BANCA POPOLARE DI MILANO

Milan, November 15th 2016

Dear Madams/Sirs,

BPM Group recognises the importance of addressing the issue of Non Performing Exposures (NPEs/NPLs): we share the objectives of a substantial reduction of Non Performing Exposures in the banking industry across the European Union, and the Euro-area in particular.

BPM is aware that high levels of NPEs/NPLs impact on profitability, funding costs, and long-term sustainability of lending operation, and to that end, it welcomes the Guidance as an important commitment from ECB to provide EU banks with a harmonised set of qualitative guidelines for NPL reduction.

However, the strategic, organizational and operational approach offered in the Guidance presents a number of improvement points. This note summarizes BPM's main comments on the Draft Guidance; a more detailed set of considerations is provided in the attached table.

1. From a **strategic** perspective, BPM is concerned about the macroeconomic impact that accelerated programs of NPLs reduction, particularly those centred on significant disposals, may entail, especially in those countries that have registered a surge in the stock of non-performing assets due to the economic toll inflicted by the crisis, and at the same time experience slow judicial recovery processes. As a matter of fact, a great number of distinguished economists and Authorities, including senior ECB representatives, have recognised that the solution to the NPL backlog may take time, and that success of the operation will depend crucially on how the banking sector's effort is matched by a proportionate reaction by the secondary market and specialised investors, as well as complemented by legal and judicial reforms aimed at establishing a real "level playing field" among Euro-area players in the NPL recovery business. An important contribution to the issue may stem from a more equilibrated balance of power between Banks, as sellers, and NPL investors, as potential buyers, which is more likely when a progressive disposal program is generated as the result of a responsible choice adopted by Bank's management body, within an appropriately phased strategy aimed to achieve the desired NPL reduction.

Furthermore, accelerated disposals imply significant transfer of value from Bank's shareholders to NPL buyers; BPM believes there is no evidence that such buyers are able to produce tangible differences in the outcome of the recovery processes as compared to situations where NPL workout operations remain internalized within the Banks/are executed by specialized servicers

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via performance-based SLA contracts. For this reason, in the context of slow economic recovery, underdeveloped distress debt markets and narrow space for public intervention, BPM would welcome a more flexible approach in setting reduction targets to avoid systemic distress.

2. From an **organizational** perspective, we fully recognise the importance of creating dedicated workout units for the management of NPLs and clear all possible conflicts of interest, and for this reason we welcome the separation between credit origination/underwriting and NPL management; however, the prescription of separate workout units according to NPL life-cycle and different portfolios appears to be excessively rigid, and not clearly specified to a certain extent. The importance of this separation principle calls for adequate margins of discretion in deciding how to apply and translate it into Banks' organizations. For example, Banks may introduce concepts of functional, as opposed to hierarchical, dependence as far as management of "Unlikely to Pay" is concerned, where the strategy is still focussed on restoring borrower's ability to repay its obligations – also by means of restructuring agreements – whilst those loans which are managed in a liquidation/workout attitude may call for a more formal organizational segregation.

3. As far as the **operational** aspects are concerned, BPM notes that the indications contained in the Draft Guidance are extremely detailed and require an impressive level of granularity in terms of data collection, as well as the creation almost from scratch of indicators and processes. The Draft Guidance might therefore end up imposing a significant burden on IT infrastructures and internal procedures, and substantive constraints on the organisational setup of the bank; at the same time, it could introduce a high level of rigidity and prescriptiveness in the management of NPL portfolios, which may turn out to result counterproductive with respect to the long-term objective to reduce overall NPL ratio.

Based on the above considerations, BPM would respectfully point out that the costs entailed in the provisions included in the Guidance may result not fully proportionate to the potential benefits. In particular, BPM would like to highlight three main areas of concern, which in general would call for the adoption of a more principle-based, less prescriptive and detail-oriented approach:

- first of all, BPM notes that the **level of automatism envisaged by the triggers** for the classification of forbearance measures and NPEs seems disproportionate, and might represent an obstacle against the objective to streamline the recognition processes. On the contrary, in our view a lack of flexibility in the assessment of individual circumstances could prove counter-productive, and ultimately push the debtor in even bigger difficulties. BPM is afraid that the foreseen provisions on the viability of forbearance measures prefigure an excessively punitive treatment for clients already facing difficulties.

- Secondly, BPM finds that the frequency of **valuation of immovable property** might be excessive. In fact, each requested update would add minimal additional information, vis à vis entailing extremely high costs. Furthermore, the threshold for indexed valuation (Eur

300,000 in terms of exposure) seems too low and would trigger material changes in Banks' internal processes, as well as impose significant operational costs; it would be highly desirable to extend the possibility to use automated/indexed valuation techniques also for exposures exceeding this threshold.

- Lastly, BPM is concerned that the **supervisory reporting and public disclosure requirements** contained in the Guidance might determine an excessive burden on the banks, not necessarily matched by material benefits for the effectiveness and efficiency of the NPL reduction goals. In our opinion, it is desirable that all further supervisory and disclosure reporting requirements are set in accordance to the procedures contained in the Regulation 575/2013; in this regard, BPM would welcome full consistency among the various instructions deriving from different Regulatory Bodies.

For all these reasons, BPM would welcome a greater attention from Supervisors towards the country-level conditions and existing national legal systems, in order to avoid potentially disruptive outcomes (e.g., fire-sales) due to a lack of flexibility in setting the target for a viable reduction of NPLs.

Finally, BPM notes that the current Draft Guidance does not provide an implementation **timeframe**; in our opinion, this timeframe should be **carefully calibrated**, given the material compliance efforts that are demanded, especially for the institutions' governance and IT systems. In this respect, ECB could clarify its expectations on the Guidance implementation timeline, highlighting those provisions which should be fast-tracked and those which, instead, should be intended as a set of general indications with a lower degree of prescriptiveness.

Once again, we would like to express our gratitude for being given the opportunity to comment on this very important initiative.

Yours faithfully,

Banca Popolare di Milano S.c. a r.l

(The Chief Risk Officer)

Edoardo Ginevra

Template for comments

Consultation on the draft ECB Guidance for banks on non-performing loans

Please enter all your feedback in this list.

When entering your feedback, please make sure:

Deadline:	15 November 2016

ID	Chapter	Section	Page	Type of comment	Detailed comment	Concise statement why your comment should be taken on board
1	1 - Intro	1.2	6	Amendment	On September 28th the EBA published the guidelines on the definition of default under Article 178 of Regulation (EU) n° 575/2013. Further clarifications of the definition of default and its application is provided in these Guidelines, which cover key aspects, such as the days past due criterion for default identification, indications of unlikeliness to pay, conditions for the return to non-defaulted status, treatment of the definition of default in external data, application of the default definition in a banking group and specific aspects related with retail exposures. The EBA ITS guidelines shall enter into force in January 2021. Therefore, banks are going to change their definition of default in the next years and the amount of their NPL portfolio will change accordingly. Since each strategy or plan that a bank can implement to manage NPL is first of all dependent on NPL definition, it should be considered to align the deadline for NPL guidance application to the one for the implementation of EBA guidelines on definition of default (i.e. January 2021) or least foreseen a phase-in period for NPL guidance application.	Institutions have to work to implement EBA guidelines on default definition by January 2021. The application of the present document should take into account that the NPL portfolio will change according to the implementation of the new default definition and therefore the deadline for the present document implementation should be aligned to the one foreseen by EBA.
2	2 - Strat	2.1 - 2.6	from 7 to 16	Amendment	The proposed definition will have a significant impact on financial institutions, depending on the distance of the proposals from the current arrangements . Given that the new provisions are, in some cases much stricter and elaborated than the current ones, we would like to stress that the full implementation of the Guidance needs an appropriate timeframe. In addition to the previous remarks, common to all banks, the whole banking sector will need sufficient time to recalibrate its own operating model, create new structures dedicated to NPL portfolio (involving a significant number of technical and human resources), revise internal policies and updated the related NPL time series. The NPL guidelines should therefore not enter into force before the mandatory application date of the IFRS9 and the implementation of "Guidelines on the application of the definition of default under article 178 of Regulation (EU) No 575/2013", which will apply from 1 January 2021.	Significant impact on Bank's operating model. Request to define the implementation date post 01.01.2021 (date of entry into force of the new default definition as to IFSR 9)
3	2 - Strat	2.2.2	9	Clarification	Sustainable NPL reduction may take time and depends crucially on market expectation, development of secondary market for distressed debt, and benchmarking analysis, as well as being influenced by national laws (e.g. insolvency procedures, tax incentives) . In order to attain a true level-playing field among Euro-area institutions, sellers (banks) should engage NPL buyers on the basis of a fair and autonomous exchange, without being "pushed" to dispose of their NPL portfolios, which may come with high cost for their viability.	Necessity to avoid hasty sales of NPLs portfolio, which could greatly hurt the values on banks' loan portfolios and hamper the long-term sustainability of NPL reduction target.
4	3 - Gov	3.2	17-18	Clarification	The Guidelines specify that the approval and the monitoring of the institutions' NPL strategy should be performed by the management body. Furthermore, the management body is expected to dedicate an amount of its capacity to NPL workout related matters proportionate to the NPL risks within the bank. Thus, the Guidelines ultimately assign to the management body (defined as in art 3(8) of the CRD IV as the body empowered to set the institution's strategy, objectives and overall direction, and which oversee and monitor management decision making) three functions: the strategic function , the control/oversight function, and the executive function over the NPL strategy. However, clarification on supervisory expectations is paramount, given the different existing models of governance of each individual institution.	Necessity to clarify further the different roles and responsibilities pertaining to the management body , keeping in mind that different jurisdictions prefigure different corporate governance models.
5	3 - Gov	3.3	18-25	Amendment	The Guidelines ask high-NPL banks to set up different WUs according to NPL life cycle and different portfolio. While we recognised the importance of creating dedicated workout units for the management of NPLs and we understand the desire of clearing all possible conflicts of interest, the approach to segmentation appears to be too prescriptive and very impactful on both the organisation and the IT requirements of the banks. Furthermore, the Guidelines request the implementation of strict hand-over triggers which allow minimal discretion for the single institutions. From an organisational and IT point of view, these requirements would be too cumbersome and carry little expected benefits. We believe that decision on separation should be left to individuals banks, upon ensuring that the potential conflict of interest has been duly addressed.	The degree of granularity and the minimal discretion left to banks in setting WUs and hand-over trigger is disproportionate and excessively costly.
6	4 - Forb	4.2	38-39-40	Clarification	Chapter n. 4 will impact greatly on the recent forbearance process adopted by the Bank. In particular, the Guidelines envisage two new concepts concerning forbearance measures, which were not indicated in the EBA ITS on forborne exposures: • Viable Vs Non Viable Forbearance; • Short Term Vs Long Term measures. The implementation of these two concepts will be challenging in terms of cost and time, since they require a deep analysis of the historical forbearance time series and the related monitoring processes in order to assess if a specific forbearance measure is to consider viable or not. Concerning the concession of a double measure, the guidelines consider not viable a second short-term forbearance measure. This aspect could influence negatively the current banks relationship with their clients, in particular in case they are included in retail/small business portfolio, where is common to grant these kind of measures during the original repayment schedule (moratorium interest only) without consider any long-term initiatives.	Viable Vs Non Viable - Short vs Long measures. Standardized approach could create difficulties with client relationship (small accounts).

7	4 - Forb	4.5	45	Clarification	The Guidance requires a much deeper analysis and relative disclosure of forbearance portfolios, as it asks for granular information which currently is not at the bank's disposal. This request will impact significantly on IT system dedicated to forbearance portfolio classification and management. It will require to update the historical series and to record more granular information (nowadays not available), in term of type of measures granted, measures duration and NPV impact of forborne exposures.	Significant impact on disclosure/reporting on forbearance portfolio.
8	5 - Recog	5.2.2	53	Deletion	Stand still agreements are measures considered as an automatic trigger for the recognition of an exposure as non-performing. We do not consider the latter as an impairment trigger, because those kind of agreements are only a confirmation of the actual credit lines to the client. Therefore, stand still agreements do not represent necessarily an impairment trigger.	Stand still agreements are not an impairment trigger.
9	5 - Recog	5.3.1	54	Clarification	To identify the conditions of financial difficulties of a debtor, the guidelines provide, among others, two indicators that have not been introduced so far: the increase of PD of internal rating and the presence in watch-list. Given their novelty, further clarification on the expectation of the ECB are requested.	Could banks use also internal rating for the identification of financial difficulties? It is necessary to clarify the concept of watch list. Which is the definition of watch list?
10	5 - Recog	5.3.1	55	Deletion	NPL guidance requests an assessment of financial situation of a borrower always when the client request changes to the contractual conditions. This approach seems to be very heavy with respect to the actual process of identification of forborne exposure. It seems not to be aligned with EBA ITS because the identification of forborne is the concession of a forbearance measures as described in ITS EBA and not a general modification of the contractual conditions.	Identification of financial difficulties not in line with ITS EBA
11	5 - Recog	5.3.2	56	Amendment	Classification as non-performing at the concession date: how can a bank evaluate "inadequate payment plans which encompass a repeated failure to comply with the payment plan, changes to the payment plan to avoid breaches, …" at the concession date if it is the first request of forbearance measure? This criterion could be applicable only for subsequent forbearance measures. Why exposures with grace periods of more than two years for repayment of the principal should classify as non-performing at the concession date? This approach seems to be too strict in order to identify non-performing exposures.	Correct classification as non-performing at the concession date.
12	5 - Recog	5.3.4	58	Deletion	The following paragraph seems not applicable to performing forborne: "for this purpose, the entity's policies should require the borrower to have settled, by means of regular payments, an amount equal to the entire amount (principal and interest) that was past due or de-recognised at the time of the concession; otherwise, the exposure remains classified as non-performing."	Unclear paragraph regarding non-performing forborne attributed to performing forborne.
13	7 - Coll	7.2.2	86	Clarification	Another aspect mentioned by the NPL draft is the assessment of the appraisal's internal/external independence, foreseeing internal procedure for a challenging on the real estate valuation. The challenging on the real estate value is a concept that could appear incoherent considering the aspects reported below: • the high reappraisal frequency suggested, which leads the real estate portfolio to have a market value constantly updated; • the prudential haircut adopted by banks during the credit file review, which often reflect a valuation not updated; • the property value represents an outcome provided by an independent qualified appraiser.	Internal challenging could appear incoherent respect to the new collateral valuation process
14	7 - Coll	7.2.2	86	Clarification	The guidance requests the banks to develop and implement a robust quality assurance to monitor and review the individual valuations. However, the regulatory expectations on this quality assurance process are not completely clear and a clarification is needed. In particular, the banks are requested to check individual valuation against market observations and perform back-testing on a regular basis. Regarding the comparison with market observations, it is worth noticing that with such a high revaluation frequency this comparison could be of little interest, since real estate market prices are not very fast-moving. Regarding the back-testing of valuation, the guidance requests the banks to check the last valuation before classification as NPL with the net sale price of the collateral. In this case it should be considered that these two values are related to two different goals, as the sale price can be affected by the haste in selling the property in order to get a recovery, so it can be very different from the market value; in particular the sale price is directly affected by the specific policies and strategy in place by the bank (potentially driven by Supervisory guidance) for recovery purposes: in this view the impact of such strategy should be taken into account in setting this back-testing requirement.	Regulatory expectations on the comparison of individual valuations with market observations and sale prices are not clear. With such a high frequency of revaluation, the comparison with market observation could be redundant. On the other hand, individual valuations before default event and the sale prices could be affected by recovery strategy followed by the bank and not always stable through time.
15	7 - Coll	7.2.3	87	Amendment	The guidance introduces a 300.000 € cap to identify loans for which an indexed collateral valuation can be performed. On the contrary, if this threshold is breached the collateral valuation can be performed only by means of individual valuations defined as property-specific appraisals not based on any automated process. The proposed threshold is extremely low and it would trigger a significant change in the internal processes of the bank together with high operational costs to bear in order to cover almost entirely the collateralized portfolio with external appraisals. The added value of this massive property-specific re-valuation is deemed as immaterial, since an indexed valuation can be effective if performed by means of sufficiently granular indexes and if referred to secondary market sufficiently contributed for standardised properties. Nonetheless in case of significant value reduction coming from indexed revaluation, updated physical appraisal are performed, as provided by the current regulation. The threshold should be increased / the scope of physical revaluation limited to specific conditions.	The proposed threshold for indexed valuation is too low, forcing banks to bear higher costs with little benefit in return.

16	7 - Coll	7.3	89	Clarification	Banks should update individual valuations at a minimum every year for commercial properties and every three years for residential property. This provision is intended in several sections of the guidance for NPL loans only; nevertheless in section 7.3 the above statement is not accompanied with a clarification of the minimum thresholds of 3 MLN € exposures (as currently foreseen by regulation below such threshold indexed methods are admitted). It is worth specifying the scope of application of the frequency prescribed. Finally, in case of individual valuation performed in the last 12 months, an indexed revaluation (for few months updating) seems of limited value.	Better clarify the scope of application of the frequency intended for individual revaluation in order to avoid misunderstanding in the concrete implementation of the guidance.
17	Annex - 7	Table 5	121	Clarification	Table 5 d. requires to expose the "NPV impact of exposures forborne in the past 6/12/24 months". Is the NPV value to be reported in this table to be calculated in compliance with the IFRS accounting principles?	Need for clarification to determine whether the methodology to produce the disclosure is consistent with IFRS.