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# Part E – Information on risks and relative hedging policies

## SECTION 1 – RISKS OF THE BANKING GROUP

The Intesa Sanpaolo Group attaches great importance to risk management and control as conditions to ensure reliable and sustainable value creation in a context of controlled risk, protect the Group's financial strength and reputation, and permit a transparent representation of the risk profile of its portfolios.

This is testified by the great efforts made in recent years to obtain the validation by the Supervisory Authorities of the Internal Models for market risks and for credit derivatives, and the recently obtained recognition of the use of internal ratings for the calculation of the requirement to cover credit risk in the Corporate segment: on this point see the paragraph dedicated to the Basel 2 Project, which describes the phases of the rollout plan for the internal models for credit and operational risks.

The definition of operating limits related to market risk indicators, the use of risk measurement instruments in granting and monitoring loans and controlling operational risk and the use of capital at risk measures for management reporting and assessment of capital adequacy within the Group represent fundamental milestones in the operational application of the strategic and management guidelines defined by the Supervisory Board and the Management Board along the Bank's entire decision-making chain, down to the single operating units and to the single desk.

The main principles in risk management and control are:

- clear identification of responsibility for acceptance of risk;
- measurement and control systems in line with international best practices;
- organisational separation between the functions that carry out day-to-day operations and those that carry out controls.

The policies relating to the acceptance of risks are defined by the Supervisory Board and the Management Board of the Parent Company with support from specific operating Committees, the most important of which are the Internal Audit Committee and the Group Risk Governance Committee, and from the Chief Risk Officer reporting directly to the Chief Executive Officer.

The economic capital, defined as the maximum "unexpected" loss that the Group may incur over a period of one year, is a key measure for determining the Group's financial structure and guiding its operations, ensuring the balance between risks assumed and shareholder return. To this end, the Group, as also required by "Pillar 2" of the Basel 2 regulations, defines its risk tolerance as follows:

- guaranteeing sound management of the public and social objectives of financial stability of intermediaries, ensuring that risk is at a 99.9% confidence level deemed to be congruous, even in conditions of severe stress;
- to ensure, alongside this general aim, the objective of the coverage of liabilities with customers and the market at a target confidence level of 99.96%, in line with the solvency of entities with an agency rating of AA-

The Group sets out these general principles in policies, limits and criteria applied to the various risk categories and business areas with specific risk tolerance sub-thresholds, in a comprehensive framework of governance, control limits and procedures.

The risks identified, covered and incorporated within the economic capital, considering the benefits of diversification, are as follows:

- credit risk. This category also includes concentration risk, country risk and residual risks, both from securitisations and uncertainty on credit recovery rates;
- market risk (trading book), including position, settlement and concentration risk on the trading portfolio;
- financial risk (banking book), mostly represented by interest rate and foreign exchange rate risk;
- operational risk, including legal risk;
- liquidity risk;
- strategic risk;
- risk on equity investments not subject to line by line consolidation;
- risk on real estate assets owned for whichever purpose;
- reputation risk;
- insurance risk.

The level of absorption of economic capital is estimated on the basis of the current situation and also at a forecast level, based on the Budget assumptions and the projected economic scenario under ordinary and stress conditions. The capital position forms the basis for the business reporting and is submitted quarterly to the Group Risk Governance Committee, the Management Board and the Control Committee, as part of the Group's Risks Tableau de Bord.

Risk coverage, in consideration of the nature, frequency and potential impact of the risk, is based on the constant balance between mitigation/hedging actions, control procedures/processes and finally capital protection.

The Parent Company is in charge of overall direction, management and control of risks. Group companies that generate credit and/or financial risks are assigned autonomy limits and each has its own control structure. For the main Group subsidiaries these functions are performed, on the basis of an outsourcing contract, by the Parent Company's risk control functions, which periodically report to the Board of Directors and the Audit Committee of the subsidiary.

For the purposes described above, Intesa Sanpaolo uses a wide-ranging set of tools and techniques for risk assessment and management, detailed in this Part of the Notes to the consolidated financial statements.

## The Basel 2 Project

In June 2004, the Basel Committee on Banking Supervision published the final version of the Capital Accord ("Basel 2"), adopted by the European Union at the end of 2005 through the Directive on Capital Adequacy and by Italy with Law Decree 297 of 27 December 2006.

Very briefly, the Accord provides for new quantitative rules to establish the minimum capital requirement to cover credit, market and operational risks:

- for credit risks, the new rules introduce a greater degree of correlation between capital requirements and risks by acknowledging ratings and other credit risk measurement tools. The Accord sets out a Standard approach together with two increasingly sophisticated approaches based on internal risk management tools;
- the legal regulations currently in force for market risks continue to apply;
- the new Accord introduces capital absorption for operational risks, which can also be measured using three increasingly analytical approaches.

Lastly, capital adequacy must also be ensured for a wider range of risks which must at least include: financial risks in the banking book, liquidity risks, strategic risks, risks on equity investments and insurance activities, risks deriving from securitisations, residual credit risks and reputation risks.

The regulations are designed to promote the adoption of more sophisticated methods, in both credit risks and operational risks, through a lower absorption of capital. However, in order to access these options, the banks must satisfy a set of minimum requirements for risk management and control methodologies, to be verified by the Supervisory authority.

Most of the advantages will come from the management and operating results obtained from the systematic application of the new methodologies that should make it possible to improve risk management and control capabilities as well as increase the efficiency and effectiveness of customer service.

In order to profit from these opportunities, in 2007 Intesa Sanpaolo launched the "Basel 2 Project", with the mission of preparing the Group for the adoption of advanced approaches, building on the pre-merger experiences of Intesa and Sanpaolo IMI.

In 2008, the Intesa Sanpaolo Group began the approval process for the adoption of the advanced approaches within the "Basel 2 Project".

With regard to credit risks, a "first scope" of Group entities that use approaches based on internal models was identified. For this scope of entities, the Group obtained authorisation for the use of the IRB Foundation approach for the Corporate segment, starting from the report as at 31 December 2008. The rating models and credit processes for the SME Retail and Retail (Residential mortgages) were also implemented in 2008. With the release of the Loss Given Default (LGD) model, which is at the completion stage, it will be possible to send the request for authorisation for the use of the IRB Advanced approach during 2009.

Also under development are the rating models for the other segments and the extension of the scope of entities for their application, in accordance with the progressive rollout plan for the advanced approaches presented to the Supervisory authority.

As regards operational risks, preparatory works are in their final phases and will permit the submission of the request for validation for the Advanced approach in 2009.

Furthermore, in 2008 the Group presented the first report of the prudential control process for capital

adequacy as “class 1” banking group, according to Bank of Italy classification, based on the extensive use of internal methodologies for measurement of risk, internal capital and total capital available.

As part of the adoption of “Basel 2” for the Italian banking system, the Bank of Italy in its Circular 263 of 27 December 2006 “New regulations for the prudential supervision of banks” set out the procedures that must be adopted by Italian banks and banking groups when disclosing information to the public concerning capital adequacy, risk exposure and the general features of the risk identification, measurement and management systems (Basel 2 Pillar 3).

In summary, the new instructions require the compilation of a separate disclosure on the risks of the banking group in addition to the one already contained in the financial statements. This disclosure, drawn up in accordance with the provisions of the aforementioned circular, which incorporates the provisions of annex XII to the EU Directive 2006/48, is published in accordance with the rules laid down by the Bank of Italy with the following frequency:

- figures as at 31 December: full qualitative and quantitative disclosure;
- figures as at 30 June: update of the quantitative disclosure (because Intesa Sanpaolo forms part of the groups that have adopted IRB and/or AMA approaches for credit and operational risk);
- figures as at 31 March/30 September: update of the information relating to capital and capital adequacy (because Intesa Sanpaolo forms part of the groups that have adopted IRB and/or AMA approaches for credit and operational risk).

The Intesa Sanpaolo Group publishes the Basel 2 Pillar 3 disclosure and subsequent updates on its Internet site at the address: [group.intesasanpaolo.com](http://group.intesasanpaolo.com).

## Internal control system

Intesa Sanpaolo, to ensure a sound and prudent management, combines business profitability with an attentive risk-acceptance activity and an operating conduct based on fairness.

Therefore, the Bank, in line with legal and supervisory regulations in force and consistently with the Code of conduct of listed companies, has adopted an internal control system capable of identifying, measuring and continuously monitoring the risks typical of its business activities.

Intesa Sanpaolo’s internal control system is built around a set of rules, procedures and organisational structures aimed at ensuring compliance with Company strategies and the achievement of the following objectives:

- the effectiveness and efficiency of Company processes;
- the safeguard of asset value and protection from losses;
- reliability and integrity of accounting and management information;
- transaction compliance with the law, supervisory regulations as well as policies, plans, procedures and internal regulations;

The internal control system is characterised by a documentary infrastructure (regulatory framework) that provides organised and systematic access to the guidelines, procedures, organisational structures, and risks and controls within the business, incorporating both the Company policies and the instructions of the Supervisory Authorities, and the provisions of the Law, including the principles laid down in Legislative Decree 231/2001 and Law 262/2005.

The regulatory framework consists of “Governance Documents” that oversee the operation of the Bank (Articles of Association, Code of Ethics, Group Regulations, Authorities and powers, Policies, Guidelines, Function charts of the Organisational Structures, Organisational Models, etc.) and of more strictly operational regulations that govern business processes, individual operations and the associated controls.

More specifically, the Company rules set out organisational solutions that:

- ensure sufficient separation between the operational and control functions and prevent situations of conflict of interest in the assignment of responsibilities;
- are capable of adequately identifying, measuring and monitoring the main risks assumed in the various operational segments;
- enable the recording, with an adequate level of detail, of every operational event and, in particular, of every transaction, ensuring their correct allocation over time;
- guarantee reliable information systems and suitable reporting procedures for the various managerial levels assigned the functions of governance and control;
- ensure the prompt notification to the appropriate levels within the business and the swift handling of any anomalies found by the business units and the control functions.

The Company’s organisational solutions also enable the uniform and formalised identification of responsibilities, particularly in relation to the tasks of controlling and correcting the irregularities found.

At Corporate Governance level, Intesa Sanpaolo has adopted a dual governance model, in which the functions of control and strategic management, performed by the Supervisory Board, are separated from the management of the Company's business, which is exercised by the Management Board in accordance with the provisions of art. 2409-octies and subsequent of the Italian Civil Code and art. 147-ter and subsequent of the Consolidated Law on Finance.

The Supervisory Board has established an internal Control Committee that proposes, advises and enquires on matters regarding the internal control system, risk management and the accounting and IT system. The Committee also performs the duties and tasks of a Surveillance Body pursuant to Italian Legislative Decree 231/2001 on the administrative responsibility of companies, supervising operations and compliance with the organisational, management and control Model adopted by the Bank.

From a more strictly operational perspective the Bank has identified the following macro types of control:

- line controls, aimed at ensuring the correct application of day-to-day activities and single transactions. Normally, such controls are carried out by the productive structures (business or support) or incorporated in IT procedures or executed as part of back office activities;
- risk management controls, which are aimed at contributing to the definition of risk management methodologies, at verifying the respect of limits assigned to the various operating functions and at controlling the consistency of operations of single productive structures with assigned risk-return targets. These are not normally carried out by the productive structures;
- compliance controls, made up of policies and procedures which identify, assess, check and manage the risk of non-compliance with laws, Supervisory authority measures or self-regulating codes, as well as any other rule which may apply to the Bank;
- internal auditing, aimed at identifying anomalous trends, violations of procedures and regulations, as well as assessing the overall functioning of the internal control system. It is performed by different structures which are independent from productive structures.

The internal control system is periodically reviewed and adapted in relation to business development and the reference context.

As a consequence, Intesa Sanpaolo's control structure is in compliance with the instructions issued by the Supervisory Authorities. Indeed, alongside an intricate system of line controls involving all the function heads and personnel, a Chief Risk Officer area has been established specifically dedicated to second level controls that incorporates both units responsible for the control of risk management (in particular, the Risk Management Department, Credit Quality Monitoring, and Internal Validation in accordance with Basel 2), and the management of compliance controls (Compliance Department). Also reporting to the Chief Risk Officer is the Legal Affairs Department, which monitors and controls the legal risk of Intesa Sanpaolo and its Group.

There is also a dedicated Internal Auditing Department, which reports directly to the Chairman of the Management Board and the Chairman of the Supervisory Board, and is also functionally linked to the Control Committee.

### *The Compliance Department*

The government of compliance risk is of strategic importance to the Intesa Sanpaolo Group as it considers compliance with the regulations and fairness in business to be fundamental to the conduct of banking operations, which by nature is founded on trust.

The management of the risk of non-compliance was assigned, in the first half of 2008, to a function operating within the Internal Auditing Department. In June, in accordance with the Supervisory provisions issued by the Bank of Italy on 10 July 2007 and the regulatory provisions contained in the joint Regulation issued by Consob and the Bank of Italy on 29 October 2007, Intesa Sanpaolo established a specific Compliance Department, reporting to the Chief Risk Officer.

The Compliance Department during the second half of the year implemented a project designed to set out the Group Compliance Model, based on Guidelines approved by the Management Board and the Supervisory Board. These Guidelines identify the responsibilities and macro processes for compliance, aimed at minimising the risk of non-compliance through a joint effort by all the company functions. The Compliance Department is responsible, in particular, for overseeing the guidelines, policies and methodologies relating to the management of compliance risk. The Compliance Department, including through the coordination of other corporate functions, is also responsible for the identification and assessment of the risks of non-compliance, the proposal of the functional and organisational measures for their mitigation, the pre-assessment of the compliance of innovative projects, operations and new products and services, the provision of advice and assistance to the governing bodies and the business units in all areas with a significant risk of non-compliance, the monitoring, also together with the Internal Auditing Department, of ongoing compliance, and the promotion of a corporate culture founded on principles of

honesty, fairness and respect for the spirit and the letter of the rules.

The activities carried out during the year concentrated on the regulatory areas considered to be the most significant in terms of compliance risk. In particular:

- with reference to the area of financial intermediation and investment services, these activities involved the government of the process of compliance with the MiFID legislation, from the implementation of the governance and organisational measures required by the implementing regulations issued by the Supervisory Authorities, through to the setting up of policies, processes and procedures and the establishment of the necessary training initiatives. The compliance activities also involved the clearing of new products and services, the management of conflicts of interest and the monitoring of customer activity for the prevention of market abuse;
- with regard to the countering of money laundering and terrorist financing, these activities involved the coordination of the organisational, IT and training activities aimed at the implementation of the Third European Directive. Monitoring also continued of the proper maintenance of the Single Electronic Archive together with the analysis of suspicious transactions for assessment concerning the reporting to the competent Authorities;
- support was provided to the business structures for the proper management of reporting transparency and more generally in relation to the regulations for consumer protection;
- the organisational, management and control Model pursuant to Italian Legislative Decree 231/2001 was overseen by verifying its compliance with the Company regulations, updating it to take into account the new predicate offences, and coordinating the training activities and the verification of its proper implementation;
- the controls on the business processes required for the certifications by the Manager responsible for preparing the Company's financial reports pursuant to art. 154 of the Consolidated Law on Finance were conducted and, on specific request by the Bank of Italy, an extraordinary verification was conducted aimed at confirming that - with reference to the capital and to the minimum individual and consolidated requirements as at 30 June - the business processes enable compliance with the provisions concerning the calculability of the capital items and the correct quantification of the risk-weighted assets.

### *The Internal Auditing Department*

With regard to Internal Auditing activities, the Internal Auditing Department is responsible for ensuring the ongoing and independent surveillance of the regular progress of the Bank's operations and processes for the purpose of preventing or identifying any anomalous or risky behaviour or situation, assessing the functionality of the overall internal control system and its adequacy in ensuring the effectiveness and efficiency of company processes, the safeguarding of asset value and loss protection, the reliability and completeness of accounting and management information, and the compliance of transactions with the policies set out by the Company's administrative bodies and internal and external regulations.

Furthermore, it provides consulting to the Bank's and the Group's departments, also through participation in projects, for the purpose of adding value and improving effectiveness of control, risk management and organisation governance processes.

The Internal Auditing Department uses personnel with the appropriate professional skills and expertise and ensures that its activities are performed in accordance with the international best practice and standards for internal auditing established by the Institute of Internal Auditors (IIA).

The Internal Auditing Department has a structure and a control model which is organised consistently with the divisional model of Intesa Sanpaolo and the Group.

During the year, the auditing was performed directly for the Parent Company Intesa Sanpaolo and for Banche dei Territori, and also for a limited number of other subsidiaries with an outsourcing contract. For the other Group companies second level controls were conducted (indirect surveillance).

The surveillance was particularly affected by the delicate situation of the international economic-financial crisis, which worsened in the second half of the year. Consequently, also in accordance with instructions issued by the Control Committee and the Top Management, verifications were aimed at monitoring the evolution of the risks associated with credit quality, liquidity, financial operations, and the Group's Investment Banking.

Direct surveillance was carried out in particular via:

- the control of the operational processes of network and central structures, with verifications, also through on-site interventions, on the functionality of line controls in place, of the respect of internal and external regulations, of the reliability of operational structures and delegation mechanisms, of correctness of available information in the various activities and of their adequate use with free and independent access to functions data and documentation and application of adequate tools

and methodologies;

- the surveillance, via distance monitoring integrated by on-site visits, over the credit origination and management process, verifying its adequacy with respect to the risks control system and the functioning of measurement mechanisms in place;
- the surveillance over the process for the measurement, management and control of the Group's exposure to market, counterparty, operational and credit risks, periodically reviewing the internal validation of the models and the ICAAP process developed for Basel 2 and the Prudential Supervisory regulations;
- the valuation of adequacy and effectiveness of information technology system development and management processes, to ensure their reliability, security and functionality;
- the surveillance, also via on-site visits, over the processes related to financial operations and over the adequacy of related risks control systems;
- the control of compliance with the behavioural rules and of the correctness of procedures adopted on investment services as well as compliance with regulations in force with respect to the separation of the assets of customers;
- the verification of the operations performed by foreign branches, with interventions by internal auditors both local and from the Head Office.

During the year the Internal Auditing Department also ensured the supervision of all the main integration projects paying particular attention to control mechanisms in the new Bank's models and processes and, in general, to the efficiency and the effectiveness of the control system established within the Group.

Indirect surveillance was conducted via direction and functional coordination of the Auditing structures in subsidiaries, for the purpose of ensuring control consistency and adequate attention to the different types of risks, also verifying the effectiveness and efficiency levels under both the structural and operational profile. Direct reviews and verification interventions were also conducted.

In conducting its duties, the Internal Auditing Department used methodologies for the preliminary analysis of risks in the various areas. Based on the assessments made and on the consequent priorities, the Internal Auditing Department prepared and submitted an Annual Intervention Plan for prior examination to the Control Committee, the Management Board and the Supervisory Board, on the basis of which it conducted its activities during the year, completing all the scheduled audits.

Any weak points have been systematically notified to the Departments involved for prompt improvement actions which are monitored by follow-up activities.

The valuations of the internal control system deriving from the checks have been periodically transmitted to the Control Committee, to the Management Board and to the Supervisory Board which request detailed updates also on the state of solutions under way to mitigate weak points; furthermore, the most significant events have been promptly signalled to the Control Committee.

A similar approach is used with respect to the responsibilities of administrative bodies pursuant to Legislative Decree 231/01 for the Control Committee, as Surveillance body.