Risk management

MAIN RISKS AND UNCERTAINTIES

The macroeconomic scenario and the high volatility of the financial markets require constant monitoring of the factors that make it possible to pursue sustainable profitability: high liquidity, funding capacity, low leverage, adequate capital base, and prudent asset valuations.
Group liquidity remains high: as at 31 March 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 March, the Central Banks eligible liquidity reserves came to 166 billion euro (171 billion euro at the end of December 2017), of which 87 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 March 2018, calculated as the ratio of loans to customers to direct deposits from banking business, including the components relating to the acquisition of certain assets and liabilities and certain legal relationships of Banca Popolare di Vicenza and Veneto Banca, is 95%.
In terms of funding, the widespread branch network remains a stable, reliable source: 74% of direct deposits from banking business come from retail operations (314 billion euro). In addition, 2.5 billion euro of unsecured senior bonds, 4.6 billion Yen of unsecured senior bonds and 1.25 billion euro of unsecured senior bonds were placed during the quarter.
With regard to the targeted refinancing operation TLTRO II, at the end of March 2018, the Group's participation amounted to 57 billion euro, equal to the maximum amount that can be requested. Including the components relating to the acquisition of certain assets and liabilities and certain legal relationships of Banca Popolare di Vicenza and Veneto Banca, the amount as at 31 March 2018 is equal to approximately 64 billion euro.
The Intesa Sanpaolo Group's leverage was 6.3% as at 31 March 2018.
The capital base also remains high. Own funds, risk weighted assets and the capital ratios at 31 March 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 quarter, total Own Funds came to 50,667 million euro, against risk-weighted assets of 282,430 million euro, which reflected primarily the credit and counterparty risk and, to a lesser extent, the operational and market risk.
The Total Capital Ratio stood at 17.9%, 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 13.3%.
Having met the regulatory requirements for its inclusion pursuant to article 26(2) of the CRR, the Common Equity Tier 1 Capital as at 31 March 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 three months of 2018 was approximately 48 million euro, compared to an average amount of approximately 85 million euro in the same period of 2017. The trend in the Group's VaR in the first three 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 2,411 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 (68.6%) and unlikely to pay positions (33.6%).
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 designated at fair value through profit and loss was carried out as follows: around 59% using level 1 inputs, around 33% 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 4 million euro during the period, whereas the hedge funds generated a loss of 8 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. However, with regard to intangible assets and goodwill, no problem issues were identified during the quarter – also in consideration of the short length of time since the last impairment test – requiring the remeasurement of their recoverable values. In particular, with regard to goodwill, the analyses conducted showed no significant changes to the main parameters and macroeconomic aggregates which could have an impact on the Group's expected cash flows and on the discounting rates thereof based on the models used to verify the retention of the recognition value of the intangible asset in the financial statements.

THE BASIC PRINCIPLES OF RISK MANAGEMENT

The 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 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.
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 Corporate 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, there were no changes in the scope of the internal models for credit risk.
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.

There were no changes relating to the authorisations for the models to be applied to the specific portfolios with respect to 31 December 2017.

Credit quality

(millions of euro)

Captions	31.03.2018			01.01.2018			Change
	Gross exposure	Total adjustments	Net exposure	Gross exposure	Total adjustments	Net exposure	Net exposure
Bad loans	33,598 (*)	-23,043 (*)	10,555 (*)	34,192 (**)	-23,630 (**)	10,562 (**)	-7
Unlikely to pay	16,523	-5,551	10,972	17,390	-5,798	11,592	-620
Past due loans	509	-110	399	475	-101	374	25
Non-Performing Loans	**50,630**	**-28,704**	**21,926**	**52,057**	**-29,529**	**22,528**	**-602**
Non-performing loans in Stage 3 (subject to impairment)	50,549	-28,695	*21,854*	*51,939*	*-29,483*	*22,456*	*-602*
Non-performing loans designated at fair value through profit or loss	81	-9	*72*	*118*	*-46*	*72*	-
Performing loans	*375,604*	*-2,411*	*373,193*	*373,493*	*-2,417*	371,076	2,117
Stage 2	54,673	-1,547	*53,126*	*51,684*	*-1,573*	*50,111*	*3,015*
Stage 1	320,473	-864	*319,609*	*321,494*	*-844*	*320,650*	*-1,041*
Performing loans designated at fair value through profit or loss	458	-	*458*	*315*	-	*315*	*143*
Performing loans represented by securities	*5,898*	*-16*	*5,882*	*5,913*	*-54*	*5,859*	*23*
Stage 2	432	-9	*423*	*662*	*-23*	*639*	*-216*
Stage 1	5,466	-7	*5,459*	*5,251*	*-31*	*5,220*	*239*
Loans held for trading	**32**	**-**	**32**	**-**	**-**	**-**	**32**
Total loans to customers	**432,164**	**-31,131**	**401,033**	**431,463**	**-32,000**	**399,463**	**1,570**
of which forborne performing	**8,451**	**-360**	**8,091**	**7,954**	**-328**	**7,626**	**465**
of which forborne non-performing	**11,034**	**-4,330**	**6,704**	**11,134**	**-4,430**	**6,704**	**-**

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

(*) of which disposable bad loans: gross exposure 22,477, total adjustments -16,214, net exposure 6,264, coverage 72.1%.

(**) of which disposable bad loans: gross exposure 23,325, total adjustments -16,880, net exposure 6,445, coverage 72.4%.

As at 31 March 2018, the Group's gross non-performing loans amounted to 50.6 billion euro, down by 1.4 billion euro from the beginning of the year, mainly due to lower unlikely-to-pay loans, which fell by 5%, and, to a lesser extent, to bad loans, which were also down by 1.7%. Gross past due loans, amounting to 509 million euro, were up by 7.2% (+34 million euro).
Net non-performing loans amounted to 21.9 billion euro at the end of the quarter and were down by 2.7% since the beginning of the year, continuing the progressive decline already recorded in the previous year. Non-performing assets decreased slightly as a percentage of total net loans to customers, down to 5.5%. As a result of the strategic agreement with Intrum currently being finalised, the stock of gross non-performing loans should decrease by over 10 billion euro and the non-performing loan ratio should be further reduced to 4.7%.
In further detail, bad loans amounted to 10.6 billion euro, net of adjustments, in the first quarter of 2018, stable from the beginning of the year, and represented 2.6% of total loans. During the same period, the coverage ratio was 68.6%. Loans

included in the unlikely to pay category amounted to almost 11 billion euro, down by 5.3%, accounting for 2.7% of total loans to customers, with a coverage ratio of 33.6%. Past due loans amounted to 399 million euro, down 6.7% since the beginning of the year, with a coverage ratio of 21.6%. Within the non-performing loan category, forborne exposures, generated by forbearance measures for borrowers experiencing difficulty in meeting their financial obligations, amounted to 6.7 billion euro, with a coverage ratio of 39.2%, while forborne exposures in the performing loans category amounted to 8.1 billion euro. Overall, the coverage ratio of performing loans was 0.6%, sufficient for the intrinsic risk of the Stage 1 and Stage 2 portfolios. More specifically, the performing loans in the Stage 2 portfolio amounted to 53.1 billion euro, representing an increase of 3 billion euro, partly due to technical defaults related to the renewal timing of credit lines. This change, together with the improvement in the riskiness of several customer segments, resulted in a slight reduction in the coverage ratio to 2.8% from 3% at the beginning of the year.

MARKET RISKS

TRADING BOOK

During the first quarter of 2018, the market risks generated by Intesa Sanpaolo and Banca IMI decreased compared to the average values of the fourth quarter of 2017. The average VaR for the period totalled 48.1 million euro compared to 58.6 million euro in the fourth quarter of 2017.

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

(millions of euro)

	2018			2017			
	average 1st quarter	minimum 1st quarter	maximum 1st quarter	average 4th quarter	average 3rd quarter	average 2nd quarter	average 1st quarter
Intesa Sanpaolo	7.8	6.9	9.5	8.0	8.9	11.6	11.5
Banca IMI	40.3	24.6	52.0	50.5	52.6	58.4	73.7
Total	**48.1**	**33.7**	**59.9**	**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 of Intesa Sanpaolo and Banca IMI, respectively; minimum and maximum values for the two companies are recalculated using aggregate historical time-series and therefore do not correspond to the sum of the individual values in the column.

In the first three months of 2018, the Group's average VaR was 48.1 million euro, down from 85.3 million euro in the same period of 2017.

(millions of euro)

	2018			2017		
	average 1st quarter	minimum 1st quarter	maximum 1st quarter	average 1st quarter	minimum 1st quarter	maximum 1st quarter
Intesa Sanpaolo	7.8	6.9	9.5	11.5	10.1	12.5
Banca IMI	40.3	24.6	52.0	73.7	60.7	93.2
Total	**48.1**	**33.7**	**59.9**	**85.3**	**72.1**	**104.8**

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

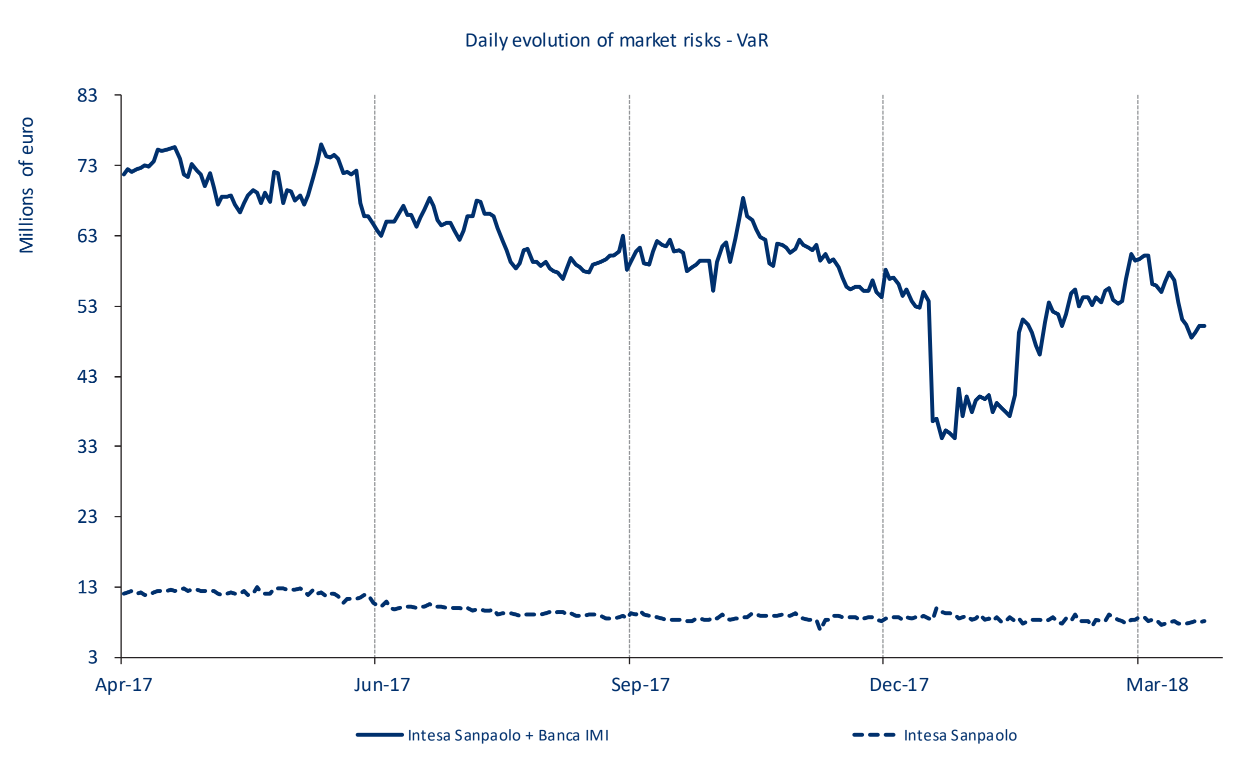
For Intesa Sanpaolo, the breakdown of risk profile in the first quarter of 2018 with regard to the various factors shows the prevalence of credit spread risk, equal to 43% of total operational VaR; for Banca IMI too credit spread risk was the most significant, representing 79% of total VaR.

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

1st quarter 2018	Shares	Hedge funds	Interest rates	Credit spreads	Foreign exchange rates	Other parameters	Commodities
Intesa Sanpaolo	4%	5%	29%	43%	18%	1%	0%
Banca IMI	5%	0%	8%	79%	1%	6%	1%
Total	**5%**	**1%**	**11%**	**72%**	**4%**	**6%**	**1%**

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

The trend in VaR is mainly attributable to Banca IMI. With effect from 1 January 2018, Banca IMI's market risk decreased due to the reclassification, upon IFRS 9 FTA, of part of the securities held in the portfolio from HTCS (former AFS) to HTC. During the first quarter of 2018, the HTCS book was reconstructed, retaining the focus on government securities.



Risk control with regard to the trading activity of Intesa Sanpaolo and Banca IMI also uses scenario analyses and stress tests. The impact on the income statement of selected scenarios relating to the evolution of stock prices, interest rates, credit spreads and foreign exchange rates as at the end of March is summarised in the following table: The shocks applied to the portfolio were updated 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	-9	16	-43	34	333	-330	28	-2	0	-1

In particular:

- on stock market positions, a 15% decrease in stock prices with a resulting 70% increase in volatility would have led to a loss of approximately 9 million euro;
- on interest rate exposures, a rise of the curves of 40 basis points would have had a negative impact of 43 million euro;
- on exposures sensitive to credit spread fluctuations, a 25 basis point widening in spreads would have led to a 330 million euro loss;
- on foreign exchange exposures, in the event of the euro appreciating against the US dollar by 10% and a reduction in volatility of -25%, a loss of approximately 2 million euro would be recorded;
- lastly, for commodity exposures a loss of 1 million euro would be recorded in the event of a bullish scenario (rising energy prices, falling precious metal prices and a general decrease in volatility).

Backtesting

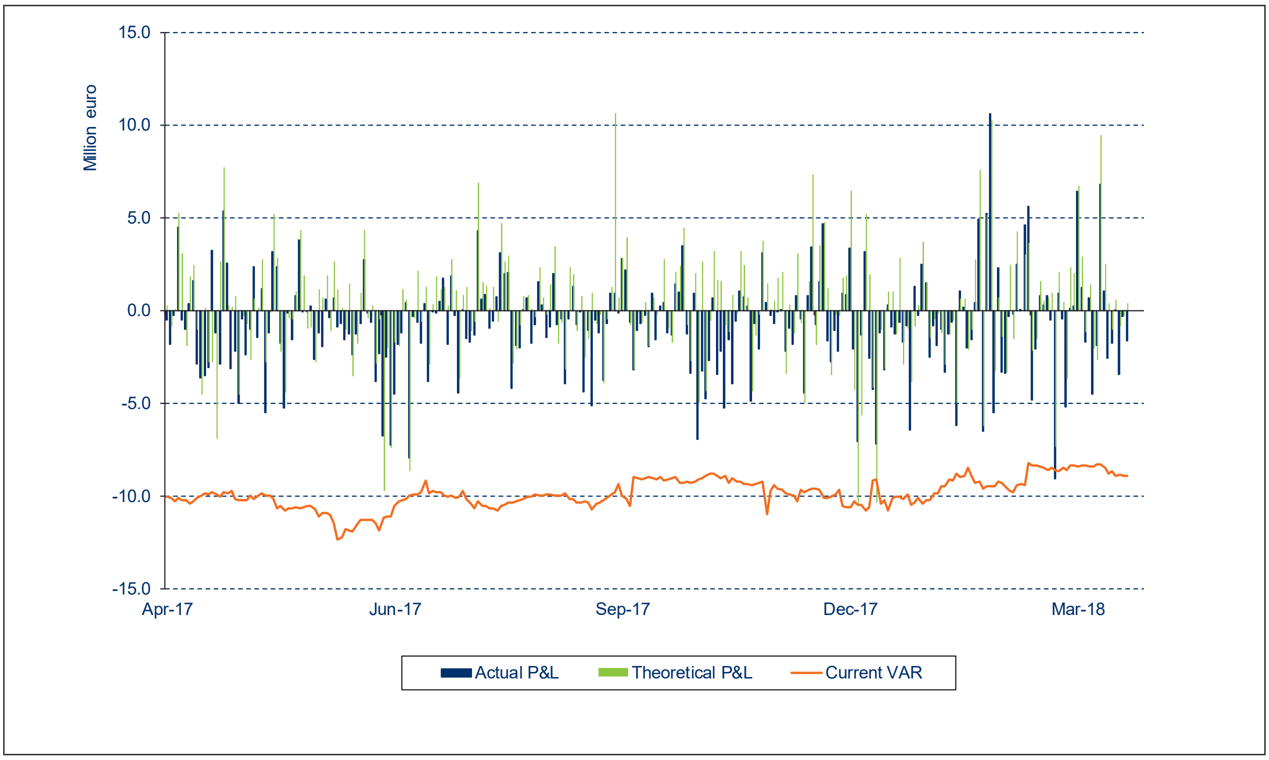
The effectiveness of the VaR calculation methods must be monitored daily via backtesting which, as concerns regulatory backtesting, compares:

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

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

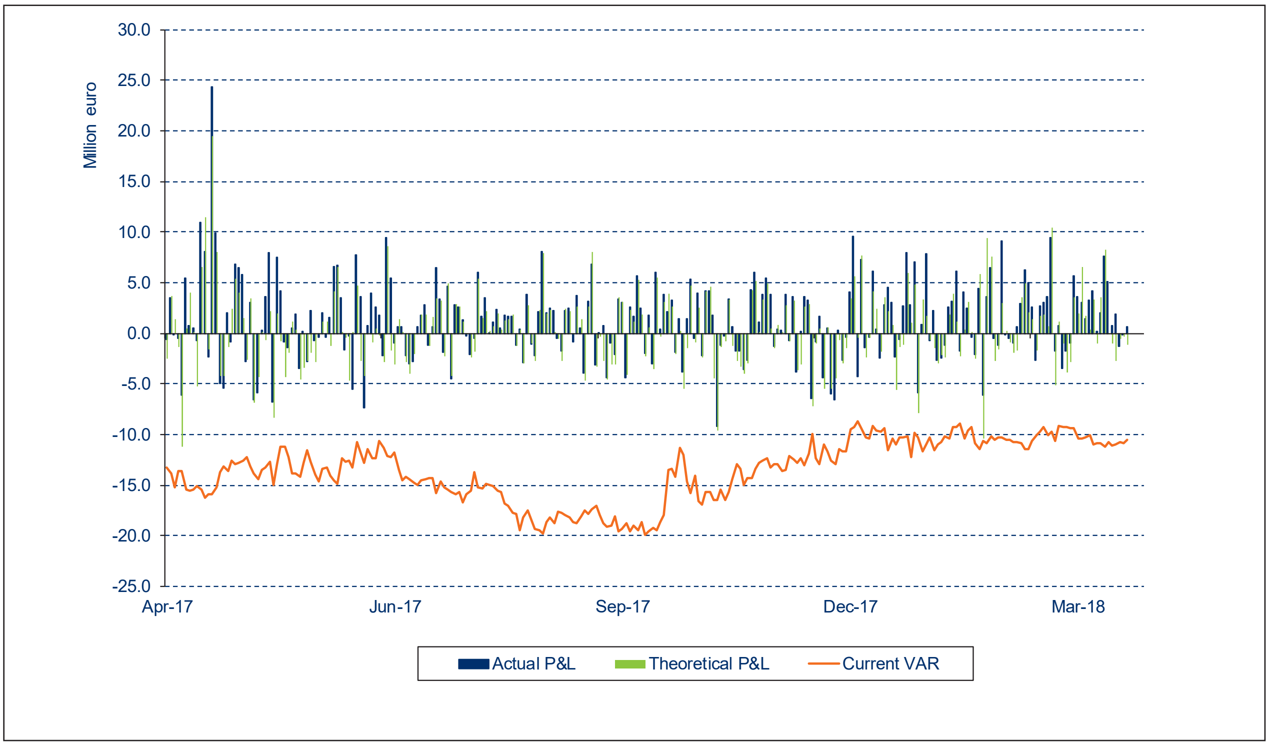
Backtesting in Intesa Sanpaolo

On 28 December 2017, there was theoretical backtesting exception on Intesa Sanpaolo's trading portfolio. The risk factor that contributed to almost all of the loss was the rate: specifically, strong short-term shocks were observed on the USD Basis and Forex curves, mainly due to year-end rolling.
On 6 March 2018, the adverse movement of the short-term segment of the Euro-Dollar curve, together with the movement of credit spreads, resulted in an overshooting of the effective backtesting.



Backtesting in Banca IMI

In the past twelve months, there were no backtesting exceptions.



BANKING BOOK

In the first three 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 1,657 million euro, settling at 1,628 million euro at the end of March 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 +100, +50 and -50 basis point change in interest rates – amounted to 1,693 million euro, 854 million euro and -917 million euro respectively, at the end of March 2018 (1,563 million euro, 794 million euro and -872 million euro at the end of 2017).
Interest rate risk, measured in terms of VaR, recorded an average of 138 million euro in the first three months of 2018 (153 million euro at the end of 2017), with a maximum value of 145 million euro and a minimum value of 127 million euro; the latter figure is the same as the value at the end of the quarter.
Price risk generated by minority stakes in listed companies, mostly classified in the HTCS category (formerly AFS), recorded an average level of 56 million euro, measured in terms of VaR, in the first three months of 2018 (64 million euro at the end of 2017), with a maximum and minimum value of 56 million euro; the latter figure is the same as the value at the end of March 2018.
Lastly, an analysis of banking book sensitivity to price risk, measuring the impact on Shareholders' Equity of a price shock on the above mentioned listed assets held in the HTCS category (formerly AFS), shows sensitivity to a 10% negative shock equal to 56 million euro at the end of March 2018.

LIQUIDITY RISK

In the first three months of 2018, the Group's liquidity position remained within the risk limits provided for in the Group's Liquidity Policy: both the LCR and NSFR indicators were largely respected, as they reached a level well above the regulatory requirements. In 2018, the Liquidity Coverage Ratio (LCR) of the Intesa Sanpaolo Group, measured according to Delegated Regulation (EU) n. 2015/61, amounted to an average of 176%, in line with the average figure for 2017. At the end of March 2018, the eligible liquidity reserves for the Central Banks, including the reserves held with Central Banks (Cash and Deposits), amounted to a total of 166 billion euro (171 billion euro at the end of December 2017), of which 87 billion euro, net of haircut, was unencumbered (98 billion euro at the end of December 2017). The HQLA component represented 64% of the reserves in own portfolio and 93% 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 main risk factors.

INFORMATION ON FAIR VALUE, PRUDENT VALUATION AND INDEPENDENT PRICE VERIFICATION

Fair value of financial instruments

The methodologies for the fair value measurement of financial instruments are governed by the Fair Value Policy of Intesa Sanpaolo Group and they are described in detail in the 2017 Annual Report.
This chapter provides a summary of the most significant changes during the first quarter 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 establishes rules for the quantitative methods supporting the SPPI Test (Benchmark Cash Flow Test and Credit Risk Assessment) for the financial 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, as described in detail in the 2017 Annual Report.

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 quarter of 2018, the Group has formalised the 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 MEASUREMENT OF FINANCIAL ASSETS AND LIABILITIES

Fair value hierarchy – Without insurance companies

(millions of euro)

Financial assets / liabilities at fair value		31.03.2018			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	13,441	26,738	2,510	12,723	27,275	2,561
a) Financial assets held for trading	13,157	25,815	708	12,125	26,778	748
of which: Equities	*618*	*-*	*1*	*625*	*-*	*1*
of which: quotas of UCI	*810*	*2*	*68*	*983*	*3*	*93*
b) Financial assets designated at fair value	-	149	64	-	150	64
c) Other financial assets mandatorily designated at fair value	284	774	1,738	598	347	1,749
of which: Equities	*8*	*455*	*187*	*24*	*186*	*187*
of which: quotas of UCI	*263*	*5*	*1,167*	*264*	*8*	*1,060*
2. Financial assets designated at fair value through other comprehensive income	52,753	6,890	808	53,093	6,079	688
of which: Equities	*471*	*2,087*	*448*	*519*	*2,208*	*435*
3. Hedging derivatives	-	3,569	13	-	4,199	14
4. Property and equipment	-	-	5,864	-	-	5,890
5. Intangible assets	-	-	-	-	-	-
Total	**66,194**	**37,197**	**9,195**	**65,816**	**37,553**	**9,153**
1. Financial liabilities held for trading	15,199	24,356	196	15,556	25,811	89
2. Financial liabilities designated at fair value through profit or loss	-	4	-	-	3	-
3. Hedging derivatives	-	7,025	5	-	7,251	-
Total	**15,199**	**31,385**	**201**	**15,556**	**33,065**	**89**

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

Fair value hierarchy – Insurance companies

(millions of euro)

Financial assets / liabilities at fair value	31.03.2018			31.12.2017		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
1. Financial assets held for trading	380	11	49	428	13	49
of which: Equities	-	-	-	-	-	-
of which: quotas of UCI	*187*	-	*49*	*205*	-	*49*
2. Financial assets designated at fair value through profit or loss	75,573	111	96	74,221	157	337
of which: Equities	*1,560*	-	-	*1,606*	-	-
of which: quotas of UCI	*69,309*	-	*19*	*68,628*	-	*19*
3. Financial assets available for sale	75,508	711	1,111	75,571	786	1,016
of which: Equities	*1,544*	-	-	*1,608*	-	-
of which: quotas of UCI	*9,134*	*20*	*998*	*8,578*	*61*	*818*
4. Hedging derivatives	-	-	-	-	-	-
5. Property and equipment	-	-	9	-	-	9
6. Intangible assets	-	-	-	-	-	-
Total	**151,461**	**833**	**1,265**	**150,220**	**956**	**1,411**
1. Financial liabilities held for trading	-	49	-	-	67	-
2. Financial liabilities designated at fair value through profit or loss	-	44,480	24,529	-	43,210	24,956
3. Hedging derivatives	-	-	-	-	-	-
Total	**-**	**44,529**	**24,529**	**-**	**43,277**	**24,956**

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

STRUCTURED CREDIT PRODUCTS

The risk exposure to structured credit products amounted to 2,201 million euro as at 31 March 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 designated at fair value decreased from 2,034 million euro in December 2017 to 1,946 million euro in March 2018. This reduction was 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 of Banca IMI (part of which were classified in the assets measured at fair value through other comprehensive income portfolio) and to European ABSs acquired 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 an increase (from 245 million euro in December 2017 to 255 million euro in March 2018), attributable to the higher investments made by Banca IMI, only partially offset by the sales by the Parent Company.
From the perspective of the income statement, a profit of 4 million euro was posted for the first three months of 2018, compared to 28 million euro for 2017.
As at 31 March 2018, the “Profits (losses) on trading – caption 80” of the exposure to funded and unfunded ABSs/CDOs came to a profit of 2 million euro (17 million euro in 2017), generated by the positions in funded European and US ABSs/CDOs, while positions in multi-sector CDOs had a nil result (4 million in 2017).
The exposure to funded and unfunded ABSs/CDOs in securities classified by the subsidiary Banca IMI in the portfolio of assets designated at fair value through other comprehensive income recorded a net increase in fair value of less than 1 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 substantially similar positive reserve as at March 2018). Securities classified in the portfolio of assets measured at amortised cost recorded a net gain of 2 million euro as at 31 March 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.

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 quarter of the year, within the multi-originator programme guaranteed by ISP OBG, the 11th series matured for an amount of 1,375 million euro and the 12th series maturing in August 2018 was redeemed in advance for an amount of 2,154 million euro, for a total of 3,529 million euro.
In March, the 25th and 26th series of floating-rate securities were issued for a total of 3,900 million 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 on 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.

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 31 March 2018, 105 transactions for a total amount granted of 2,643 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 – 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.

INFORMATION ON INVESTMENTS IN HEDGE FUNDS

The hedge fund portfolio held for trading as at 31 March 2018 totalled 112 million euro, compared to 270 million euro recorded as at December 2017, the majority of which was held in the MAP platform.
The reduction of the portfolio is attributable to the distributions and redemptions that started at the end of 2015 (when this portfolio amounted to 760 million euro) aimed at reducing the risk level of the exposure.
In particular, the most significant redemptions in 2018 concerned 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.
The profit or loss result for the first quarter was a loss of 8 million euro, compared to a profit of 5 million euro recorded in the Profits (Losses) on trading in March 2017. The profit or loss result was mainly attributable to the write-down of the Matrix Pve Map 6A fund by over 5 million euro, due to the particularly conservative policies (worst case scenarios) used by the servicer for the valuation of the underlying assets, and of the Halcyon fund by almost 3 million euro, whose NAV, linked to the revaluation of the sole underlying position in Nextdecade (listed on Nasdaq), underwent a repositioning after the excellent performance posted in 2017.
The overall strategy of the portfolio continues to be geared towards the progressive liquidation of the portfolio, by seeking to benefit from the occurrence of specific corporate events that are largely independent from the general market trend.

INFORMATION ON TRADING TRANSACTIONS IN DERIVATIVES WITH CUSTOMERS

Considering relations with customers only, as at 31 March 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 7,000 million euro (7,011 million euro as at 31 December 2017). The notional value of these derivatives totalled 41,473 million euro (50,488 million euro as at 31 December 2017).
The positive fair value of the structured contracts in existence with the 10 customers with the highest exposures was 4,904 million euro.
Conversely, negative fair value determined with the same criteria, for the same types of contracts and with the same counterparties, totalled 1,075 million euro as at 31 March 2018 (1,082 million euro as at 31 December 2017).
The notional value of these derivatives totalled 35,348 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 31 March 2018, this led to a positive effect of 18 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 amounts to 1,489 million euro as at 31 March 2018, up slightly 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 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 were initiated during the first quarter of 2018.

Except as discussed below with regard to the ENPAM case, there have been no significant developments with regard to the disputes indicated in the Notes to the 2017 financial statements, to which reference is made.

ENPAM case - By order of 15 February 2018, the judge rejected part of the preliminary objections raised, while reserving judgment on the others (including those relating to the claimant's lack of standing to sue and the defendants' lack of standing to be sued), to be decided together with the decision on the merits. The judge also ordered a court-appointed expert's review aimed at determining, among other matters:

- whether during the pre-contractual phase the structure, value and costs of the securities at issue were properly represented to ENPAM;
- whether the securities were fit for the purpose indicated in the entity's Charter and Investment Guidelines;
- the performance achieved by ENPAM as at the date of conclusion of the individual transactions;
- the difference, if any, between the performance achieved by ENPAM and the performance that would have resulted if other investments consistent with the entity's Charter and Investment Guidelines had been undertaken (also considering the need for diversification of the risk).

The case was continued until the hearing of 18 April 2019 for a review of the expert's report, which will be prepared during the year.

Tax litigation

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

The Parent Company has 166 pending litigation proceedings (144 as at 31 December 2017) for a total amount of 223 million euro (214 million euro as at 31 December 2017), calculated considering proceedings in both administrative and judicial venues at various instances. In relation to these circumstances, the actual risks were quantified at 64 million euro at 31 March 2018 (65 million euro as at 31 December 2017).

In the first quarter of 2018, there was no new litigation involving Intesa Sanpaolo in which significant amounts were at issue, nor were there any significant developments in ongoing litigation. Accordingly, the Notes to the 2017 financial statements should be consulted for further information.

INSURANCE RISKS

Life business

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

Non-life business

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

Financial risks

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

Investment portfolios

The investments of the insurance companies of the Intesa Sanpaolo Group (Intesa Sanpaolo Vita, Intesa Sanpaolo Assicura, Intesa Sanpaolo Life and Fideuram Vita) are made with their free capital and to cover contractual obligations with customers. These refer to traditional revaluable life insurance policies, Index- and Unit-linked policies, pension funds and non-life policies.
As at 31 March 2018, the investment portfolios of Group companies, recorded at book value, amounted to 156,921 million euro. Of these, a part amounting to 81,710 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 75,211 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, 84.5 % of assets, i.e. approximately 69,036 million euro, were bonds, whereas assets subject to equity risk represented 2.1 % of the total and amounted to 1,740 million euro. The remainder (10,965 million euro) consisted of investments relating to UCI, Private Equity and Hedge Funds (13.4%).
The carrying value of derivatives came to approximately -31 million euro, of which -41 million euro relating to effective management derivatives[3], and the remaining portion (10 million euro) is attributable to hedging derivatives.

At the end of the first three months of 2018, investments made with the free capital of Intesa Sanpaolo Vita and Fideuram Vita amounted to approximately 1,491 million euro at market value, and presented a risk in terms of VaR (99% confidence level, 10-day holding period) of approximately 46 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 3,839 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 8.5%. Low investment grade securities (BBB) were approximately 85.8% of the total and the portion of speculative grade or unrated was minimal (approximately 2.3%).
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 75.3% of the total investments, while financial companies (mostly banks) contributed approximately 13.3% of exposure and industrial securities made up approximately 11.4%.

[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.

At the end of the first 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 3,909 million euro, with 3,065 million euro due to government issuers and 844 million euro to corporate issuers (financial institutions and industrial companies).