

**2009**  
**PILLAR III**

# Table of Contents

|    |  |
|----|--|
| 3  | <b>FOREWORD</b>  |
| 4  | <b>INTRODUCTION</b>  |
| 4  | 1. Purpose   |
| 4  | 2. Document Structure  |
| 6  | <b>1. General Disclosures Requirement</b>                                  |
| 6  | 1.1. Risk Management and Internal Control System                           |
| 6  | 1.2. Risk Management and Compliance Function                               |
| 7  | 1.2.1. Financial Risk and Credit Risk Management Unit                      |
| 7  | 1.2.2. Operational Risk Management Unit                                    |
| 8  | 1.2.3. Compliance Unit   |
| 8  | 1.3. Material Risks  |
| 8  | 1.3.1. First Pillar Risks  |
| 9  | 1.3.2. Second Pillar Risks   |
| 9  | 1.4. Credit Risk   |
| 12 | 1.4.1. Reporting System  |
| 12 | 1.5. Market Risk   |
| 13 | 1.5.1. Reporting System  |
| 14 | 1.6. Operational Risk  |
| 16 | 1.6.1. Reporting System  |
| 17 | 1.7. Risk Management and Mitigation  |
| 18 | <b>2. SCOPE OF APPLICATION</b>   |
| 19 | <b>3. COMPOSITION OF REGULATORY CAPITAL</b>                                |
| 21 | <b>4. CAPITAL ADEQUACY</b>   |
| 23 | <b>5. CREDIT RISK - GENERAL INFORMATION (ALL BANKS)</b>                    |
| 23 | 5.1. Definition of Default   |
| 24 | 5.2. Method used to calculate Impairment                                   |
| 31 | <b>6. CREDIT RISK - EXPOSURES MEASURED UNDER THE STANDARDISED APPROACH</b> |
| 32 | <b>8. RISK MITIGATION TECHNIQUES</b>                                       |
| 34 | <b>9. COUNTERPARTY RISK</b>  |
| 35 | <b>12. OPERATIONAL RISK</b>  |
| 38 | <b>13. EQUITY EXPOSURES</b>  |
| 39 | <b>14. INTEREST RATE RISK IN THE BANKING BOOK</b>                          |

The chapter of this document correspond to the Synoptic Tables of Circular 263/06. Chapters 7, 10 and 11 relative to tables 7, 10 and 11 of Circular 263/06 are not applicable to the Mediolanum Banking Group.

**MEDIOLANUM  
BANKING GROUP**

**Disclosures pursuant  
to Title IV Chapter 1 of Bank  
of Italy's Circular 263/06  
Information at December 31,  
2009**



## Foreword

The June 2006 EU Capital Requirements Directive adopting the New Basel Capital Accord ('Basel II') marked the beginning of sweeping changes in banking regulations.

The new regulatory framework introduced key novelties in capital measurements and triggered a comprehensive, in-depth review of risk measurement and management systems especially within Banking Groups.

After public consultation, on December 27, 2006, the Bank of Italy adopted the Capital Requirements Directive for credit institutions and investment firms (i.e. Directives 2006/48/EC and 2006/49/EC of the European Parliament and of the Council) by issuing Circular 263 that set forth new regulations governing capital requirements for banks. The regulations issued by the Bank of Italy were based on amendments to the Consolidated Banking Act approved by Italy's Cabinet Decree on December 22, 2006 and the criteria set out in the December 27, 2006 Decree of Italy's Treasury Minister.

The Supervisory Regulations in effect from January 1, 2008 are based on 'three pillars':

1. The first pillar relates to capital requirements for risks that are typical of banking and finance, i.e. credit risk, counterparty risk, market risk and operational risk. Banks have alternative options for the calculation of capital requirements in accordance with the degree of complexity of their operations.
2. The second pillar requires banks to have a process for assessing their overall capital adequacy and a strategy for maintaining adequate capital levels (Internal Capital Adequacy Assessment Process or 'ICAAP'). Supervisory authorities are required to review and evaluate the effectiveness and reliability of the internal capital adequacy assessment process of banks, and, if not satisfied with the results, take appropriate supervisory action (also 'Supervisory Review Process' or 'SREP').
3. The third pillar requires banks to disclose information about their capital adequacy, risk exposures and the general features of their internal control system and risk management framework.

# Introduction

## ● 1. Purpose

The purpose of this document is to disclose information about the capital adequacy and risk exposures of the Mediolanum Banking Group as well as the methods it uses to identify, measure and manage risks.

## ● 2. Document Structure

This document contains both qualitative and quantitative information. Apart from the preamble and the introduction, this document is organised into chapters that mirror the disclosure requirements Tables in Annex A, Title IV, Chapter 1 of Bank of Italy's Circular 263/06.

These chapters are:

### **Chapter 1:** Risk Management - General Information

This chapter sets out information about risk management policies and goals by type of risk.

### **Chapter 2:** Scope of application

This chapter sets out information about the entities within the Banking Group to which disclosure requirements apply.

### **Chapter 3:** Composition of Regulatory Capital

This chapter sets out regulatory capital components and related quantitative information.

### **Chapter 4:** Capital Adequacy

This chapter sets out information about the methods used to measure capital adequacy and calculate capital charges for current and future operations.

### **Chapter 5:** Credit risk – general information

This chapter sets out the definitions of the various categories of impaired loans as well as the method used to calculate impairment.

### **Chapter 6:** Credit risk – exposures measured under the standardised approach

This chapter sets out information on external credit assessment institutions (ECAI) and credit ratings.

### **Chapter 8:** Risk mitigation techniques

This chapter sets out information about credit risk mitigation policies and practices.

### **Chapter 9:** Counterparty Risk

This chapter sets out information about the methods used to monitor counterparty risk.

### **Chapter 12:** Operational Risk

This chapter sets out information about the method used to calculate operational risk capital charges.

### **Chapter 13:** Equity exposures

This chapter sets out information about the purpose of holding equity instruments, the methods used to measure and recognise them and information about gains/losses realised upon their sale or liquidation.

### **Chapter 14:** Interest Rate Risk in the Banking Book

This chapter sets out information about interest rate risk and how it is measured.

The chapter of this document correspond to the Synoptic Tables of Circular 263/06. Chapters 7, 10 and 11 relative to tables 7, 10 and 11 of Circular 263/06 are not applicable to the Mediolanum Banking Group.

Banca Mediolanum disclosed this information to the public on its internet site at: [www.bancamediolanum.it](http://www.bancamediolanum.it) in the public section "Transparency", as well as on the site of holding company Mediolanum S.p.A., at [www.mediolanum.com](http://www.mediolanum.com) in the section Investor Relation/Annual & Interim Reports.

## 1. GENERAL DISCLOSURES REQUIREMENT

### 1.1. Risk Management and Internal Control System

The internal control system consists of the set of rules, procedures and functions established to ensure the effectiveness and efficiency of corporate processes, the protection of corporate assets as well as the proper management of customer assets, the reliability and accurateness of management representations and financial information as well as the compliance of transactions with the law, the regulations issued by Supervisory Authorities, self-discipline and internal rules.

The various entities within the Mediolanum Banking Group have in place a comprehensive, effective internal control system in accordance with applicable regulations and the business they conduct.

The Board of Directors and management play a key role in the establishment of an adequate risk management framework and the implementation of an effective internal control system.

Internal control, however, is not just the responsibility of certain functions or committees, but all departments are responsible to a different extent for the transactions they execute.

The internal control system is designed to encompass the following three main lines of defence:

- **line controls:** this first line of defence consists of controls made by the individuals who carry out a certain activity and by their supervisors, generally within the same organisational unit or function. These controls are carried out by operational units or embedded in automated procedures, and they are part of back-office activities. The level of controls depends upon the size, nature and complexity of the operations;
- **risk controls:** these are specific controls performed by units other than operating units; they contribute to the definition of risk measurement methods, control of operating limits of officers to whom authorities are delegated, and verify compliance of transactions with the risk/return targets set by corporate bodies in their respective areas of responsibility. This second line of defence is tailored to the risk profile of the individual business. Specifically, it includes controls over credit risk, capital risk and investment risk, operational and reputational risks. It also includes control of compliance with the law, the regulations issued by Supervisory Authorities and self-discipline rules (e.g. codes of conducts) as well as with any other rules applicable to the entity;
- **internal audit:** this third line of defence entails the periodic assessment of the completeness, effectiveness and adequacy of the internal control system in relation to the nature of the business and the level of risks undertaken. The head of Internal Audit (Chief Auditor) is appointed by the Board of Directors. The Internal Audit function is separate and independent of operating units. Due to the scope and sensitiveness of the internal audit work, expert knowledge is required of internal auditors.

In the performance of their duties, internal auditors are granted access to all corporate structures as well as to any information they may need to assess outsourced activities. The Board of Directors and the Board of Statutory Auditors receive regular reports on internal audit work so that they can promptly take suitable corrective measures if deficiencies are detected.

### 1.2. Risk Management and Compliance Function

The 'Risk Management and Compliance' function is responsible for ensuring the adequacy of risk management procedures for financial, operational and credit risks as well as regulatory compliance of the financial conglomerate.

The following general principles form the bedrock of the Group risk management framework:

- identification and full coverage of all categories of risks;
- separation and independence of the Risk Management function from Operating Units, in accordance with the proportionality principle, which entails an implementation approach by subsidiaries commensurate with the size of the entity;



- use of uniform, consistent models and methods for the collection of data and information as well as for the analysis and measurement of risks by all organisational units and/or companies within the Group;
- timely and consistent analysis and measurement of risks; subsequent preparation of reports to support control and decision-making processes;
- transparency and dissemination of models, methods and criteria applied in the analysis and measurement of risks to promote a control culture within the organisation and understanding of the reasons underlying the choices made;
- delegation of risk management authorities and responsibilities from the Board of Directors to the Operating Units for their direct management of the risks to which corporate processes are exposed.

To ensure adherence to the principles above and have a comprehensive risk management framework, the Mediolanum Banking Group has adopted a set of risk policies.

The main purposes of risk policies are:

- to ensure that any material breaches/anomalies be promptly identified by the internal control system and adequate corrective/mitigating actions be taken;
- to ensure the consistent application of risk management principles and rules across the Group;
- to promote a risk management culture at all levels of the organisation and encourage consistent, knowledgeable operating choices and practices, in a structured way.

The 'Risk Management and Compliance' function of Banca Mediolanum is organised into three main operating units: the Financial Risk Management Unit, the Operational Risk Management Unit, and the Compliance Unit.

### ○ 1.2.1. Financial Risk and Credit Risk Management Unit

The Financial and Credit Risk Management Unit is mainly responsible for:

- overseeing the definition of risk measurement methods applied by the risk management units of subsidiaries as well as monitoring and managing concentration of the exposures and the risk faced by individual companies as a result of being part of the Group;
- validating the flows of information needed to ensure timely control of exposure to credit and financial risks associated with assets managed by subsidiaries, taking actions to mitigate risks and, whenever possible, prevent any anomalies;
- preparing reports to the Audit Committee, the Board of Directors, Senior Management and heads of operating units on risk evolution within Group companies, including any proposed corrective measures;
- assisting the line control units of subsidiaries in assessing Asset – Liability Management models and techniques for proper understanding and management of risk exposures arising from any asset/liability mismatch.

### ○ 1.2.2. Operational Risk Management Unit

Operational risk is the risk of loss resulting from inadequate or failed internal processes or controls, technical or human errors, the use of technology – especially systems that enable remote access and transactions – or unpredictable events, that can be, at least partly, mitigated.

For both Banca Mediolanum and its subsidiaries, the Operational Risk Management Unit is mainly responsible for:

- overseeing the definition of the operational risk measurement methods (scoring and rating) applied by the risk management units of subsidiaries as well as the definition of the operational risk management model of the Bank;

- validating the flows of information needed to ensure timely control of subsidiaries' exposure to operational risk; taking mitigating actions and, whenever possible, preventing any anomalies;
- coordinating and monitoring the management of complaints received from the customers of the companies within the banking group, identifying possible mitigating actions in relation to risks associated with corporate processes;
- preparing reports to the Audit Committee, the Board of Directors, Senior Management and heads of operating units on risk evolution within Group companies, including any proposed corrective measures.

### ○ 1.2.3. Compliance Unit

The Compliance Unit is responsible for continuously monitoring the financial and insurance regulatory environment to anticipate the impact of statutes and regulations on the Group business. Compliance Unit staff provide advice and assistance to the Chief Executive Officers, the Chairman and the Secretary of the Boards of Directors in their assessment of compliance of procedures and practices with applicable laws and regulations as well as in the timely introduction of amendments thereto, in case of regulatory changes.

Specifically, in relation to Banca Mediolanum, the compliance team:

- monitors the regulatory environment, assesses the impact of regulations on the business at banking Group level, and proposes changes to operating processes and/or procedures;
- reviews compliance of processes with the law, the regulations issued by Supervisory Authorities and self-discipline rules (e.g. codes of conducts) as well as with any other applicable rules. This is done working together with Internal Audit, Corporate Affairs and Operations staff.

## ● 1.3. Material Risks

### ○ 1.3.1. First Pillar Risks

#### **Credit Risk (including counterparty risk)**

Credit risk is the risk of loss arising from the deterioration in the creditworthiness up to default of both retail/corporate customers and institutional counterparties of whom the bank is a creditor in its investment or lending business, as a result of which debtors fail to meet all or part of their contractual obligations.

#### **Market Risk**

For banks using the standardised approach the capital requirement for market risk is the sum of capital requirements for position risk, settlement risk, concentration risk and commodity risk.

#### **Operational Risk**

Banca Mediolanum defines operational risk as "the risk of economic loss or damage to assets, and sometimes legal and administrative consequences, resulting from any misconduct or inappropriate behaviour of its personnel, inadequate or failed systems or internal processes, or external events".

## ○ 1.3.2. Second Pillar Risks

### **Concentration Risk**

Concentration risk is the risk resulting from exposure to individual counterparties, groups of related counterparties or counterparties in the same industry, business segment or geographical location.

### **Interest Rate Risk**

Interest rate risk arising on activities other than trading: the risk of potential movements in interest rates.

### **Liquidity Risk**

Liquidity risk is typically the risk that arises from the difficulty of liquidating assets. More specifically, it is the risk that a financial instrument cannot be bought or sold without a material decrease/increase in its price (wide bid-ask spread) due to the potential inability of the market to settle the transaction wholly or partly. Liquidity risk is also the potential that an entity will be unable to obtain adequate funding.

### **Residual Risk**

The risk that the credit risk mitigation techniques adopted by the Bank turn out to be less effective than anticipated.

### **Strategic Risk**

Strategic risk is the current or prospective risk of impact on earnings or capital arising from changes in the industry, adverse business decisions, improper implementation of decisions, lack of responsiveness to industry changes.

### **Reputational Risk**

Reputational risk is the current or prospective risk of impact on earnings or capital arising from the negative perception of the bank's image by clients, counterparties, shareholders, investors or supervisory authorities.

## ● 1.4. Credit Risk

The Mediolanum Banking Group has in place models and measurement tools as well as controls that ensure proper credit risk management. As already noted, credit risk in the 'retail portfolio' is managed differently and separately from credit risk in the 'institutional portfolio'.

The credit risk management system for both the retail and institutional portfolios ensures the Group is always current with its risk exposure in relation to each customer or group of customers, and takes prompt corrective actions, when needed, in accordance with related policies.

The credit risk management system pursues the following objectives:

- develop adequate credit risk identification, measurement and monitoring processes in relation to each counterparty and portfolio;
- ensure a steady flow of timely information to effectively monitor the composition and quality of the loan portfolio and promptly adjust loss estimates and capital charges;
- ensure compliance with the prudential requirements of domestic and international supervisory authorities;
- promote the adoption of policies and procedures for credit risk prudent management;
- support operational decisions of lending officers by providing the information needed to properly assess the borrower creditworthiness and type of financing;

- provide an adequate flow of information on credit risk exposures and mitigation techniques to senior management. The credit risk management system reflects the specific characteristics of the banking lending business and any changes thereof in addition to any regulatory or statutory changes. The different levels of credit risk controls for the 'retail portfolio' are described below.

## 1. First level controls

These are controls carried out by lending officers and fall into two categories: line controls and performance monitoring.

### *a. Line controls*

Credit risk line controls are conducted by the staff of two units, i.e. the short-term lending unit and the medium/long-term lending unit.

Generally, line controls include:

- collection and examination of information needed to assess the borrower's financial condition and earnings capacity in relation to the requested credit facility;
- analysis of intelligence obtained from private and public Credit Bureaus;
- checks to make sure the credit facility is suitable for the purpose for which it is requested;
- checks to make sure that any security taken is true and current;
- review of the score assigned by the 'Customer Performance Expert System'.

### *b. Performance monitoring*

Performance monitoring for both performing and problem loans (infrequent) as well as for any security taken. Specifically, it includes:

- regular review of credit facilities and related drawdowns;
- review and management of any and all overdrawn or past/due amounts, either arranged or unarranged;
- regular review of any security taken to make sure its value has remained unchanged.

## 2. Second level controls

These controls are carried out by staff in the Financial Risk and Credit Risk Management unit, within the Risk Management and Compliance function of Banca Mediolanum. The Financial Risk and Credit Risk Management unit is separate and independent of lending operations.

Second level controls are designed to assess overall credit risk exposure in the loan portfolio of the Banking Group. The Financial Risk and Credit Risk Management unit is also responsible for defining risk measurement methods as well as steadily monitoring capital adequacy pursuant to both Pillar 1 and Pillar 2 requirements.

Specifically, in relation to the Loan Portfolio Credit Risk Exposure, the Financial Risk and Credit Risk Management unit staff:

- identify, define and analyze risk measurement methods with the assistance of line staff;
- oversee credit risk monitoring, working together with Operations first level units staff;
- ensure effective reporting to the Board of Directors, Senior Management and heads of operating units;
- assess and propose risk prevention and mitigation actions, when necessary.

The credit risk controls for the 'Institutional Portfolio' are described below.

### 1. First level controls

These are line controls conducted by front-office and back-office staff and geared to assess the accurateness, completeness and consistency of transactions information and compliance with the operating licences and limits of the respective operating units.

These activities are the responsibility of the Treasury unit.

### 2. Second level controls

Second level controls are carried out by staff in the Financial Risk and Credit Risk Management unit. This unit is separate and independent of those operating units that engage in investment transactions with institutional counterparties on behalf of the Bank.

Financial Risk and Credit Risk Management unit staff:

- coordinate collection, processing and generation of financial data and statistics for risk analysis;
- manage the credit risk control process at Banking Group level;
- report on financial market performance and the related risk position taken by the Bank and the Banking Group;
- assess and monitor the risk exposure of the Bank and other entities, proposing corrective measures when needed;
- gather real economy, monetary policy, credit and financial market information and data including for the purpose of preparing financial statements.

The control process consists of various steps that engage a multitude of players with different roles and responsibilities. These are the key steps in the process:

#### *A. Annual review of operating licenses and limits*

The annual review of operating licenses and limits entails the review of strategic guidelines and the Maximum Risk Appetite for the year. This exercise includes the review of counterparties, internal rating and limits in accordance with credit rating. Credit rating is determined applying primarily the score assigned by the internal rating system. Qualitative assessment of specific market conditions may lead to a change in limits or, in exceptional circumstances, to overriding the internal rating score. Any such override is properly justified and reported to the Treasury Management Committee.

The Institutional Counterparties' Credit Risk Management Policy is usually examined by Banca Mediolanum's Board of Directors during its first meeting for the year and the version approved by Banca Mediolanum's Board of Directors serves as Group guidelines for all entities within the Banking Group.

#### *B. Daily risk management practices*

Daily risk management practices consist of daily monitoring and reporting practices put in place to ensure risk exposure is within operating licences and limits. Specifically, on a daily basis, the Financial Risk and Credit Risk Management unit staff measure and check credit risk and analyze the output of this exercise i.e. daily reports showing risk exposure. If the analysis of the output does not reveal any problem no action is taken.

#### *C. Amendments to operating licenses and limits*

The operating licences and limits approved by the Board of Directors cannot be exceeded except when approved by the Chief Executive Officer upon proposal of the Finance & Treasury Management Committee.

However, also in these instances, the CEO approval is to be ratified by the Board of Directors. The Financial Risk and Credit Risk Management unit staff are responsible for preparing the documentation relating to any such amended licences and limits and submitting it together with their monthly report to the Board of Directors.

### ○ 1.4.1. Reporting System

An adequate credit risk reporting system enables to analyze precisely quantitative and qualitative information about the composition of the portfolio and the level of portfolio exposure as well as to identify any variables that impact the level of provisioning and capital requirements.

Lending officers prepare reports on the retail loan portfolio as part of their first level control duties. Specifically these reports, prepared with varied frequency, include analysis of capital adequacy in relation to credit risk and concentration risk in the retail portfolio as well as analysis of impaired assets. Loan portfolio information includes: analysis by rating class, expected loss, average expected loss and risk development. These reports are submitted to the heads of Organisational Units, the Loan Watch Committee, Senior Management and the Board of Directors.

Financial Risk and Credit Risk Management staff prepare summary and detailed reports as part of their second level control duties. Summary reports are submitted to the head of the Risk Management and Compliance function, the Deputy Chairman, the Chief Executive Officer, the Board of Directors on a monthly, quarterly and annual basis. Detailed reports are submitted to the Treasury Unit and the Securities Brokerage Unit on a daily basis. Detailed reports contain information on daily risk management practices, and limits for settlement, allocation, positions in unlisted derivatives, positions in funds, forex positions and individual credit limits.

## ● 1.5. Market Risk

The market risk management system of the Mediolanum Banking Group consists of a suite of control models and tools.

The main types of controls put in place to manage market risk exposures are described below.

### 1. First level controls

These are line controls conducted by front office and back-office staff and geared to assess the accurateness, completeness and consistency of transactions information and compliance with the operating licences and limits of the respective operating units.

Specifically, these controls are carried out by staff in the Securities Brokerage Unit and the Treasury Unit.

### 2. Second level controls

The Financial Risk and Credit Risk Management staff are responsible for second level controls. The Financial Risk and Credit Risk Management unit is separate and independent of operating units that engage in investment transactions with institutional counterparties on behalf of the Bank.

As to market risk, the staff in this unit:

- coordinate collection, processing and generation of financial data and statistics for risk analysis;
- manage the market risk control process at Banking Group level;
- report on financial market performance and the related risk position taken by the Bank and the Banking Group;
- assess and monitor the risk exposure of the Bank and other entities, proposing corrective measures when needed;

- gather real economy, monetary policy, credit and financial market information and data, including for the purpose of preparing financial statements.

The control process consists of various steps that engage a multitude of players with different roles and responsibilities. These are the key steps in the process:

#### *A. Annual review of operating licenses and limits*

The annual review of operating licenses and limits is a key component of the review of strategic guidelines and the Maximum Risk Appetite for market risk.

Operating licences and limits are usually examined by Banca Mediolanum's Board of Directors during its first meeting for the year.

#### *B. Daily risk management practices*

Daily risk management practices consist of daily monitoring and reporting practices put in place to ensure risk exposure is within operating licences and limits. Specifically, on a daily basis, the Financial Risk and Credit Risk Management unit staff measure and check market risk and analyze the output of this exercise i.e. daily reports showing risk exposure. If the analysis of the output does not reveal any problem no action is taken.

#### *C. Amendments to operating licences and limits*

The operating licences and limits approved by the Board of Directors are the Maximum Risk Appetite of the Bank therefore they cannot be exceeded except when approved by the Chief Executive Officer upon proposal of the Finance & Treasury Management Committee.

Only in exceptional circumstances of proven urgency the General Manager can approve transactions that exceed the limits approved by the Board of Directors by over 100%, after hearing the opinion of the Risk Management and Compliance function, upon request of the Treasury Unit or the Securities Brokerage Unit.

It is incumbent upon the head of the Treasury Unit and the head of the Securities Brokerage Unit, respectively, to report any structural or cycle-related conditions that require a review of the Maximum Risk Appetite (MRA) in force, to the General Manager prior to the MRA approval. The Finance & Treasury Management Committee is the venue where any such needs are discussed and any requests for increases in the limits are prepared for submission to the Board of Directors. The Finance & Treasury Management Committee is the venue where Front Office staff, i.e. operating staff, and the Risk Control function staff meet and discuss pending issues concerning the analysis of the riskiness of investments.

### **1.5.1. Reporting System**

As part of their control duties the Financial Risk and Credit Risk Management staff are responsible for preparing reports, namely:

- internal reports to be submitted to the Board of Directors during scheduled meetings and to the competent operational unit officers;
- market disclosures in the manner and within the timeframe required by the Supervisory Authorities.

Specifically, summary reports are submitted to the head of the Risk Management and Compliance function, the Deputy Chairman, the Chief Executive Officer, the Board of Directors on a monthly, quarterly and annual basis.

Detailed reports are submitted to the Treasury Unit and the Securities Brokerage Unit on a daily basis. Detailed reports contain information on daily risk management practices in relation to VaR limits, stress test scenarios, Stop Loss limits, limits for allocation, positions in unlisted derivatives, positions in funds, forex positions and individual credit limits.

## ● 1.6. Operational Risk

The operational risk framework of the Mediolanum Banking Group is based on the following underlying principles:

- identification and full coverage of operational risk;
- separation and independence of the Risk Management function and Operating Units. The risk management framework is designed to guarantee also separation and independence of duties between the Risk Management function and the Internal Audit function. However, temporary dispensations from this requirement may be obtained according to the complexity and volume of the business as well as potential risks, in accordance with the proportionality principle;
- use of uniform, consistent models and methods for the collection of data and information as well as for the analysis and measurement of risks by all organisational units and/or companies within the Group;
- timely and consistent analysis and measurement of risk; subsequent preparation of reports to support control and decision-making processes;
- transparency and dissemination of models, methods and criteria applied in the analysis and measurement of risks to promote a control culture within the organisation and understanding of the reasons underlying the choices made;
- delegation of risk management authorities and responsibilities to Operating Units for their direct management of operational risk.

The principles and guidelines above, as well as the nature and features of operational risk entail that:

- operational risk identification, measurement, monitoring and management are based on the analysis of Group operations and main operational processes;
- controls are carried out by all organisational units and functions in accordance with their respective roles and responsibilities with frequent meetings and mutual exchanges of information to ensure synergistic, effective risk management.

Specifically, the controls they conduct are as follows:

### 1. First level controls

First level controls are those conducted by operating staff that carry out the various activities and processes and can identify and measure the related operational risk (e.g. Securities Brokerage, Banking Services Center, Sales Network Control, Teller, Lending units).

### 2. Second level controls

Second level controls are conducted by organisational units that are separate from operating units, and specifically, the 'Sales Network Inspectors' and the 'Operational Risk Management Unit' within the Risk Management and Compliance function.



### 3. Third level controls

Third level controls include controls conducted by Internal Audit staff as part of annual self-assessment of operational risk that is required of banks applying the standardised approach.

\* \* \*

The introduction of regulations has given impetus to the dissemination of a risk management culture and has brought about increased awareness of the importance of managing operational risk. This, in turn, led to the creation of an organisational unit dedicated to operational risk management.

The Operational Risk Management Unit is primarily responsible for:

- identifying, measuring and assessing operational risk to which the Group is exposed and that may affect business continuity with subsequent losses or damage to assets;
- assisting organisational units in the identification, prevention and mitigation of operational risk and its consequences.

The Operational Risk Management Unit regularly reports on its activities to Senior Management. The activities conducted by the Operational Risk Management Unit include:

- definition of criteria and methods for measuring operational risk;
- collection of information needed to quantify, manage and control operational risk with the assistance of staff in the respective organisational units;
- regular assessment and review of the operational risk profile of the various business units of the entities within the Group;
- fine-tuning of operational risk rating and scoring models;
- proposing actions for the prevention, mitigation or elimination of operational risk;
- operational coordination of any extraordinary measures taken in extraordinary circumstances in accordance with the instructions received from Senior Management.

The Operational Risk Management Unit staff work together with:

- the Audit Committee, the Supervisory Board (Act 231/2001), the Compliance function, Operations & Systems and Internal Audit officers responsible for the internal control system. Together they examine the overall risk profile, identify those processes and areas that are highly sensitive to operational risk, the measures needed to remedy any organisational or operational shortfalls in relation to operational risk, fine-tune the internal control system;
- the Sales Network Inspectors for second level controls over Sales Network operations.

The work of the Operational Risk Management Unit in relation to the identification, measurement and management of operational risk is conducted applying the proportionality principle i.e. in accordance with the level of risk to which the various Organisational Units are exposed.

There are four key steps in the work of the Operational Risk Management Unit, i.e.:

1. annual risk assessment process: the risk exposure of the Organisational Units is periodically reviewed via interviews with the heads of the various organisational units and on the basis of a preliminary assessment of risk

exposures conducted every fall. The preliminary assessment consists of the analysis of Key Risk Indicators derived from business indicators for the period and evidence gathered during the year. Said evidence consists of risk exposure estimates and the ratings assigned to the organisational units to prioritise actions according to the level of risk exposure;

2. collection of operational loss data relating to risk events. This exercise relies also on data from 'errors reports' that are generated on a regular basis and on specific alerts;
3. adoption of operational risk mitigation actions prior to or after the occurrence of a certain event or upon request of the heads of the various Organisational Units;
4. preliminary analysis of risk exposure when starting a new business or making new commercial agreements/contracts or upon the introduction of changes in the organisation/regulations. This exercise is internally named 'Generic Assessment' and is conducted in connection with specific events and using methods that facilitate concurrent changes/upgrades within all the various organisational units involved, i.e. Regulatory Compliance, Operations, Legal Affairs, Financial Risk Management, Operational Risk Management, Supervisory Board, Internal Audit.

Against this backdrop and considering the specific traits of the Mediolanum Banking Group's business model that entails outsourcing of a number of internal processes, including those relating to the management of assets, strict compliance with the Group policies and guidelines is required when selecting and controlling outsourcees activities.

### ○ 1.6.1. Reporting System

An adequate operational risk reporting system promotes the dissemination of the control culture within the Group and greater awareness of the level of risk to which Organisational Units are exposed.

The reporting system used by the Operational Risk Management Unit is differentiated by information recipient and scope of analysis.

Information about the following aspects is particularly important:

- actual operational losses, related recoveries and mitigation actions after major events;
- developments in the operating environment and in the internal control system that change significantly the operational risk profile;
- identification of vulnerable spots in major business processes;
- description of operational risk prevention and mitigation actions and their effectiveness;
- assessment of operational risk connected with the introduction of new products, activities, processes and systems;
- estimate of operational risk capital charge under the approach in use;
- risk transfer, if any.

The reports prepared by the Operational Risk Management Unit staff are submitted to the staff and heads of Organisational Units, the head of the Risk Management and Compliance function, the Audit Committee, the Chief Executive Officer, the Board of Directors and the Supervisory Authorities.

Specifically, the detailed reports on operational risk by organisational unit and event, and the reports on actions already taken or underway are prepared monthly, quarterly, semi-annually and annually; the Generic Assessment Report setting out qualitative assessment information on business initiatives or events are prepared quarterly; the summary report on key Loss Data Collection evidence and the report on the effectiveness of controls are prepared monthly; the reports with semi-annual statistics on loss events and related recoveries are prepared semi-annually.

The Operational Risk Management Unit staff also prepare an annual self-assessment report and reports to Supervisory Authorities, beginning from April 2009, attached to the annual ICAAP report.

## ● 1.7. Risk Management and Mitigation

The Banking Group defines, implements and maintains an adequate risk management and mitigation system in relation to all risks to which it is exposed.

The adequacy and effectiveness of this system entails that, in exceptional circumstances, the Group may allocate capital also to cover risks that cannot be measured beforehand.

The risk management and mitigation system consists of a set of procedures, methods, rules and functions that operate in a coordinated fashion to ensure:

- adherence to corporate strategies;
- effectiveness and efficiency of corporate processes;
- protection of the entity's assets;
- reliability and integrity of accounting and management information;
- compliance with internal and external rules and regulations.

Specifically, for each type of risk, the Banking Group's risk management and mitigation system consists of:

- strategies, conduct rules, general principles and goals, risk taking, protection and mitigation policies that are set forth in 'guidelines' and 'policy statements';
- clear roles and responsibilities of governing bodies and corporate function involved in risk management, set forth in 'internal rules';
- risk management processes set forth in 'organisational procedures' and 'operating instructions';
- information flows set out in 'organisational procedures' and 'operating instructions'.

The risk management and mitigation system includes internal risk measurement methods developed and applied to properly manage risk and enhance awareness of risks taken also in view of future capital requirements. These methods are also used to check the appropriateness of capital charges calculated under the standardised approach vis-à-vis actual risk exposures based on the analysis of corporate processes and positions held.

The main goals pursued by the Banking Group's risk management system are:

- to ensure the internal control system effectively captures any significant anomalies and adequate risk prevention and mitigation actions are taken;
- to ensure the broadest and deepest possible understanding, implementation and consistency of risk management principles, rules and approaches within the Group;
- to promote a risk management culture at all levels of the organisation and encourage consistent, knowledgeable operating choices and practices, in a structured way.

The corporate bodies that are responsible for risk supervision, management and control play a key role in the definition and implementation of the risk management and mitigation system across the organisation whose adequacy and effectiveness depend on the degree of engagement of all people within the Group.

## 2. SCOPE OF APPLICATION

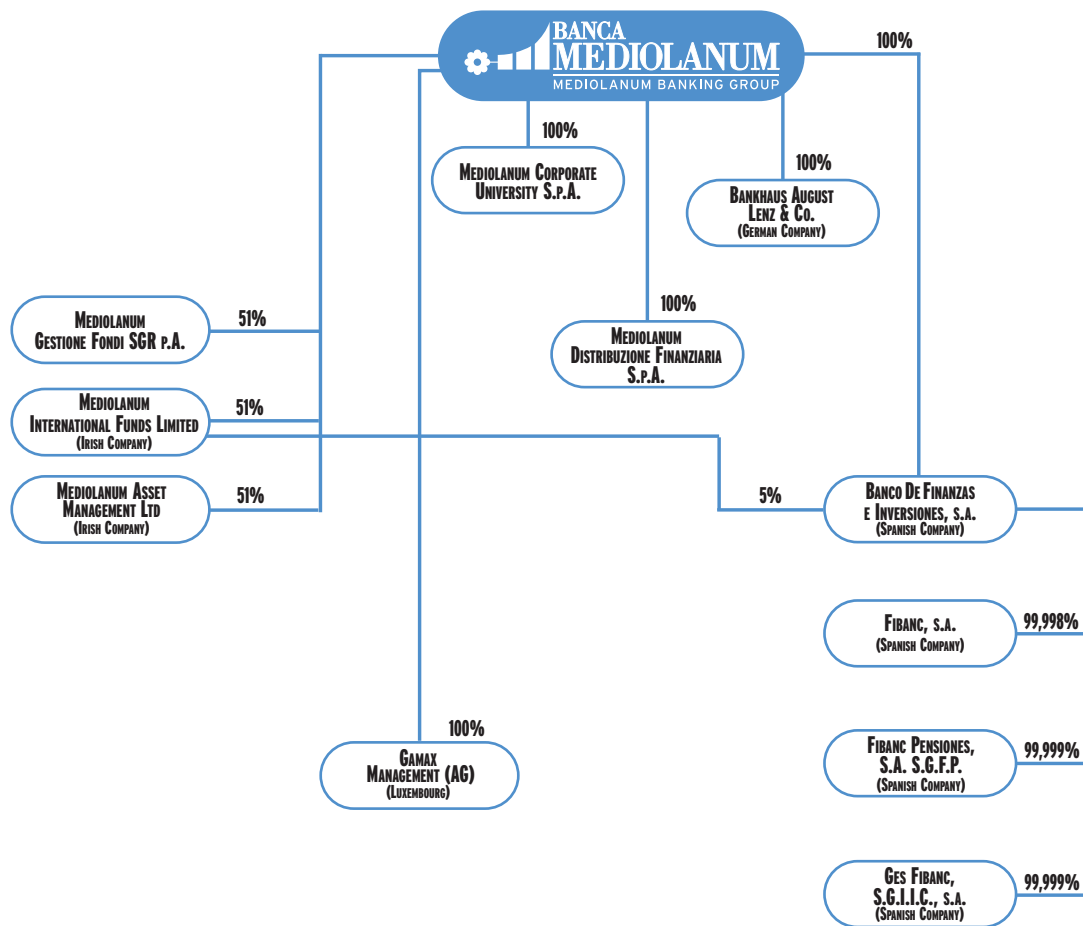
The information contained in this document relates to the Mediolanum Banking Group. Within the Group there are no legal or other material obstacles, either in existence or foreseeable, that could hamper a prompt transfer of assets or funds.

In compliance with regulatory provisions, since the capital requirement is met at consolidated level, the individual capital requirement for banks within the Group is reduced by 25%.

The scope of application of supervisory capital and disclosure requirements is shown in the chart below that sets out the entities that make up the Mediolanum Banking Group.

### Group Structure

at December 31, 2009



### 3. COMPOSITION OF REGULATORY CAPITAL

Bank of Italy's Circular 263 of December 27, 2006 setting forth the regulations governing banks' capital requirements also incorporates international rules introduced to take account of the adoption of the international accounting and financial reporting standards (IAS/IFRS) and their impact on the calculation of regulatory capital. Specifically, to safeguard the quality of regulatory capital and reduce the potential volatility arising from the adoption of the international accounting and financial reporting standards, certain "prudential filters" are applied to financial data.

Regulatory capital is the sum of core capital (Tier 1 capital), included in the calculation without restrictions, supplementary capital (Tier 2), which cannot exceed the amount of Tier 1 capital before deductions, and Tier 3 capital. Tier 3 capital can be used only to cover market risk (net of counterparty risk and settlement risk in the banking book) and up until 71.4% of capital requirements for market risk. Shareholdings, non-innovative, innovative, hybrid capital instruments and subordinated assets held in other banks and financial companies, shareholdings in and subordinated instruments issued by insurance companies are deducted from said aggregates.

At December 31, 2009, Tier 1 capital consisted of share capital, equity reserves and net profit for the year (after dividends) less goodwill, intangible assets, and negative valuation reserves.

At December 31, 2009, Tier 2 capital consisted of lower tier 2 subordinated liabilities.

At December 31, 2009, Mediolanum Banking Group's capital did not include any instruments falling within Tier 3 capital.

The analysis of Consolidated Regulatory Capital is set out in the table below.

**Table 3.1 - Analysis of Regulatory Capital (part 1)**

| €/'000   | At December 31, 2009 |
|--|----------------------|
| <b>Tier 1 positive components</b>  |                      |
| Share capital  | 452,670              |
| Share premium account  | -                    |
| Reserves   | 134,135              |
| Non innovative equity instruments  | -                    |
| Innovative equity instruments  | -                    |
| Profit for the period  | 25,232               |
| Prudential filters: increases in Tier 1 capital  | -                    |
| <b>Total Tier 1 positive components</b>  | <b>612,037</b>       |
| <b>Tier 1 negative components</b>  |                      |
| Treasury shares  | -                    |
| Goodwill   | 205,714              |
| Other intangible assets  | 12,979               |
| Loss for the period  | -                    |
| Other negative components  | -                    |
| Prudential filters: deductions from Tier 1 capital   | -                    |
| <b>Total Tier 1 negative components</b>  | <b>218,693</b>       |
| <b>Tier 1 before deductions</b>  | <b>393,344</b>       |
| <b>Deductions from Tier 1 capital</b>  |                      |
| Shareholdings in lenders and financial institutions above 20% of their capital               | -                    |
| Shareholdings in lenders and financial institutions above 10% but below 20% of their capital | -                    |
| Shareholdings in insurers  | -                    |
| Expected losses in excess of total impairment losses   | -                    |
| Deductions in connection with securitisations  | -                    |
| Deductions for settlement risk on non-DVP transactions                                       | -                    |
| <b>Total deductions</b>  | <b>-</b>             |
| <b>TOTAL TIER 1 CAPITAL</b>  | <b>393,344</b>       |
| <b>Tier 2 positive components</b>  |                      |
| Valuation reserves   | 1,422                |
| Non innovative equity instruments that cannot be included in Tier 1 capital                  | -                    |
| Hybrid equity instruments  | -                    |
| Tier 2 subordinated liabilities  | 168,007              |
| Total impairment losses in excess of expected losses   | -                    |
| Net gains on equity investments  | -                    |
| Other positive components  | -                    |
| Prudential filters: increases in Tier 2 capital  | -                    |
| <b>Total Tier 2 positive components</b>  | <b>169,429</b>       |

Table 3.1 - Analysis of Regulatory Capital (part 2)

| €/000  | At December 31, 2009 |
|--|----------------------|
| <b>Tier 2 negative components</b>  |                      |
| Net losses on equity investments   | -                    |
| Loans  | -                    |
| Other negative components  | (711)                |
| Prudential filters: deductions from Tier 2 capital   | -                    |
| <b>Total Tier 2 negative components</b>  | <b>(711)</b>         |
| <b>Tier 2 before deductions</b>  | <b>168,718</b>       |
| <b>Deductions from Tier 2 capital</b>  |                      |
| Shareholdings in lenders and financial institutions above 20% of their capital               | -                    |
| Shareholdings in lenders and financial institutions above 10% but below 20% of their capital | -                    |
| Shareholdings in insurers  | -                    |
| Expected losses in excess of total impairment losses   | -                    |
| Deductions in connection with securitisations  | -                    |
| Deductions for settlement risk on non-DVP transactions                                       | -                    |
| <b>Total deductions</b>  | <b>-</b>             |
| <b>TOTAL TIER 2 CAPITAL</b>  | <b>168,718</b>       |
| Deductions from Tier 1 & Tier 2 capital  | -                    |
| <b>TOTAL REGULATORY CAPITAL</b>  | <b>562,062</b>       |
| <b>TOTAL TIER 3 CAPITAL</b>  | <b>-</b>             |
| <b>REGULATORY CAPITAL INCLUDING TIER 3</b>   | <b>562,062</b>       |

#### 4. CAPITAL ADEQUACY

Pursuant to the Bank of Italy's classification of banks, the Mediolanum Banking Group is a Class 2 entity (banks and banking groups with assets greater than €3.5 billion that apply the standardised approach for the calculation of their capital requirements). Therefore, the Mediolanum Banking Group applies the building-block approach, under which the total capital requirement is calculated by adding up the capital requirements for each identified risk. The building-block approach does not assume any diversification effects due to the interaction between items that contribute to determine each individual risk.

Thus, total capital requirement is the sum of the capital requirements for the individual measurable risks calculated at Banking Group level in compliance with the Bank of Italy's instructions which are incorporated into internal policies.

At December 31, 2009, the Mediolanum Banking Group had a Tier 1 capital ratio (core capital/RWA) of 10.17% and a total capital ratio (regulatory capital/RWA) of 14.53%.

Table 4.1 - Capital Adequacy

At December 31, 2009

| €/000  | Exposure  | Weighted exposure | Capital Requirement |
|--|-----------|-------------------|---------------------|
| <b>ASSETS/CREDIT RISK</b>  |           |                   |                     |
| <b>Standardised approach</b>   |           |                   |                     |
| Exposures to/guaranteed by Governments & Central Banks               | 841,404   | -                 | -                   |
| Exposures to/guaranteed by local government entities                 | 205,493   | 40,059            | 3,205               |
| Exposures to/guaranteed by nonprofits and public entities            | 6,908     | 6,544             | 524                 |
| Exposures to/guaranteed by Multilateral Development Banks            | 45,583    | -                 | -                   |
| Exposures to/guaranteed by Supervised Intermediaries                 | 3,530,328 | 705,931           | 56,474              |
| Exposures to/guaranteed by Companies                                 | 363,931   | 284,000           | 22,720              |
| Retail exposures   | 1,131,304 | 531,712           | 42,537              |
| Exposures secured by properties                                      | 1,889,737 | 658,601           | 52,688              |
| Past due exposures   | 37,313    | 36,195            | 2,896               |
| High risk exposures  | 11,279    | 16,549            | 1,324               |
| Exposures in secured bank bonds                                      | -         | -                 | -                   |
| Exposures to UCITS   | 166,241   | 166,241           | 13,299              |
| Other exposures  | 436,718   | 184,071           | 14,726              |
| Securitisation exposures   | 79,079    | 15,816            | 1,265               |
| <b>TOTAL CREDIT RISK</b>   |           | <b>2,645,719</b>  | <b>211,658</b>      |
| <b>ASSETS/MARKET RISK</b>  |           |                   |                     |
| <b>Standardised approach</b>   |           |                   |                     |
| General risk   |           |                   | 3,462               |
| Specific risk  |           |                   | 27,632              |
| UCITS holdings risk  |           |                   | -                   |
| Options  |           |                   | 3,735               |
| Currency risk  |           |                   | -                   |
| Commodity risk   |           |                   | -                   |
| <b>TOTAL MARKET RISK</b>   |           |                   | <b>34,829</b>       |
| <b>ASSETS/OPERATIONAL RISKS</b>                                      |           |                   |                     |
| Foundation approach  |           |                   | 3,582               |
| Standardised approach  |           |                   | 61,713              |
| Advanced approach  |           |                   | -                   |
| <b>TOTAL OPERATIONAL RISK</b>  |           |                   | <b>65,295</b>       |
| <b>OTHER PRUDENTIAL REQUIREMENTS</b>                                 |           |                   |                     |
| Adjustments to regulatory requirements for intercompany transactions |           |                   | (2,303)             |
| <b>TOTAL PRUDENTIAL REQUIREMENTS</b>                                 |           |                   | <b>309,479</b>      |
| Risk-weighted assets (RWA)*  |           |                   | 3,868,479           |
| Tier 1/RWA (Tier 1 Capital Ratio)                                    |           |                   | 10.17%              |
| Regulatory capital/RWA (Total Capital Ratio)                         |           |                   | 14.53%              |

\* Total prudential requirements multiplied by the reciprocal of the mandatory minimum coefficient for credit risk (8%).



## 5. CREDIT RISK – GENERAL INFORMATION (ALL BANKS)

Lending, be it the provision of home loans or consumer credit, or in other forms to meet other financing needs, is part of the business of the Mediolanum Banking Group. In line with the Group mission, lending complements the Group primary business i.e. the distribution of banking, asset management, insurance and retirement savings products. The Group applies prudent lending policies, which are geared to develop and strengthen the relationship with customers who invest in products managed by the entities within the Group.

Credit risk is largely in connection with traditional lending. It relates to all loans, either secured or unsecured, on balance sheet or similar off-balance sheet items, e.g. endorsements. The analysis of the Group's lending operations is therefore crucial to enforce an effective system of internal control.

The loans extended by the banking group essentially consist of:

- overdraft facilities repayable on demand or fixed-term credit lines;
- loans repayable in instalments;
- bank guarantees in favour of customers;
- residential mortgage loans.

The Group also monitors any amounts that exceed the credit limit, either under arranged or unarranged overdrafts, for any reasons, including under standard credit cards or credit cards with revolving credit facilities.

The risk management framework includes policies that set out general principles and instructions on lending as well as on monitoring the quality of the loan portfolio. The Parent Company of the Banking Group is responsible for assessing overall exposure to credit risk and defining credit risk measurement policies for the whole Group.

Credit risk exposure is also assessed at the level of individual companies in their respective areas of responsibility, by measuring and monitoring the risk associated with the various categories of financial instruments.

### ● 5.1. Definition of Default

To determine 'default' Banca Mediolanum refers to the definition of 'impaired loans' used for the purpose of financial reporting. Impaired loans include:

- nonperforming loans;
- watch list loans;
- restructured loans;
- over 180 days past due loans.

Nonperforming loans consist of on and off-balance sheet exposures (e.g. loans, securities, derivatives) to borrowers that are unable to meet their payment obligations – even if their insolvency has not been established by a court of law – or in equivalent conditions, regardless of any losses estimated by the lender and irrespective of any security taken. This category does not include country risk exposures, but includes exposures to local government entities (municipal, provincial administrations) that are insolvent for the share of the exposure recognised in the insolvency proceedings.

Watch list loans consist of on and off-balance sheet exposures (e.g. loans, securities, derivatives) to borrowers that are experiencing objective temporary difficulties in meeting their payment obligations, but are expected to make good within a reasonable timeframe. These exposures are recognised irrespective of any security taken. This category does not include country risk exposures.

Restructured loans consist of on and off-balance sheet exposures (e.g. loans, securities, derivatives) for which a bank (or a syndicate of banks) agrees to change the original loan terms and conditions (e.g. rescheduling payments, reducing debt and/or interest) due to the deterioration of the financial condition of the borrower, with ensuing losses. This category does not include exposures to companies that are going out of business (e.g. voluntary wind-up or similar conditions) as well as country-risk exposures.

An additional impaired loan category was introduced by the Bank of Italy (Circular Letter 262 of December 22, 2005 'The Financial Statements of Banks: Instructions for the preparation of the financial statements'), i.e. over 180 days past due loans. These consist of on and off-balance sheet exposures (e.g. loans, securities, derivatives) to borrowers other than those classified in the categories above (nonperforming, watch list, restructured) that at the reporting date were over 180 days past due or overdrawn. This category does not include country risk exposures. For recognition in this category, both following conditions are to be satisfied:

- the borrower is past due more than 180 days in a row (to determine actual past due borrowers, overdrawn/unpaid amounts can be offset against balances in credit under other loans/credit facilities extended to the same borrower);
- the mean value of daily past due/overdrawn amounts in the last quarter is 5% or more of total exposure.

When the borrower is a government entity that exceeded the limits above yet the overdrawn/past due amount does not exceed €10,000, the relevant exposure is not classified as past due.

## ● 5.2. Method used to Calculate Impairment

The Mediolanum Banking Group calculate impairment applying the following two-step approach:

- Identification of assets to be individually or collectively tested for impairment;
- Measurement and recognition of the impairment loss in accordance with the specific impairment rules.

The first step is preliminary to the impairment test that assesses and measures the impairment loss, if any.

Banca Mediolanum tests for impairment loans and endorsements with fixed or determinable payments extended to retail and institutional clients. Loans and endorsements to retail clients typically consist of arranged overdraft facilities, loans and credit lines repayable in instalments, while those extended to institutional clients (banks and other financial institutions) are made up of deposits, repurchase agreements (amount paid for the purchase of the asset under an agreement to resell it at a future date) and hot money.

To identify loans and endorsements to be individually/collectively tested for impairment it is necessary to analyse the significance of the exposure and check whether there is objective evidence of any losses.

Banca Mediolanum individually tests for impairment all exposures classified as nonperforming, watch list and over 180 days past due loans (pursuant to Bank of Italy's instructions) irrespective of their significance. In fact these are exposures for which there is objective evidence of impairment as per §64 of IAS 39. Other exposures, i.e. performing loans, are collectively tested for impairment. Only for monitoring purposes a € 750,000 threshold is set for the determination of the significance of the individual exposure. Any exposure in excess of said threshold is examined separately and individually.

For exposures that are individually assessed for impairment the recoverable amount of the individual exposure is determined on the basis of:

- estimated recoverable cash flows;
- timing of recoveries;
- the interest rate used to discount future cash flows.

As individually they are not significant, Banca Mediolanum treats nonperforming, watch list, restructured and over 180 days past due exposures as groups of assets with similar risk characteristics and related impairment losses are determined applying a single rate commensurate with the severity of the problem.

Exposures that are not individually assessed are grouped on the basis of similar risk characteristics and collectively assessed for impairment.

The collective impairment loss is obtained by adding up the losses of each group. The collective impairment amount is compared with the previous carrying amount of loans to determine the amount of provisions to set aside or use. The process for the identification of the groups of loans to be collectively assessed under IAS is in line with the credit risk approach under Bank of Italy's Circular Letter 263 of December 27, 2006. Specifically, the risk parameters under said regulations, i.e. probability of default (PD) by rating class and Loss Given Default (LGD) are significant parameters for the classification of loans into groups with similar credit risk characteristics and for the calculation of provisions.

At present, the grouping of loans for the purpose of collective assessment is by rating and client segment (Retail/Corporate).

The calculation of the impairment loss is made applying a "Basel-oriented" approach, i.e. impairment is approximated to the concept of Expected Loss (EL) introduced by the Basel II Accord. Expected Loss is the average loss the Bank expects to incur on an exposure as a result of the deterioration of credit quality or default of the borrower.

Banca Mediolanum's loan loss provision for collectively assessed exposures is thus determined by calculating the Expected Loss (EL) on all exposures in a given rating class, applying the following formula:

$$EL_{exposure}^{class} = Balance_{exposure} \times PD^{class} \times LGD$$

where:

- $Balance_{exposure}$ : is the book value for short-term financing and amortised cost for loans repayable in instalments;
- $LGD$ : failed recoveries rate to be applied to performing loans;
- $PD^{class}$ : probability of default over 1 year for performing loans in a given rating class.

The loan loss provision for collectively assessed exposures is thus obtained by adding up expected losses on each exposure:

$$Total\ provision = \sum_{exposure, class} EL$$

Especially in relation to the IAS rule that requires to consider the “time value of money” when calculating impairment, the Group is developing a model for the calculation of LGD that takes account of average time to recovery and recovery schedule as well as the type of asset and security taken.

Due to the lack of sufficiently robust historical data for internal loss estimates the Group used the LGD rates as per the Basel II Accord as follows:

- cretail mortgage loans: LGD=25%;
- other retail loans: LGD=85%;
- loans extended to businesses: LGD=45%.

Based on observed historical loss data LGD was assumed to be zero (meaning no collective assessment is applied) for the following exposure categories:

- Hot money;
- Repurchase agreements with banks;
- Deposits with banks.

The 1-year PD is a good approximation of “incurred but not reported (IBNR) losses” calculated on the basis of current indications, for losses that are expected to materialise within one year.

Table 5.1 - Analysis of financial assets by category and credit quality (book value)

|  | At December 31, 2009 |               |              |               |                  |                  |
|--|----------------------|---------------|--------------|---------------|------------------|------------------|
| €/’000                                 | Non performing       | Watch list    | Restructured | Past due      | Other assets     | Total            |
| 1. Financial assets held for trading   | -                    | -             | -            | -             | 843,663          | 843,663          |
| 2. Available-for sale financial assets | -                    | 102           | -            | -             | 808,724          | 808,826          |
| 3. Held-to-maturity investments        | -                    | -             | -            | -             | 1,329,347        | 1,329,347        |
| 4. Loans to banks                      | -                    | -             | -            | -             | 1,673,368        | 1,673,368        |
| 5. Loans to customers                  | 7,699                | 22,181        | 328          | 13,315        | 3,288,379        | 3,331,902        |
| 6. Financial assets at fair value      | -                    | -             | -            | -             | -                | -                |
| 7. Financial assets being disposed of  | -                    | -             | -            | -             | -                | -                |
| 8. Hedging derivatives                 | -                    | -             | -            | -             | 1,179            | 1,179            |
| <b>Total at Dec. 31, 2009</b>          | <b>7,699</b>         | <b>22,283</b> | <b>328</b>   | <b>13,315</b> | <b>7,944,660</b> | <b>7,988,285</b> |
| <b>Total at Dec. 31, 2008</b>          | <b>5,945</b>         | <b>9,968</b>  | <b>522</b>   | <b>12,390</b> | <b>8,857,318</b> | <b>8,886,143</b> |

Table 5.2 - Geographical distribution of on-balance sheet and off-balance sheet customer loans (book value)

| €/'000                        | Italy            |                 | -Other european countries- |                | America       |                | Asia         |                | At December 31, 2009<br>- Rest of the world - |                |
|-------------------------------|------------------|-----------------|----------------------------|----------------|---------------|----------------|--------------|----------------|---|----------------|
|                               | Net exposure     | Net impairment  | Net exposure               | Net impairment | Net exposure  | Net impairment | Net exposure | Net impairment | Net exposure                                  | Net impairment |
| <b>A. On balance sheet</b>    |                  |                 |                            |                |               |                |              |                |   |                |
| A.1 Non performing            | 7,297            | (9,690)         | 402                        | (2,677)        | -             | -              | -            | -              | -   | -              |
| A.2 Watch list                | 18,447           | (9,068)         | 3,732                      | (2,068)        | 2             | (1)            | -            | -              | -   | -              |
| A.3 Restructured              | 221              | -               | 107                        | -              | -             | -              | -            | -              | -   | -              |
| A.4 Past due                  | 9,354            | (1,302)         | 3,961                      | -              | -             | -              | -            | -              | -   | -              |
| A.5 Others                    | 3,362,943        | (1,637)         | 626,758                    | (822)          | 7,116         | -              | -            | -              | 388   | -              |
| <b>Total</b>                  | <b>3,398,262</b> | <b>(21,697)</b> | <b>634,960</b>             | <b>(5,567)</b> | <b>7,118</b>  | <b>(1)</b>     | <b>-</b>     | <b>-</b>       | <b>388</b>                                    | <b>-</b>       |
| <b>B. Off balance sheet</b>   |                  |                 |                            |                |               |                |              |                |   |                |
| B.1 Non performing            | -                | -               | -                          | -              | -             | -              | -            | -              | -   | -              |
| B.2 Watch list                | 438              | (22)            | -                          | -              | -             | -              | -            | -              | -   | -              |
| B.3 Other impaired assets     | 189              | -               | -                          | -              | -             | -              | -            | -              | -   | -              |
| B.4 Others                    | 108,307          | (32)            | 182                        | -              | -             | -              | 49           | -              | -   | -              |
| <b>Total</b>                  | <b>108,934</b>   | <b>(54)</b>     | <b>182</b>                 | <b>-</b>       | <b>-</b>      | <b>-</b>       | <b>49</b>    | <b>-</b>       | <b>-</b>                                      | <b>-</b>       |
| <b>Total at Dec. 31, 2009</b> | <b>3,507,196</b> | <b>(21,751)</b> | <b>635,142</b>             | <b>(5,567)</b> | <b>7,118</b>  | <b>(1)</b>     | <b>49</b>    | <b>-</b>       | <b>388</b>                                    | <b>-</b>       |
| <b>Total at Dec. 31, 2008</b> | <b>4,503,658</b> | <b>(17,113)</b> | <b>974,303</b>             | <b>(7,126)</b> | <b>14,621</b> | <b>(5)</b>     | <b>101</b>   | <b>-</b>       | <b>54</b>                                     | <b>-</b>       |

Table 5.3 - Geographical distribution of on-balance sheet and off-balance sheet bank loans (book value)

| €/'000                        | Italy            |                | -Other european countries- |                | America       |                | Asia         |                | At December 31, 2009<br>- Rest of the world - |                |
|-------------------------------|------------------|----------------|----------------------------|----------------|---------------|----------------|--------------|----------------|---|----------------|
|                               | Net exposure     | Net impairment | Net exposure               | Net impairment | Net exposure  | Net impairment | Net exposure | Net impairment | Net exposure                                  | Net impairment |
| <b>A. On balance sheet</b>    |                  |                |                            |                |               |                |              |                |   |                |
| A.1 Non performing            | -                | -              | -                          | -              | -             | -              | -            | -              | -   | -              |
| A.2 Watch list                | -                | -              | 102                        | (916)          | -             | -              | -            | -              | -   | -              |
| A.3 Restructured              | -                | -              | -                          | -              | -             | -              | -            | -              | -   | -              |
| A.4 Past due                  | -                | -              | -                          | -              | -             | -              | -            | -              | -   | -              |
| A.5 Others                    | 3,264,776        | -              | 651,042                    | (4,387)        | 13,284        | -              | 22           | -              | -   | -              |
| <b>Total</b>                  | <b>3,264,776</b> | <b>-</b>       | <b>651,144</b>             | <b>(5,303)</b> | <b>13,284</b> | <b>-</b>       | <b>22</b>    | <b>-</b>       | <b>-</b>                                      | <b>-</b>       |
| <b>B. Off balance sheet</b>   |                  |                |                            |                |               |                |              |                |   |                |
| B.1 Non performing            | -                | -              | -                          | -              | -             | -              | -            | -              | -   | -              |
| B.2 Watch list                | -                | -              | -                          | -              | -             | -              | -            | -              | -   | -              |
| B.3 Other impaired assets     | -                | -              | -                          | -              | -             | -              | -            | -              | -   | -              |
| B.4 Others                    | 31,463           | (25)           | 7,254                      | (90)           | -             | -              | -            | -              | -   | -              |
| <b>Total</b>                  | <b>31,463</b>    | <b>(25)</b>    | <b>7,254</b>               | <b>(90)</b>    | <b>-</b>      | <b>-</b>       | <b>-</b>     | <b>-</b>       | <b>-</b>                                      | <b>-</b>       |
| <b>Total at Dec. 31, 2009</b> | <b>3,296,239</b> | <b>(25)</b>    | <b>658,398</b>             | <b>(5,393)</b> | <b>13,284</b> | <b>-</b>       | <b>22</b>    | <b>-</b>       | <b>-</b>                                      | <b>-</b>       |
| <b>Total at Dec. 31, 2008</b> | <b>2,798,657</b> | <b>(14)</b>    | <b>833,804</b>             | <b>(1,099)</b> | <b>27,848</b> | <b>(1)</b>     | <b>173</b>   | <b>-</b>       | <b>6</b>                                      | <b>-</b>       |

Table 5.4 - Analysis of customer loans by borrower category (on and off-balance sheet positions)

At December 31, 2009

|                                   | Governments      |                       |                       | Government agencies |                       |                       | Financial companies |                       |                       | Insurance companies |                       |                       | Non financial companies |                       |                       | Others           |                       |                       |
|-----------------------------------|------------------|-----------------------|-----------------------|---------------------|-----------------------|-----------------------|---------------------|-----------------------|-----------------------|---------------------|-----------------------|-----------------------|-------------------------|-----------------------|-----------------------|------------------|-----------------------|-----------------------|
|                                   | Net exposure     | Individual impairment | Collective impairment | Net exposure        | Individual impairment | Collective impairment | Net exposure        | Individual impairment | Collective impairment | Net exposure        | Individual impairment | Collective impairment | Net exposure            | Individual impairment | Collective impairment | Net exposure     | Individual impairment | Collective impairment |
| €/000                             |                  |                       |                       |                     |                       |                       |                     |                       |                       |                     |                       |                       |                         |                       |                       |                  |                       |                       |
| <b>A. On balance sheet</b>        |                  |                       |                       |                     |                       |                       |                     |                       |                       |                     |                       |                       |                         |                       |                       |                  |                       |                       |
| A.1 Non performing                | -                | -                     | X                     | -                   | -                     | X                     | -                   | -                     | X                     | -                   | -                     | X                     | 21                      | (91)                  | X                     | 7,678            | (12,276)              | X                     |
| A.2 Watch list                    | -                | -                     | X                     | -                   | -                     | X                     | -                   | -                     | X                     | -                   | -                     | X                     | 315                     | (180)                 | X                     | 21,866           | (10,957)              | X                     |
| A.3 Restructured                  | -                | -                     | X                     | -                   | -                     | X                     | -                   | -                     | X                     | -                   | -                     | X                     | 221                     | -                     | X                     | 107              | -                     | X                     |
| A.4 Past due                      | -                | -                     | X                     | -                   | -                     | X                     | -                   | -                     | X                     | -                   | -                     | X                     | 48                      | (11)                  | X                     | 13,267           | (1,291)               | X                     |
| A.5 Others                        | 634,859          | X                     | -                     | -                   | X                     | -                     | 643,133             | X                     | (130)                 | 76,955              | X                     | (58)                  | 123,636                 | X                     | (4,059)               | 2,566,966        | X                     | (6,330)               |
| <b>Total A</b>                    | <b>634,859</b>   | <b>-</b>              | <b>-</b>              | <b>-</b>            | <b>-</b>              | <b>X</b>              | <b>643,133</b>      | <b>-</b>              | <b>(130)</b>          | <b>76,955</b>       | <b>-</b>              | <b>(58)</b>           | <b>124,241</b>          | <b>(282)</b>          | <b>(4,059)</b>        | <b>2,609,884</b> | <b>(24,524)</b>       | <b>(6,330)</b>        |
| <b>B. Off balance sheet</b>       |                  |                       |                       |                     |                       |                       |                     |                       |                       |                     |                       |                       |                         |                       |                       |                  |                       |                       |
| B.1 Non performing                | -                | -                     | X                     | -                   | -                     | X                     | -                   | -                     | X                     | -                   | -                     | X                     | -                       | -                     | X                     | -                | -                     | X                     |
| B.2 Watch list                    | -                | -                     | X                     | -                   | -                     | X                     | -                   | -                     | X                     | -                   | -                     | X                     | -                       | -                     | X                     | 438              | (22)                  | X                     |
| B.3 Other impaired assets         | -                | -                     | X                     | -                   | -                     | X                     | -                   | -                     | X                     | -                   | -                     | X                     | -                       | -                     | X                     | 189              | -                     | X                     |
| B.4 Others                        | -                | X                     | -                     | -                   | X                     | -                     | 1,581               | X                     | -                     | 6                   | X                     | -                     | 2,864                   | X                     | (3)                   | 104,087          | X                     | (29)                  |
| <b>Total B</b>                    | <b>-</b>         | <b>-</b>              | <b>-</b>              | <b>-</b>            | <b>-</b>              | <b>-</b>              | <b>1,581</b>        | <b>-</b>              | <b>-</b>              | <b>6</b>            | <b>-</b>              | <b>-</b>              | <b>2,864</b>            | <b>-</b>              | <b>(3)</b>            | <b>104,714</b>   | <b>(22)</b>           | <b>(29)</b>           |
| <b>Total (A+B), Dec. 31, 2009</b> | <b>634,859</b>   | <b>-</b>              | <b>-</b>              | <b>-</b>            | <b>-</b>              | <b>-</b>              | <b>644,714</b>      | <b>-</b>              | <b>(130)</b>          | <b>76,961</b>       | <b>-</b>              | <b>(58)</b>           | <b>127,105</b>          | <b>(282)</b>          | <b>(4,062)</b>        | <b>2,714,598</b> | <b>(24,546)</b>       | <b>(6,359)</b>        |
| <b>Total (A+B), Dec. 31, 2008</b> | <b>1,579,179</b> | <b>-</b>              | <b>-</b>              | <b>-</b>            | <b>-</b>              | <b>-</b>              | <b>1,870,835</b>    | <b>-</b>              | <b>(77)</b>           | <b>8,150</b>        | <b>-</b>              | <b>-</b>              | <b>140,574</b>          | <b>(564)</b>          | <b>(49)</b>           | <b>1,894,002</b> | <b>(17,102)</b>       | <b>(6,451)</b>        |

Table 5.5 - Time to maturity of financial assets and liabilities

At December 31, 2009

| Item/Time-to-Maturity<br>€/000                  | On demand | 1 to 7<br>days | 7 to 15<br>days | 15 days to<br>1 month | 1 to 3<br>months | 3 to 6<br>months | 6 months<br>to<br>1 year | 1 to 5<br>years | Over 5<br>years | Indefinite<br>maturity |
|---|-----------|----------------|-----------------|-----------------------|------------------|------------------|--------------------------|-----------------|-----------------|------------------------|
| <b>On balance sheet assets</b>                  |           |                |                 |                       |                  |                  |                          |                 |                 |                        |
| Government securities                           | -         | -              | -               | -                     | 4,489            | -                | -                        | 570,115         | 68,991          | -                      |
| Other debt securities                           | 6,239     | 1              | 2,504           | 3,005                 | 40,199           | 24,010           | 303,240                  | 2,508,406       | 189,487         | -                      |
| Holdings in UCITS                               | 164,577   | -              | -               | -                     | -                | 3,395            | -                        | 946             | -               | -                      |
| Loans to:                                       | 614,926   | 165,643        | 216,909         | 173,759               | 252,954          | 531,633          | 143,076                  | 445,248         | 1,645,302       | 10,892                 |
| - banks   | 106,513   | 107,237        | 116,225         | 127,026               | 73,205           | 400,103          | 80,000                   | 9,008           | -               | 2,107                  |
| - customers                                     | 508,413   | 58,406         | 100,684         | 46,733                | 179,749          | 131,530          | 63,076                   | 436,240         | 1,645,302       | 8,785                  |
| <b>On balance sheet liabilities</b>             |           |                |                 |                       |                  |                  |                          |                 |                 |                        |
| Deposits  | 5,689,620 | -              | 213,300         | 325,158               | 208,273          | 589,968          | 7,464                    | 1,078           | 313             | -                      |
| - banks   | 12,106    | -              | 203,300         | 91,937                | 193,117          | 586,221          | -                        | -               | -               | -                      |
| - customers                                     | 5,677,514 | -              | 10,000          | 233,221               | 15,156           | 3,747            | 7,464                    | 1,078           | 313             | -                      |
| Debt securities                                 | -         | -              | -               | 106                   | 213              | 319              | 9,779                    | 131,195         | 36,956          | -                      |
| Other liabilities                               | 191,794   | 6,505          | 6,798           | 12,431                | 44,898           | -                | 134,886                  | 159,233         | 86,086          | -                      |
| <b>Off-balance sheet items</b>                  |           |                |                 |                       |                  |                  |                          |                 |                 |                        |
| Financial derivative w/o<br>exchange of capital | 658       | 4,058          | 84              | 90,422                | 28,000           | 152,016          | 351                      | 25,299          | 3,887           | -                      |
| - long positions                                | 329       | 1,955          | 42              | 45,980                | 23,421           | 76,184           | 250                      | 1,478           | 3,694           | -                      |
| - short positions                               | 329       | 2,103          | 42              | 44,442                | 4,579            | 75,832           | 101                      | 23,821          | 193             | -                      |
| Financial derivative w/o<br>exchange of capital | 1,512     | -              | -               | 1,440                 | 3,088            | 4,431            | 8,743                    | 65,256          | 159,704         | -                      |
| - long positions                                | 854       | -              | -               | -                     | -                | -                | -                        | -               | -               | -                      |
| - short positions                               | 658       | -              | -               | 1,440                 | 3,088            | 4,431            | 8,743                    | 65,256          | 159,704         | -                      |
| Deposits & financing<br>to be received          | -         | -              | -               | -                     | -                | -                | -                        | -               | -               | -                      |
| - long positions                                | -         | -              | -               | -                     | -                | -                | -                        | -               | -               | -                      |
| - short positions                               | -         | -              | -               | -                     | -                | -                | -                        | -               | -               | -                      |
| Firm commitments to<br>disburse funds           | -         | 23,602         | -               | -                     | -                | -                | -                        | -               | -               | -                      |
| - long positions                                | -         | 11,801         | -               | -                     | -                | -                | -                        | -               | -               | -                      |
| - short positions                               | -         | 11,801         | -               | -                     | -                | -                | -                        | -               | -               | -                      |
| Guarantees issued                               | -         | -              | -               | -                     | -                | -                | -                        | 30              | -               | -                      |

Table 5.6 - Loans to customers: analysis of net impairment (on-balance sheet positions)

At December 31, 2009

| €/000  | Non performing | Watch list | Restructured | Past due |
|--|----------------|------------|--------------|----------|
| <b>A. Net impairment at beginning of the year</b>    | 8,050          | 6,716      | -            | 2,757    |
| - of which: loans sold but not derecognised          | -              | -          | -            | -        |
| <b>B. Increases</b>                                  |                |            |              |          |
| B.1 impairment                                       | 3,336          | 8,252      | -            | 1,313    |
| B.2 reclassified from other impaired loan categories | 2,669          | 1,055      | 420          | 24       |
| B.3 other increases                                  | 83             | 58         | -            | -        |
| <b>C. Decreases</b>                                  |                |            |              |          |
| C.1 revaluations                                     | (379)          | (1,411)    | (210)        | (679)    |
| C.2 repayments                                       | (162)          | (309)      | (210)        | (967)    |
| C.3 cancellations                                    | (913)          | (115)      | -            | -        |
| C.4 reclassified to other impaired loan categories   | -              | (3,080)    | -            | (1,088)  |
| C.5 other decreases                                  | (317)          | (29)       | -            | (58)     |
| <b>D. Net impairment at end of the year</b>          | 12,367         | 11,137     | -            | 1,302    |
| - of which: loans sold but not derecognised          | -              | -          | -            | -        |

Table 5.7 - Loans to banks: analysis of net impairment (on-balance sheet positions)

At December 31, 2009

| €/000  | Non performing | Watch list | Restructured | Past due |
|--|----------------|------------|--------------|----------|
| <b>A. Net impairment at beginning of the year</b>    | -              | 916        | -            | -        |
| - of which: loans sold but not derecognised          | -              | 916        | -            | -        |
| <b>B. Increases</b>                                  |                |            |              |          |
| B.1 impairment                                       | -              | -          | -            | -        |
| B.2 reclassified from other impaired loan categories | -              | -          | -            | -        |
| B.3 other increases                                  | -              | -          | -            | -        |
| <b>C. Decreases</b>                                  |                |            |              |          |
| C.1 revaluations                                     | -              | -          | -            | -        |
| C.2 repayments                                       | -              | -          | -            | -        |
| C.3 cancellations                                    | -              | -          | -            | -        |
| C.4 reclassified to other impaired loan categories   | -              | -          | -            | -        |
| C.5 other decreases                                  | -              | -          | -            | -        |
| <b>D. Net impairment at end of the year</b>          | -              | 916        | -            | -        |
| - of which: loans sold but not derecognised          | -              | 916        | -            | -        |



## 6. CREDIT RISK - EXPOSURES MEASURED UNDER THE STANDARDISED APPROACH

The Mediolanum Banking Group applies the ratings of the rating agency:

- Moody's.

The analysis of ratings applied to the Group's portfolios is set out in the table below.

Table 6.1 - Portfolios and official ratings

| Portfolios   | ECA/ECAI | Rating                  |
|--|----------|-------------------------|
| Exposures to Governments & Central Banks                                 | Moody's  | Solicited & Unsolicited |
| Exposures to international organisations                                 | Moody's  | Solicited               |
| Exposures to multilateral development banks                              | Moody's  | Solicited & Unsolicited |
| Exposures to companies and others  | Moody's  | Solicited               |
| Exposures to UCITS   | Moody's  | Solicited               |
| Positions in short-term rated securitisations                            | Moody's  | N/A                     |
| Positions in securitisations other than short-term rated securitisations | Moody's  | N/A                     |

Table 6.2 - Standardised approach

| Exposure<br>€/000                    | CREDIT RATING |           |         |         |         |         |           | Unrated   | TOTAL |
|--------------------------------------|---------------|-----------|---------|---------|---------|---------|-----------|-----------|-------|
|                                      | Class 1       | Class 2   | Class 3 | Class 4 | Class 5 | Class 6 |           |           |       |
| <b>Non derivative exposures:</b>     | 957,388       | 3,219,969 | 547,008 | -       | -       | -       | 2,809,447 | 7,533,812 |       |
| - banks                              | 628,122       | 2,700,400 | 299,361 | -       | -       | -       | 25,791    | 3,653,674 |       |
| - customers                          | 329,266       | 519,569   | 247,647 | -       | -       | -       | 2,783,656 | 3,880,138 |       |
| <b>Derivatives</b>                   | 2,752         | 605       | -       | -       | -       | -       | 1,582     | 4,939     |       |
| - financial derivatives              | 2,752         | 605       | -       | -       | -       | -       | 1,582     | 4,939     |       |
| - credit derivatives                 | -             | -         | -       | -       | -       | -       | -         | -         |       |
| <b>Guarantees issued</b>             | 78            | -         | 5,653   | -       | -       | -       | 27,256    | 32,987    |       |
| <b>Commitments to disburse funds</b> | -             | 11,801    | -       | -       | -       | -       | 98,156    | 109,957   |       |
| <b>Total</b>                         | 960,218       | 3,232,375 | 552,661 | -       | -       | -       | 2,936,441 | 7,681,695 |       |

At December 31, 2009

## 8. RISK MITIGATION TECHNIQUES

The Banking Group does not offset credit risk exposures against positive balances of on or off-balance sheet items.

Credit risk mitigation (CRM) techniques consist of loan-related contracts or other instruments and techniques that reduce credit risk whose risk mitigating effect is recognised in the calculation of regulatory capital, as well as, for risk management purposes, the internal policies of the Mediolanum Banking Group. Credit risk is inherent in the lending operations of the Product Manufacturing Division and in Treasury's liquidity management transactions.

Eligible CRM techniques fall into two broad categories:

1. real guarantees
2. personal guarantees

Real guarantees are:

1. financial collateral, i.e. cash, certain financial instruments, gold – pledged or transferred –, repurchase/reverse repurchase and securities lending/borrowing transactions;
2. master netting agreements;
3. on balance sheet netting;
4. mortgages and real estate leases.

Personal guarantees include personal guarantees and credit derivatives.

Currently, within the Mediolanum Banking Group, the use of credit derivatives is allowed only for trading purposes and not for banking book credit risk mitigation.

Eligible CRM techniques are mortgages and pledges or other equivalent security interests in assets with a reasonable degree of liquidity and a reasonably stable market value.

Conversely, although taken into account when deciding whether or not to extend a loan, 'irrevocable orders to sell other Group financial products' are not eligible for CRM purposes.

As to pledges, the financial asset that is directly or indirectly pledged as security must be one of the following:

- bank account balances held with our bank;
- treasuries or securities guaranteed by governments, and securities that are accepted as guarantee by central banks;
- holdings in mutual funds and open-end investment companies;
- liens on insurance policies issued by the Mediolanum Banking Group;
- assets in discretionary accounts managed by our Bank;
- bonds and certificates of deposit issued by our Bank or other Banks;
- repo transactions relating to listed bonds, treasuries or accepted as guarantee by central banks, with retail customers;
- listed bonds;
- listed equities.

When the borrower's equity does not cover entirely the loaned amount, the loan is recognised at full risk.

Credit risk on mortgage loans is mitigated by the property given as collateral. Properties given as loan collateral must be located in Italy and be residential properties.

Semi-residential properties are accepted provided that they satisfy the following requirements:

- the non-residential portion does not exceed 40% of the estimated property value;
- the property is located in a residential area;
- the borrower is self-employed and intends to use the property as his/her primary residence.

In all these instances Loan-to-Value shall not exceed 70%.

The bank applies a disciplined approach to lending and adequate checks e.g. it checks the accurateness and completeness of the property appraisal as this is crucial to get a true view of risk. The bank requires that any request for mortgage loan approval be accompanied by a valid property appraisal setting out a true estimate of the value of the property for which the loan is sought and certifying to the highest possible degree that a valid building permit and any other authorisations for the property have been obtained. If not so, the loan will not be extended or the loan amount reduced to be commensurate with the true property value (which depends on its location, on how easily it can be resold, etc.).

The appraisal can be prepared by Banca Mediolanum in-house staff or external valuers who have entered into an agreement with Banca Mediolanum.

The Appraisal unit within the Lending Division is responsible for ensuring that internal procedures for the preparation of property appraisals are thoroughly and properly applied.

## 9. COUNTERPARTY RISK

The Mediolanum Banking Group devotes great attention to monitoring counterparty risk, i.e. the risk that a party to a financial contract (in particular repurchase agreements, OTC derivatives and long settlement transactions) may fail to perform its contractual obligations.

The methods used by the Mediolanum Banking Group to calculate counterparty risk exposures are set out in the table below.

Table 9.1 - Methods used to calculate exposures

| Exposure category            | Method                  |
|------------------------------|-------------------------|
| OTC derivatives              | Present Value           |
| SFT transactions             | CRM - simplified method |
| Long settlement transactions | Present Value           |

For the purposes of calculating the capital charge for counterparty risk arising on securities financing transactions (SFT), the Mediolanum Banking Group uses the simplified method, while for OTC derivatives and long settlement transactions the Group uses the present value method.

For each set of assets, the credit equivalent is calculated as the sum of the replacement cost and the future credit exposure ('add-on'). The replacement cost of each contract is its fair value, if positive. The fair value is positive if the bank is a net creditor of the counterparty. The credit exposure reflects the probability that the future fair value of the contract, if positive, may increase or, if negative, may turn positive. This probability is linked to the volatility of the underlying market variables as well as the residual life of the contract.

The Mediolanum Banking Group enters into derivative contracts essentially for hedging purpose, to protect against market risk (e.g. OIS - Overnight Indexed Swaps, futures), and risk in its loan portfolios, e.g. its mortgage loan portfolio via Interest Rate Swaps (IRS) and Interest Rate Options (IRO). IRS and IRO can be used only to hedge against risk in the mortgage loan portfolio. ISDA Master Agreements and the related Credit Support Annexes are to be made prior to entering into a contract with a new counterparty.

The Banking Group has no positions in credit derivatives.

Repurchase transactions are part of the activities conducted by the Treasury and the Securities Brokerage units and are used for liquidity management and as part of the business with retail customers. Typically, the Treasury unit uses repurchase agreements to refinance the securities portfolio while the Securities Brokerage unit uses them as part of its dealings with customers. Credit risk in repurchase agreements used by the Treasury unit is the risk of counterparty's default and the risk connected to the volatility of securities given as guarantee. Therefore, any securities given as guarantee need to satisfy minimum requirements in terms of rating (i.e. 'investment grade' and any exception is to be approved by the head of the Treasury unit) and institutional counterparties must be counterparties that were approved during the annual review process.

The analysis of counterparty risk exposures is set out in the table below.

Table 9.2 - Counterparty Risk Exposures

| Item/Value<br>€/000                | Exposure | At December 31, 2009 |             |
|------------------------------------|----------|----------------------|-------------|
|                                    |          | Weighted exposure    | Requirement |
| Derivate Contracts                 | 10,615   | 2,123                | 170         |
| SFT & Long Settlement Transactions | 498,111  | 15,962               | 1,277       |

The analysis of Mediolanum Banking Group's counterparty risk exposures in derivatives is set out in the table below.

Table 9.3 - Analysis of derivatives with positive fair value by type of product

| Portfolio<br>€/000 | At December 31, 2009 |                           |                            |                 |                      |         |        | Total |
|--------------------|----------------------|---------------------------|----------------------------|-----------------|----------------------|---------|--------|-------|
|                    | Options              | Interest<br>Rate<br>Swaps | Cross<br>Currency<br>Swaps | Equity<br>Swaps | Forward<br>contracts | Futures | Others |       |
| Trading            | 792                  | 62                        | 2,903                      | -               | 2                    | -       | -      | 3,759 |
| Hedging            | -                    | 1,179                     | -                          | -               | -                    | -       | -      | 1,179 |

The table above includes the analysis by product of all OTC financial derivatives with institutional counterparties. Exposure is the positive fair value of derivatives and is determined in accordance with the regulations issued by the banking supervisor.

## 12. OPERATIONAL RISK

Operational risk is pervasive across the organisation and is closely correlated to legal risk and regulatory risk (compliance risk).

Banca Mediolanum defines operational risk as *"the risk of economic loss or damage to assets, and sometimes legal and administrative consequences, resulting from any misconduct or inappropriate behaviour of its personnel, inadequate or failed systems or internal processes, or external events"*.

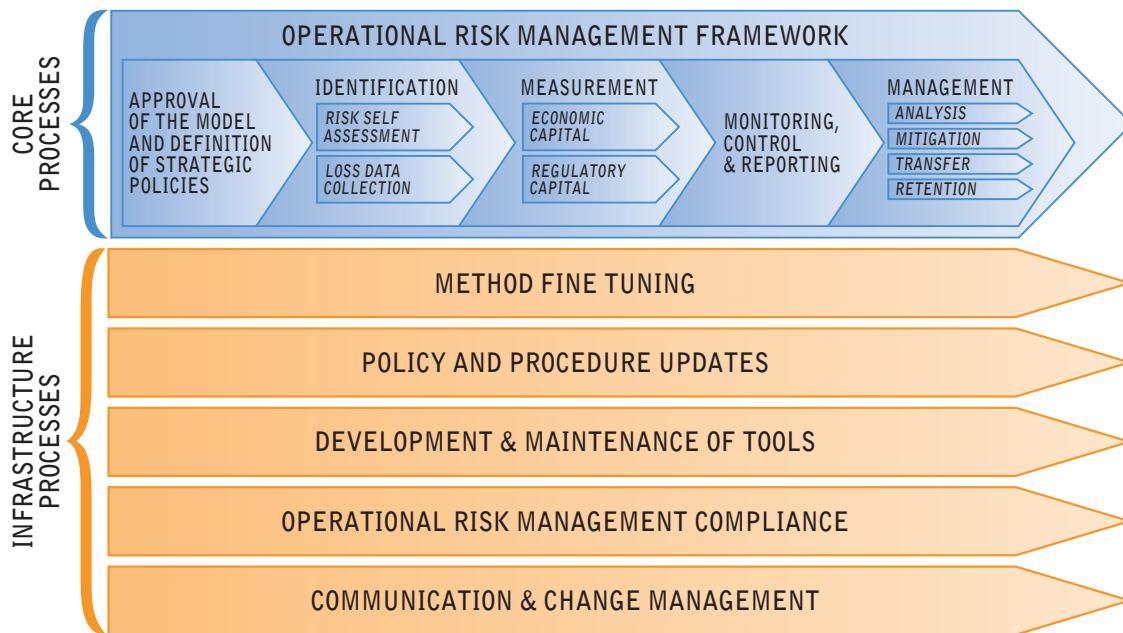
In consideration of the characteristics and the type of business conducted by Banca Mediolanum, special attention is given to risks arising in connection with the operation of the Sales Network and the multiple channels, including those channels which enable access and transactions from a remote location. These risks are managed, *inter alia*, through local controls and procedures for risk assessment, management, prevention and mitigation. The operational risk assessment and measurement method developed beginning from 2006 includes qualitative measurement of exposure to operational risk of each unit within the organisation via an internal rating system. The qualitative metrics differentiate between exposure to risk that is inherent in business management and exposure to risk that is anomalous or at critical levels.

The system uses four ratings, which identify a different level of risk and related response, i.e.:

- **A, negligible risk:** risk in line with the risk appetite; minimum risk of loss;
- **B, moderate risk:** the risk of loss is not negligible; first red flag;
- **C, significant risk:** it indicates a critical condition; more in-depth analysis is recommended to assess the opportunity of mitigating actions;
- **D, untenable risk:** the situation is severe and mitigating actions need to be taken immediately.

The operational risk management framework was approved by the Board of Directors in December 2006 and periodically reviewed and updated in the month of December of each year thereafter. The latest review and update were conducted in December 2009. The bank conducts Risk Self Assessment of organisational units and collection of operational loss data on an annual basis. This is groundwork for assessment of the level of risk to which organisational processes are exposed and provides input for the supervisory review process which entails the submission of half-yearly reports by banks that apply the standardised approach.

The operational risk management framework is summarised in the diagram below.



'Identification' consists of the following:

- 'Risk Self Assessment': *ex-ante* assessment of exposure to operational risk of an organisational unit or process based on subjective estimates and self-assessment models applied by the risk officer. One of the main outcomes of the Risk Self Assessment exercise is rating, which is the concise indication of the level of operational risk the organisational unit/process is exposed to;
- 'Loss Data Collection': *ex-post* collection of internal data on actual losses including any information that is relevant to risk measurement and management (including insurance and direct recoveries). This exercise is conducted applying both an 'account driven' approach and an 'event driven' approach.

'Measurement' relates to the calculation of risk capital, specifically:

- Economic capital: internal risk measurement through a rating system that enables to steer and calibrate risk management and mitigation according to the potential economic impact and the current risk management framework. This exercise is based on the outcome of risk identification analyses, applies an actuarial statistical model and is used in the development of operational risk stress tests;
- Regulatory capital: calculated in accordance with capital requirements indicated by supervisory authorities. Based on the examination of the results of self-assessment, first made on November 7, 2007, and then reviewed on an annual basis thereafter (on March 23, 2009 for the year 2009), the Board of Directors resolved to apply the standardised approach at individual level. This decision was made considering that both quantitative and qualitative requirements for the adoption of said approach were satisfied. Notice thereof was duly given to the Bank of Italy. For the measurement of regulatory capital at consolidated level, the Board of Directors resolved to adopt a "combination of the basic indicator approach and the standardised approach". Said combination of approaches was applied after ascertaining the satisfaction of the relevant requirements for its use. The same approach will be applied for financial year 2010 as satisfaction of the relevant requirements was ascertained by the Board of Directors at the its meeting of March 23, 2010.

'Monitoring, Control and Reporting' consists of the following:

- 'Monitoring and Control': analysis of actual exposure vs. estimated exposure to operational risk; identification of mitigating actions; fine tuning of risk assessment models;
- 'Reporting': preparation of regular reports to Organisational Units, Senior Management, Control Committees and the Board of Directors;

'Management' is composed of the following:

- 'Management analysis'
- 'Risk mitigation'
- 'Management of risk transfer techniques'
- 'Risk retention management'

The Operational Risk Management framework is complemented by the following processes that cut across business lines:

- 'Policies & procedures'
- 'Fine-tuning of methods'
- 'Development and maintenance of tools and applications'
- 'Operational Risk Management Compliance'
- 'Internal Communications/Change Management'

The tests and analyses performed within the Mediolanum Banking Group show the adequacy of consolidated regulatory capital vis-à-vis operational risk, measured applying not only the standardised approach but also internal statistical analyses of processes and probability of adverse events.

As part of risk self assessment, the controls in place at Mediolanum Banking Group companies are reviewed to assess their completeness and effectiveness also in relation to the tools used.

No material aspect emerged from controls carried out.

Over 2,500 operational risk checkpoints were identified within the Mediolanum Banking Group. About 74% of checkpoints were judged to be adequate or in need of being just better formalised.

The Operational Risk Management Unit staff also focused on putting in place risk mitigation and enforcing it in certain instances to improve existing controls, enhance their effectiveness and reduce potential operational risk sources. In 2009 over 100 operational risk mitigation actions were taken within the Mediolanum Banking Group.

### 13. EQUITY EXPOSURES

Equity exposures include either listed or unlisted equity instruments, controlling or non-controlling equity holdings. Equity instruments classified as 'Financial Assets Held for Trading' are equity instruments held for trading purposes and are measured at fair value. If they are quoted in an active market<sup>1</sup> their fair value is determined using their market quotation. If the market for the equity instrument is not active, fair value is determined using estimation and valuation techniques which measure all instrument-related risks and use market data, e.g. the quoted price of instruments with similar characteristics, discounted cash flow analysis, option pricing models, recent comparable transactions.

Equity instruments classified as 'Available for Sale Financial Assets' consist of non-controlling interests. On initial recognition available-for-sale financial assets are measured at cost, i.e. the fair value of the instrument, plus any directly attributable transaction costs or income. After initial recognition available-for-sale financial assets continue to be measured at fair value, and are amortised through profit or loss, while gains or losses arising from a change in their fair value are recognised in a specific equity Reserve until the financial asset is derecognised or impaired. At the time of dismissal or impairment, the cumulative gain or loss previously recognised in equity is recognised in the income statement. Equity instruments whose fair value cannot be reliably measured as set out above are measured at cost.

Equity holdings in subsidiaries and associates are carried at cost.

<sup>(1)</sup> A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from an exchange, dealer, broker, industry group, pricing service or regulatory agency and those prices represent actual and regularly occurring market transactions on an arm's length basis.



If there is evidence that an equity holding may be impaired, its recoverable amount is calculated by estimating the present value of future cash flows expected to be generated by the equity holding, including the proceeds on its ultimate disposal. If the recoverable amount is lower than the carrying amount, the resultant difference is recognised in the income statement. If the value of a previously impaired equity holding increases and the increase can be objectively related to an event occurring after the impairment loss was recognised, the impairment loss is reversed and the reversal recognised in the income statement.

Table 13.1 - Analysis of equity exposures

|                           |            |            | At December 31, 2009               |
|---------------------------|------------|------------|------------------------------------|
| €/000                     | Book Value | Fair value | Gains/losses<br>for the period (*) |
| <b>Held for Trading</b>   |            |            |                                    |
| equity instruments        | 10         | 10         | (27)                               |
| <b>Available for Sale</b> |            |            |                                    |
| equity instruments        | 328        | 328        | -                                  |
| non-controlling interests | 11,117     | -          | 483                                |
| <b>Investments</b>        |            |            |                                    |
| controlling shareholdings | 375,185    | -          | (7,885)                            |

(\*) For equity instruments in the HFT portfolio these are trading profits/losses; for non-controlling interests these are dividends received, while for controlling shareholdings these are

## 14. INTEREST RATE RISK IN THE BANKING BOOK

Interest rate risk is the risk of potential impact of unexpected interest rate changes on the Bank's current earnings and equity. This risk is typical of banking book positions.

The Banking Book consists of on and off-balance sheet items that are not held for trading.

The goals pursued by the interest rate risk management system are to:

- ensure the stability of net interest income, minimising any adverse impact of changes in interest rates (earnings perspective), largely with near-term focus. The stability of net interest income is mainly influenced by re-pricing risk, yield curve risk, basis risk, re-fixing risk and optionality risk;
- protect the economic value, i.e. the present value of expected cash flows from assets and liabilities. The economic value perspective is focused on the potential medium/long-term effects of changes in interest rates and is mainly associated with re-pricing risk;
- ensure that interest rate risk that has been taken or can be taken be properly identified, measured, monitored and managed in accordance with uniform methods and procedures shared across the Group;
- make sure that risk measurement models are commensurate with actual earnings generated by the various risk owners;
- ensure that the quality of risk measurement and management systems is aligned with market standards and best practices;
- define risk limits and licences for the various levels of responsibility;
- ensure the generation of accurate data and reports by the various officers responsible for risk management and control at the different levels within the organisation;
- ensure compliance with requirements established by domestic and international supervisory authorities.

The definition of limits and licences reflects the risk appetite of the organisation and permits to control that practices at the various levels within the organisations are aligned with the strategic guidelines and policies adopted by the Board of Directors.

The application of principles above led to the definition of the following indicators:

- **net interest income sensitivity** to parallel shifts in the yield curve;
- **economic value sensitivity** to parallel shifts in the yield curve.

Management of the interest rate risk in the banking book is part of Asset Liability Management (ALM). The Mediolanum Banking Group has in place an ALM system that measures performance of Net Interest Income for annual reviews and the Bank's Economic Value in relation to regulatory capital. The ALM system is also used by management to assess the impact of funding and lending policies on the entity's financial condition and earnings.

On a quarterly basis, the Financial Risk and Credit Risk Management staff prepare summary reports on overall interest rate risk exposures and stress test reports for the Board of Directors and Senior Management.

Stress tests are conducted applying the rate shocks scenarios set out in the relevant internal policy.

The main currency denomination of Mediolanum Banking Group exposures is the Euro; the value of positions in other currencies is not significant and therefore they were translated into Euros and grouped together with other euro-denominated items.

Table 14.1 - Interest Rate Risk Indicators

| Shift (+/-) | At December 31, 2009          |                              |
|-------------|-------------------------------|------------------------------|
|             | Effect on net interest income | Effect on regulatory capital |
| Eur + 100bp | 2,245                         | -                            |
| Eur - 100bp | (17,183)                      | -                            |
| Eur + 200bp | -                             | 47,977                       |
| Eur - 200bp | -                             | (57,149)                     |

