><td>n.a</td></tr>
<tr><td>Intesa Sanpaolo Bank Luxembourg</td><td>n.a.</td><td>Jun - 2017</td><td>Sep - 2017</td><td>n.a.</td><td>n.a.</td><td>n.a</td><td>n.a</td></tr>
</table>

With regard to counterparty risk on OTC derivatives and SFTs, the Group has improved the measurement and monitoring, by refining the instruments required under Basel 3. For reporting purposes, Intesa Sanpaolo, Banca IMI and the companies of the Banca dei Territori Division have been authorised to use internal models (both for the determination of Exposure at default for replacement risk and for the CVA capital charge for migration risk).

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 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 2018.

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’s strategies, powers and rules for credit granting and management 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 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 consistent 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.

There were no changes relating to the authorisations for the models to be applied to the specific portfolios with respect to 31 December 2017, except for the abovementioned extension, in June 2018, of the Group's Banks and Public Sector Entities and Corporate internal models to the portfolio acquired from Banca Nuova.

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, does not deem likely 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), which are not a separate category of non-performing assets, but rather a sub-category. Similarly, exposures characterised by "forbearance measures" are also included among performing loans.
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)

Captions	30.06.2018 Gross exposure	Total adjustments	Net exposure	01.01.2018 Gross exposure	Total adjustments	Net exposure	Change Net exposure
Bad loans	22,851	-15,330	7,521	34,192	-23,630	10,562	-3,041
Unlikely to pay	15,945	-5,611	10,334	17,390	-5,798	11,592	-1,258
Past due loans	678	-155	523	475	-101	374	149
Non-Performing Loans	**39,474**	**-21,096**	**18,378**	**52,057**	**-29,529**	**22,528**	**-4,150**
Non-performing loans in Stage 3 (subject to impairment)	*39,378*	*-21,068*	*18,310*	*51,939*	*-29,483*	*22,456*	*-4,146*
Non-performing loans designated at fair value through profit or loss	*96*	*-28*	*68*	*118*	*-46*	*72*	*-4*
Performing loans	**378,273**	**-2,160**	**376,113**	**373,569**	**-2,417**	**371,152**	**4,961**
Stage 2	*48,512*	*-1,350*	*47,162*	*51,684*	*-1,573*	*50,111*	*-2,949*
Stage 1	*329,268*	*-810*	*328,458*	*321,570*	*-844*	*320,726*	*7,732*
Performing loans designated at fair value through profit or loss	*493*	*-*	*493*	*315*	*-*	*315*	*178*
Performing loans represented by securities	**5,346**	**-9**	**5,337**	**5,913**	**-54**	**5,859**	**-522**
Stage 2	*386*	*-6*	*380*	*662*	*-23*	*639*	*-259*
Stage 1	*4,960*	*-3*	*4,957*	*5,251*	*-31*	*5,220*	*-263*
Loans held for trading	***31***	***-***	***31***	***-***	***-***	***-***	***31***
Total loans to customers	**423,124**	**-23,265**	**399,859**	**431,539**	**-32,000**	**399,539**	**320**
of which forborne performing	**7,902**	**-340**	**7,562**	**7,954**	**-328**	**7,626**	**-64**
of which forborne non-performing	**10,350**	**-4,073**	**6,277**	**11,134**	**-4,430**	**6,704**	**-427**
Loans to customers classified as discontinued operations (*)	**10,902**	**-7,637**	**3,265**	**314**	**-35**	**279**	**2,986**

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

(*) As at 30 June 2018, this caption included the portfolio of bad loans to be sold to Intrum (which has decreased since date of the agreement, mainly due to collections received in the meantime, to a gross exposure amount of 10,330 million euro, total adjustments of 7,559 million euro and a net exposure of 2,771 million euro) and high risk loans originating from the Aggregate Set of Banca Popolare di Vicenza and Veneto Banca, reclassified as bad loans and/or unlikely-to-pay loans, for which the sale contract provides for their transfer to the Banks in compulsory liquidation (gross exposures of 572 million euro, total adjustments of 78 million euro, net exposure of 494 million euro). As at 31 December 2017, the caption included the high risk loans; the figures for the portfolio of bad loans to be sold to Intrum have not been restated.

As at 30 June 2018 the Group's net non-performing loans – which at the end of the first half no longer included the bad loans sold to Intrum, recognised under the caption non-current assets held for sale and discontinued operations – amounted to 18.4 billion euro, a reduction of 18.4% since the start of the year, continuing the progressive decrease already seen during the previous year. Non-performing assets decreased as a percentage of total net loans to customers, down to 4.6%.
In further detail, bad loans came to 7.5 billion euro, net of adjustments and positions reclassified as discontinued operations, at the end of June 2018, down (-28.8%) compared with the beginning of the year, and represented 1.9% of total loans. During the same period, the coverage ratio stood at 67.1%. Loans included in the unlikely to pay category amounted to 10.3 billion euro, down by 10.9%, accounting for 2.6% of total loans to customers, with a coverage ratio of 35.2%. Past due loans amounted to 523 million euro, up 39.8% since the beginning of the year, with a coverage ratio of 22.9%. Within the non-performing loan category, forborne exposures, generated by forbearance measures for borrowers experiencing difficulty in meeting their financial obligations, amounted to 6.3 billion euro, with a coverage ratio of 39.4%, while forborne exposures in the performing loans category amounted to 7.6 billion euro.
Overall, the coverage ratio of performing loans was stable at 0.6%, sufficient for the intrinsic risk of the Stage 1 and Stage 2 portfolios.

Counterparty risk

Counterparty risk is a particular type of credit risk, relating to OTC derivatives and SFTs (Securities Financing Transactions, i.e. repurchase agreements and security lending), which refers to the possible default of the counterparty before the expiry of a contract that has a positive market value.

The Group uses techniques to mitigate counterparty risk through bilateral netting arrangements which enable the offsetting of credit and debit positions in the event of counterparty default.

This is achieved by entering into ISDA and ISMA/PSA agreements, for OTC derivatives, which also reduce the absorption of regulatory capital in accordance with supervisory provisions.
In addition, the bank establishes collateral arrangements, where possible, usually with daily margining, to hedge bilateral OTC derivatives (CSAs) and SFTs (GMRAs and GMSLAs).

For reporting purposes, Intesa Sanpaolo, Banca IMI and the banks of the Banca dei Territori Division have obtained authorisation from the Supervisory Authority to use the internal models approach to calculate the counterparty risk requirement for OTC derivatives and SFTs.
These advanced risk measurement methods are also used at operational level to perform the "use test": the Financial and Market Risks Head Office Department calculates, validates and sends the metrics to the credit monitoring systems on a daily basis to measure the use of the credit lines for OTC derivatives and SFTs.
The Group's banks which are not included in the roll-out plan for the internal models nevertheless apply the advanced metrics in a simplified manner at operational level.

To perform the use test of the model, the Group has implemented the processes required by the "Basel 3" regulations.
In particular, stress tests are carried out to measure the impacts on risk measures under extreme market conditions. Backtesting is also conducted to ensure the robustness of the model.
In addition, to complete the risk analysis process, the following corporate processes have been activated:
– definition and periodic analysis of Wrong-Way Risk, i.e. the risk of a positive correlation between the future exposure to a counterparty and that counterparty's probability of default;
– definition and monitoring of management limits;
– contribution of collateral inflow/outflow risk measures, calculated on the basis of the internal counterparty risk model, for margined OTC derivatives and SFTs;
– periodic reporting to management of the measures calculated using the current and future internal exposure model, analysis of portfolio composition by type of counterparty/division/segment/country, underlying type per SFT capital requirement, level of use of management limits, and results of stress tests and Wrong-Way Risk analyses.

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 2% 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 requirement 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 units 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.

While using the historical simulation approach, the latter point is a discriminating condition in the selection of the holding period. Actually, 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 April 2008 to 30 March 2009 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.

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

During the second quarter of 2018, the market risks generated by Intesa Sanpaolo and Banca IMI increased compared to the average values of the first quarter of 2018. The average VaR for the period totalled 61.9 million euro compared to 48.1 million euro of March 2018.

(millions of euro)

	2018				2017			
	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	11.8	6.7	20.9	7.8	8.0	8.9	11.6	11.5
Banca IMI	50.1	28.0	85.8	40.3	50.5	52.6	58.4	73.7
Total	**61.9**	**34.8**	**105.3**	**48.1**	**58.6**	**61.5**	**70.0**	**85.3**

(a) Each line in the table sets out past estimates of daily VaR calculated on the quartely historical time-series respectively of Intesa Sanpaolo and Banca IMI; minimum and maximum values for 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.

However, compared to last year, the risk measures for the first half have decreased: for 2018 an average group VaR of 55 million was recorded whilst in 2017 the average amounted to approximately 78 million euro.

(millions of euro)

	2018			2017		
	average 1st half	minimum 1st half	maximum 1st half	average 1st half	minimum 1st half	maximum 1st half
Intesa Sanpaolo	9.8	6.7	20.9	11.5	9.2	12.5
Banca IMI	45.2	24.6	85.8	66.2	52.9	93.2
Total	**55.0**	**33.7**	**105.3**	**77.8**	**62.2**	**104.8**

(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.

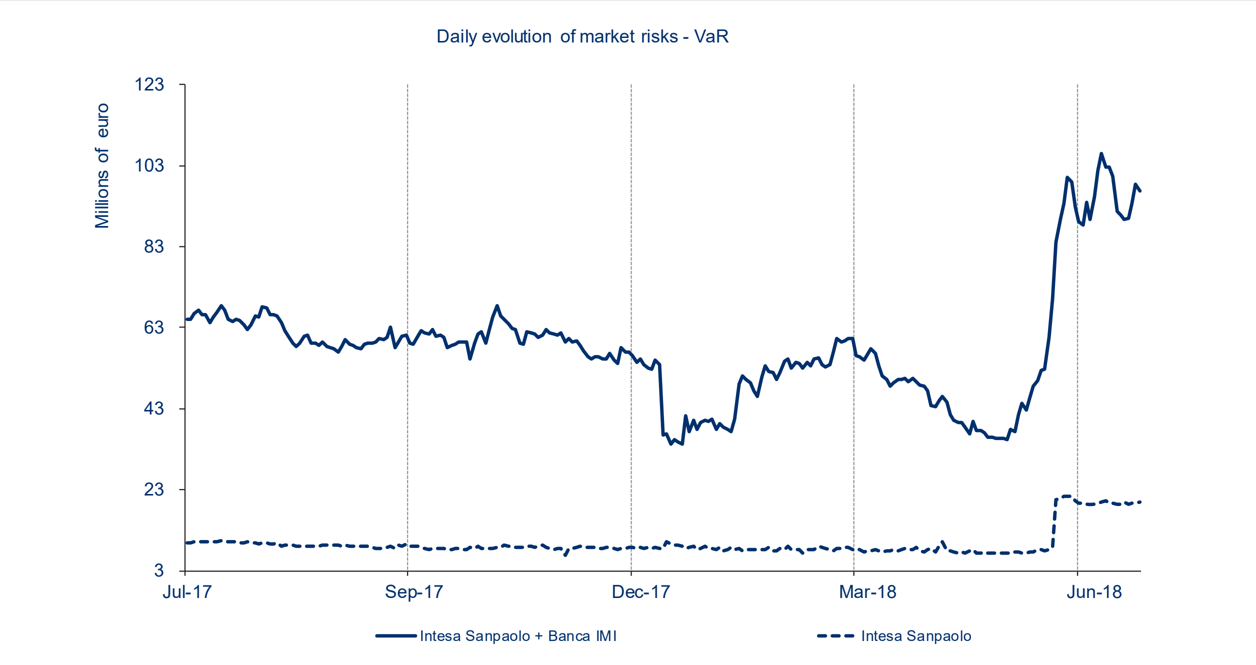
For Intesa Sanpaolo the breakdown of risk profile in the second quarter of 2018 with regard to the various factors shows the prevalence of the risk generated by credit spread, which produced 66% of total operational VaR; for Banca IMI too credit spread risk was the most significant, representing 76% of total operational VaR.

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

2nd quarter 2018	Shares	Hedge funds	Interest rates	Credit spreads	Foreign exchange rates	Other parameters	Commodities
Intesa Sanpaolo	3%	4%	16%	66%	10%	1%	0%
Banca IMI	4%	0%	13%	76%	0%	6%	1%
Total	**5%**	**1%**	**13%**	**74%**	**1%**	**5%**	**1%**

(a) Each line in the table sets out the contribution of risk factors considering 100% the overall VaR, calculated as the average of daily estimates in the second quarter of 2018, 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 half of 2018 (May), the risk measures rose and reflected the increase in the volatility of the financial markets, particularly in the Italian government sector. In June, the trend was also influenced by changes in the portfolio. The Parent Company also recorded an increase in risks, albeit to a lesser extent, and this was also due to the increase in volatility of the credit spread risk factor (indices). The VaR limits were sufficient at Group level.



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 following table:

(millions of euro)

	EQUITY		INTEREST RATES		CREDIT SPREADS		FOREIGN EXCHANGE RATES		COMMODITIES	
	Crash	Bullish	+40bp	lower rate	-25bp	+25bp	-10%	+10%	Crash	Bullish
Total	-1	7	-71	62	295	-289	35	-15	2	-4

In particular:
- on stock market positions, a 15% decrease in stock prices with a resulting 25% increase in volatility would have led to a loss of approximately one million euro;
- on interest rate exposures, a rise of the curves of 40 basis points would have had a negative impact of 71 million euro, whereas a scenario with a reduction in interest 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 289 million euro loss;
- on foreign exchange exposures, were the Euro to appreciate against the US dollar by 10%, a loss of approximately 15 million euro would be recorded;
- lastly, for commodity exposures potential losses would be recorded for an amount equal to 4 million euro in case of a 20% increase in prices of commodities (accompanied by a reduction in the price of gold of 15%).

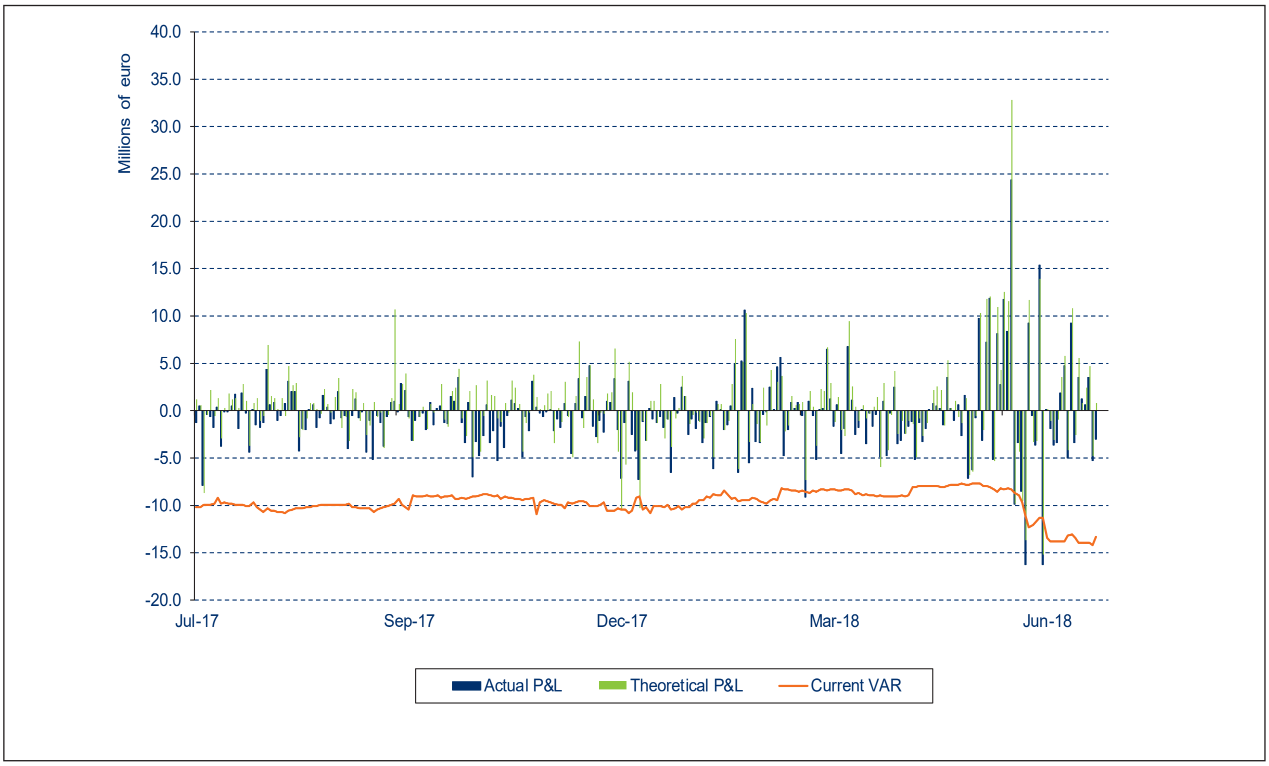
Backtesting

The soundness 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. The backtesting used by Intesa Sanpaolo involves both the P&L series actually recorded and the theoretical series. The latter is based on valuation of the portfolio value through the use of pricing models adopted for the VaR measurement calculation. The number of significant backtesting exceptions is determined as the maximum between those for actual P&L and theoretical P&L.

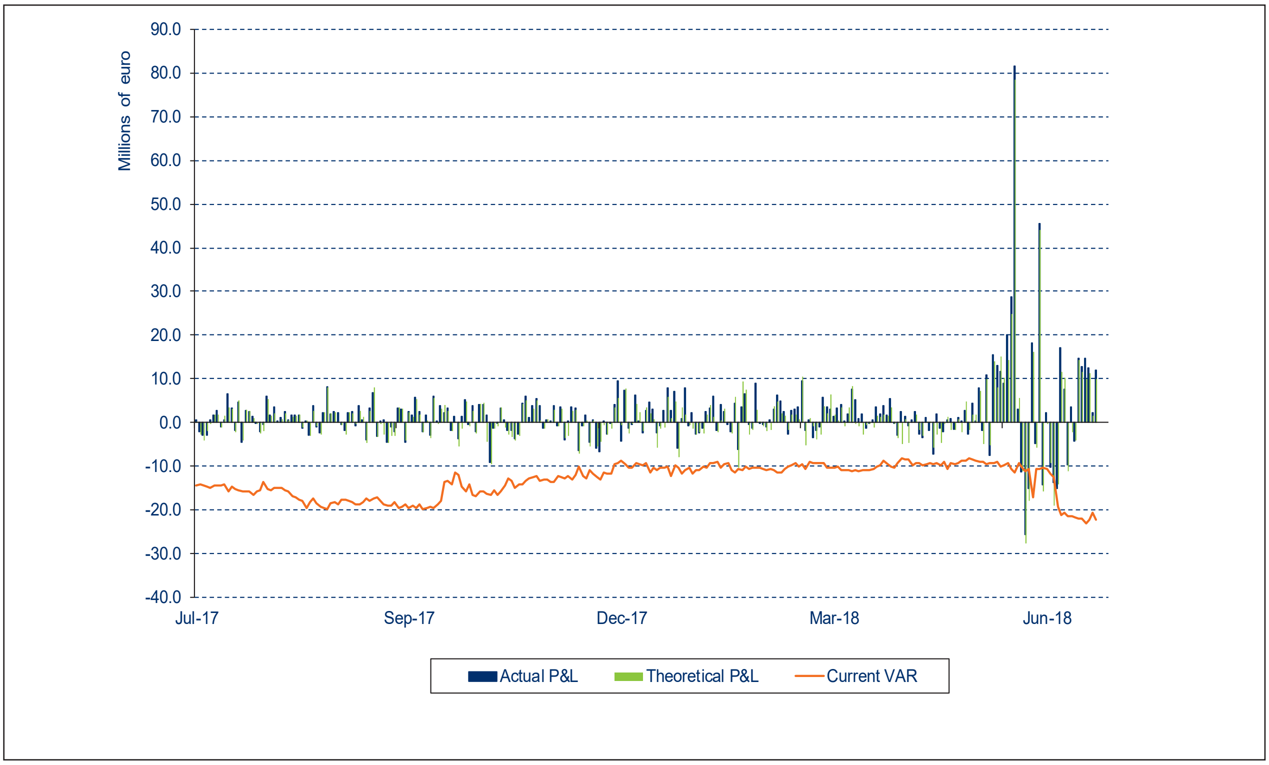
Backtesting in Intesa Sanpaolo

Over the last twelve months there have been four backtesting exceptions. The breaches were caused by the credit component of the portfolio, which was particularly affected by the volatility in the second half of May 2018. The volatility was particularly high for buy protection positions on credit indices.



Backtesting in Banca IMI

The credit spread volatility was very high in the second quarter of 2018. This volatility led to five backtesting breaches for both theoretical and actual P&L. The portfolio was particularly sensitive to the performance of the financial sector and to a lesser extent to the government sector.



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 IMI Investimenti.

The internal system for measuring interest rate risk assesses and describes the effect of changes in interest rates on the economic value and the net interest income and identifies all significant sources of risk that affect the banking book:

- *repricing risk*: risk arising from maturity mismatches (for fixed-rate positions) and interest rate revision date mismatches (for floating-rate positions) of financial items due to parallel movements in the yield curve;
- *yield curve risk*: risk arising from maturity mismatches and interest rate revision date mismatches due to changes in the inclination and shape of the yield curve;
- *basis risk*: risk arising from imperfect correlation in the adjustment of lending and deposit rates of floating-rate instruments which may differ according to indexing parameters, rate revision method, indexing algorithm, etc. This risk arises as a result of non-parallel changes in market rates;
- *option risk*: risk due to the presence of automatic options or options that depend on the behaviour of the counterparty to the assets, liabilities and off-balance sheet instruments of the Group.

The following metrics are used to measure the interest rate risk generated by the banking book:

1. shift sensitivity of economic value (∆EVE);
2. net interest income:
   - shift sensitivity of net interest income (∆NII);
   - dynamic simulation of net interest income (NII);
3. Value at Risk (VaR).

The shift sensitivity of the economic value (or shift sensitivity of the fair value) measures the change in the economic value of the banking book and is calculated at individual cash flow level for each financial instrument, based on different instantaneous rate shocks and reflects the changes in the present value of the cash flows of the positions already in the balance sheet for the entire remaining duration until maturity (run-off balance sheet).

In measurements, capital items are represented based on their contractual profile, except for categories of instruments whose risk profiles are different from those contractually envisaged. In this respect, therefore, the choice was made to use a behavioural representation to calculate the risk measures. More specifically:

- for mortgages, statistical techniques are used to determine the probability of prepayment, in order to reduce the Group's exposure to interest rate risk (overhedging) and to liquidity risk (overfunding);
- for core deposits, a financial representation model is adopted aimed at reflecting the behavioural features of stability of deposits and partial and delayed reaction to market interest rate fluctuations, in order to stabilise net interest income both in absolute terms and in terms of variability over time;
- for the expected loss on loans, which represents the average cost of long-term loans, a shift in the discounting curve is envisaged, according to the aggregate credit risk levels by economic segment, in order to reduce this component in the cash flows.

The cash flows used for both the contractual and behavioural profile are calculated at the contractual rate or at the FTP;

To determine the present value, a multi-curve system is adopted which has different discounting and forwarding curves according to the type of instrument and the tenor of its indexing. For the determination of shift sensitivity, the standard shock applied to all the curves is defined as a parallel and uniform shifting of +100 basis points of the curves.

In addition to the standard +100 scenario, the measurement of the economic value (EVE) is also calculated based on the 6 scenarios prescribed by the BCBS document and based on historical stress simulations aimed at identifying worst- and best-case scenarios.

The shift sensitivity of the net interest income quantifies the impact on short-term interest income of a parallel, instantaneous and permanent, shock to the interest rate curve.

Margin sensitivity is measured using a method that enables the estimation of the expected change in net interest income as a result of a shock to the curves produced by items subject to interest rate revision within a gapping period set at 12 months from the analysis date.

This measure highlights the effect of variations in market interest rates on the net interest income generated by the portfolio being measured, on a constant balance sheet basis, excluding potential effects resulting from the new operations and from 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.

To determine changes in net interest income (ΔNII), standard scenarios of parallel rate shocks of +-50 basis points are applied, in reference to a time horizon of twelve months.

Dynamic margin simulation analyses are also conducted that combine shifts in yield curves with changes in base and liquidity differentials, as well as changes in customer behaviour in different market scenarios.

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).

Besides measuring the equity portfolio, VaR is also used to consolidate exposure to financial risks of the various Group companies which perform banking book activities, thereby taking into account diversification benefits. Value at Risk calculation models have certain limitations, as they are based on the statistical assumption of the normal distribution of the returns and on the observation of historical data that may not be repeated in the future. Consequently, VaR results cannot guarantee that the possible future losses will not exceed the statistically calculated estimates.

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 and liabilities (microhedging), 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 demand deposits (core deposits) and on the already fixed portion of variable-rate loans and on a portion of fixed-rate loans. For this last type, an open-portfolio macrohedging model has been adopted 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 of the Parent Company is in charge of measuring the effectiveness of interest rate risk hedges for the purpose of hedge accounting, in compliance with international accounting standards.
During 2018, no hedging activities have been performed to cover the price risk of the banking book.
In the first six months of 2018, interest rate risk generated by the Intesa Sanpaolo Group's banking book, measured through shift sensitivity analysis, recorded an average value of 1,648 million euro, settling at 1,618 million euro at the end of June 2018, almost entirely concentrated on the euro; this figure compares with 1,615 million euro at the end of 2017.
The sensitivity of net interest income – assuming a +50 and -50 basis point change in interest rates – amounted to 868 million euro and -929 million euro respectively, at the end of June 2018 (794 million euro and -872 million euro at the end of 2017).
Interest rate risk, measured in terms of VaR, recorded an average of 136 million euro in the first six months of 2018 (153 million euro at the end of 2017), with a minimum value of 123 million euro and a maximum value of 147 million euro; the latter figure coincides with the value at the end of June 2018. Price risk generated by minority stakes in listed companies, mostly held in the HTCS (former AFS) category and measured in terms of VaR, recorded an average level of 59 million euro in the first six months of 2018 (64 million euro at the end of 2017), with a minimum value of 52 million euro and a maximum value of 70 million euro; the latter figure coincides with the value at the end of June 2018.
Lastly, an analysis of banking book sensitivity to price risk, measuring the impact on Shareholders' Equity of a price shock on the above listed assets recorded in the HTCS (former AFS) category shows a sensitivity to a 10% negative shock equal to 53.4 million euro at the end of June 2018.

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).

Intesa Sanpaolo's internal control and management system for liquidity risk is implemented within the Group Risk Appetite Framework and in compliance with the tolerance thresholds for liquidity risk approved in the system, which establish that the Group must maintain an adequate liquidity position in order to cope with periods of strain, including prolonged periods, on the various funding supply markets, also by establishing adequate liquidity reserves consisting of marketable securities and refinancing at Central Banks. To this end, a balance needs to be maintained between incoming and outgoing funds, both in the short and medium-long term. This goal is implemented by the Group Liquidity Risk Management Guidelines approved by the Corporate Bodies of Intesa Sanpaolo.

These guidelines contain the latest regulatory provisions on liquidity risk and illustrate the tasks of the various corporate functions, the rules and the set of control and management processes aimed at ensuring prudent monitoring of such risk, thereby preventing the emergence of crisis situations.

In particular, from an organisational standpoint, a detailed definition is prepared of the tasks assigned to the Board of Directors 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 Active Value Management Head Office Department, responsible for liquidity management, and the Financial and Market Risks Head Office Department, directly responsible for measuring liquidity risk on a consolidated basis.

The Chief Audit Officer assesses the functioning of the overall structure of the control system monitoring the process for measuring, managing and controlling the Group's exposure to liquidity risk and verifies the adequacy and compliance of the process with the requirements established by the regulations. The results of the controls carried out are submitted to the Corporate Bodies, at least once a year.

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 indicators are 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 - LCR) respectively, in addition to a system of early warning indicators for maturities from 3 months to one year.

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 LCR (for which the minimum regulatory threshold is 100% after 1 January 2018) is aimed at strengthening the short-term liquidity risk profile, ensuring the holding of sufficient unencumbered high-quality liquid assets (HQLA) that can be easily and immediately converted into cash on the private markets to satisfy the short-term liquidity requirements (30 days) in a liquidity stress scenario, as defined by Delegated Regulation (EU) 2015/61.

The aim of Intesa Sanpaolo Group's structural Liquidity indicators is to adopt the structural requirement provided for by the regulatory provisions of Basel 3: the 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. NSFR's regulatory requirement, which is still subject to a period of observation, will come into force at the end of the legislative process in progress for the application of the global reform package on the CRR and CRD IV (Regulation 575/2013 and Directive 2013/36/EU). Early warning indicators have been established for maturities of more than 1 year, with particular attention to long-term gaps (> 5 years).

The Guidelines for Group Liquidity Risk Management also envisage the time extension of the stress scenario for the LCR indicator provided by the 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. For this purpose, the internal management guidelines also envisage an alert threshold (Stressed soft ratio) for 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. Within this framework, the Treasury Head Office Department and the Active Value Management Head Office Department of the Parent Company were officially entrusted with drawing up the Contingency Funding Plan (CFP), which contains the various lines of action that can be activated in order to face potential stress situations, specifying the extent of the mitigating effects attainable in the short-term.

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.

In the first six months of the year, the Group's liquidity position - supported by suitable high-quality liquid assets (HQLA) and the significant contribution from retail stable funding - remained within the risk limits set out in the current Guidelines: both indicators, LCR and NSFR, were fully met and were already above the regulatory requirements. The Liquidity Coverage Ratio (LCR) of the Intesa Sanpaolo Group, measured according to Delegated Regulation (EU) no. 2015/61, amounted to an

average of 171%. As at 30 June 2018, the eligible liquidity reserves for the Central Banks, including the reserves held with Central Banks (Cash and Deposits), amounted to a total of 163 billion euro (171 billion euro at the end of December 2017), of which 79 billion euro, net of haircut, was unencumbered (98 billion euro at the end of December 2017). The HQLA component represented 63% of the reserves in own portfolio and 88% of the unencumbered reserves. The other eligible reserves mainly consist of retained self-securitisations.
The stress tests, when considering the high availability of liquidity reserves (liquid or eligible), yielded results in excess of the target threshold for the Intesa Sanpaolo 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 various 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, PRUDENT VALUATION AND INDEPENDENT PRICE VERIFICATION

Fair value of financial instruments

The methodologies for the fair value measurement of financial instruments, as well as any adjustments attributable to uncertainties in valuation, are governed by the Fair Value Policy of Intesa Sanpaolo Group and are described in detail in the 2017 Annual Report, to which reference is made for more information.

This chapter provides a summary of the most significant changes during the first half of 2018.
In particular, the Group has aligned its Fair Value Policy to IFRS 9, introducing a methodology for the fair valuation of loans measured at fair value required by the business model classification or by the failure of the Solely Payment of Principal and Interest (SPPI) Test. The Fair Value Policy also established rules for the quantitative methods supporting the SPPI Test (Benchmark Cash Flow Test and Credit Risk Assessment) for the instruments that require them.

Prudent value of financial instruments

Following the introduction of IFRS 9, the Group has also updated its Prudent Valuation Policy, which governs the measurement of the prudent value of the financial instruments and specifically the calculation of the Additional Value Adjustments (AVAs), as described in detail in the 2017 Annual Report, to which reference is made for more information.
With respect to 31 December 2017, the calculation rules for the Additional Value Adjustments (AVAs) have been extended to measure the prudent value of the loans at fair value and the Prudential filters have been updated after the end of the transitional period established by the Bank of Italy with the issue of Circular 285.

Independent price verification (IPV)

In the first half of 2018, the Group formalised its Independent Price Verification Process through its IPV Policy.
According to the provisions of Regulation EU 575/2013, Article 4, par. 1.70 and Article 105, par. 8, the IPV process consists of the regular verification of the accuracy and independence of market prices or the data input in pricing models, carried out by an organisational unit independent from the managers of the business, at a frequency commensurate with the trading carried out and the nature of the market. The IPV process is integrated with the risk management processes, in compliance with the regulations on the measurement of financial instruments (IFRS) and the measurement of risk (CRR).
The IPV Policy formalises in a single framework at Group level a series of already existing controls that have been developed over time.

Fair value hierarchy

Assets and liabilities designated at fair value on a recurring basis: fair value by level *- Excluding insurance companies*

(millions of euro)

Financial assets / liabilities at fair value	30.06.2018			01.01.2018		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
1. Financial assets designated at fair value through profit or loss	13,111	26,952	2,688	12,723	27,275	2,561
a) Financial assets held for trading	*12,822*	*26,462*	*624*	*12,125*	*26,778*	*748*
of which: Equities	*709*	*-*	*1*	*625*	*-*	*1*
of which: quotas of UCI	*709*	*2*	*63*	*983*	*3*	*93*
b) Financial assets designated at fair value	-	144	65	-	150	64
c) Other financial assets mandatorily designated at fair value	289	346	1,999	598	347	1,749
of which: Equities	*3*	*92*	*190*	*24*	*186*	*187*
of which: quotas of UCI	*267*	*10*	*1,351*	*264*	*8*	*1,060*
2. Financial assets designated at fair value through other comprehensive income	55,950	5,168	722	53,093	6,079	688
of which: Equities	*536*	*2,117*	*457*	*519*	*2,208*	*435*
3. Hedging derivatives	-	3,464	9	-	4,199	14
4. Property and equipment	-	-	5,805	-	-	5,890
5. Intangible assets	-	-	-	-	-	-
Total	**69,061**	**35,584**	**9,224**	**65,816**	**37,553**	**9,153**
1. Financial liabilities held for trading	13,860	25,532	90	15,556	25,768	132
2. Financial liabilities designated at fair value	-	4	-	-	3	-
3. Hedging derivatives	-	7,082	4	-	7,246	5
Total	**13,860**	**32,618**	**94**	**15,556**	**33,017**	**137**

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

Excluding insurance companies, level 3 instruments, which allow for more discretion in fair value measurement, account for a limited portion of the financial assets portfolio equal to 8.1%.
As far as liabilities are concerned, level 3 instruments account for 0.2% of total liabilities.
Over 60% of financial assets designated at fair value (excluding the insurance segment) 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 designated at level 3 as detailed below, please note that the following transfers were made during the first half of 2018:

- from level 1 to level 2:
  financial assets held for trading for 96 million euro (book value as at 30 June 2018);
  financial assets designated at fair value through other comprehensive income for 56 million euro (book value as at 30 June 2018);
  financial liabilities held for trading for 207 million euro (book value as at 30 June 2018);
- from level 2 to level 1:
  financial assets held for trading for 67 million euro (book value as at 30 June 2018);
  financial liabilities held for trading for 72 million euro (book value as at 30 June 2018).

The transfers between fair value levels are determined by the trends in the observability of prices or market data used to measure the instruments and by the materiality of the unobservable inputs.
The transition from level 1 to level 2 is a consequence of the disappearance of the presence of an active market for that instrument assessed by analysing the reliability and the reciprocal consistency of the available prices according to the provisions of the Group's Fair Value Policy. Conversely, securities for which a mark-to-model measurement is performed using inputs that can be observed on the market – classified, therefore, as level 2 – are transferred to level 1 when the existence of an active market is identified.

Assets and liabilities designated at fair value on a recurring basis: fair value by level *- Insurance companies*

(millions of euro)

Financial assets / liabilities at fair value	30.06.2018			31.12.2017		
	Level 1	**Level 2**	**Level 3**	**Level 1**	**Level 2**	**Level 3**
1. Financial assets held for trading	300	16	49	428	13	49
of which: Equities	-	-	-	-	-	-
of which: quotas of UCI	*156*	-	*49*	*205*	-	*49*
2. Financial assets designated at fair value through profit or loss	76,347	140	450	74,221	157	337
of which: Equities	*1,608*	-	-	*1,606*	-	-
of which: quotas of UCI	*70,516*	-	*19*	*68,628*	-	*19*
3. Financial assets available for sale	72,976	735	1,216	75,571	786	1,016
of which: Equities	*1,001*	-	-	*1,608*	-	-
of which: quotas of UCI	*8,778*	*17*	*1,112*	*8,578*	*61*	*818*
4. Hedging derivatives	-	-	-	-	-	-
5. Property and equipment	-	-	9	-	-	9
6. Intangible assets	-	-	-	-	-	-
Total	**149,623**	**891**	**1,724**	**150,220**	**956**	**1,411**
1. Financial liabilities held for trading	-	47	-	-	67	-
2. Financial liabilities designated at fair value through profit or loss	-	45,698	24,592	-	43,210	24,956
3. Hedging derivatives	-	-	-	-	-	-
Total	**-**	**45,745**	**24,592**	**-**	**43,277**	**24,956**

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

Having regard to insurance companies, as shown in the table, level 3 instruments, which allow for more discretion in fair value measurement, account for a limited portion of the financial assets portfolio equal to 1.1%.
As far as liabilities are concerned, level 3 instruments account for 35% of total liabilities of the segment.
Over 98% of financial assets designated at fair value in the insurance segment 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 in the insurance segment designated at level 3 as detailed below, please note that the following transfers were made during the first half of 2018:

- from level 1 to level 2:
  financial assets designated at fair value through profit and loss for 8 million euro (book value as at 30 June 2018);
  financial assets available for sale for 90 million euro (book value as at 30 June 2018);
- from level 2 to level 1:
  financial assets designated at fair value through profit and loss for 3 million euro (book value as at 30 June 2018);
  financial assets available for sale for 61 million euro (book value as at 30 June 2018).

The transfers between fair value levels are determined by the trends in the observability of prices or market data used to measure the instruments and by the materiality of the unobservable inputs.
The transition from level 1 to level 2 is a consequence of the disappearance of the presence of an active market for that instrument assessed by analysing the reliability and the reciprocal consistency of the available prices according to the provisions of the Group’s Fair Value Policy. Conversely, securities for which a mark-to-model measurement is performed using inputs that can be observed 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) *- Excluding insurance companies*

(millions of euro)

	Financial assets designated at fair value through profit or loss				Financial assets designated at fair value through other comprehensive income	Hedging derivatives	Property and equipment	Intangible assets
	TOTAL	*of which: a) Financial assets held for trading*	*of which: b) Financial assets designated at fair value*	*of which: c) Other financial assets mandatorily designated at fair value*				
1. Initial amount	**2,561**	**748**	**64**	**1,749**	**688**	**14**	**5,890**	**-**
2. Increases	**1,162**	**647**	**1**	**514**	**135**	**-**	**3**	**-**
2.1 Purchases	636	501	-	135	114	-	-	-
2.2 Gains recognised in:	52	20	1	31	6	-	3	-
2.2.1 Income statement	52	20	1	31	-	-	-	-
- of which capital gains	*47*	*17*	*1*	*29*	-	-	-	-
2.2.2 Shareholders' equity	-	X	X	X	6	-	3	-
2.3 Transfers from other levels	33	23	-	10	5	-	-	-
2.4 Other increases	441	103	-	338	10	-	-	-
3. Decreases	**-1,035**	**-771**	**-**	**-264**	**-101**	**-5**	**-88**	**-**
3.1 Sales	-838	-689	-	-149	-58	-4	-	-
3.2 Reimbursements	-45	-23	-	-22	-26	-	-	-
3.3 Losses recognized in:	-61	-31	-	-30	-5	-1	-52	-
3.3.1 Income statement	-61	-31	-	-30	-	-1	-52	-
- of which capital losses	*-57*	*-27*	-	*-30*	-	*-1*	-	-
3.3.2 Shareholders' equity	-	X	X	X	-5	-	-	-
3.4 Transfers to other levels	-27	-19	-	-8	-8	-	-	-
3.5 Other decreases	-64	-9	-	-55	-4	-	-36	-
4. Final amount	**2,688**	**624**	**65**	**1,999**	**722**	**9**	**5,805**	**-**

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

(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	**49**	**337**	**1,016**	**-**	**9**	**-**
2. Increases	**-**	**120**	**534**	**-**	**-**	**-**
2.1 Purchases	-	-	193	-	-	-
2.2 Gains recognised in:	-	-	26	-	-	-
2.2.1 Income statement	-	-	-	-	-	-
- of which capital gains	-	-	-	-	-	-
2.2.2 Shareholders' equity	X	X	26	-	-	-
2.3 Transfers from other levels	-	-	101	-	-	-
2.4 Other increases	-	120	214	-	-	-
3. Decreases	**-**	**-7**	**-334**	**-**	**-**	**-**
3.1 Sales	-	-	-36	-	-	-
3.2 Reimbursements	-	-	-	-	-	-
3.3 Losses recognized in:	-	-	-20	-	-	-
3.3.1 Income statement	-	-	-1	-	-	-
- of which capital losses	-	-	-	-	-	-
3.3.2 Shareholders' equity	X	X	-19	-	-	-
3.4 Transfers to other levels	-	-	-90	-	-	-
3.5 Other decreases	-	-7	-188	-	-	-
4. Final amount	**49**	**450**	**1,216**	**-**	**9**	**-**

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

(millions of euro)

	Financial liabilities held for trading	Financial liabilities designated at fair value	Hedging derivatives
1. Initial amount	**132**	**-**	**5**
2. Increases	**4**	**-**	**-**
2.1 Issues	-	-	-
2.2 Losses recognised in:	2	-	-
2.2.1 Income statement	2	-	-
- of which capital losses	*5*	-	-
2.2.2 Shareholders' equity	X	-	-
2.3 Transfers from other levels	2	-	-
2.4 Other increases	-	-	-
3. Decreases	**-46**	**-**	**-1**
3.1 Reimbursements	-	-	-
3.2 Repurchases	-	-	-
3.3 Gains recognised in:	-16	-	-1
3.3.1 Income statement	-16	-	-1
- of which capital gains	*-5*	-	*-1*
3.3.2 Shareholders' equity	X	-	-
3.4 Transfers to other levels	-23	-	-
3.5 Other decreases	-7	-	-
4. Final amount	**90**	**-**	**4**

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

(millions of euro)

	Financial liabilities held for trading	Financial liabilities designated at fair value through profit or loss	Hedging derivatives
1. Initial amount	**-**	**24,956**	**-**
2. Increases	**-**	**1,496**	**-**
2.1 Issues	-	1,496	-
2.2 Losses recognised in:	-	-	-
2.2.1 Income statement	-	-	-
- of which capital losses	-	-	-
2.2.2 Shareholders' equity	X	X	-
2.3 Transfers from other levels	-	-	-
2.4 Other increases	-	-	-
3. Decreases	**-**	**-1,860**	**-**
3.1 Reimbursements	-	-1,316	-
3.2 Repurchases	-	-	-
3.3 Gains recognised in:	-	-	-
3.3.1 Income statement	-	-	-
- of which capital gains	-	-	-
3.3.2 Shareholders' equity	X	X	-
3.4 Transfers to other levels	-	-	-
3.5 Other decreases	-	-544	-
4. Final amount	**-**	**24,592**	**-**

Assets and liabilities not designated at fair value or designated at fair value on a non-recurring basis - Excluding insurance companies

(millions of euro)

Assets/liabilities not measured at fair value or measured at fair value on a non-recurring basis	30.06.2018		31.12.2017	
	Book value	Fair value	Book value	Fair value
1. Financial assets measured at amortised cost	481,214	486,886	483,959	486,548
2. Investment property	1	1	-	-
3. Non-current assets held for sale and discontinued operations	3,609	3,609	627	556
Total	**484,824**	**490,496**	**484,586**	**487,104**
1. Financial liabilities measured at amortised cost	522,460	521,618	516,360	518,978
2. Liabilities associated with non-current assets	261	261	264	264
Total	**522,721**	**521,879**	**516,624**	**519,242**

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

Assets and liabilities not designated at fair value or designated at fair value on a non-recurring basis - *Insurance companies*

(millions of euro)

Assets/liabilities not measured at fair value or measured at fair value on a non-recurring basis	30.06.2018		31.12.2017	
	Book value	Fair value	Book value	Fair value
1. Investments held to maturity	-	-	-	-
2. Due from banks	651	651	405	406
3. Loans to customers	31	31	18	18
4. Investment property	-	-	-	-
5. Non-current assets held for sale and discontinued operations	-	-	-	-
Total	**682**	**682**	**423**	**424**
1. Due to banks	8	8	1	1
2. Due to customers	120	120	57	58
3. Securities issued	1,285	1,285	1,254	1,254
4. Liabilities associated with non-current assets	-	-	-	-
Total	**1,413**	**1,413**	**1,312**	**1,313**

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
Securities at FVTPL and Securities at FVTOCI	Credit spread	-239	1 bp
Securities at FVTPL and Securities at FVTOCI	Correlation	-	1%
Securities at FVTPL and Securities at FVTOCI	CPR	-23	1%
Securities at FVTPL and Securities at FVTOCI	Recovery rate	-66	-1%
OTC Derivatives - Interest Rates	Correlation for spread options between swap rates	-197	0.10
OTC Derivatives - Equity	Correlation between underlying equity baskets	-86	0.10
OTC Derivatives - Equity	Historical volatility	-454	10%
OTC Derivatives - Equity CPPI	Historical correlation	-145	10%
OTC Derivatives - Interest Rate	Volatility for JPY swaption	-61	10%

Information on "Day one profit/loss"

Under IFRS 9, financial instruments shall be initially recognised at fair value. The fair value of a financial instrument at 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 allow for partial discretion by the valuator of the instrument, and therefore 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).

This difference shall be recognised in the income statement only when it arises from changes to 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 whole 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 changes in the DOP amount 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**

INFORMATION ON STRUCTURED CREDIT PRODUCTS

The risk exposure to structured credit products amounted to 1,938 million euro as at 30 June 2018 with respect to funded and unfunded ABSs/CDOs, compared to 2,279 million euro as at 31 December 2017. There were no exposures in structured packages.
The strategy regarding the portfolio in question in 2018 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 exposure to funded and unfunded ABSs/CDOs measured at fair value went from 2,034 million euro in December 2017 to 1,731 million euro in June 2018, with decrease attributable to sales and redemptions of ABSs by Banca IMI and of European ABSs by the Parent Company, only partially offset by investments in ABSs by Banca IMI (part of which were classified to the portfolio of financial assets measured at fair value through other comprehensive income) and in European ABSs purchased by the Parent Company and classified to the trading book.
Banca IMI's investments mainly consist of securities with underlying residential mortgages and CLOs with mainly AA ratings, while the Parent Company confirmed its transactions in European RMBS with mainly AAA ratings, aimed at seizing market opportunities.
The exposure represented by securities classified in the portfolio of assets measured at amortised cost showed a net decrease (from 245 million euro in December 2017 to 207 million euro in June 2018) due to greater investments made by Banca IMI, offset by sales by the Parent Company, and by reclassifications to the accounting categories measured at fair value through profit or loss, upon First Time Adoption (FTA) of IFRS9, due to the failure to pass the SPPI Test on the contractual cash flow characteristics.
From the perspective of the income statement, a profit of +7 million euro was posted for the first half of 2018, against the +28 million euro for 2017.
As at 30 June 2018, the profits (losses) on trading – caption 80 of the income statement – for the exposures in funded and unfunded ABSs came to nil overall (+17 million euro in 2017) and was also nil for the positions in multi-sector CDOs (+4 million euro in 2017).
The profits (losses) from financial assets mandatorily measured at fair value was +4 million euro and related to the funded and unfunded ABS positions in the Parent Company’s loan portfolio, reclassified into the new accounting category upon First Time Adoption (FTA) of IFRS 9.
The exposure to funded and unfunded ABSs in securities classified by the subsidiary Banca IMI in the portfolio of assets measured at fair value through other comprehensive income recorded a net decrease in fair value of 2 million euro in 2018, recognised in the specific Shareholders’ Equity Reserve (from a positive reserve at the end of December 2017 of +4 million euro to a reserve of +2 million euro in June 2018) and an impact of +1 million euro from sales made in the period (nil impact in 2017).
Securities classified in the portfolio of assets measured at amortised cost recorded a net gain of +2 million euro as at 30 June 2018 (nil impact in 2017) essentially related to valuation components.
With regard to the monoline and non-monoline packages, there were no positions in 2018 because they had been disposed of in 2017, generating a contribution of +7 million euro to the profits (losses) on trading – caption 80 of the income statement – as at 31 December 2017.

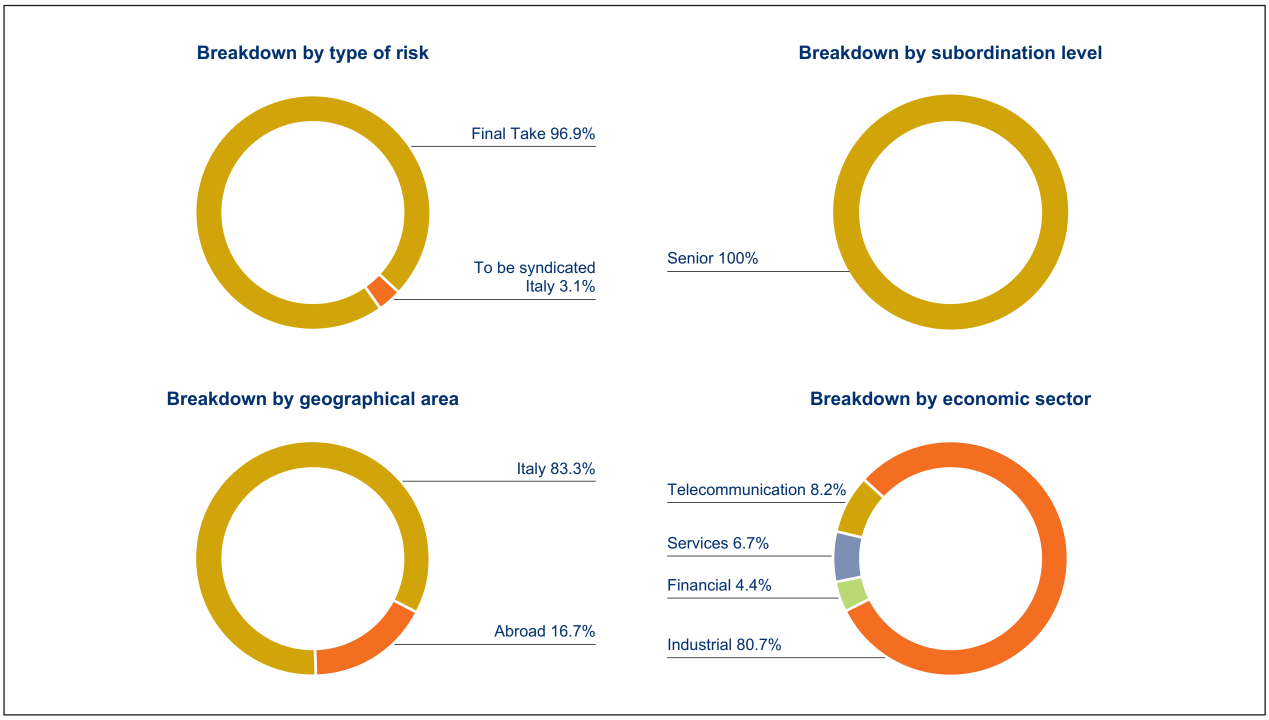
INFORMATION ON ACTIVITIES PERFORMED THROUGH SPECIAL PURPOSE ENTITIES (SPEs)

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 2017 financial statements.
During the first half of 2018, within the multi-originator programme guaranteed by ISP OBG, the 11th series matured for an amount of 1.375 billion euro and the 12th series maturing in August 2018 was redeemed in advance for an amount of 2.154 billion euro, for a total of 3.529 billion euro.
In March, the 25th and 26th series of floating-rate securities were issued for a total of 3.9 billion euro with a duration of 7 and 10 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 with the Eurosystem.
With regard to the covered bond issue programme guaranteed by ISP CB Pubblico, in January the 11th series was partially redeemed for an amount of 600 million euro, bringing the nominal amount to 500 million euro.
Under the covered bond issue programme guaranteed by ISP CB Ipotecario, the 23rd series was issued in February for an amount of 2 billion euro. This is a floating-rate security with a duration of 12 years, listed on the Luxembourg Stock Exchange, rated Aa2 by Moody's, subscribed by the Parent Company and eligible with the Eurosystem.

INFORMATION ON LEVERAGED FINANCE TRANSACTIONS

Since 2008 Intesa Sanpaolo has represented in this category 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 30 June 2018, 116 transactions for a total amount granted of 3,193 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.
Moreover, it is noted that – as stated in the 2017 Annual Report and in the Interim Statement as at 31 March 2018 – in May 2017 the ECB published specific Guidance on Leveraged Transactions, which applies to all significant entities subject to direct supervision by the ECB. The purpose of the new regulations is to strengthen company controls over "leveraged" transactions, where such transactions increase globally and in the context of a highly competitive market, marked by a long period of low interest rates and the resulting search for yields.
The guidance covers, *inter alia*, the following issues with regard to leveraged transactions: definition, risk appetite and governance, syndication activities, policies and procedures for new deal approval, longer-term monitoring and management of longer-term transactions, secondary market activities and internal reporting requirements, while it does not explicitly regulate public disclosure.
In particular, the scope identified by the ECB is larger than the one currently surveyed by Intesa Sanpaolo in that it includes – in addition to exposures to parties whose majority of capital is held by one or more financial sponsors – also exposures in which the borrower's level of leverage, measured as the ratio of total debt to EBITDA, is greater than 4.
The guidance requires that Banks set up the instruments necessary to apply the new rules, and an internal audit report, describing how the expectations of the Regulator have been endorsed and implemented, must be sent to the specific Joint Supervisory Team of the ECB by November 2018.
Intesa Sanpaolo thus launched a specific project with the purpose of gradual alignment with the ECB guidance on leveraged transactions.

A breakdown of exposures by risk type, geographical area, level of subordination and economic sector is set out in the charts below.



INFORMATION ON INVESTMENTS IN HEDGE FUNDS

The Hedge Fund portfolio as at 30 June 2018 amounted to 214 million euro in the Trading Book and approximately 90 million euro in the Banking Book, compared to 263 million euro and 64 million euro respectively at the end of March and 416 million euro and 19 million euro in December 2017. The amounts allocated to the Banking Book are recognised under Other financial assets mandatorily measured at fair value and relate to recent investments made in funds that have medium/long-term investment strategies and redemption times that are longer than those of UCITS Funds (Undertakings for Collective Investment in Transferable Securities).

During 2018, the reduction of the Trading Book continued through distributions and redemptions, with a consequent reduction in the risk level of the exposure. In particular, the most significant redemptions in 2018 involved the MAP 1A Fund for 46 million euro, the MAP 17A Fund for 36 million euro, the MAP 4A Fund for almost 33 million euro, and the Charity Investment Fund for 13 million euro in the first quarter, and the MAP 19A for 40 million euro in the second quarter.

The result for the first half was a loss of 6 million euro, compared to a profit of 8 million euro recorded in the Profits (Losses) on trading in June 2017. This result mainly reflected the write-down of the Matrix Pve Map 6A fund by more than 5 million euro, due to particularly prudent policies (worst case scenario) used by the servicer to value the underlying assets and of the Harbinger Distressed Credit fund by almost 3 million euro, in relation to the write-down of the investment in Lingado.

As a whole, the current strategy of the portfolio is prudent, while waiting for any market opportunities to arise.

INFORMATION ON TRADING TRANSACTIONS IN DERIVATIVES WITH CUSTOMERS

Considering relations with customers only, as at 30 June 2018, 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 6,792 million euro (7,011 million euro as at 31 December 2017). The notional value of these derivatives totalled 51,284 million euro (50,488 million euro as at 31 December 2017). In particular, the notional value of plain vanilla contracts was 48,137 million euro (46,764 million euro as at 31 December 2017), while that of structured contracts was 3,147 million euro (3,724 million euro as at 31 December 2017).

Please note that the positive fair value of contracts outstanding with the 10 customers with the highest exposures came to 4,755 million euro (4,901 million euro as at 31 December 2017), of which 479 million euro (480 million euro as at 31 December 2017) 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 1,411 million euro as at 30 June 2018 (1,082 million euro as at 31 December 2017). The notional value of these derivatives totalled 24,769 million euro (22,846 million euro as at 31 December 2017). In particular, the notional value of plain vanilla contracts was 20,950 million euro (20,304 million euro as at 31 December 2017), while that of structured contracts was 3,819 million euro (2,542 million euro as at 31 December 2017).

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 2018, this led to a positive effect of 9 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 Part A of the Notes to the consolidated financial statements. 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 the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Operational risk includes legal risk and compliance risk, model risk, ICT risk and financial reporting risk; strategic and reputational risk 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 traditional standardised approach (TSA) and the basic indicator approach (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 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, Operational and Reputational 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 organisational units to be responsible for Operational Risk Management (structured collection of information relative to operational events, detection of critical issues and related mitigation actions, 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:

- estimate the exposure to potential future losses deriving from operational events (Scenario Analysis) and assess the level of control of the business environment (Business Environment Evaluation);
- analyse ICT risk exposure;
- create significant synergies with Cybersecurity and Business Continuity, which supervises the planning of operational processes, IT security and business continuity issues, with the Administrative and Financial Governance and with control functions (Compliance and Internal Auditing) that supervise specific regulations and issues (Legislative Decree 231/01, Law 262/05) or conduct tests on 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 the 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.

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.

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 1,437 million euro as at 30 June 2018, down from 1,488 million euro as at 31 December 2017.

Legal risks

Legal risks are thoroughly analysed by the Parent Company and Group companies. Provisions have been 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 first half of 2018, there were no new significant disputes or changes with respect to the pending legal disputes indicated in the Notes to the 2017 Financial Statements, apart from that disclosed in the Interim Statement as at 31 March 2018.

Disputes connected with the acquisition of certain assets, liabilities and legal relationships of Banca Popolare di Vicenza S.p.A. in compulsory administrative liquidation and Veneto Banca S.p.A. in compulsory administrative liquidation - With regard to the risks connected with the possible outcomes for the Intesa Sanpaolo Group of the lawsuits relating to Banca Popolare di Vicenza and Veneto Banca (and/or their directors and top management), the following is noted:

a) based on the agreements between the two Banks in compulsory administrative liquidation and Intesa Sanpaolo (sale contract of 26 June 2017 and Second Acknowledgement Agreement of 17 January 2018), two distinct categories of disputes can be identified (also relating to the subsidiaries of the former Venetian banks included in the sale):
   - the Previous Disputes, included among the liabilities of the Aggregate Set transferred to Intesa Sanpaolo, which include civil disputes relating to judgements already pending at 26 June 2017, with some exceptions, and in any case different from those included under the Excluded Disputes (see the point below);
   - the Excluded Disputes, which remain under the responsibility of the Banks in compulsory administrative liquidation and which concern, among other things, disputes brought (also before 26 June 2017) by shareholders and convertible and/or subordinate bondholders of one of the two former Venetian banks, disputes relating to non-performing loans, disputes relating to relationships terminated at the date of the transfer, and all disputes (whatever their subject) arising after the sale and relating to acts or events occurring prior to the sale;

b) the relevant allowances were transferred to Intesa Sanpaolo along with the Previous Disputes; in any case, if and to the extent the provisions transferred prove insufficient, Intesa Sanpaolo will be entitled to be indemnified by the Banks in compulsory administrative liquidation, at the terms provided for in the sale contract of 26 June 2017. This indemnity is backed by a government guarantee, pursuant to Decree Law 99/2017;

c) after 26 June 2017, a number of lawsuits included within the Excluded Disputes were initiated or resumed against Intesa Sanpaolo. With regard to these lawsuits:
   - Intesa Sanpaolo is pleading and will plead its non-involvement and lack of capacity to be sued, both on the basis of the provisions of Decree Law 99/2017[4] (Article 3), the sale contract signed with the two Banks in compulsory administrative liquidation on 26 June 2017 (Articles 3.1.1, 3.1.4 and 3.2), the First Acknowledgement Agreement signed on 19 December 2017, and the Second Acknowledgement Agreement signed on 17 January 2018 (Article 3 and Attachment 1.1), and in compliance with the European Commission provisions on State Aid (Decision C(2017) 4501 final and Attachment B to the sale contract of 26 June 2017), which prohibit Intesa Sanpaolo from taking responsibility for any claims made by the shareholders and subordinated bondholders of the former Venetian Banks;
   - even if there were to be a ruling against Intesa Sanpaolo (and in any event for the charges incurred by Intesa Sanpaolo for any reason in relation to its involvement in any Excluded Disputes), it would have the right to be fully reimbursed by the Banks in compulsory administrative liquidation;
   - it should be noted that the Banks in compulsory administrative liquidation have contractually acknowledged their capacity to be sued with respect to the Excluded Disputes, such that, with effect from 26 June 2017, they have entered appearances in various proceedings initiated (or re-initiated) by various shareholders and subordinate bondholders against Intesa Sanpaolo (or in any case included in the category of Excluded Disputes), asking for the declaration of their exclusive capacity to be sued and the consequent exclusion of Intesa Sanpaolo from those proceedings;

d) pursuant to the agreements between the two Banks in compulsory administrative liquidation and Intesa Sanpaolo, the disputes regarding the marketing of shares/convertible and/or subordinated bonds initiated against Banca Nuova (subsequently merged by incorporation into Intesa Sanpaolo) and Banca Apulia are also included in the Excluded Disputes (and therefore have the same treatment as described above, as a result of the abovementioned provisions and based on the criteria set out in the retransfer agreements signed on 10 July 2017, as subsequently supplemented). In this regard, however, it should be noted that, as at 30 June 2018, the Securities and Financial Ombudsman (*Arbitro per le Controversie Finanziarie*) upheld 20 appeals filed against Banca Nuova regarding shares of Banca Popolare di Vicenza and 14 against Banca Apulia regarding shares of Veneto Banca. Banca Nuova (now Intesa Sanpaolo) and Banca Apulia did not implement the decisions because – for the reasons set out above and in accordance with the provisions of the European Commission Decision C(2017) 4501 final on State aid – any liability relating to the marketing of the shares of the former Venetian banks must be considered as being borne exclusively by the two Banks in compulsory administrative liquidation.

Some information is provided below on two decisions made by the Judicial Authority.

(i) *Criminal proceedings against the top management of Veneto Banca* - In January 2018, as part of a criminal proceeding before the Court of Rome for the alleged market rigging and obstructing the Supervisory Authorities in the performance of their functions with respect to officers and executives of Veneto Banca, the preliminary hearing judge decided that Intesa Sanpaolo could be charged with civil liability. According to the judge, the exclusion from the sale to

[4] Published in the Official Gazette no. 146 of 25 June 2017 and converted by Law 121 of 31 July 2017.

Intesa Sanpaolo of the debts, responsibilities and liabilities deriving from the sale of shares and subordinated bonds – envisaged by Decree Law 99/2017 – would not be objectionable by third parties, while Article 2560 of the Italian Civil Code would be applicable in the case in question and Intesa Sanpaolo should therefore take on those liabilities.
As a result of this decision, more than 3,800 civil plaintiffs holding Veneto Banca shares or subordinated bonds joined the proceedings. Intesa Sanpaolo therefore entered an appearance requesting its exclusion from the proceedings, in application of the provisions of Decree Law 99/2017, of the rules established for the compulsory administrative liquidation of banks and, before that, of the principles and rules contained in the bankruptcy law, in addition to the constitutional principles and decisions made at EU level with regard to the operation relating to the former Venetian banks. In turn, Veneto Banca in compulsory administrative liquidation intervened voluntarily affirming its exclusive, substantial and procedural capacity to be sued.
In March 2018, the preliminary hearing judge declared his lack of territorial jurisdiction, transferring the files to the Public Prosecutor's Office of Treviso. The charge of civil liability and the joinders of the civil parties were therefore removed.
On the other hand, it should be noted that, in a criminal proceeding before the Court of Vicenza against the directors and executives of Banca Popolare di Vicenza, the preliminary hearing judge rejected the request for authorisation to charge Intesa Sanpaolo with civil liability, arguing on the basis of the provisions of the sale contract of 26 June 2017 and the special provisions contained in Decree Law 99/2017.

(ii) *Civil dispute pending before the Court of Vicenza against Veneto Banca in compulsory administrative liquidation* – In March 2018, as part of a lawsuit filed by a Veneto Banca shareholder, the Court of Vicenza ordered Intesa Sanpaolo to be summoned to appear in the proceedings, based on arguments similar to those put forward by the preliminary hearing judge in Rome in the proceedings referred to in point (i) above. However, it should be noted that, in other civil proceedings, the exclusive capacity to be sued of the two Banks in compulsory administrative liquidation has been affirmed, without the involvement of Intesa Sanpaolo.

Tax litigation

The Group's tax payable litigation risks are covered by adequate provisions to the allowances for risks and charges.
As at 30 June 2018, Intesa Sanpaolo had pending litigation proceedings (for tax, fines and interest) for a total amount of 220 million euro (214 million euro as at 31 December 2017), considering both administrative and judicial proceedings at various instances.
In relation to these proceedings, the actual risks were quantified at 64 million euro as at 30 June 2018 (65 million euro as at 31 December 2017).
In the first half, only one new dispute of a significant amount was initiated (dispute of 6.7 million euro, plus interest; fines not imposed). Two transactions involving the contribution of private equity business lines and the subsequent partial demerger were contested against the Parent Company and IMI Investimenti, as jointly and severally liable, which the Italian Revenue Agency - Second Provincial Office of Milan reclassified as transfers of business lines subject to registration tax at a proportional rate (3%).
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 131 million euro as at 30 June 2018 (139 million euro at 31 December 2017), covered by specific provisions of 31 million euro (32 million euro at the end of 2017).
No new significant claims were recorded for these companies during the first half.
For Banca IMI, two tax disputes of a significant amount relating to 2005 and 2006 were closed as a result of access to the procedure for the settlement of pending tax disputes concerning withholding tax on manufactured dividends paid to non-residents in relation to Italian shares borrowed by Banca IMI. With respect to a total value of claims of 20.2 million euro, the settlement was made for a total of 8.6 million euro, without effect on the income statement, as the claims were covered by specific allowances for tax litigation. In addition, on 24 January 2018, the Lombardy Regional Office - Large Taxpayers Department of the Italian Revenue Agency began a tax audit of direct taxes, VAT, IRAP and withholding tax for 2015.
In May, the IRES and IRAP disputes for the year 2012 were settled for Banca Apulia, a company that joined the ISP Group following the acquisition of the business lines of the Venetian Banks. Starting from an initial total claim for IRES and IRAP for the 2012 tax year of 5.5 million euro, the dispute was settled by means of a tax settlement proposal for a total charge of 0.8 million euro (partly already paid by the bank in the form of substitute tax and acknowledged by the Italian Revenue Agency and partly through use of the allowance for tax litigation). This settlement prevented an identical claim of significant value for the tax periods from 2013 to 2021.
As regards Mediocredito Italiano, following the final judgement handed down by the Lombardy Regional Tax Commission, the litigation concerning VAT for the tax year 2007 (former Leasint) was concluded in the bank's favour with respect to an original claim of over 7 million euro (for taxes, interest and fines).
The general tax audit of Intesa Sanpaolo Assicura concerning the tax periods 2013, 2014 and 2015 was completed on 21 May, with an overall positive outcome. For the settlement of the findings, it is estimated that the actual cost will not exceed 0.3 million euro.
Tax disputes involving international subsidiaries, totalling 5.4 million euro (11 million euro as at 31 December 2017), are covered by allowances of 3.6 million euro (3 million euro as at 31 December 2017).
A tax audit of IMI SEC by the US tax authorities was initiated for the years 2015 and 2016. Lastly, the VAT dispute of the foreign subsidiary CIB Bank Ltd (claim amount of 3.6 million euro) was concluded with an unfavourable ruling by the local Supreme Court. Nevertheless, this had no effect on the income statement, as the company had already paid the entire amount of the tax claim in full in previous years.

INSURANCE RISKS

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

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

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

Investment portfolios
The investments of the insurance companies of the Intesa Sanpaolo Group (Intesa Sanpaolo Vita, Intesa Sanpaolo Assicura, Intesa Sanpaolo Life and Fideuram Vita) are made with their free capital and to cover contractual obligations with customers. These refer to traditional revaluable life insurance policies, Index- and Unit-linked policies, pension funds and non-life policies.
As at 30 June 2018, the investment portfolios - recorded at book value and gross of transactions with other companies within the scope of consolidation - amounted to 155,480 million euro. Of these, a part amounting to 78,929 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 76,551 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, 85.2% of assets, i.e. approximately 67,221 million euro, were bonds, whereas assets subject to equity risk represented 1.5% of the total and amounted to 1,197 million euro. The remainder (10,532 million euro) consisted of investments relating to UCI, Private Equity and Hedge Funds (13.3%).
The carrying value of derivatives came to approximately -21.3 million euro, of which 20.7 million euro relating to effective management derivatives[5], and the remaining portion (0.5 million euro) is attributable to hedging derivatives.
At the end of the first six months of 2018, investments made with the free capital of Intesa Sanpaolo Vita and Fideuram Vita amounted to approximately 1,538 million euro at market value, and presented a risk in terms of VaR (99% confidence level, 10-day holding period) of approximately 40 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 3,555 million euro.
The distribution of the portfolio by rating class is as follows. AAA/AA bonds represented approximately 3.4% of total investments and A bonds approximately 8.6%. Low investment grade securities (BBB) were approximately 85.5% of the total and the portion of speculative grade or unrated was minimal (approximately 2.5%).
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 75.5% of the total investments, while financial companies (mostly banks) contributed approximately 13.2% of exposure and industrial securities made up approximately 11.3%.

[5] 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.

At the end of the first half of 2018, 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 3,629 million euro, with 2,823 million euro due to government issuers and 806 million euro to corporate issuers (financial institutions and industrial companies).