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 September 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 September, the Central Banks eligible liquidity reserves came to 173 billion euro (171 billion euro at the end of December 2017), of which 82 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 September 2018, calculated as the ratio of loans to customers to direct deposits from banking business, came to 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 (313 billion euro). In addition, 2.5 billion USD of unsecured senior bonds, 46.6 billion Yen of unsecured senior bonds, 2.25 billion euro of unsecured senior bonds and 1 billion euro of covered bonds were placed during 2018.

With regard to the targeted refinancing operation TLTRO II, at the end of September 2018, the Group’s participation amounted to 61 billion euro.

The Intesa Sanpaolo Group's leverage ratio was 6.2% as at 30 September 2018.

The capital base also remains high. Own funds, risk weighted assets and the capital ratios at 30 September 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 period, Own Funds – taking account of the transitional treatment adopted to mitigate the impact of IFRS 9 – came to 48,957 million euro, against risk-weighted assets of 275,944 million euro, which primarily reflected credit and counterparty risk and, to a lesser extent, operational and market risk.

The Total Capital Ratio stood at 17.7%, while the ratio of the Group’s Tier 1 capital to its total risk-weighted assets (Tier 1 ratio) was 15.2 %. The ratio of Common Equity Tier 1 capital (CET1) to risk-weighted assets (the Common Equity Tier 1 ratio) was 13.5%.

Please note that the impairment of government bonds as a result of the trend in the spread on sovereign debt had a negative impact of 45 basis points on the CET 1 capital of the Intesa Sanpaolo Group as at 30 September 2018.

On 2 November 2018, the EBA published the results of its Stress Test and Supervisory Review and Evaluation Process (SREP) for the year 2018. In this regard, it should be noted that even in the adverse scenario at 2020, the capital requirements of the Intesa Sanpaolo Group were significantly above the regulatory requirements, with a CET 1 Ratio of 11% under the transitional arrangements and 10.3% on a fully loaded basis, taking into account the capital increase to service the long-term incentive plan for personnel completed in July 2018 and the conversion of savings shares finalised in August.

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 September 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 nine months of 2018 was 67 million euro, compared to an average amount of approximately 72 million euro in the same period of 2017. The trend in the Group’s VaR in the period - 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 2,083 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 (66.7%) and unlikely to pay positions (36%).

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 63% using level 1 inputs, around 30% using level 2 inputs and only around 7% using level 3 inputs.

Investment levels in structured credit products and hedge funds remained low. The structured credit products generated a positive contribution of 8 million euro during the period, whereas the hedge funds generated a loss of 14 million euro over the nine 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 as at 30 September 2018. In particular, with regard to goodwill, there were no material deviations in the forecast cash flows compared to those envisaged in the 2018-2021 Business Plan and used for the impairment test as at 31 December 2017. 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, it was significantly lower than 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 the 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.
Subject 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 respect to 31 December 2017, the use of the new Retail model has been extended to the former Banca Nuova portfolio and of the SME Retail model to the former Banca Popolare di Vicenza, Veneto Banca and Banca Nuova portfolios.
The development of the IRB systems is proceeding according to the plan presented to the Supervisory Authority.
There were no changes in the scope of application of the internal models concerning counterparty risk for OTC derivatives and operational risks compared to 31 December 2017.
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 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.
On 31 August 2018, the Group received the authorisation to use the new Retail model, applied to the Retail Mortgages sub-segment (Model Change) and the Other Retail sub-segment (First Adoption). The new model adopts a counterparty approach instead of the previous product approach. During the first disbursement phase, an on-line rating is calculated, also including social and income information. A mass calculation is then used for the entire Retail portfolio (Retail and Other Retail Mortgages).

Credit quality

(millions of euro)

Captions	*30.09.2018* Gross exposure	Total adjustments	Net exposure	*01.01.2018* Gross exposure	Total adjustments	Net exposure	*Change* Net exposure
Bad loans	22,165	-14,790	7,375	34,192	-23,630	10,562	-3,187
Unlikely to pay	15,580	-5,612	9,968	17,390	-5,798	11,592	-1,624
Past due loans	630	-149	481	475	-101	374	107
Non-Performing Loans	**38,375**	**-20,551**	**17,824**	**52,057**	**-29,529**	**22,528**	**-4,704**
Non-performing loans in Stage 3 (subject to impairment)	*38,295*	*-20,531*	*17,764*	*51,939*	*-29,483*	*22,456*	*-4,692*
Non-performing loans designated at fair value through profit or loss	*80*	*-20*	*60*	*118*	*-46*	*72*	*-12*
Performing loans	**374,410**	**-2,083**	**372,327**	**373,569**	**-2,417**	**371,152**	**1,175**
Stage 2	*49,361*	*-1,284*	*48,077*	*51,684*	*-1,573*	*50,111*	*-2,034*
Stage 1	*324,560*	*-799*	*323,761*	*321,570*	*-844*	*320,726*	*3,035*
Performing loans designated at fair value through profit or loss	*489*	*-*	*489*	*315*	*-*	*315*	*174*
Performing loans represented by securities	**5,217**	**-12**	**5,205**	**5,913**	**-54**	**5,859**	**-654**
Stage 2	*379*	*-9*	*370*	*662*	*-23*	*639*	*-269*
Stage 1	*4,838*	*-3*	*4,835*	*5,251*	*-31*	*5,220*	*-385*
Loans held for trading	**66**	**-**	**66**	**-**	**-**	**-**	**66**
Total loans to customers	**418,068**	**-22,646**	**395,422**	**431,539**	**-32,000**	**399,539**	**-4,117**
of which forborne performing	**7,920**	**-360**	**7,560**	**7,954**	**-328**	**7,626**	**-66**
of which forborne non-performing	**9,993**	**-4,057**	**5,936**	**11,134**	**-4,430**	**6,704**	**-768**
Loans to customers classified among discontinued operations (*)	**10,885**	**-7,605**	**3,280**	**314**	**-35**	**279**	**3,001**

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

(*) As at 30 September 2018, this item included the bad loan portfolio to be sold to Intrum (which has decreased since the date of the agreement, primarily due to collections in the meantime, to a gross exposure amount of 10,170 million euro, total adjustments of 7,500 million euro, and net exposure of 2,670 million) and the 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 the option to transfer them to the Banks in compulsory administrative liquidation (gross exposure of 715 million euro, total adjustments of 105 million euro, and net exposure of 610 million euro).
As at 1 January 2018, this item included the high-risk loans; the figures for the bad loan portfolio to be sold to Intrum have not been restated.

As at 30 September 2018, the Group's net non-performing loans, which already at the end of the half-year no longer included the bad loans to be sold to Intrum, classified among non-current assets held for sale and discontinued operations, amounted to 17.8 billion euro, down by 20.9% compared with the beginning of the year, continuing the gradual decline witnessed in the previous year. There was also a significant decrease in non-performing assets as a percentage of total net loans to customers to 4.5%. The coverage ratio for non-performing loans was 53.6%, in accordance with the de-risking strategy outlined in the Business Plan.

In further detail, bad loans came to 7.4 billion euro, net of adjustments and positions reclassified as discontinued operations, at the end of September 2018, down (-30.2%) compared with the beginning of the year, and represented 1.9% of total loans. During the same period, the coverage ratio stood at 66.7%. Loans included in the unlikely to pay category amounted to 10 billion euro, down by 14%, accounting for 2.5% of total loans to customers, with a coverage ratio of 36%. Past due loans amounted to 481 million euro, up 28.6% since the beginning of the year, with a coverage ratio of 23.7%. Within the non-performing loan category, forborne exposures, generated by forbearance measures for borrowers experiencing difficulty in meeting their financial obligations, amounted to 5.9 billion euro, with a coverage ratio of 40.6%, while forborne exposures in the performing loans category amounted to 7.6 billion euro.

Overall, the coverage ratio of performing loans remained stable at 0.6%, sufficient for the intrinsic risk of the Stage 1 and Stage 2 portfolios.

MARKET RISKS

TRADING BOOK

During the third quarter of 2018, the market risks generated by Intesa Sanpaolo and Banca IMI increased compared to the average values of the second quarter of 2018. The average VaR for the period totalled 90.4 million euro compared to 61.9 million euro (average figure) in the second quarter.

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

(millions of euro)

	2018					2017			
	average 3rd quarter	minimum 3rd quarter	maximum 3rd quarter	average 2nd quarter	average 1st quarter	average 4th quarter	average 3rd quarter	average 2nd quarter	average 1st quarter
Intesa Sanpaolo	14.4	9.5	20.0	11.8	7.8	8.0	8.9	11.6	11.5
Banca IMI	75.9	67.3	83.4	50.1	40.3	50.5	52.6	58.4	73.7
Total	**90.4**	**79.7**	**98.2**	**61.9**	**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.

In the first nine months of 2018, the Group's average VaR was 67 million euro, down from 72.4 million euro in the same period of 2017.

(millions of euro)

	2018			2017		
	average 30.09	minimum 30.09	maximum 30.09	average 30.09	minimum 30.09	maximum 30.09
Intesa Sanpaolo	11.3	6.7	20.9	10.2	7.9	14.2
Banca IMI	55.6	24.6	85.8	61.7	47.4	93.2
Total	**67.0**	**33.7**	**105.3**	**72.4**	**56.4**	**104.8**

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

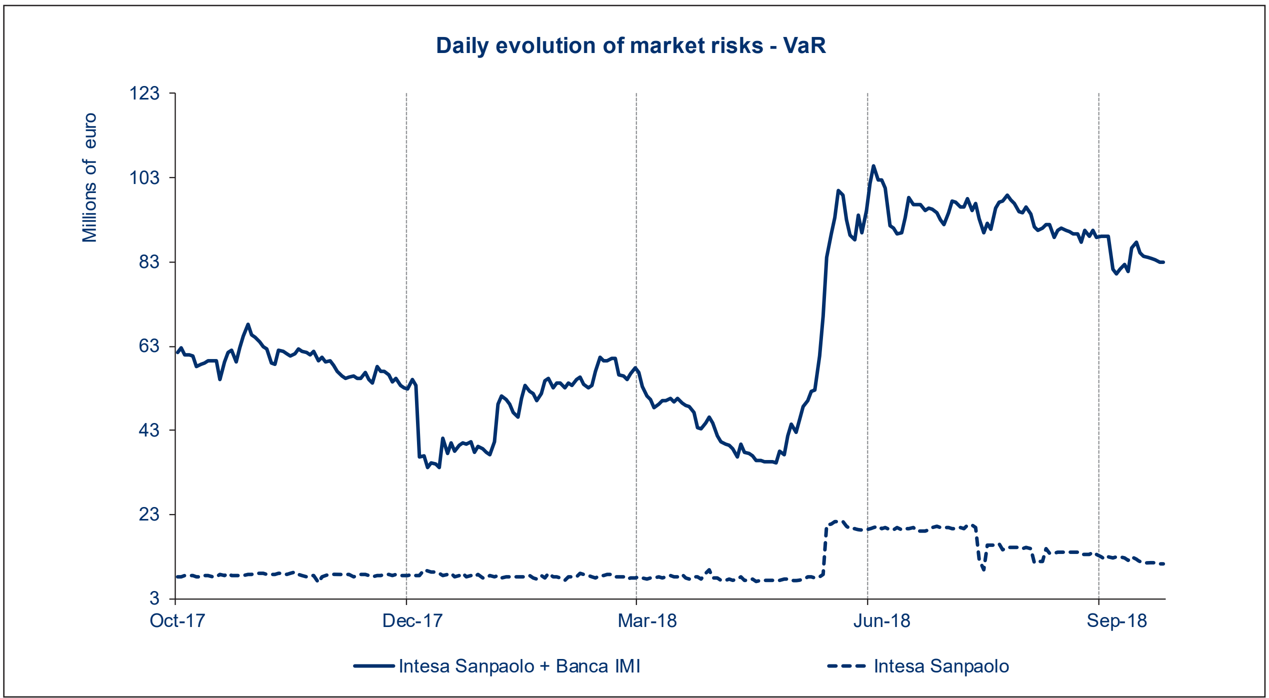
For Intesa Sanpaolo, the breakdown of risk profile in the third quarter of 2018 with regard to the various factors shows the prevalence of credit spread risk, equal to 61% of total operational VaR; for Banca IMI too, credit spread risk was the most significant, representing 79% of total VaR.

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

3rd quarter 2018	Shares	Hedge funds	Interest rates	Credit spreads	Foreign exchange rates	Other parameters	Commodities
Intesa Sanpaolo	2%	3%	19%	61%	15%	1%	0%
Banca IMI	3%	0%	13%	79%	0%	4%	1%
Total	**3%**	**0%**	**14%**	**76%**	**2%**	**4%**	**1%**

(a) Each line in the table sets out the contribution of risk factors considering 100% the overall capital at risk, calculated as the average of daily estimates in the third quarter of 2018, broken down between Intesa Sanpaolo and Banca IMI and indicating the distribution of overall capital at risk.

The trend in VaR is mainly attributable to Banca IMI. In particular, during the third quarter of 2018, the risk measures rose and reflected the increase in the volatility of the financial markets, particularly in the Italian government sector. From June onwards, for Banca IMI, the trend in VaR was also explained by portfolio movements and technical model effects (VaR scenarios) linked to the passage of time. The VaR of the Parent Company increased (second quarter) due to greater volatility in the credit spread risk factor (indices), the impact of which was less significant, due to a change in positioning, in July. 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, commodity prices, interest rates, credit spreads and foreign exchange rates as at the end of September is summarised in the following table: The shocks applied to the portfolio were updated annually.

(millions of euro)

	EQUITY		INTEREST RATES		CREDIT SPREADS		FOREIGN EXCHANGE RATES		COMMODITIES	
	Crash	Bullish	+40bp	lower rate	-25bp	+25bp	-10%	+10%	Crash	Bullish
Total	20	10	-114	95	316	-303	35	-6	2	-8

In particular:

– on stock market positions, a 15% decrease in stock prices with a resulting 100% increase in volatility would lead to potential gains of approximately 20 million euro;
– on interest rate exposures, a rise of the curves of 40 basis points would have a negative impact of -114 million euro, whereas a scenario with a cut in interest rates would lead to potential gains of 95 million euro;
– on exposures sensitive to credit spread fluctuations, a 25-basis point widening in spreads would lead to a 303 million euro loss;
– on foreign exchange exposures, in the event of the euro appreciating against the US dollar by 10%, a loss of approximately 6 million euro would be recorded;
– lastly, for commodity exposures potential losses would be recorded for an amount of 8 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:

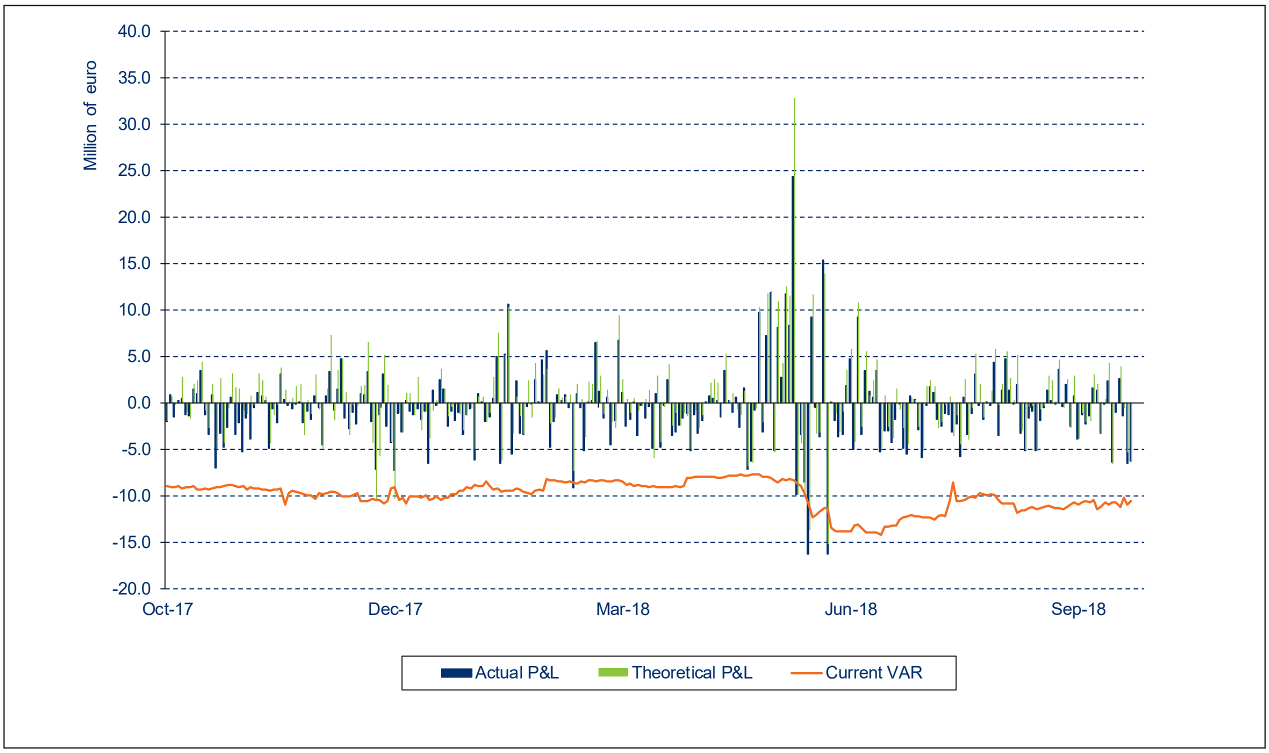
– the daily estimates of value at risk;
– the daily profits/losses based on backtesting which are determined using actual daily profits and losses achieved by individual desks, net of components which are not considered in backtesting such as commissions and intraday activities.

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. Current regulations require that backtesting is performed by taking into consideration both the actual P&L series recorded and the theoretical series. The latter is based on revaluation of the portfolio value through the use of pricing models adopted for the VaR measurement calculation. The number of significant backtesting exceptions is determined as the maximum between those for actual P&L and theoretical P&L.

Backtesting in Intesa Sanpaolo

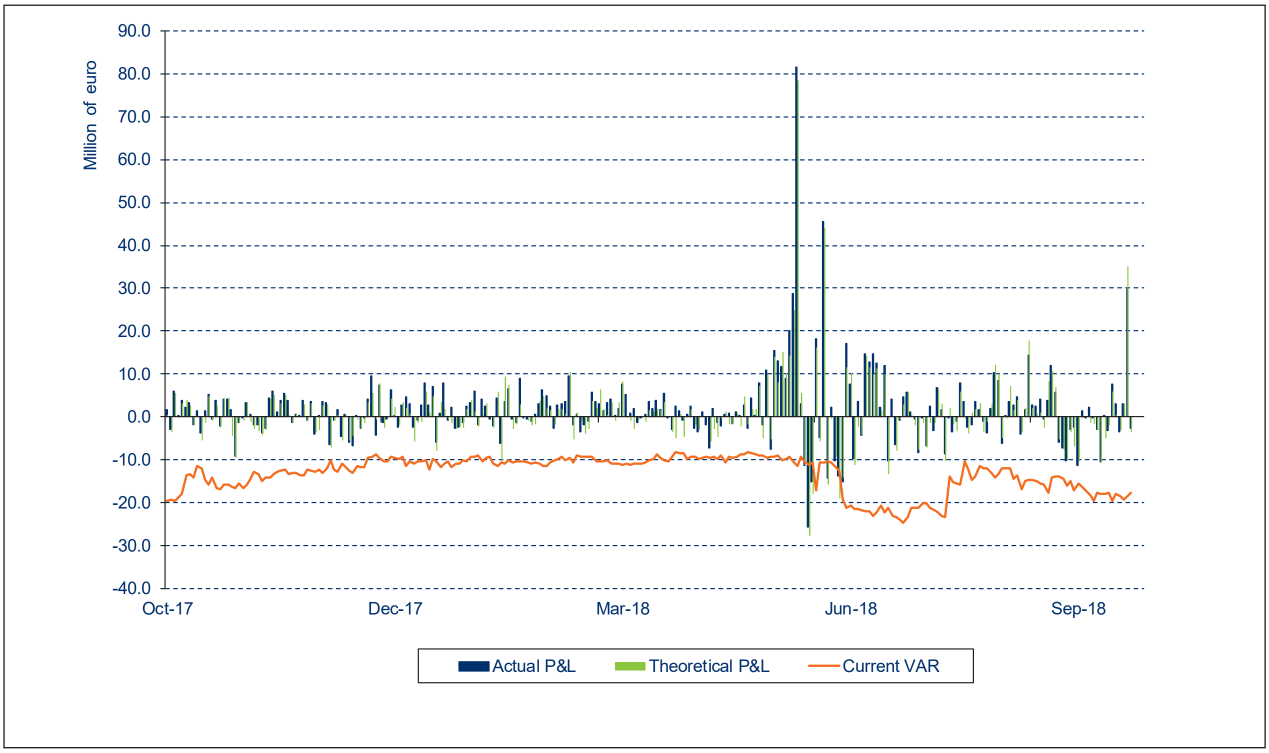
Over the last twelve months there have been four backtesting exceptions. The breaches were caused by the credit

component of the portfolio, which was particularly affected by the volatility in the second half of May 2018.
The volatility was particularly high for purchase positions hedging 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

In the first nine 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 1,472 million euro, settling at 691 million euro at the end of September 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 831 million euro and -889 million euro respectively, at the end of September 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 128 million euro in the first nine months of 2018 (153 million euro at the end of 2017), with a minimum value of 91 million euro and a maximum value of 147 million euro; the figure at the end of September 2018 was 97 million euro. Price risk generated by minority stakes in listed companies, mostly held in the HTCS (formerly AFS) category and measured in terms of VaR, recorded an average level of 62 million euro in the first nine 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 September 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 category shows sensitivity to a 10% negative shock equal to 48.2 million euro at the end of September 2018.

LIQUIDITY RISK

In the first nine months of 2018, the Group's liquidity position remained within the risk limits provided for in the current Group's Liquidity Policy: both the LCR and NSFR indicators were largely respected, as they reached a level well above the final requirements. In 2018, the Liquidity Coverage Ratio (LCR) of the Intesa Sanpaolo Group, measured according to Delegated Regulation (EU) 2015/61, amounted to an average of 165%. For the purposes of compliance with the internal limits, the LCR indicator also takes account of the prudential estimate of the "additional outflows for other products and services", assessed based on the provisions of Delegated Regulation (EU) 2015/61 (Article 23).
As at 30 September 2018, the eligible liquidity reserves for the Central Banks, considering including the reserves held with Central Banks (Cash and Deposits), amounted to a total of 173 billion euro (171 billion euro at the end of December 2017), of which 82 billion euro, net of haircut, was unencumbered (98 billion euro at the end of December 2017). The HQLA component represented 64% of the own portfolio and 95% of the unencumbered. 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 main risk factors.

FAIR VALUE MEASUREMENT OF FINANCIAL ASSETS AND LIABILITIES

Fair value hierarchy – Excluding insurance companies

(millions of euro)

Financial assets / liabilities at fair value	**30.09.2018**			**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	13,833	25,678	2,484	12,723	27,275	2,561
a) Financial assets held for trading	*13,540*	*25,108*	*510*	*12,125*	*26,778*	*748*
of which: Equities	*622*	*-*	*1*	*625*	*-*	*1*
of which: quotas of UCI	*690*	*2*	*48*	*983*	*3*	*93*
b) Financial assets designated at fair value	*-*	*208*	*-*	*-*	*150*	*64*
c) Other financial assets mandatorily designated at fair value	*293*	*362*	*1,974*	*598*	*347*	*1,749*
of which: Equities	*2*	*92*	*185*	*24*	*186*	*187*
of which: quotas of UCI	*272*	*6*	*1,376*	*264*	*8*	*1,060*
2. Financial assets designated at fair value through other comprehensive income	60,141	6,391	724	53,093	6,079	688
of which: Equities	*451*	*2,153*	*437*	*519*	*2,208*	*435*
3. Hedging derivatives	-	3,057	8	-	4,199	14
4. Property and equipment	-	-	5,732	-	-	5,890
5. Intangible assets	-	-	-	-	-	-
Total	**73,974**	**35,126**	**8,948**	**65,816**	**37,553**	**9,153**
1. Financial liabilities held for trading	15,827	23,897	142	15,556	25,768	132
2. Financial liabilities designated at fair value	-	4	-	-	3	-
3. Hedging derivatives	-	6,490	34	-	7,246	5
Total	**15,827**	**30,391**	**176**	**15,556**	**33,017**	**137**

Fair value hierarchy – Insurance companies

(millions of euro)

Financial assets / liabilities at fair value	30.09.2018			31.12.2017		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
1. Financial assets held for trading	179	17	48	428	13	49
of which: Equities	-	-	-	-	-	-
of which: quotas of UCI	*45*	-	*48*	*205*	-	*49*
2. Financial assets designated at fair value through profit or loss	77,581	145	452	74,288	157	270
of which: Equities	*1,724*	-	-	*1,605*	-	-
of which: quotas of UCI	*71,665*	-	*19*	*68,629*	-	*18*
3. Financial assets available for sale	72,958	750	1,218	75,572	786	1,015
of which: Equities	*1,044*	-	-	*1,608*	-	-
of which: quotas of UCI	*9,636*	*17*	*1,217*	*8,578*	*61*	*817*
4. Hedging derivatives	-	2	-	-	4	-
5. Property and equipment	-	-	9	-	-	9
6. Intangible assets	-	-	-	-	-	-
Total	**150,718**	**914**	**1,727**	**150,288**	**960**	**1,343**
1. Financial liabilities held for trading	-	44	-	-	67	-
2. Financial liabilities designated at fair value through profit or loss	-	71,018	-	-	68,166	-
3. Hedging derivatives	-	7	-	-	-	-
Total	**-**	**71,069**	**-**	**-**	**68,233**	**-**

STRUCTURED CREDIT PRODUCTS

The risk exposure to structured credit products amounted to 1,913 million euro as at 30 September 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 2018 focused on investments to exploit market opportunities, on the one hand, and on disposing of the portfolio hard hit by the financial crisis, 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 1,723 million euro in September 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 190 million euro in September 2018) due to greater investments made by Banca IMI, fully 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 IFRS 9.
From the perspective of the income statement, a profit of 8 million euro was posted for the first nine months of 2018, compared to a profit of 28 million euro for 2017.
As at 30 September 2018, the profits (losses) on trading – caption 80 of the income statement – for the exposures in funded and unfunded ABSs amounted to -5 million euro (+17 million euro in 2017), whereas the positions in multi-sector CDOs were at nil (+4 million euro in 2017).
The profits (losses) from financial assets mandatorily measured at fair value was +8 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 of IFRS 9. This result was made up of +4 million euro for the valuation components and +4 million euro for the realisation components.
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 4 million euro in 2018, recognised in the specific Shareholders' Equity Reserve 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 +4 million euro as at 30 September 2018 (nil impact in 2017) equally distributed between the valuation and realisation components.
There were no positions in the monoline and non-monoline packages in 2018, because they had been fully disposed of in 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 nine months 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.
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, whereas in September the 27th and 28th series were issued, both for 1.6 billion euro at a floating rate with a duration of 11 and 12 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, the notional amount of the 11th series was partially redeemed in January for an amount of 600 million euro and in July for an additional 250 million euro, bringing the nominal amount to the current 250 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.
In July, securities in the 24th series were placed on the market for 1 billion euro at a fixed rate of 1.125% with a duration of 7 years. The securities, listed on the Luxembourg Stock Exchange, have a Moody's rating of Aa2.

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 September 2018, 116 transactions for a total amount granted of 3,715 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 Statements of 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 is consequently finalising this specific project with the purpose of gradual alignment with the ECB guidance.

INFORMATION ON INVESTMENTS IN HEDGE FUNDS

The Hedge Fund portfolio as at 30 September 2018 amounted to 169 million euro in the Trading Book and just under 100 million euro in the Banking Book, compared to 416 million euro and 19 million euro respectively in December 2017. The investments 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 (Undertakings for Collective Investment in Transferable Securities) Funds.
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 in the first quarter, and the

MAP 19A for 40 million euro in the second quarter. In contrast, the sales and reductions in the third quarter were more fragmented.
The income statement effect for the Profits (Losses) on trading at the end of September was a loss of 11 million euro, compared to a profit of 10 million euro recorded in this caption in September 2017. This figure 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 Ligado.
The income statement effect for the Net profit (loss) on other financial assets mandatorily measured at fair value at the end of September was a loss of 3 million euro.
As a whole, the current strategy of the portfolio remains 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 September 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 6,736 million euro (7,011 million euro as at 31 December 2017). The notional value of these derivatives totalled 53,746 million euro (50,488 million euro as at 31 December 2017).
The positive fair value of the contracts outstanding with the 10 customers with the highest exposures was 4,672 million euro.
Conversely, the negative fair value determined with the same criteria, for the same types of contracts and with the same counterparties, totalled 1,553 million euro as at 30 September 2018 (1,082 million euro as at 31 December 2017). The notional value of these derivatives totalled 26,299 million euro (22,846 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 September 2018, this led to a positive effect of 27 million euro being recorded under “Profits (Losses) on trading” in the income statement.
As regards the different methodologies used in determining the fair value of financial instruments, see the specific paragraphs in this chapter.

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.
To determine its capital requirements, the Group employs a combination of the methods allowed under applicable regulations. The capital absorption resulting from this process amounted to 1,437 million euro as at 30 September 2018, unchanged compared to 30 June 2018.

Legal risks

Legal risks are thoroughly analysed by the Parent Company and Group companies. Provisions are made to the allowances for risks and charges in the event of disputes for which it is probable that funds will be disbursed and where the amount of the disbursement may be reliably estimated.
No new significant legal disputes arose during the third quarter of 2018 and there were no significant developments regarding the significant disputes indicated in the Notes to the 2017 Annual Report and in the Half-Yearly Report as at 30 June 2018, to which reference is made.

Tax litigation

The Group's tax litigation risks are covered by adequate provisions to the allowances for risks and charges.
With regard to the new developments in the third quarter, the following is noted:

- for Intesa Sanpaolo, the completion of the general tax audit by the Piedmont Regional Office - Large Taxpayers Office, covering the 2014 tax period. The Tax Auditors' Report, notified to the Bank on 28 September 2018, contains two findings for the year 2014 of a non-material amount (a total of 1.5 million euro), in addition to the notification of higher taxable income for IRES and IRAP for the years 2013, 2014 and 2015 for a total taxable income of 1.2 million euro.
- for Banca IMI, the tax audit started on 24 January 2018 by the Lombardy Regional Office - Large Taxpayers Department of the Italian Revenue Agency, on direct taxes, VAT, IRAP and withholding tax for 2015, was completed without findings on 31 July 2018.

For a complete description of the current disputes and the developments in the first six months of 2018, see the 2017 Annual Report and the Half-Yearly Report as at 30 June 2018.

INSURANCE RISKS

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 September 2018, the investment portfolios of Group companies, recorded at book value, amounted to 156,340 million euro. Of these, a part amounting to 78,687 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 77,653 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, 84% of assets, i.e. approximately 66,097 million euro, were bonds, whereas assets subject to equity risk represented 1.6% of the total and amounted to 1,240 million euro. The remainder (11,376 million euro) consisted of investments relating to UCI, Private Equity and Hedge Funds (14.4%).
The carrying value of derivatives came to approximately -25 million euro, of which -20 million euro relating to effective management derivatives[3], and the remaining portion (-5 million euro) is attributable to hedging derivatives.
At the end of the first nine months of 2018, investments made with the free capital of Intesa Sanpaolo Vita and Fideuram Vita amounted to approximately 1,196 million euro at market value, and presented a risk in terms of VaR (99% confidence level, 10-day holding period) of approximately 35 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 3,361 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 8.9%. Low investment grade securities (BBB) were approximately 85.3% of the total and the portion of speculative grade or unrated was minimal (approximately 2.4%).
A considerable portion of the BBB area is made up of securities issued by the 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 almost 13.1% of exposure and industrial securities made up approximately 11.4%.
At the end of the third quarter 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 3,431 million euro, with 2,666 million euro due to government issuers and 765 million euro to corporate issuers (financial institutions and industrial companies).

[3] 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.