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Ms. Jennifer J. Johnson Secretary Board of Governors of the Federal Reserve System 20th Street and Constitution Avenue, NW. Washington, DC 20551 regs.comments@federalreserve.gov Docket Number R-1261	Office of the Comptroller of the Currency 250 E. Street, SW. Mail Stop 1-5 Washington, DC 20219 regs.comments@occ.treas.gov Docket Number 06-09
Regulation Comments Chief Counsel's Office Office of Thrift Supervision 1700 G Street, NW. Washington, DC 20552 regs.comments@ots.treas.gov Attention: No. 2006-33	Mr. Robert E. Feldman Executive Secretary Attention: Comments Federal Deposit Insurance Corporation 550 17th Street, NW. Washington, DC 20429 comments@FDIC.gov

Re: Risk-Based Capital Standards: Advanced Capital Adequacy Framework
71 FR 55830 (September 25, 2006)

Ladies and Gentlemen:

Northern Trust Corporation appreciates the opportunity to comment on the Risk-Based Capital Standards: Advanced Capital Adequacy Framework Proposed Rules and Notices ("NPR").

Northern Trust Corporation ("Northern Trust") is a multi-bank holding company with its headquarters in Chicago, Illinois. The corporation has a network of offices in 18 U.S. states and international offices in 13 countries. Northern Trust had balance sheet assets totaling over $60 billion and assets under custody totaling $3.5 trillion as of December 31, 2006. Northern Trust conducts its global activities through The Northern Trust Company, an Illinois-chartered bank, four national banks, a federal thrift institution, an Edge Act subsidiary, and a number of non-bank subsidiaries.

In this letter we offer both general comments and then several specific points on the NPR. Several of our comments refer to letters drafted by the Financial Services Roundtable ("FSR") and the American Bankers Association ("ABA") in response to the NPR. Northern Trust participated in the FSR's and the ABA's comment processes and generally supports the points made in those letters. The comments we offer in this letter supplement the FSR's and ABA's comments and reflect Northern Trust's own views.

General Comment: Commensurate Requirements for Credit Risk

Northern Trust is a mandatory Basel II bank under the proposed rules, due to the level of international assets on our balance sheet. Nevertheless, Northern Trust's business strategy and risk profile are markedly different from most other mandatory banks. Northern Trust is primarily a processing bank and asset management company. As part of our business strategy, Northern Trust's lending activities are relatively simple and our credit quality is very high. In retail lending in particular, exposures are primarily to Wealth Management and Private Banking clients with low risk profiles. This credit risk profile is very different from other, large mandatory Basel II banks. At the same time, the scale and complexity of Northern Trust's operational activities, and the operational risk profile associated with these activities, are similar to many of the other mandatory Basel II banks.

Northern Trust views the NPR's credit risk framework as overly complex for its credit risk profile, and for other processing banks with similar profiles. Northern Trust believes the framework imposes costly requirements with little or no business benefits to these banks. The framework is designed to support determination of minimum regulatory capital requirements for a credit portfolio with complex lending arrangements to customers across a wide range of credit quality. There are no elements to address suitability of requirements or scalability of approaches within the framework, or conditions under which requirements may not apply. Instead, many of the rules are imposed with a broad brush, without consideration of implementation costs and with no cost/benefit analysis.

Northern Trust recommends that, for banks that can demonstrate that their products or portfolios do not warrant so complex a risk management approach, the credit risk framework provide flexibility in the application of the rules, and allow banks to demonstrate that their overall framework or specific elements of the framework are sufficient.

General Comment: Alignment with the Global Basel II Framework

Northern Trust is implementing a Basel II compliant framework in multiple countries and regulatory jurisdictions. It is our intent to develop the AIRB and AMA frameworks both in the U.S., and for subsidiaries outside the U.S. subject to Basel II. However, the numerous differences between the U.S. approach to Basel II and the approaches taken in other countries have already added to the complexity of the overall implementation effort.

Northern Trust supports the views expressed in the FSR and ABA comment letters that the U.S. rules and implementation timetable have already moved too far from the international Basel II framework. We support the views that the U.S. should work to make the rules of implementation more consistent with international capital standards, and work with banking regulators in all jurisdictions to adjust the framework post-implementation. This view extends to the timing differences between the U.S. and other countries: the timing differences have already made the implementation efforts more costly and difficult, and the U.S. should endeavor to meet the current target dates for Basel implementation.

General Comment: Leverage Ratio

Within the NPR's proposed framework, the U.S. has retained the leverage ratio as an element of minimum regulatory capital requirements. Northern Trust believes the leverage ratio is contrary to the goal of making minimum capital requirements risk sensitive. Northern Trust agrees with the ABA and FSR comments that the leverage ratio could become the binding capital constraint for many banks. We believe this could lead to an unintended form of regulatory arbitrage. Banks constrained by the leverage ratio would have an incentive to shed low risk credit assets and take on higher risk assets to boost net interest income, or alternately assume off-balance sheet credit risk, up to the point that the leverage ratio and risk-based capital requirements are equal. We do not believe it is the intent of the framework to encourage banks to take on riskier assets due to regulatory rules.

Northern Trust supports the views expressed in the FSR and ABA comment letters, that the leverage ratio may be appropriate through a transition period. Northern Trust recommends that, once the impacts of the new framework are clear, the regulators reconsider the need for the leverage ratio.

Specific Comments

Requirements for Retail Segmentation Review and Assignment.

In Section 22 of the NPR, rule 22.b.5 sets out a requirement that banks must review and update retail segmentation assignments 'no less frequently than quarterly'. While this may make sense for general retail portfolios, it does not make sense for high credit quality retail portfolios, such as Wealth Management or Private Banking clients. These exposures exhibit a high credit quality stability, and quarterly reviews would be an inefficient use of resources.

Northern Trust recommends that the rule be changed to require review and update at a frequency appropriate to the credit quality of the retail segment. Under this approach, the Pillar 2 supervisory review could be used to determine if the frequency of reviews is appropriate to the portfolio.

Requirements for Recognition of Wholesale Guarantees.

Section 33 of the NPR presents a framework for dealing with guarantees that is too complex for many credit portfolios. The challenge posed by that complexity is not in the computation of the parameter impacts of guarantees; rather, it is the operational difficulty of creating an additional ratings process for guarantors and guarantees and of tracking that data and maintaining that process over the lives of the guarantees. That approach might be appropriate for complex credit structures, but many guarantees are simple and straightforward enhancements to credit facilities that strengthen the bank's ability to lay claim to assets in the event of default. In many cases, guarantees are used to strengthen a facility's overall strength via pledges of physical

or financial assets, and the financial strength of the guarantor does not play a role in determining the degree to which the facility's credit risk is improved.

The LGD Adjustment Approach described in the NPR requires banks to rate guarantors and guarantees in the same manner as they rate direct credit extensions. That is often not the prevailing practice at banks. Some banks, including Northern Trust, determine the impact of guarantees through adjustments to either borrower ratings or facility ratings, and on a cost-benefit basis cannot justify developing additional processes and investing in additional systems to track the detailed data that would be needed to calculate a separate capital requirement for the guarantor or guarantee as described in the proposed rules.

Importantly, we note that the approach of adjusting borrower or facility ratings is consistent with requirements in the Advance Notice of Proposed Rulemaking for Basel II (ANPR, August, 2003). It was in response to the ANPR language that Northern Trust developed an approach for the recognition of guarantees via adjustments to facility ratings. The language in the NPR, coming at this relatively late stage, would render that investment as wasted and would require new development in another set of processes that would offer virtually no business benefit. In addition, we do not see why collateral-based guarantees require any determination of the guarantor's PD, or how such information provides a better basis for determining capital requirements.

Northern reiterates our general comment that the NPR rules should be flexible enough to respect economic trade-offs and realities and that they be risk-based; i.e., they impose requirements commensurate with the risks being managed and measured. Northern suggests that the regulators allow banks an alternative to demonstrate that their ratings approaches and parameterization processes reasonably consider the impacts of guarantees and do not create an inappropriate bias towards lower capital requirements. This would allow banks with limited use of guarantees to recognize their impact and to support the broad principles and aims of the Basel II framework without bearing undue or economically unjustified costs.

Treatment of Securitization Exposures.

The credit risk framework for securitization exposures (NPR Sections 41 - 47) seems to be written for banks that underwrite and sell securitizations, or hold residual equity tranches of such securitizations. However, the language of the NPR does not explicitly state that this is the case, and could be interpreted as applying to any balance sheet exposures that could be viewed as 'securitizations', including purchases of securitized assets or participations in syndicated loans or lines of credit. For banks with simple exposures to securitizations, such as purchasing and holding positions in non-equity tranches of securitized assets, or limited participation in syndications of Asset Backed Commercial Paper (ABCP) liquidity facilities, the exposures carry essentially the same risks as loans or committed lines, and should not be subject to the operational overhead imposed by the proposed framework.

While the framework does offer a four distinct methods for determining risk-weighted assets for securitizations, three of the methods have qualifying requirements involving creation of specialized ratings approaches (costly processes to support purchased assets or participations), or a harsh alternative involving deducting 100% of the book value of the securitization from Tier 1 and Tier 2 capital. Northern Trust does not believe the framework was designed to impose such high costs on banks which only purchase securitized assets. Such onerous requirements or capital treatment could easily eliminate many banks as secondary market participants in these assets.

Northern Trust recommends that the NPR rules clarify where the requirements for securitizations apply, specifically restricting the application of these rules to the appropriate range of activities (e.g., origination, underwriting, equity holdings). Further, the NPR should explicitly allow banks that are limited purchasers of securitizations to treat such exposures as part of their general wholesale or retail exposures.

Downturn LGDs.

The NPR proposes that banks calculate LGD parameter values that reflect 'an estimate of the economic loss that would be incurred on an exposure … during economic downturn conditions'. Northern Trust has two issues with this approach.

First, unless the formula has been adjusted properly, a downturn LGD is incompatible with the capital formula. The formula is intended to calculate potential aggregate losses at a high confidence level (99.9%), which is already a stressed environment. If the formula is derived and calibrated around LGD parameters reflecting average loss values, then putting in stressed (downturn) values for LGD compounds the conservatism of the calculation. It would be helpful to the industry to receive clarification on whether the capital formula has been re-calibrated to accept downturn LGDs, or if this approach is compounding the conservatism of the capital calculation.

Second, the NPR imposes this requirement across all credit exposures, and has not outlined any exceptions. One key exception should be lending facilities with liquid collateral that is marked to market and can be liquidated if proper collateral value is not maintained. This type of lending arrangement has a built in immunity to declines in collateral value. There may be other categories with similar characteristics, as not all forms of collateral are subject to drops in value during economic downturns. Unfortunately, default data for such collateral arrangements is difficult to obtain, because the arrangements tend to be very safe. Without empirical data, banks may be forced to use the adjustment formula prescribed by the NPR to convert ELGD values to LGD values.

Northern Trust recommends that if downturn LGDs remain a requirement of the framework, the NPR should ensure that the capital formula is consistent with the use of such values, and that banks be allowed to use ELGD values for collateral arrangements that are not sensitive to downturns.

Definition of Default and Current FFIEC Reporting Requirements.

The NPR provides definitions of default for wholesale and retail obligors that are not consistent with the classification of credit exposures under the FFIEC. In particular, the FFIEC requires banks to determine classification of credit exposures into Criticized, Classified, and Loss categories with consideration of both likelihood of default and determination of loss. The FFIEC rules permit banks to continue to classify exposures as 'Accruing' if the risk of loss is remote (due to collateral strength or other considerations) even if the borrower has met the NPR definition of default. This inconsistency creates a need for two internal classification systems: one around the NPR's definition of 'default', and the other around the FFIEC's classification of probable loss.

Northern Trust recognizes that the NPR framework and the FFIEC rules address different issues. However, developing and maintaining two classification systems to support two regulatory requirements is costly and inefficient.

Northern Trust recommends that regulators consider ways to align the two sets of requirements. In particular, it would be helpful to address two key discrepancies between the NPR and FFIEC rules: 1) the NPR's retail definition of default considers days past due without consideration of likelihood of loss, while the FFIEC allows banks to consider likelihood of loss, and 2) the NPR wholesale definition of default requires all exposures to an obligor to be in default if any single exposure is in default, while the FFIEC addresses the issue at the note or facility level.

Credit Risk Weights for Fixed Assets.

In the preamble to the NPR, there is a request for comment on the treatment of fixed assets (Question 19). The NPR credit risk approach applies risk weights to all assets on the balance sheet, including fixed assets. However, with the new requirement for operational risk capital, the risk associated with fixed assets would effectively be double counted - once in the AMA approach, and then again with a 100% risk weight in the AIRB approach.

Northern Trust believes that the AMA approach is better suited to determine the proper capital to apply to fixed assets. There is no credit risk associated with these assets, and the operational risk approach can directly assess the risks of these assets through internal loss history, external loss data, and scenario analysis. Northern Trust recommends that in the Basel II credit risk approach, fixed assets should receive a 0% risk weight.

Conclusion

Overall, Northern Trust supports the effort to update the risk-based capital rules, and it offers its comments in the spirit of advancing that effort and continuing to promote sound risk management.

Northern Trust Corporation appreciates the opportunity to comment on its primary concerns with the proposed revisions to the existing risk-based capital framework. Northern Trust appreciates the patience and diligence of the national supervisors in their efforts to consider and address the many important issues raised by all interested parties in this effort.

Respectfully Submitted,

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