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November 19, 2020

Via Electronic Mail
Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551
Docket No. R-1724; RIN 7100-AF95

Re: Amendments to Capital Planning and Stress Testing Requirements for Large Bank Holding Companies, Intermediate Holding Companies and Savings and Loan Holding Companies

Dear Madam:

Northern Trust Corporation (“**Northern Trust**” or “**we**”) welcomes the opportunity to comment on the notice of proposed rulemaking (the “**Proposal**”) issued by the Board of Directors of the Federal Reserve System (the “**Federal Reserve**”) that would tailor the application of the Federal Reserve’s capital plan rule (the “**Capital Plan Rule**”) to large bank holding companies and U.S. intermediate holding companies of foreign banking organizations.¹ Northern Trust appreciates the Federal Reserve’s efforts to tailor capital planning requirements to firms’ business models and writes to address Question 15 of the Proposal:

Question 15: What if any changes should the Board consider with respect to the scope of application of its existing capital planning guidance and why? What if any considerations regarding firms’ risk profiles should be factored into the applicability of capital planning guidance and why? Factoring in the applicability of the Board’s regulations, what if any aspects of the Board’s capital planning guidance should be changed or tailored differently based on firms’ risk profiles and why?²

Category II firms – of which there is currently only one, Northern Trust – are by definition less complex than Category I / LISCC firms. In the case of Northern Trust, it is classified as a Category II firm rather than a Category III firm solely by virtue of exceeding \$75 billion in cross-jurisdictional activity. The

¹ Federal Reserve, Amendments to Capital Planning and Stress Testing Requirements for Large Bank Holding Companies, Intermediate Holding Companies and Savings and Loan Holding Companies, 85 Fed. Reg. 63,222 (Oct. 7, 2020) (“**Proposal**”).

² Proposal at 63,227–28.

Amendments to Capital Planning and Stress Testing Requirements for Large Bank Holding Companies, Intermediate Holding Companies and Savings and Loan Holding Companies**November 19, 2020****Page 2 of 5**

differences in capital requirements applicable to a Category II firm, compared to a Category III firm, are that a Category II firm must calculate its risk-weighted assets (“RWAs”) using the advanced approaches in addition to the standardized approach under the applicable U.S. Basel III capital rules, is not eligible to use the simplified approach for minority interests and certain capital deductions under the standardized approach, and must recognize accumulated other comprehensive income (“AOCI”) in its calculation of Common Equity Tier 1 capital. There are no differences between the annual supervisory stress testing and capital planning requirements applicable to Category II and III firms.

In this letter we address how any new guidance on capital planning, to the extent it builds on and modifies existing guidance in SR 15-18 and SR 15-19, should be tailored to the lower risk profile of Category II firms relative to firms that would be subject to SR 15-18. While this distinction would be applicable to any Category II firm, in light of the fact that Northern Trust currently is the only Category II firm, this letter is driven by considerations relevant to our unique business and risk profile.

1. The unique business models of Category II firms

Because of the fact that the criteria for Category II firms can range from a relatively large asset size (\$700 billion or more in total consolidated assets) to institutions with much smaller balance sheets that nevertheless have relatively large amounts of cross-jurisdictional activity (\$100 billion or more in total consolidated assets and \$75 billion or more in cross-jurisdictional activity), it is clear that Category II firms may have business models that differ significantly from those of other firms in Category I or Category III and that do not react in the same manner to macroeconomic conditions or trends compared to Category I or Category III firms with more traditional lending business models. One such business model is that of a custody bank. Northern Trust focuses on a custody business and, as with some other firms that engage in custody activities, also conducts a wealth management business. Each line of business has a relatively simple business model, but also faces idiosyncratic risks.

Northern Trust’s Custody Business

Custody services consist of holding and servicing assets, primarily securities, as agent for the beneficial owners of the assets, providing safekeeping, recordkeeping, reconciliation and monitoring services relating to clients’ assets. In this capacity Northern Trust acts as agent for, and on the instructions of, its clients and does not exercise any discretion over the use or reuse of client assets and does not use them for any proprietary purposes. As the client’s assets are segregated from Northern Trust’s own assets, we bear no market or credit risk in respect of our clients’ securities. Northern Trust’s balance sheet is driven primarily by its client cash deposits, which in turn are driven by clients’ investment and transactional activity, and we have little or no direct means of control over such client activities. As a result, custody-related cash balances can fluctuate even on a relatively short-term basis, and in times of market unrest or crisis – such as, most recently, at the height of the COVID-19 pandemic earlier this year – can actually expand as custody clients may liquidate holdings of securities in favor of cash and leave more cash on deposit. The loan profile of Northern Trust’s custody business is also relatively simple and short term, focusing on short-term credit (typically intraday or overnight) extended to clients in the course of facilitating the settlement of the client’s securities transactions or the timing of availability of cash receipts arising from redemptions. As such, this loan profile does not reflect significant maturity transformation activities or present significant duration or liquidity mismatch.

Amendments to Capital Planning and Stress Testing Requirements for Large Bank Holding Companies, Intermediate Holding Companies and Savings and Loan Holding Companies
November 19, 2020
Page 3 of 5

Northern Trust's Wealth Management Business

Northern Trust's wealth management business also is relatively straightforward. The business focuses on providing trust, investment management, custody, and philanthropic services; financial consulting; guardianship and estate administration; family business consulting; family financial education; brokerage services; and private and commercial banking services to high-net-worth individuals and families, business owners, executives, professionals, retirees, and established privately-held businesses. The wealth management business is funded primarily by stable deposits from individuals and family investment vehicles such as trusts. The asset side of the wealth management business consists of high quality relationship-based loans, including loans secured by cash or marketable securities, residential real estate loans primarily made as an accommodation to clients and commercial real estate loans extended primarily to investors well known to the bank and pursuant to generally conservative underwriting standards (e.g., regarding loan-to-value ratios and debt service coverage requirements). Like the client assets held by the custody business, wealth management client assets are beneficially owned by the clients and thus are not reflected on Northern Trust's balance sheet.

2. Category II firms should be permitted to tailor their capital planning to their businesses and risks.

Because Category II firms, particularly a Category II custody bank such as Northern Trust, have unique business models with particular strengths and idiosyncratic risks, Category II firms should have greater flexibility than would be applicable under SR 15-18 to tailor their capital planning processes to their businesses and risks.

While Category II firms could be subject to higher expectations for governance and risk management of their capital planning processes than Category III firms, e.g., expectations similar to those in SR 15-18, in other respects (such as model development, use and validation, the approaches to estimating losses, pre-provision net revenue ("PPNR") and resulting capital positions, and the use of benchmark models and sensitivity analyses), we believe that it would be more appropriate for Category II firms – and particularly Category II custody banks such as Northern Trust – to be subject to expectations similar to those in SR 15-19. Specifically, we believe that the following SR 15-18 expectations should not be applied to, or should be adjusted for, Category II firms:

- Quantitative vs. qualitative approaches to loss estimates, PPNR and capital positions: Firms are, appropriately, expected to estimate the impact of various stress conditions and events on their capital positions and PPNR projections. The Federal Reserve expects SR 15-18 firms to rely solely on quantitative approaches in estimating losses and PPNR, whereas SR 15-19 firms are permitted to rely on quantitative or qualitative approaches. Because Category II firms have lower risk profiles and more idiosyncratic business models than Category I / LISCC firms, Category II firms should be expected – consistent with the expectations in SR 15-19 – to rely on an appropriate mix of quantitative and qualitative approaches to estimating their losses, PPNR and resulting capital positions. Northern Trust's custody banking business, for example, may react to macroeconomic drivers differently from more complex Category I / LISCC firms or Category III firms with more traditional lending business models. For example, in stressed conditions,

**Amendments to Capital Planning and Stress Testing Requirements for Large Bank Holding Companies, Intermediate Holding Companies and Savings and Loan Holding Companies
November 19, 2020**

Page 4 of 5

Category II banks may show an increase in deposits that are caused not by an increase in draw-downs on credit or liquidity facilities, but by clients' choosing to leave higher levels of deposits with Northern Trust as opposed to investing them in assets whose credit and price risks may be greater and more volatile in stressed conditions. While it is appropriate to expect Category II firms to use models and adopt quantitative approaches to reflect the advanced approaches capital requirements applicable to such firms, e.g., in the modeling of operational risk loss events, these expectations should nevertheless recognize the impact of a Category II firm's lower risk profile and different business model in the context of stress testing and ongoing capital planning activities. Precisely because, for example, Northern Trust's loss estimates, PPNR and capital position may be affected by macroeconomic drivers in different ways from more complex Category I / LISCC firms or Category III firms with more traditional lending business models, a Category II firm should have the flexibility, and in fact should be encouraged, to develop and rely on qualitative analyses designed to address the unique risks it faces where these risks cannot be captured as accurately using quantitative approaches.

- **Model overlays:** Consistent with the flexibility Category II firms should have to develop and rely on qualitative analyses where quantitative approaches are not adequately capturing their idiosyncratic businesses and risks, Category II firms should also have greater flexibility to deploy model overlays to adjust quantitative models where appropriate. Under SR 15-18, firms are more limited in their use of model overlays than they are under SR 15-19, including an expectation that firms subject to SR 15-18 use model overlays sparingly, subject model overlays to validation or effective challenge and perform sensitivity analyses before using model overlays. Because quantitative models may not be tailored to capture the lower risk profiles and risks of Category II firms, we believe Category II firms should be encouraged to identify such potential gaps in quantitative models and develop model overlays to adjust the quantitative models as needed. SR 15-19 expectations with respect to model overlays are more consistent with this approach.
- **Granularity of loss estimates and PPNR projections:** For the same reasons described above for Category II firms to have the flexibility to use a mixture of quantitative and qualitative approaches to estimating losses, PPNR and their resulting capital positions, we believe that a Category II firm should not be expected to calculate its estimated losses, PPNR and capital positions with the same granularity as expected under SR 15-18. SR 15-19 states that a firm should estimate losses by type of business activity, i.e., credit risk losses on loans and securities and operational risk losses, and that for non-material portfolios or business lines a firm may use simple approaches such as loss or revenue rates during prior periods of stressed conditions. Because of the less complex and more idiosyncratic business models for Category II firms – compared to Category I / LISCC firms, we believe that it would be appropriate for Category II firms to be expected to apply a level of granularity consistent with SR 15-19. These firms should not be expected to project losses and PPNR with the heightened level of granularity provided under SR 15-18. Instead, Category II firms should be encouraged to tailor their capital planning projections, including loss and PPNR projections, to their business models and risks, which likely will result in less granular and more qualitative, but also more accurate, analyses.



**Amendments to Capital Planning and Stress Testing Requirements for Large Bank Holding Companies, Intermediate Holding Companies and Savings and Loan Holding Companies
November 19, 2020**


Page 5 of 5

- Use of benchmark models: Appendix C of SR 15-18 specifically states that a firm should use a variety of methods, including benchmark or challenger models, to assess the performance of its primary models or to supplement, where appropriate, its primary models. As noted above, Category II firms such as Northern Trust may have unique business models and risk profiles for which benchmark models may not exist, may not be appropriate, or may produce less accurate results than our primary models. A Category II firm should thus benefit from the same flexibility not to use benchmark models, and to rely on other model validation methods, as afforded under SR 15-19.
- Sensitivity analyses: Consistent with our other comments, we believe that Category II firms should be expected to conduct sensitivity analyses for material models – i.e., the narrower set of models that more closely fit our business model and capture our idiosyncratic risks – rather than all models, as the expectation would be under SR 15-18. While we recognize that sensitivity analyses can be a valuable check on a firm’s estimates, these analyses will provide the most value for Category II firms with respect to the material models that capture their risks.

For all of the foregoing reasons, Northern Trust respectfully submits that the Federal Reserve should tailor any capital planning guidance applicable to Category II firms including Northern Trust– to the lower risk profile of Category II firms relative to firms that would be subject to SR 15-18. The capital planning guidance to which Category II firms should be subject should generally be consistent with the expectations currently set forth in SR 15-19, especially in the specific areas noted in this comment letter.

As a final matter, Northern Trust strongly supports the Federal Reserve’s recently proposed definition for the LISCC portfolio³. Northern Trust respectfully submits that a firm in Category II should not be in the LISCC portfolio unless and until it becomes subject to Category I standards.

Northern Trust appreciates the opportunity to comment on the Proposal. We would be pleased to meet with Federal Reserve staff to answer any questions about this comment letter or discuss further any of the recommendations we have made. Please feel free to contact Susan C. Levy, General Counsel, at 312-557-9270, or Jason J. Tyler, Chief Financial Officer, at 312-630-0619, if you would like to discuss this comment letter with us.

Sincerely,

Michael O’Grady

³ See Federal Reserve Board, Press Release, “Federal Reserve publishes latest version of its supervision and regulation report,” Nov. 6, 2020
<https://www.federalreserve.gov/newsevents/pressreleases/bcreg20201106a.htm/>.