NORTHERN TRUST

June 3, 2016

Via e-mail

Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
E-mail: regs.comments@federalreserve.gov

Re: Single-Counterparty Credit Limits for Large Banking Organizations; Proposed Rule (RIN 7100-AE 48)

Dear Mr. Frierson:

Northern Trust Corporation ("Northern Trust") greatly appreciates the opportunity to offer its support and provide comments on the Board of Governors of the Federal Reserve System's (the "Federal Reserve") re-proposal (the "Re-Proposal") of single-counterparty credit limits ("SCCL") for domestic and foreign bank holding companies with total consolidated assets of $50 billion or more ("covered companies"), as required by section 165(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1]

Northern Trust is a global custody bank with, as of March 31, 2016, approximately $118 billion in total consolidated assets, assets under custody of $6.2 trillion, and assets under management of $900 billion. Northern Trust provides a number of custody services important to the proper functioning of the financial markets to its clients, which include employee pension funds, mutual funds, institutional investors and asset managers. These services include: the safekeeping of assets and securities; the settlement of securities transactions; payments processing; various investment fund administration services (including the redemption and subscription of fund shares); and ancillary services such as foreign exchange trading (predominantly spot activity) and securities lending (acting as agent on behalf of Northern Trust's clients).

This letter is being submitted to present issues of specific interest to Northern Trust and its business, as well as to support certain trade association and industry comment letters. In particular, we request the following revisions to the Re-Proposal:

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[1] Federal Reserve, Single-Counterparty Credit Limits for Large Banking Organizations, 81 Fed. Reg. 14328 (March 16, 2016).

(1) foreign demand deposits associated with custody services should be excluded from the SCCL's exposure calculation; (2) the calculation of the $10 billion foreign exposure threshold that triggers application of a more stringent version of the rule should exclude foreign demand deposits associated with custody services; and (3) the final rule should include exemptive authority that allows the Federal Reserve to tailor application of the final rule to the extent appropriate in light of particular business models and practices and the policy objectives of the Re-Proposal. We think these revisions, described in Sections I, II and III below, are important to allow the continued provision of custody services. Importantly, as we explain below, we do not think the revisions we request would contravene the policy purposes of the Re-Proposal.

Finally, in Section IV below, we provide support for certain comments made in other trade association letters.

I. The Federal Reserve should exclude foreign demand deposits that are associated with custody services.

As a result of securities ownership, cash deposits denominated in a foreign currency are often received from custody clients. In order to accommodate its clients, Northern Trust holds demand deposit accounts with sub-custodian banks in jurisdictions where it does not self-custody. These demand deposits naturally follow from the lifecycle of a client's securities ownership, which entails dividend distributions, purchases and sales, and a general need to hold the cash associated with these events. Consequently, custody clients that hold securities accounts with Northern Trust also hold cash accounts with us. Because of the significant operational and risk management advantages of holding a securities account and associated cash account with the same institution, many custodian banks (including Northern Trust) offer their custody clients operational deposit accounts. From the client perspective, using a single institution for both securities and cash accounts enables a client to simplify and more efficiently monitor its risk management activities.

Under the Re-Proposal, the "due-from" demand deposits that Northern Trust holds with foreign sub-custodians to facilitate client securities transactions would need to be aggregated along with other credit exposures that Northern Trust has to the sub-custodian. If Northern Trust were to face restrictions on the amount of foreign cash deposits it could hold on behalf of a client (*i.e.*, because such deposits implicate the SCCL in respect of the sub-custodians), it may have to implement a large internal buffer to avoid an inadvertent exposure violation to a given sub-custodian in a certain market under SCCL. This action would then limit the ability of Northern Trust to receive and hold foreign currency cash deposits placed at the discretion of our clients, therefore curtailing our ability to provide global custody services and fragmenting the client's custodial banking relationship between two or more banks. In such a case, clients transacting in that market would need to find a separate bank to hold their cash deposits. In sum, the inability to hold both a client's securities account and the associated cash account with the same institution creates significant operational challenges, risk management issues, and limits the ability of Northern Trust and the client to have a single view of its securities and cash positions.

In order to avoid this result, Northern Trust requests that the Federal Reserve exclude foreign demand deposits that occur as a result of the custody services model from the SCCL. This exclusion would be consistent with the European Union's large exposure framework, which exempts certain short-term exposures, including exposures in connection with (1) the ordinary course of securities settlement during the five working days following payment or delivery of the securities[2] and (2) delays in the receipt of funding arising from the provision of clearing, settlement and custody services to clients.[3]

The exclusion would appropriately recognize that these types of demand deposits are held for the benefit of clients on a temporary, interim basis to facilitate purchases and sales of securities, as well as cash distributions, including dividends and coupon payments, and thus generally should not be considered part of a covered company's counterparty exposures. Further, the exclusion also would ensure globally consistent regulatory treatment and remove a component from the SCCL that could interrupt the provision of critical custody services and impede risk management practices of Northern Trust's clients. For these reasons, we do not believe the exclusion would contravene the Re-Proposal's policy objective. In particular, we view the exclusion as substantively similar to the proposed exclusion of intra-day exposures, which the Federal Reserve notes is intended to "minimize the impact of the rule on payment and settlement of financial transactions."[4] Excluding foreign demand deposits associated with custody services would serve to further reduce the impact of the SCCL on payment and settlement services.

We strongly believe the exclusion requested above is necessary and appropriate. Nevertheless, to the extent the Federal Reserve does not include such an exclusion in the final rule, we would support the enhanced use of the SCCL "cure period," as recommended in the letter to the Federal Reserve from The Clearing House Association L.L.C., the American Bankers Association, the Financial Services Roundtable and the

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2 The Federal Reserve's Regulation Q includes a provision that embodies a similar concept. Specifically, under Regulation Q, a banking organization is not required to hold risk-based capital against certain delivery-versus-payment (DvP) or payment-versus-payment (PvP) transactions with a "normal" settlement period, so long as the banking organization's counterparty makes delivery or payment within five business days after the settlement date. *See* 12 CFR 217.38(d).

3 *See* EU regulation No. 575/2013 of the European Parliament and the Council of 26 June 2013 on Prudential Requirements for Credit Institutions and Investment Firms and Amending Regulation EU No. 648/2012, CRR Article 390(6).

4 81 Fed. Reg. at 14343.

Securities Industry and Financial Markets Association regarding the Re-Proposal (the "Joint Trade Association Letter") for certain short-term credit exposures. We think using an enhanced cure period to address the issue is not ideal, however, because the inclusion of foreign demand deposits may produce exposure breaches that, although uncommon, would occur with greater frequency than the other events that may trigger the 90-day cure period. In addition, although Northern Trust agrees with the cure period prohibition on entering into additional credit transactions with an exposure-exceeding counterparty, we believe that applying the prohibition to short-term credit exposures would serve to fragment a client's custodial servicing and risk management practices and disrupt broader securities markets.

II. The calculation of the $10 billion foreign exposure threshold for applicability also should exclude foreign demand deposits associated with custody services.

The Re-Proposal would apply more stringent requirements to covered companies having $250 billion or more in total consolidated assets or $10 billion or more in on-balance-sheet foreign exposure (the "advanced approaches thresholds"). For example, a covered company that meets either of those thresholds would be required to calculate its credit limits based on an eligible capital base of tier 1 capital rather than "total capital stock and surplus." Under the Federal Reserve's regulatory capital rules, on-balance sheet foreign exposure is measured by reference to a banking organizations' most recent year-end FFIEC 009 Report.[5] Under that methodology, the $10 billion foreign exposure threshold includes deposits held by a banking organization at foreign banks. As described above, Northern Trust holds demand deposits at sub-custodians from clients in order to fulfill its obligations as custodian. We do not believe that these deposits present the types of risks that should result in Northern Trust being subject to the more stringent version of the Re-Proposal. For this reason, we urge the Federal Reserve to remove such deposits from the calculation of the $10 billion foreign exposures threshold for purposes of the SCCL.

The Federal Reserve uses the $10 billion foreign exposures threshold as a trigger for application of the advanced approaches capital rules. The advanced approaches capital rules have been described by Federal Reserve staff as designed to address the "reduced effectiveness" of the standardized approach "for the largest internationally active banking organizations that offer ever more complex and sophisticated products and services in a competitive global environment."[6] In particular, Federal Reserve staff noted

5 *See* 12 CFR § 217.100(b)(1). We note that the Re-Proposal does not define "on-balance-sheet foreign exposure," but we assume the Federal Reserve's intent was to align the definition with the regulatory capital rules.

6 Staff Memo to the Board of Governors, *Implementation of Advanced Capital Adequacy Framework (Basel II Draft Final Rule)* (Oct. 26, 2007) at p. 5, *available at* http://www.federalreserve.gov/generalinfo/basel2/FinalRule_BaselII/Board_memo.pdf.

that the standardized approach rules "are particularly inadequate for dealing with capital markets transactions, such as repurchase agreements, securities borrowing and lending, margin loans, and over-the-counter (OTC) derivatives."[7]

Offering traditional custody services and providing clients with cash deposit accounts to hold cash throughout the lifecycle of securities ownership – a traditional banking service – would not appear to be implicated by the concerns of complex capital markets activity. Thus, we think applying the more stringent version of the Re-Proposal on the basis of the pre-existing framework set forth by the advanced approaches methodologies is inappropriate. Consequently, Northern Trust requests that the Federal Reserve exclude such deposits from the calculation of the threshold for purposes of the SCCL.

III. The Federal Reserve Board should reserve flexibility to tailor application of the final rule.

Although the Re-Proposal grants the Federal Reserve the authority to exempt exposures from the SCCL,[8] the Re-Proposal does not explicitly provide the Federal Reserve broader authority to tailor application of the rule. We urge the Federal Reserve to include regulatory exemptive authority in the final rule that would provide explicit flexibility for tailoring the rule for a particular covered company based on the company's risk profile. We believe that this type of exemptive provision would provide flexibility that would help avoid impeding transactions that may fall under a plain reading of the rule, but do not raise the concerns the Re-Proposal is intended to address, such as those transactions described above in Sections I and II.[9]

IV. Support for Trade association and other comments

In addition to the comments set out above, we support various comments made in trade association comment letters and highlight below three particular issues: the exposure calculation for "repo-style" transactions; the treatment of sponsored and advised investment funds as a "subsidiary" of a covered company; and the "look-through"

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[7] *Id.*

[8] Re-Proposal § 252.77(c).

[9] This type of exemptive provision would be consistent with the approach the Federal Reserve has taken in other regulations. *See, e.g.*, 12 CFR 217.100(c) (providing a "principle of conservatism" for application of the advanced approaches portion of Regulation Q that permits a banking organization to not calculate capital under the advanced approaches for certain exposures, providing certain conditions are met, including that the banking organization "appropriately manages" the risk of such exposures and provides prior notice to the Federal Reserve); 12 CFR 252.153(c) (providing the Federal Reserve authority to permit foreign banking organizations that are subject to a U.S. intermediate holding company requirement to use an alternative organizational structure under Regulation YY).

requirement applicable to covered companies that meet one of the advanced approaches thresholds. Our discussion of these issues is brief; we refer the Federal Reserve to the comment letters cited below for a more complete discussion of the issues.

A. Exposure Calculation for Repo-Style Transactions

The Re-Proposal would require a covered company to calculate net credit exposure for repo-style transactions with a counterparty subject to a bilateral netting agreement by using the collateral haircut approach set out in the Federal Reserve's Regulation Q, pursuant to which covered companies would be required to use standard supervisory haircuts.[10] The Re-Proposal would not permit agent banks to measure such exposure using any of the other methods available under Regulation Q, including the internal models or simple VaR methodologies or the methodology proposed by the Basel Committee in its December 2015 consultation on "Revisions to the Standardised Approach for credit risk."[11]

Northern Trust supports each of the recommendations on this aspect of the Re-Proposal set forth in the comment letter from the Securities Lending Committee of the Risk Management Association and the joint letter from State Street Corporation, The Bank of New York Mellon Corporation and Northern Trust. In particular, Northern Trust agrees that:

- The Federal Reserve should adopt the Basel Committee's proposed methodology for measuring exposures to repo-style transactions.
- The Federal Reserve should allow a more flexible range of approaches for measuring exposures to repo-style transactions until such time that it decides whether to adopt the Basel Committee proposal for the purposes of the Federal Reserve's regulatory capital rules.
- The definition of "eligible collateral" should be made consistent with the definition of "financial collateral" under the Federal Reserve's regulatory capital rules.

B. Aggregation of Sponsored and Advised Funds

The Re-Proposal would apply on a consolidated basis to a covered company and all of its subsidiaries, which includes all entities the covered company directly or indirectly controls based on Bank Holding Company Act ("BHC Act") standards.[12] The

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10 *See* Re-Proposal § 252.74(b).

11 *See* 12 CFR § § 217.132(b)(3), (d).

12 81 Fed. Reg. at 14331.

preamble to the Re-Proposal asks whether the proposed definition of "subsidiary" should be expanded beyond the normal BHC Act definition to include any investment fund or vehicle advised or sponsored by a covered company.[13] Northern Trust believes that such an expansion is unwarranted and inconsistent with the underlying policy objectives of the SCCL. Accordingly, Northern Trust supports re-defining a covered company by adopting the U.S. GAAP financial reporting consolidation in an effort to ensure consistency with the regulatory capital rules already in effect.

Further, in all events, Northern Trust supports the recommendations in the Joint Trade Association Letter that the term "covered company" should exclude registered investment companies, foreign public funds and Volcker Rule covered funds operated pursuant to the asset management exemption, including during a permitted seeding period when a covered company may hold 25 percent or more of such a fund's voting shares. This exclusion, as explained in the Joint Trade Association Letter, would be consistent with the Federal Reserve's final regulations implementing the Volcker Rule and guidance issued thereunder.[14]

C. Look-Through Requirement

The Re-Proposal would require a covered company that meets one of the advanced approaches thresholds to calculate its gross credit exposure to each issuer of assets held by a securitization vehicle, investment fund or other special purpose vehicle ("SPV") if it is unable to demonstrate that its gross credit exposure to each issuer, based only on the exposures arising from its investment in such securitization vehicle, investment fund or SPV, is less than 0.25 percent of the covered company's eligible capital base.[15] If a covered company is required to conduct such a "look-through," but is unable to identify each issuer of assets held by the securitization vehicle, investment fund or other SPV, then the covered company must attribute its gross credit exposure to a single unknown counterparty.[16] Northern Trust is concerned that that proposed look-

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13 *Id.*

14 *See* 12 CFR § 248.2 (excluding covered funds from the Volcker Rule's definition of the term "banking entity"); 12 CFR § 248.10(c)(12) (excluding registered investment companies and seeding vehicles for registered investment companies from the Volcker Rule's definition of the term "covered fund"); See Volcker Rule FAQ #14, available at http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#14 (recognizing that "unlike in the case of U.S. registered investment companies, sponsors of foreign public funds in some foreign jurisdictions select the majority of the fund's directors or trustees, or otherwise control the fund for purposes of the BHC Act by contract or through a controlled corporate director," but nevertheless determining that such a fund should not be deemed a "banking entity" that is subject to the Volcker Rule).

15 Re-Proposal § 252.75(a)(3).

16 Re-Proposal § 252.75(b)(2).

through approach is overbroad and unworkable as proposed. Northern Trust therefore supports each of the recommendations on this aspect of the Re-Proposal set forth in the Joint Trade Association Letter. In particular, Northern Trust agrees that the Federal Reserve should revise the Re-Proposal as follows.

- Exempt from the look-through requirement exposures to retail asset-backed securities, pools of finance receivables in which the underliers are comprised of small business borrower receivables, commercial mortgage-backed securities and other well-diversified funds or vehicles. The underliers of these funds and vehicles would be highly unlikely to approach the relevant credit limits and, therefore, should be exempt.

- Require the look-through only in cases of exposures arising from a covered company's investment in or extensions of credit or liquidity facilities to a securitization vehicle, investment fund or other SPV. At a minimum, if the look-through approach is required to apply more broadly, exemptions should be available for exposures relating to the provision of services under a custody or equivalent arrangement.

- Modify the mechanics of the look-through approach to: (1) apply only to exposures that exceed the 0.25 percent materiality threshold; (2) permit reliance on prospectus information in conducting the look-through; and (3) reduce the look-through frequency to coincide with the availability of information from disclosures from a fund or vehicle.

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If the Federal Reserve would like additional information regarding these comments, please contact Ryan P. Hayden at (312) 444-3285 or via e-mail at rph1@ntrs.com.

Respectfully submitted,

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