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> **Re: Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity (RINs 1557-AE78, 7100-AG64, 3064-AF29)**

I. Introduction

The Northern Trust Corporation (**Northern Trust**) welcomes the opportunity to comment on the proposal of the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System (the **Federal Reserve**) and the Federal Deposit Insurance Corporation (collectively, the **Agencies**) to modify the regulatory capital requirements applicable to large banking organizations and banking organizations with

significant trading activity,[1] which would implement the final components of the Basel III capital standards known as the Basel III endgame (the **Proposed Rule**).

As both Congress and the Agencies have acknowledged,[2] banking organizations such as Northern Trust and their operating subsidiaries which are "predominantly engaged in custody, safekeeping, and asset servicing activities" (such holding companies referred to in this letter as **custody banks**) occupy a unique space in financial markets.[3] Custody banks such as Northern Trust maintain significantly smaller deposit-taking, lending, trading and investment banking activities that characterize the operations of other large banking organizations.

By contrast, Northern Trust's core businesses do not involve significant maturity transformation or other activities in which the bank takes long-dated principal and / or credit risk or market risk. Northern Trust is a provider of wealth management, asset servicing, asset management and banking solutions to corporations, institutions, families and individuals. The Corporation focuses on managing, safeguarding and servicing client assets through its two client-focused businesses: Asset Servicing and Wealth Management. Client Assets under Custody were $11.0 trillion at September 30, 2023, all recorded in each particular client's name and held in accounts segregated from Northern Trust's proprietary assets. These holdings are beneficially owned by our clients, not by Northern Trust.

These businesses are stable and distinct from other kinds of financial intermediation which create material credit and liquidity risks for the banking organization undertaking such activities. Indeed, based solely on the size of its balance sheet, Northern Trust would be classified as a Category IV banking organization rather than a Category II banking organization.[4]

This letter focuses on eight issues of particular importance to Northern Trust. In addition to the specific issues addressed in this letter, Northern Trust supports the recommendations raised in the comment letter from the Risk Management Association Advanced Operational Risk Group, as well as the comment letters from the Risk Management Association Securities Lending Council, the Global Pension Fund

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[1] 12 C.F.R. Parts 3 (OCC), 217 (Federal Reserve) and 324 (FDIC) (collectively, the "**capital rules**"). For convenience, citations in this letter to the currently effective capital rules reflect the Federal Reserve's capital rules (e.g., 12 C.F.R. § 217.2). To distinguish the currently effective capital rules from the Proposed Rule, citations to sections of the Proposed Rule are formatted as in the following example: Proposed Rule § _.110.

[2] *See* Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174, § 401(a), 132 Stat. 1359 (2018) (codified at 12 U.S.C. § 1831o); 12 C.F.R. § 217.2 (defining custodial banking organization).

[3] Economic Growth, Regulatory Relief, and Consumer Protection Act § 401(a).

[4] As of September 30, 2023, Northern Trust had a balance sheet of approximately $146 billion.

Association and the Bank Policy Institute, to the extent they are not inconsistent with the recommendations of this comment letter.

II. Executive Summary

While we support the Agencies' intent to strengthen safety and soundness for banking organizations both as individual institutions and as participants in the U.S. banking system, the Proposed Rule in some instances undermines this purpose, particularly as it applies to Northern Trust's focused business model. In general, we encourage the Agencies to review the information received by the Federal Reserve, and, as appropriate, to accordingly revise the Proposed Rule. More specifically, we would like to call the attention of the Agencies to six substantive aspects of the Proposed Rule, which are primarily organized into three risk categories of operational risk, credit risk and market risk. In addition, we have identified two technical issues related to requirements of the Proposed Rule that would be burdensome to implement, for which we recommend alternative approaches to reduce their burden.

Operational Risk

Issue 1: Services Component of the Business Indicator

- Issue: The Business Indicator (**BI**) measure would count all fee income, regardless of the type of activities from which the fee income is derived, towards the Services Component to the same extent, and without any cap or scalar limiting its contribution, as all other activity measures reflected in the BI, including for example net interest income or trading income measures. We believe that the lack of a limiting principle on the Services Component would severely overstate the operational risk capital requirements for banking organizations, like Northern Trust, that have a business model focused on steady and comparatively balance sheet-light fee-generating businesses like custody and wealth management.

- Recommendation: We recommend that the Agencies implement some form of limit or scaling factor to reduce the contribution of the Services Component, at least for banking organizations like Northern Trust that have a fee-centric business model, such as custody. We believe any of the approaches outlined below would improve the requirement relative to the Proposed Rule by better aligning operational risk capital requirements with the actual underlying risk as estimated by historical operational losses. We also believe these changes would avoid unreasonably punishing banking organizations engaging in the specialized provision of services, especially fee-generating services, that are comparatively less balance sheet-based than other services. Specifically, we outline three potential alternative approaches:

    - ***Hard cap approach***: Under this approach, the share of the Services Component would be capped at the sum of (i) the Interest, Lease and Dividend Component and (ii) the Financial Component. This approach is similar to how the Federal Reserve's capital surcharge for global systemically

important banks (the **GSIB Surcharge**) caps the contribution of the substitutability indicators, including a measure of assets under custody, to the size of the capital charge.

  - ***Soft cap approach***: Under this approach, a threshold would be established to identify banking organizations with a fee-centric business model based on the share of the unadjusted BI measure that would be composed of fee income. For identified fee-centric banking organizations such as custody banks, fee income would contribute to the BI as proposed up to this threshold, but would contribute to the BI at reduced rate above this threshold. This approach would recognize the specific business model of custody banks such as Northern Trust.

  - ***Risk-sensitive scaling approach***: Under this approach, the Services Component for all banking organizations would be subject to a scaling factor less than 1.0, so that fee income would not contribute on a dollar-for-dollar basis to the BI and thus to capital requirements. This approach would recognize that not all components of the BI pose the same operational risks and would effectively impose different operational risk weights to different activities. Although this approach would be relatively simple to calculate, it would require the Agencies to calibrate scaling factors for each category of operational risk-generating activity.

Issue 2: Internal Loss Multiplier Floor

- Issue: Northern Trust has a track record of managing its operations effectively minimizing operational losses, and, based on its experience, estimates that its Internal Loss Multiplier (**ILM**) under the Proposed Rule would be less than 1.0 if the ILM were not floored at 1.0. The Proposed Rule's ILM floor fails to reward and further incentivize Northern Trust's strong operational management practices, contrary to the purpose of the operational risk capital requirements.

- Recommendation: We recommend that the Agencies permit the ILM to be calculated without a floor. This would allow operational risk capital requirements to be more risk sensitive and create capital incentives that appropriately reward stronger operational risk management.

Credit Risk

Issue 3: Expansion of Preferential Risk Weights for Certain Investment Grade Corporate Exposures

- Issue: Under the Proposed Rule, investment grade corporate exposures would be eligible for a preferential risk weight of 65% only if the counterparty has publicly traded securities outstanding. This limitation would exclude many corporate entities and virtually all small- and medium-sized entities (**SMEs**), regardless of the availability of sufficient data relating to their creditworthiness. An exposure to

an SME would be eligible for preferential risk weight only as a "regulatory retail exposure," which would disqualify exposures to any borrower or counterparty above a $1 million aggregate threshold. For exposures to SMEs above this threshold, the applicable risk weight would be 110%, effectively penalizing SMEs relative to larger corporates. These restrictions would exclude many of Northern Trust's exposures to SMEs, despite creditworthiness comparable to corporates that would be eligible for preferential risk weights under the Proposed Rule.

- Recommendations: We have two recommendations related to investment grade corporate exposures, including SMEs:
  - First, investment grade exposures to corporate entities, including SMEs, should qualify for a 65% risk weight if the corporate entity provides audited financial statements to the banking organization at least annually. This approach would put exposures to non-publicly listed corporate entities on a comparable footing with publicly listed corporates by allowing them to satisfy, on a bilateral contractual basis, a transparency-based criterion that is consistent with the purpose of the public listing criterion for other corporates.
  - Second, investment grade exposures to SMEs that provide unaudited financial statements to the banking organization on an annual basis should be eligible for an 85% risk weight, without regard to the quantitative limits applicable to regulatory retail exposures. This approach – which is consistent with the international Basel Framework's 85% risk weight category for SMEs – would recognize that certain SME exposures are highly creditworthy and satisfy an objective standard for transparency to the banking organization, even if they are unable to meet the higher standard of providing annual audited financial statements.

Issue 4: Treatment of Bank Exposures and Exposures to Other Prudentially Regulated Financial Institutions

- Issue: The Proposed Rule would assign a minimum base risk weight of 40% for banking organizations' exposures to depository institutions. It would permit a 20% risk weight only for certain short-term trade credit exposures to highly creditworthy banks, but would not generally extend this 20% risk weight to all short-term exposures, as under the Basel Framework. The Proposed Rule diverges from the current U.S. capital rules as well as the international Basel Framework by ***doubling*** the applicable minimum base risk weight for exposures to depository institutions, as well as limiting the applicability of preferential capital treatment to only short-term exposures in the context of trade credit. This treatment would severely penalize and impose additional costs on custody banks like Northern Trust which maintain nostro and sub-custodian relationships with other banks, upon which we rely in our custody business. Custody banks maintain high levels of exposures in the form of deposits with banking institutions to meet client demands, ensure settlement of client transactions, and as part of their risk management strategies.

- Recommendation: We have two recommendations related to the treatment of bank exposures and exposures to other prudentially regulated financial institutions:

    - First, we recommend that the Agencies reconsider the proposed treatment of exposures to depository institutions in general and, at a minimum, expand the 20% risk weight to apply generally to all short-term bank exposures, not only trade credit exposures. We also recommend a technical correction to prevent the 20% risk weight for trade credit exposures from being limited to foreign bank exposures, which we believe is an error.

    - Second, we recommend that the Agencies extend the proposed treatment of exposures to depository institutions to entities which are not banks but which are nevertheless subject to prudential standards, including broker-dealers and insurance companies. This approach – which is consistent with the international Basel Framework – would recognize that broker-dealers, insurance companies and other entities which are subject to prudential standards and supervision are highly creditworthy, regardless of whether they are part of a publicly listed corporate group.

Issue 5: Non-Significant Equity Exposures

- Issue: The Proposed Rule would eliminate the limited 100% risk weight category for certain non-significant equity exposures below the applicable threshold and instead subject them to higher risk weights (to the extent they are not required to be deducted from capital). Northern Trust relies on the 100% risk weight treatment for non-significant equity exposures to certain financial market infrastructure platforms (e.g., clearinghouses and exchanges). These equity investments are necessary to ensure Northern Trust has access to critical financial market infrastructure to conduct its core business. In addition, Northern Trust relies on the 100% risk weight non-significant equity exposure treatment for seed investments in funds as part of our asset management business, and for certain equity derivatives and other *de minimis* equity exposures.

- Recommendation: We recommend that the Agencies retain the limited 100% risk weight category for non-significant equity exposures in the same form and subject to the same limits as under the existing capital rules. We do not believe punitive risk weights for such exposures would reflect increased risk sensitivity for capital requirements, as the Agencies intend. For Northern Trust, the 100% risk weight category for equity exposures is important, as it provides an appropriate risk weight for equity exposures to financial market utilities (**FMUs**) that we are required to hold as part our business as well as seed investments in funds and other *de minimis* exposures. Equity exposures to FMUs, many of which are overseen by U.S. and international regulators and in any event engage in a narrow range of financial activities as agents or riskless principals, should not be subject to the higher risk weights (generally 400%) assigned to exposures to all non-publicly traded companies under the Proposed Rule.

Issue 6: Availability of Fallback Capital Requirement for Market Risk

- Issue: The Proposed Rule would subject several, low-volume aspects of our business to market risk capital requirement calculations. It nevertheless provides a backstop, "fallback" capital requirement when a banking organization is "unable to calculate" such requirements. Considering Northern Trust's relatively small portfolio of market risk covered positions, calculating the market risk capital requirements would be computationally burdensome relative to the size of certain businesses and the corresponding trading portfolios. For Northern Trust seed capital positions in Northern Trust investment funds – the costs of determining the amount of sensitivities-based market risk capital we would be required to hold against such positions would not justify the capital saved relative to apply the more conservative (dollar-for-dollar) fallback capital requirement for market risk.

- Recommendation: We recommend that the Agencies clarify the fallback capital requirement may be applied on a permanent basis for portfolios for which developing capabilities to determine sensitivities-based capital requirements would be overly burdensome relative to the size of the portfolio. As a prudent limit, the use of this exception could be subject to a *de minimis* threshold whereby portfolios could be designated for the fallback capital requirement only if they are less than 1% of total capital of the banking organization.

Other Issues

In addition, Northern Trust has identified two other technical issues with the Proposed Rule's treatment of operational risk capital requirements – one concerning the treatment of operational risk capital requirements arising from mergers and acquisitions, the second concerning the calculation of timing losses over the entire ten-year look-back period – that are discussed in more detail in Part VII below.

III. Northern Trust's Business Model

Northern Trust is a leading custody bank with approximately $11 trillion assets under custody at September 30, 2023. Northern Trust focuses on managing, safeguarding and servicing client assets through its two client-focused businesses: Asset Servicing and Wealth Management. Revenues for services generally comprise 70 to 80% of total revenues of Northern Trust. Northern Trust's total assets at September 30, 2023 were $146 billion.

Asset Servicing is a leading global provider of asset servicing and related services to corporate and public retirement funds, foundations, endowments, fund managers, insurance companies, sovereign wealth funds and other institutional investors around the globe. Asset servicing and related services encompass a full range of custody-related capabilities, including but not limited to custody; fund administration; investment operations outsourcing; investment management; investment risk and analytical services; employee benefit services; securities lending; foreign exchange; treasury management; brokerage services; transition management services; banking; and cash management.

Wealth Management focuses on high-net-worth individuals and families, business owners, executives, professionals, retirees and established privately-held businesses in its target markets. In supporting these targeted segments, Wealth Management provides custody, trust, investment management, and philanthropic services; financial consulting; guardianship and estate administration; family business consulting; family financial education; brokerage services; family office services; and private and business banking.

Each of these businesses presents relatively low credit risk, and we remain focused on acting as an agent and service provider to help clients maximize their returns and plan for their futures. Each business generates revenues that consist primarily of stable, fee-based income for the provision of services, supplemented by net interest income derived from the reinvestment of client cash deposits in diversified and liquid investment portfolios. Each business funds itself primarily from client deposits rather than other forms of wholesale funding or significant interbank borrowings. The asset side of Northern Trust's balance sheet is invested approximately 30% in cash primarily held in central banks, including Federal Reserve Banks, and 35% in high-quality liquid assets, mainly fixed-income securities, including government, agency and asset-backed securities. Approximately 30% of Northern Trust's assets represents loans to clients well known to Northern Trust.

Northern Trust operates primarily through one U.S. subsidiary bank, The Northern Trust Company, and expects that, for the foreseeable future, this primary bank subsidiary will continue to be the major source of Northern Trust's consolidated assets, revenues, and net income. The liabilities side of Northern Trust's balance sheet is heavily weighted toward client deposits, which represent approximately 82% of the firm's total consolidated liabilities and typically approximately 1% of client Assets under Custody.

Custody banking is a stable line of business.[5] Custody services consist of holding and safeguarding assets, primarily securities, as agent for the beneficial owners of the securities. Northern Trust provides custody, safekeeping, recordkeeping, payments, entitlements, 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. Client cash, which typically represents less than 1% of client Assets under Custody, is reflected as a deposit on Northern Trust's balance sheet.

As of September 30, 2023, Northern Trust had assets under custody/administration of $14.2 trillion, assets under custody of $11.0 trillion, and assets under management of $1.3 trillion.[6] Northern Trust also engages in certain ancillary

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[5] For additional information on the operations and business model of custody banks, see generally, The Clearing House, The Custody Services of Banks (July 2016), *available at* https://media.theclearinghouse.org/-/media/TCH/Documents/Research/Articles/2016/07/20160728_TCH_White_Paper_The_Custody_Services_of_Banks.pdf.

[6] Northern Trust Form 10-Q, for quarter ending September 30, 2023.

activities in the course of providing custody services, such as foreign exchange and agency securities lending services.

The combination of Northern Trust's two core business lines results in an aggregate business model that is focused on custody banking rather than business activities with long-dated credit or other risk, with no material trading or investment banking activities. It is a business model that generates stable fee income, even during periods of economic stress.

IV. Operational Risk

The Proposed Rule would eliminate the existing advanced measurement approach to operational risk and replace it with a new standardized approach for operational risk (the **SA-OR Approach**). We understand the Agencies' concern that operational risks are "inherent in all banking products, activities, processes, and systems," which supports the Agencies' proposal to apply operational risk capital requirements based on a broad measure of business activity referred to as the Business Indicator Component (the **BIC**).[7] Consistent with the standardized approach to operational risk under the international Basel Framework,[8] the Proposed Rule would require a banking organization to calculate its RWAs for operational risk using a formula proportional to the product of (1) the BI, which is a measure of the banking organization's overall volume of business activity, (2) the BIC Coefficient, which is a tiered, marginal scaling factor based on the BI[9] and (3) the ILM, a firm-specific scalar calculated based on the banking organization's historical experience of operational losses, measured as the ratio of the ten-year trailing average of the organization's annual total net operational losses, relative to its BIC. Under the SA-OR Approach as proposed, the ILM would be subject to a floor of 1.0.

While we recognize that the SA-OR Approach is simpler and more transparent than the existing advanced measurement approach, this letter highlights two primary issues with the SA-OR Approach that we believe would adversely impact Northern Trust. We recommend targeted changes to the SA-OR Approach that would address these concerns while preserving the basic structure of the approach. In addition, we highlight two other technical issues with the SA-OR Approach as proposed.

First, the proposed SA-OR Approach implicitly assumes that all business activities captured by the BI contribute equally to operational risk. As an empirical matter, however, not all business activities pose the same operational risks. For Northern Trust, the BI would be largely driven by fee income from its custody and asset

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[7] *Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity*, 88 Fed. Reg. 64028, 64083 (Sept. 18, 2023), *available at* https://www.govinfo.gov/content/pkg/FR-2023-09-18/pdf/2023-19200.pdf.

[8] BCBS, *OPE 25 – Calculation of RWA for Operational Risk* (2022), https://www.bis.org/basel_framework/chapter/OPE/25.htm.

[9] The product of the BI and BIC Coefficient is referred to as the Business Indicator Component or BIC.

management activities, which would be reflected in the Services Component of the BI. In our experience, increased fee income from custody and asset management services is not associated with increased operational losses. Accordingly, we believe that the proposed calculation of operational risk RWAs under the Proposed Rule would undermine the efficient provision of custodial and asset management services by imposing operational risk capital requirements that are not commensurate with the risks of these activities. To better reflect the operational risks of custody and asset management activities, we offer three recommendations, as explained below.

Second, the proposed ILM floor of 1.0 under the SA-OR Approach would fail to reward and further incentivize firms for their management of operational risks, especially for firms, such as Northern Trust, that would have an ILM of less than 1.0. We recommend removing the floor, allowing the ILM to float below 1.0, in order to create a uniform incentive for all firms to enhance their management of operational risks, regardless of the firm's recent history of operational loss events.

Finally, there are two technical issues in the Proposed Rule which would create considerable burden without a commensurate increase in capital levels or safety and soundness generally. First, a banking organization would be required to calculate operational risk capital requirements for acquired or merged entities based on historical data. We recommend that the Agencies introduce a materiality threshold for requiring calculating and holding capital for a merger or acquisition based on the BIC of the target organization relative to the BIC of the acquiring organization. Second, we recommend that the Agencies clarify that the proposed treatment of timing losses for purposes of calculating operational risk capital requirements apply only prospectively. Retroactive application of the proposed treatment of timing losses would create computational and resource burdens for Northern Trust which would exceed the incremental benefits to capital levels sought by the Agencies.

A. Services Component of the Business Indicator Component

Under the Proposed Rule, the BIC would be calculated as the product of a banking organization's BI and its BIC Coefficient. The BI would be calculated as the sum of three equally weighted components: (1) the Interest, Lease and Dividend Component, (2) the Services Component and (3) the Financial Component. The BIC Coefficient would be determined based on the level of a firm's BI, with the marginal BIC Coefficient rising from 12% (applicable to the first $1 billion of BI) to 15% (applicable to the next $29 billion of BI) to 18% (applicable to the extent the BI exceeds $30 billion).

The formula for the BIC reflects three key assumptions implicit in the SA-OR Approach. First, the approach assumes that the risk of operational losses is generally proportional to a banking organization's overall business volume. This assumption is consistent with Agencies' statement in the preamble to the Proposed Rule that the three components of the BI aim to comprehensively capture the volume of a banking organization's business activities, thereby serving as a "proxy for a banking organization's business volume . . . . [B]anking organizations with higher overall business volume are larger and more complex, which likely results in exposure to higher

operational risk."[10] Second, because the BIC Coefficient increases as a function of the BI, the approach assumes that the risk of operational losses increases as overall business volumes increase. The Agencies support this assumption by asserting that "the complexities associated with a higher business volume can give rise to gaps or other deficiencies in internal controls that result in operational losses."[11] Third, because the BI would be the simple sum of each equally weighted component, the approach assumes that all business activities captured by the BI present the same degree of operational risk, regardless of the type of activities from which the fee income is derived. The Agencies invite commenters to explain how the calculation of the Services Component could affect specific business models and to describe any adjustments or limits related to specific business lines that the Agencies should consider.[12]

Given Northern Trust's business model, the Services Component would be the primary driver of Northern Trust's BI under the SA-OR Approach. The table below reflects the historical proportional contribution of each component to the BI for Northern Trust.

Component	% of BI
Interest, Lease, and Dividend Component	25%
Services Component	70%
Financial Component	5%

This reflects the concentration of the business models of custody banks such as Northern Trust which are fee-based and therefore captured by the Services Component.

Northern Trust does not observe a correlation between operational losses and its fee-driven business activity that underpins the assumptions that the Services Component should have equal weight as the other components of the BI and that larger business volumes give rise to complexities that can create gaps in internal controls. Our review of Northern Trust's historical losses indicate that increased fee income is not associated with increased operational risk losses. Figure 1 below shows the growth of Northern Trust's fee income, which primarily reflects custody fees and asset management fees that are reported as income from fiduciary activities on Form FR Y-9C, Schedule HI, from 2009 to 2022. Figure 2 below shows, for the same period, Northern Trust's ten-year trailing average of annual total net operating losses (the **Loss Component**), which has been calculated consistent with the proposed methodology for determining the ILM.

[10] 88 Fed. Reg. at 64083.

[11] 88 Fed. Reg. at 64083.

[12] 88 Fed. Reg. at 64084 (Question 74).

Figure 1: Northern Trust Annual Fee Income[13]

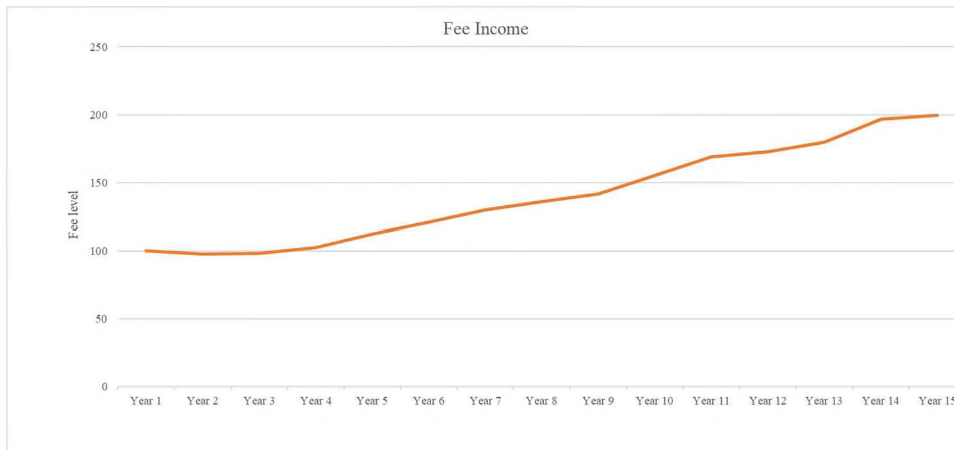
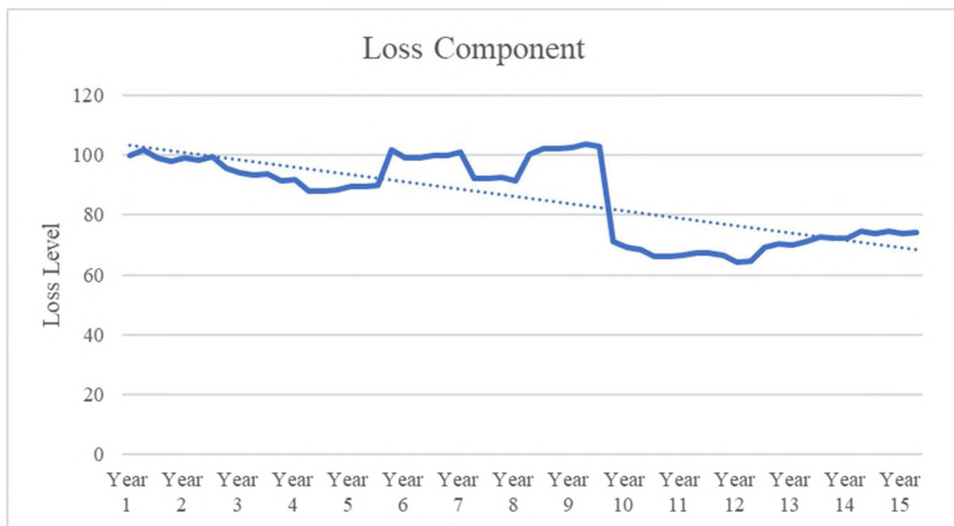


Figure 2: Northern Trust Annual Loss Component[14]



The figures above show that Northern Trust's Loss Component has decreased as its fee income has increased, contrary to the assumptions underlying the SA-OR Approach. In our view, the observed inverse relationship between Northern Trust's fee income and Loss Component over this period is a reflection of our commitment to our

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[13] Fee Income levels are normalized to equal 100 in Year 1.

[14] The Loss levels are normalized to equal 100 in Year 1. Loss levels are not on the same scale as Fee Income levels. Loss levels are usually a relatively small percentage of Fee Income levels.

core business model and to the use of operational risk mitigants such as automation and straight-through processing.

Northern Trust's observed loss history runs counter to the assumptions underlying the SA-OR Approach's progressive BIC Coefficient structure and its uncapped treatment of the Services Component. While increased business activity *can* result in increased complexity leading to control gaps and other risk management challenges, particularly if the increased activity results from expansion into new businesses, this dynamic does not necessarily hold for all forms of growth. In Northern Trust's case, we organically grew our fee income while remaining focused on our core business model as a custody bank. In short, the assumption that complexity and risk increase with scale does not apply to Northern Trust's relatively focused business model.

If the SA-OR Approach is implemented as proposed, Northern Trust would face incentives that challenge our long-standing focus on our core businesses. The one-size-fits-all approach to calibrating operational risk capital requirements diminishes the incentive to favor lower-risk businesses over riskier businesses. Such a result would not be consistent with Northern Trust's historical practices or the Agencies' goals of safety and soundness.

To better align the incentive structure of the SA-OR Approach with the Agencies' goals, we believe the Agencies should revise the BI calculation to reflect the relatively lower operational risks associated with custody and asset management businesses, which are fee-based, stable and comparatively less balance sheet-intensive than commercial banking and trading-based businesses.

We offer three alternatives to the calculation of the Services Component set out in the Proposed Rule: (1) a cap on the contribution of the Services Component to the total BI, (2) a graduated soft cap on the Services Component to the total BI and (3) a risk-based approach based on scaling factors for different activities.

Option 1: Capped Services Component

Instead of a simple summation of the components of the BI, which would not capture differences in risks between each component, we recommend the Agencies limit the share of the Services Component to no more than the sum of (i) the Interest, Lease and Dividend Component and (ii) the Financial Component. Insofar as the Agencies believe size generally reflects complexity and risk, we believe the kind of complexity which would create such risks would manifest most in banking organizations which participate in many business lines which generate idiosyncratic risks that may be hidden. It would not, by contrast, necessarily be reflected in focused organizations that concentrate narrowly, if deeply, on a particular business model. This is particularly true of the fee-based, stable and comparatively balance sheet-light business model of Northern Trust and other custody banks. The special role of the custody banking model in the context of the U.S. banking sector, where four of the five largest custody banks measured by assets under custody and administration are based, justifies this modification of the

methodology for calculating the Services Component.[15] In addition, insofar as risks to safety and soundness arise from threats to solvency or liquidity on the balance sheet of a banking organization, the Agencies should prefer diversification by banking organizations into businesses in which they would participate as agent or fiduciary and which do not require material participation as a principal.

Implementing such a limit on the Services Component of the BI would be similar to an approach taken by Federal Reserve under the GSIB Surcharge rule.[16] In implementing that rule, the Federal Reserve adopted a limit on the contribution of the systemic indicators in the substitutability category to the overall Method 1 score under that rule.[17] The substitutability category includes indicators related to payments activity, assets under custody and underwriting activity in the debt and equity capital markets. The Federal Reserve stated that the purpose of limiting the aggregate contribution of these indicators was to avoid a "greater-than-intended impact on the assessment of systemic importance for certain banking organizations that are dominant in the provision of asset custody, payment systems and underwriting services."[18]

Option 2: Soft Cap on Services Component

As an alternative, we recommend an approach proposed by the Basel Committee on Banking Supervision (**BCBS**) in 2016, as part of its development of the revised standards for operational risk capital requirements.[19] These standards included a proposed approach that would avoid applying punitive capital treatment for banking organizations with fee-dependent business models. Specifically, the 2016 BCBS proposal included a "soft cap" on the contribution of fee income to the total BI of 50%, above which fee

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[15] Nasdaq, *What is the Market Share of the 5 Largest Custody Banks in the Global Custody Banking Industry*, June 14, 2016, https://www.nasdaq.com/articles/what-market-share-5-largest-custody-banks-global-custody-banking-industry-2016-06-14.

[16] *Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies*, 80 Fed. Reg. 49082 (Aug. 14, 2015), *available at* https://www.federalregister.gov/documents/2015/08/14/2015-18702/regulatory-capital-rules-implementation-of-risk-based-capital-surcharges-for-global-systemically.

[17] The Method 1 score is used to determine whether a bank holding company is a U.S. global systemically important bank holding company (**GSIB**). The Method 2 score, which is generally the operative score used to calculate the level of the GSIB Surcharge applicable to a GSIB, does not use the substitutability indicators at all.

[18] 79 Fed. Reg. at 75478.

[19] *See* BCBS, CONSULTATIVE DOCUMENT: STANDARDISED MEASUREMENT APPROACH FOR OPERATIONAL RISK, 4.1.20-21 (2016).

income would contribute to the BI at a reduced marginal rate.[20] This proposed approach was removed from the final BCBS standard without discussion or justification.[21]

We believe that such an approach would better capture the unique business model of custody banks such as Northern Trust (as well as other fee-dependent banking organizations) than the one-size-fits-all approach reflected in the Proposed Rule, while retaining an appropriate degree of risk sensitivity sought by the Agencies. In particular, this approach would be appropriately limited to banking organizations with a focused business model, such as custody banks. Moreover, this approach would appropriately reflect the relatively lower contribution, at the margin, arising from additional fee-generating activities for banking organizations that have long track records concentrated on those very activities, such as custody banks.

In addition, there are compelling reasons for the Agencies to return to the approach proposed by the BCBS in 2016. While the BCBS may have foregone the soft cap in a desire to streamline its recommendations in the context of a broad, international group of banking regulators, the U.S. landscape of banking organizations and financial market participants is importantly distinct from other national markets. The United States is home to three large custody banks, each of which are Category I or II banking organizations,[22] and U.S. custody banks collectively hold over half of assets under custody and administration globally.[23] The concentration of such activities in the United States justifies an approach that was evidently considered by the BCBS, even if it was not incorporated into the final Basel Framework, which omitted such an approach before finalization, and also may explain its absence from the international Basel Framework. The Agencies should acknowledge the unique place custody banks play in the U.S. banking system by limiting the applicable capital charge for associated fee-based activities. The 2016 BCBS approach provides a readily administrable path for the Agencies to make such a revision to the Proposed Rule.

Option 3: Risk-based Scaling Factor for Services Component

As an additional alternative, the Agencies should consider applying different weights to the components (or sub-components) of the BIC, reflecting the expected contribution of each component to operational risk. We refer to this approach as a

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[20] Under the BCBS proposal, each dollar of fee income above the 50% threshold generally would contribute 10 cents to the BI, subject to a specified cap and floor. *Id.*

[21] *See* BCBS, *Basel III: Finalising Post-Crisis Reforms* (Dec. 2017), available at https://www.bis.org/bcbs/publ/d424.pdf.

[22] These are Bank of New York Mellon, State Street and Northern Trust. *See Tailoring Rule Visual*, *available at* https://www.federalreserve.gov/aboutthefed/boardmeetings/files/tailoring-rule-visual-20191010.pdf.

[23] Nasdaq, *What is the Market Share of the 5 Largest Custody Banks in the Global Custody Banking Industry*, June 14, 2016, https://www.nasdaq.com/articles/what-market-share-5-largest-custody-banks-global-custody-banking-industry-2016-06-14.

standardized risk-based approach to operational risk, which is similar to the implementation of risk weights under the standardized approach for credit risk.

For example, a relatively simple version of a standardized risk-based approach to operational risk would be to reduce the weight of the Services Component by applying a scaling factor of less than 1.0 to the total amount of the Services Component. Such a scaling factor would reflect the fact that the operational risks associated with a given amount of fee-based service income are generally lower than the operational risks associated with the same amount of interest income or trading revenues. In addition, such an approach could incentivize diversification by some banking organizations into more stable, fee-based sources of income, which is consistent with safe and sound banking practices.

Like the standardized and enhanced risk-based approaches to credit risk, a standardized risk-based approach to operational risk could be implemented with varying degrees of granularity and complexity. If the Agencies believe that certain business activities are more prone to operational risks than others, the scaling factors could be increased or decreased accordingly, while preserving an overall calibration of operational risk capital requirements for the banking system as a whole.

In addition to the alternatives above, we recommend that the Agencies align the methodology for calculating the Services Component with that of both of the Interest, Lease and Dividend and Financial Components, permitting netting of fee income and related expenses in the calculation of the Services Component. Requiring such a calculation to occur on a gross basis only in the case of the Services Component unduly penalizes fee-centric businesses, such as custody.

B. ILM floor

Under the Proposed Rule, risk weighted assets for operational risk would be calibrated in part according to the ILM. The ILM would be a function of historical operational losses and the BIC, subject to a floor of 1.0. The ILM is designed to reflect the Agencies' view that "[h]igher historical operational losses are associated with higher future operational loss exposure."[24]

The ILM as proposed would not achieve the Agencies' goals and is not consistent with BCBS's recommendations. The presence of an output floor of 1.0 provides capital requirements for operational risk which are untethered from historical experience and increases costs for banks which have historically engaged in safe business practices, such as custody banks, without sufficient support. The ILM floor also diverges from BCBS's

[24] 88 Fed. Reg. at 64086.

recommendation with respect to the ILM, which is functionally equivalent to the Proposed Rule except for the output floor.[25]

Northern Trust estimates that its current unbounded ILM would be below 1.0, and as a result the floor would set our ILM at 1.0. We estimate that average operational losses could increase by more than a third before our ILM would reflect any additional operational capital charge. Because our historically low operational losses do not provide favorable capital treatment below the ILM floor, the ILM floor as proposed would fail to reward and further incentivize strong risk management practices and control procedures which have effectively reduced operational risk. As in the case of calibration the Services Component, we believe the Agencies should seek to encourage, rather than discourage, banking organizations' diversification into balance sheet-light activities which would improve resiliency. The Proposed Rule would undermine this goal.

In addition, a strictly fixed or floored ILM would present serious and growing capital charges for Northern Trust's business model. As discussed in Section IV.A, Northern Trust's businesses have trended toward reduced losses and increased fees over time, contrary to the implied logic of the Proposed Rule which applies operational risk charges according to business volume. In this context, the unbounded growth of the BIC and uncapped treatment of the Services Component would apply increasing pressure to bank capital levels despite a Loss Component which diminishes over time.

We therefore strongly encourage the Agencies to revise the ILM calculation to remove the floor. Such a change would be consistent with the Agencies' goals and with the international standards of BCBS, which do not require the ILM to be floored at 1.0. In the alternative, we recommend the Agencies set a cap of the ILM at 1.0, while letting the ILM float below 1.0 in order to reward firms with prudent operational risk management practices and create incentives for firms to pursue further enhancements to management of operational risks. Either change would recognize Northern Trust's diligent risk management practices and ensure appropriate calibration of capital charges to continue to encourage such practices.

V. Credit Risk

A. Expansion of Preferential Risk Weights for Certain Investment Grade Corporate Entities

Under the Proposed Rule, investment grade corporate exposures would be eligible for a preferential risk weight of 65% only if the borrower or counterparty, or its parent company, has publicly traded securities outstanding.[26] The Agencies explain that this is a two-part test, with the investment grade criterion addressing credit quality of the exposure and the public listing criterion acting as "a simple, objective criterion that

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[25] BCBS, *OPE 25 – Standardised Approach*, 25.8 (2022), https://www.bis.org/basel_framework/chapter/OPE/25.htm.

[26] Proposed Rule § __.111(h)(1).

would provide a degree of consistency across banking organizations."[27] The Agencies note that "publicly-traded corporate entities are subject to enhanced transparency and market discipline."[28] The public listing criterion would exclude many corporate entities and virtually all SMEs from this preferential risk weight.

In addition, an exposure to an SME would be eligible for preferential risk weight only as a "regulatory retail exposure," which would disqualify exposures to any borrower or counterparty above a $1 million aggregate threshold. Specifically, a "regulatory retail exposure" would be defined as a revolving credit or line of credit or a term loan or term lease that is not in default, subject to an aggregate limit and a granularity limit. Under the aggregate limit, an exposure would be excluded from the definition if the banking organization's total exposure amount to the obligor and its affiliates exceeds $1 million.[29] For exposures to SMEs above this threshold, the applicable risk weight would be 110%, effectively penalizing SMEs relative to larger corporates.[30]

The public listing criterion and aggregate limit on regulatory retail exposures would exclude many of Northern Trust's exposures to corporate entities and SMEs from these preferential risk weights. Northern Trust believes these requirements are weak indicators of creditworthiness and needlessly disfavor non-publicly listed corporate exposures. Many of Northern Trust's corporate exposures would satisfy the investment grade criterion but would be excluded from preferential risk weights due to the public listing criterion, and many of Northern Trust's SME exposures would be subject to the punitive risk weight because of the $1 million aggregate limit. The Proposed Rule would therefore put non-publicly traded corporate exposures and SMEs on unequal footing with public companies, despite the fact that many such exposures are highly creditworthy and, although not subject to public reporting requirements and the discipline of public markets, nevertheless provide financial transparency to their bank lenders through contractual obligations to disclose financial information to their lenders. Northern Trust believes that non-publicly traded corporate companies should be afforded the opportunity to access bank credit on comparable terms as publicly listed companies.

In addition, Northern Trust has certain exposures to insurance companies which are not SMEs and do not have publicly traded securities outstanding. These exposures, including exposures to bank owned life insurance policies through mutual insurers, would not qualify for a preferential risk weight for corporate exposures with publicly traded securities outstanding. Nevertheless, these exposures are highly creditworthy by nature of the business lines of such exposures, by virtue of their status as prudentially regulated entities and, as in the case of certain SME exposures, can provide transparency to their bank lenders through the provision of audited financial statements. Northern Trust seeks to diversity its bank-owned life insurance asset holdings across a number of high-quality

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[27] 88 Fed. Reg. at 64054.

[28] *Id.*

[29] Proposed Rule § __.111(g)(1).

[30] Proposed Rule § __.111(g)(2).

insurers, many of which are mutual insurance companies, and cannot readily switch between them to take advantage of preferential risk weights.

We have two recommendations with respect to capital requirements for exposures to SMEs and other corporate entities. First, investment grade exposures to corporate entities should qualify for a 65% risk weight if the corporate entity provides audited financial statements to the banking organization at least annually. Insofar as the Agencies believe the characteristic of having, or having a parent which has, publicly traded securities will provide banking organizations with information about their exposures to corporate entities, we believe that providing annual, audited financials would provide comparable transparency consistent with the Agencies' goal of a simple, objective standard.

Second, investment grade exposures to SMEs that provide unaudited financial statements to the banking organization on an annual basis should be eligible for an 85% risk weight, without regard to the quantitative limits applicable to regulatory retail exposures. This approach would avoid the disadvantageous capital treatment which the Proposed Rule would apply to exposures without publicly traded securities relative to their similarly creditworthy counterparts while conforming to the Agencies' goals of requiring banking organizations to obtain transparency for their corporate exposures. It would also be consistent with the Basel Framework's 85% risk weight category for SMEs, recognizing that certain SME exposures satisfy standards for transparency and creditworthiness even in the absence of annual audited financial statements.[31]

B. Treatment of Bank Exposures and Exposures to Other Prudentially Regulated Financial Institutions

Treatment of Bank Exposures

Under current U.S. capital rules, the risk weight for exposures to U.S. depository institutions and foreign banks in certain developed countries is 20%.[32] This risk weight is consistent with the base risk weight under the revised Basel Framework for exposures to highly rated depository institutions, for jurisdictions using the external credit risk assessment approach (**ECRA**).[33] The Proposed Rule would assign a base risk weight to exposures to Grade A depository institutions of 40%.[34] Although the Proposed Rule's base risk weights for bank exposures are consistent with the revised Basel Framework's

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[31] BCBS, *CRE 20 – Standardised Approach: Individual Exposures*, 20.47 (2022), https://www.bis.org/basel_framework/chapter/CRE/20.htm.

[32] 12 C.F.R. § 217.32(d).

[33] BCBS, *CRE 20 – Standardised Approach: Individual Exposures*, 20.18 (2022), https://www.bis.org/basel_framework/chapter/CRE/20.htm.

[34] Table 2 to Proposed Rule § _.111.

standardized credit risk assessment approach (**SCRA**),[35] the lowest risk weight under the SCRA is twice the current risk weight and twice the lowest base risk weight under ECRA.

The Proposed Rule would assign a 20% risk weight to exposures to depository institutions only in highly limited circumstances involving trade credit exposures with a maturity of three months or less. All other bank exposures, even demand deposits and other very short-term exposures, would be excluded from this preferential risk weight under the Proposed Rule. The revised Basel Framework's SCRA applies the 20% risk weight to any short-term exposure, defined as an exposure of any kind with an original maturity of three months or less (or six months or less for trade credit exposures).[36] Thus, the Proposed Rule would apply the 20% risk weight to a much narrower set of exposures than under the revised Basel Framework.

We recommend that the Agencies reconsider the proposed treatment of exposures to depository institutions in general and, at a minimum, revise the scope of the 20% risk weight to align it with broader scope of short-term exposures under the revised Basel Framework. We recognize that the SCRA was designed by the BCBS to apply to jurisdictions, like the United States, that do not allow the use of external ratings for regulatory purposes. We point out, however, that the SCRA was also designed to apply to *unrated* banks in jurisdictions that do allow the use of external ratings for regulatory purpose.[37] These two prongs of the applicability of the SCRA reflect very different types of bank exposures. In the United States, the Agencies are prohibited from using external ratings for regulatory purposes under Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[38] Unrated bank exposures, in contrast, are less likely to be creditworthy. Exposures of U.S. banking organizations to highly creditworthy banks should not, in our view, be treated the same as exposures of non-U.S. banking organizations to unrated banks.

At a minimum, we recommend that the Agencies revise the proposed treatment of short-term bank exposures to align it with the SCRA under the revised Basel Framework, under which all bank exposures of three months or less would qualify for a reduced risk weight (e.g., 20% for Grade A banks) relative to the base risk weights (e.g., 40% for Grade A banks). In connection with our custody business, Northern Trust has deposits with depository institutions who act as sub-custodians for our clients or with whom we hold nostro accounts. These exposures are demand deposits that are highly creditworthy and that are subject to a 20% risk weight under the current capital rules and the Basel

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[35] BCBS, *CRE 20 – Standardised Approach: Individual Exposures*, 20.21 (2022), https://www.bis.org/basel_framework/chapter/CRE/20.htm.

[36] BCBS, *CRE 20 – Standardised Approach: Individual Exposures*, 20.31 (2022), https://www.bis.org/basel_framework/chapter/CRE/20.htm.

[37] BCBS, *CRE 20 – Standardised Approach: Individual Exposures*, 20.21 (2022), https://www.bis.org/basel_framework/chapter/CRE/20.htm.

[38] Pub. L. 111–203, Title IX, § 939A (July 21, 2010).

Framework. The Proposed Rule would double the risk weight for these exposures, in a deviation from both the current U.S. capital rules and the Basel Framework without any change in creditworthiness. As an alternative approach, we support the definition of short-term bank exposure under the Basel Framework, which would apply to all exposures of three months or less and to trade credit exposures of six months or less.

In addition to this heightened requirement relative to international standards, the Proposed Rule would restrict the lower risk weights for trade credit exposures to foreign bank exposures.[39] We believe the limitation of this treatment to foreign banks was introduced potentially in error. The corresponding provision of the Basel Framework does not limit the treatment to exposures to banks organized in jurisdictions outside the home country of the banking organization.[40] Although trade credit exposures involve account parties located in different countries and often involve local banks in each country, it is not empirically true that all trade credit exposures involve an exposure to a foreign bank. For example, in practice, a trade credit exposure may be an exposure to a foreign branch of a U.S. bank. Therefore, we recommend the Agencies revise the scope of trade credit exposures eligible for the reduced risk weights under the Proposed Rule to remove the reference to foreign banks.

Treatment of Exposures to Other Prudentially Regulated Financial Institutions

We also recommend that exposures to broker-dealers, insurance companies and other entities subject to prudential regulation and supervision be subject to the same risk weighting framework as exposures to depository institutions. Specifically, the standardized, grade-based approach used for bank exposures should be expanded and adapted to apply to prudentially regulated entities, including broker-dealers and insurance companies, with adoption of comparable grade-based thresholds for insurance companies that are based on the entity's actual capitalization levels relative to its statutory or regulatory requirements. This approach would reflect the reality that such exposures are highly creditworthy as a result of their business models and as a result of their supervision and regulation. It would also be consistent with the Basel Framework, which permits national regulators to treat exposures to prudentially regulated non-bank entities the same as exposures to banks, provided such entities are subject to prudential standards and supervision at a level comparable to banks.[41]

C. Non-Significant Equity Exposures

Under the current U.S. capital rules, banking organizations may apply a risk weight of 100% on a limited basis to a category of equity exposures (other than

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[39] Table 2 to Proposed Rule § _.111 refers to "risk weights for *foreign bank* exposures" (emphasis added).

[40] BCBS, *CRE 20 – Standardised Approach: Individual Exposures*, 20.31 (2022), https://www.bis.org/basel_framework/chapter/CRE/20.htm.

[41] BCBS, *CRE 20 – Standardised Approach: Individual Exposures*, 20.40 (2022), https://www.bis.org/basel_framework/chapter/CRE/20.htm.

significant common-stock exposures to unconsolidated financial institutions and certain exposures to leveraged investment firms), provided the aggregate amount of such exposures is no more than 10% of the banking organization's total capital.[42] Equity exposures above this 10% threshold are subject to higher risk weights (e.g., 400% for non-publicly traded equity exposures), unless the exposure is otherwise required to be deducted from total capital.[43] The Proposed Rule would eliminate the limited 100% risk weight category for equity exposures. Under the Proposed Rule, many of these exposures would face higher risk weights of up to 400%.

This proposed change would adversely affect Northern Trust. Despite a small balance sheet relative to its custody and wealth management operations, Northern Trust nevertheless must maintain direct equity exposures to certain financial market utilities, such as securities trading platforms, exchanges and clearinghouses, as a condition of participation in their platform and services. In addition, certain international activities require that banks hold equity investments in nominee companies. These exposures are atypical equity exposures because these FMUs and similar entities engage in a narrow range of financial activities as agents or riskless principals, and accordingly should not be subject to higher risk weights. Northern Trust also uses the existing 100% risk weight category for non-significant equity investments for seed investments in funds, certain equity derivatives, and other *de minimis* exposures in connection with its existing business.

In addition, we believe that eliminating the limited 100% risk weight category for equity exposures would undermine certain national public policy goals. Banking organizations support these goals, such as renewable energy investment, tax equity finance transactions, certain affordable housing developments[44] and national infrastructure projects, through non-significant equity investments facilitated through the existing 100% risk weight category. We encourage the Agencies to consider the adverse consequences of eliminating the limited 100% risk weight category, particularly in light of such diverse national public policy priorities which this general category helps facilitate and, which, given their variety and frequently evolving scope, may be difficult to facilitate on a one-for-one basis under the capital rules by limiting the 100% risk weight to an enumerated list of exposure types.

We recommend that the Agencies retain the limited 100% risk weight category for non-excluded equity exposures in its current form and subject to existing limits in the current U.S. capital rules. This existing risk weight category appropriately reflects the fact that certain equity exposures are necessary for the provision of banking services, and therefore should not face punitive capital requirements. Clearinghouses and similar

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[42] 12 C.F.R. § 217.52(b)(3)(iii).

[43] *See, e.g.*, 12 C.F.R. § 217.22(c)(5) (threshold deduction framework for non-significant investments in the capital of unconsolidated financial institutions).

[44] To the extent not eligible for preferential risk weight as an exposure as a community development investment under section 24 (Eleventh) of the National Bank Act. *See* Proposed Rule § __.141(b)(3)(i).

institutions are subject to prudential and market structure regulation which distinguishes them from other equity exposures. Other, concurrent regulatory changes, such as the Securities and Exchange Commission's rule to facilitate additional central clearing for U.S. Treasury securities, will increase our use of clearinghouses.[45] Unlike other equity exposures for which banking organizations may have alternatives to achieve comparable ends, equity exposures to such institutions generally lack substitutions. If the Agencies were to adopt the Proposed Rule without any favorable treatment for equity exposures to such entities, it would amount to a capital charge for an effectively mandated investment (as a condition for accessing certain widely used services) that is not commensurate with the substantive risk of such exposures. This is especially true considering the liquidity access that such participation provides, which may support the resiliency of a banking organization in times of stress. In addition, we believe that rules for exceptions based on significance thresholds should be aligned internationally to prevent complexity which would not be justified by any particular conditions or circumstances of the U.S. banking system. Finally, the elimination of the 100% limited risk weight category would impede the ability of banking organizations to support certain national public policy goals.

VI. Market Risk

Although Northern Trust does not have significant trading activity and is not subject to substantial market risk, it is nevertheless subject to current and proposed market risk capital requirements. In some cases, however, the burdens of calculating the market risk capital requirements for certain of our activities outweigh the supervisory benefits of precisely determining such requirements relative to the more conservative fallback capital requirement included in the Proposed Rule. Yet the scope of the fallback capital requirement would be limited to positions for which a banking organization is "*unable* to calculate market risk capital requirements" under the detailed methodologies prescribed by the proposed rule. We recommend that the fallback capital requirement under the Proposed Rule be clarified or expanded so that banking organizations may elect to apply the more conservative, dollar-for-dollar fallback treatment for certain seed capital investments, as discussed below.

In connection with our asset management activities, from time to time we sponsor and organize new investment fund opportunities for our clients. In order to build a track record prior to marketing these funds to our clients, we provide seed capital for such funds, taking limited proprietary positions in the funds consistent with the requirements of the Volcker Rule. We typically exit such positions within a year. The preamble provides the following example of when a banking organization may be unable to calculate the market risk capital requirements for a position:

> For example, a banking organization may not be able to calculate some risk factor sensitivities or components for one or more market risk covered

[45] *See Standards for Covered Clearing Agencies for U.S. Treasury Securities and Application of the Broker-Dealer Consumer Protection Rule with Respect to U.S. Treasury Securities*, *available at* https://www.sec.gov/files/rules/final/2023/34-99149.pdf.

> positions due to an operational issue or a calculation failure. Such issues could arise when a new market product is introduced and the banking organization has not had sufficient time to develop models and analytics to produce the required sensitivities or the new data feeds for the proposed market risk capital calculations. In such cases, the proposal would require a banking organization to apply the fallback capital requirement to the affected market risk covered positions[.][46]

Under the Proposed Rule, we would be newly required to treat these seed capital exposures to investment funds as market risk covered positions subject to capital requirements for market risk.[47] These activities are nevertheless distinguishable from traditional trading activities because they are held primarily for the purpose of facilitating our clients' access to such investments rather than for material profits to Northern Trust. Because we manage the investment funds in which we hold seed investments, we would technically have the information required to apply the look-through approach to calculate a market risk capital requirement for our proportional ownership share of each of the exposures held by the investment fund. Applying the look-through approach for market risk to these positions, however, would be unduly burdensome relative to the simplicity and conservatism of applying the fallback capital requirement.

We therefore recommend that the Agencies further clarify that a banking organization may apply the fallback capital requirement in place of applying the look-through approach for market risk in such circumstances. Modeling sensitivities for such investments would be resource-intensive, particularly relative to the ultimate capital requirements arising from those calculations, and it would not undermine the Agencies' goals because electing to apply the fallback capital requirement for seed capital investments would require a banking organization to hold more capital than it would be required to under the standardized approach.

VII. Other Issues

We have also identified practical challenges with certain provisions of the Proposed Rule's treatment of operational risk capital requirements that would be unduly burdensome to implement relative to the benefits to safety and soundness sought by the Agencies. While the issues in Sections III-VI of this comment letter are substantive objections to the capital treatment of certain exposures or businesses, in this Section VII we recommend that the Agencies consider certain technical and procedural aspects of the Proposed Rule. Some modest changes to these aspects of the Proposed Rule would meaningfully reduce these procedural burdens without an accompanying reduction in safety and soundness.

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[46] 88 Fed. Reg. at 64111.

[47] *See* 88 Fed. Reg at 64096 fn. 240.

A. Treatment of Operational Losses Acquired Through Mergers and Acquisitions

The Proposed Rule would include a special provision to address the scenario where a banking organization subject to the operational risk capital requirements merges with or acquires an entity that does not have complete operational loss event data for the ten-year look-back period required to calculate the ILM. Specifically, the provision prescribes an approach for calculating a substitute measure of the operational losses of the merged or acquired entity to back-fill for any years that are missing from the records of the acquired entity over the ten-year look-back period. It is Northern Trust's understanding that the proposed approach would effectively apply the loss history of the acquiring entity to back-fill any gaps in the data of the acquired entity, with the result being the preservation of the acquiring entity's loss history and ILM.

In our view, that the proposed provision for these relatively rare instances is overly complex and is prone to a wide range of industry practices in its implementation. In order to balance the complexity and resulting burden on banking organizations, Northern Trust recommends that the Agencies introduce a materiality threshold – based on the BIC of the target institution relative to the BIC of the acquiring institution – for a merger or acquisition transaction below which the acquiring organization would be permitted to retrospectively exclude the effects of the merger or acquisition from the calculations of historical losses and the BIC for purposes of the acquiring organization's ILM calculations.

If the ratio of the BIC of the acquired entity to the BIC of the acquiring organization is less than the materiality threshold, no back-fill adjustment would be required. For such non-significant mergers and acquisitions, Northern Trust recommends that the banking organization be permitted to treat the historical loss amounts attributed to the acquired entity for any periods prior to the acquisition for which data of the acquired entity is unavailable as zero for purposes of the ILM. In addition, to reflect a corresponding adjustment to the denominator of the ILM, the acquiring organization would be required to exclude the historical activity of the acquired entity, for any period for which the acquired entity's historical losses are excluded from the ILM numerator, from the calculation of the BI.

B. Treatment of Timing Losses

The Proposed Rule would include a special provision to address the treatment of timing losses—i.e., a negative financial impact that a banking organization books in its financial statements in one period due to having incorrectly booked a positive financial impact in a previous period.

Northern Trust understands that the proposed provision on timing losses would reflect a change in current practice for the treatment of timing losses. Northern Trust recommends that the proposed provision on timing losses should be clarified to apply only prospectively (i.e., to new timing losses recognized after the adoption of the Proposed Rule), rather than retroactively to all potential timing losses over the ten-year look-back period for the ILM. To the extent that the proposed treatment would differ

from a banking organization's historical treatment of timing losses, banking organizations would face a significant burden to properly support the retroactive application of the proposed timing loss provision. Such a burden is not, in our view, justified by the benefits of retrospectively applying the proposed provision.

VIII. Conclusion

We appreciate the opportunity to provide feedback to the Agencies on the elements of the Proposed Rule that would have a particular impact on Northern Trust. In general, we believe the Agencies should revise some aspects of the Proposed Rule which would have a disproportionate and poorly calibrated effect on custody banks, like Northern Trust, which despite their size do not present the same risks as other banking organizations. With respect to operational risk, the Proposed Rule would apply punitive risk weights which would discourage our balance sheet-light, fee-centric business and thereby undermine the Agencies' goals of safety and soundness. Further, some credit risk calibrations in the Proposed Rule have deviated from the Basel Framework and thereby unduly burden our exposures with, for instance, sub-custodians which empirically do not pose risks to bank safety and soundness commensurate with proposed risk weights for such exposures. Finally, we encourage the Agencies to adopt several revisions or make explicit certain calculation methods in the context of market risk and operational risk which would mitigate the operational burdens of compliance relative to the modest increases in bank capital levels that would occur in the absence of those revisions or explicit guidance.

In addition, Northern Trust supports the recommendations raised in the comment letter from the Risk Management Association Advanced Operational Risk Group, as well as the comment letters from the Risk Management Association Securities Lending Council, the Global Pension Fund Association and the Bank Policy Institute, to the extent they are not inconsistent with the recommendations of this comment letter.

We would be pleased to discuss any of these comments with the Agencies in greater detail if it would be helpful with in their consideration of the Proposed Rule. Please contact Marek Dudek at md78@ntrs.com or at (312) 444-7745 if you wish to discuss the points raised in this letter further.

Sincerely,

Jason J. Tyler

Chief Financial Officer, Northern Trust Corporation

Appendix: Northern Trust's Business Model

A. Northern Trust's Custody Business

In the course of our custody business, client securities are recorded and held in securities accounts. These securities are beneficially owned by Northern Trust's clients, or by clients of Northern Trust's clients, not by Northern Trust, and are segregated from Northern Trust's own assets. Northern Trust bears no market or credit risk in respect of its clients' securities. As a result, securities held in client securities accounts are not reflected on Northern Trust's balance sheet. A custody bank such as Northern Trust provides post-trade securities settlement services by facilitating the delivery or receipt of sold or purchased securities and any related cash consideration at the direction of its clients. In settling securities transactions, Northern Trust may simply record credits and debits to securities and cash accounts on its books (if both the purchaser and seller of securities have accounts with Northern Trust) or may transmit purchase or sale settlement instructions to its sub-custodians or securities settlement systems in the relevant jurisdictions in which the securities are physically held (if the securities are represented by global or individual certificates) or are recorded on an electronic register (if they are in dematerialized form). Northern Trust thus facilitates transactions in client securities, but does not make markets in or underwrite the issuance of the securities.

Clients with securities held under custody at a custody bank such as Northern Trust also need access to a cash account in order to hold cash used to purchase securities, receive cash from the sale of securities and from dividends and interest payments, and hold cash used for or resulting from various corporate actions by issuers of securities (such as repurchases, exchanges, mergers or spin-offs), and for subscriptions and redemptions of, for example, mutual fund shares. Client cash is held on deposit in a cash account with Northern Trust and represents a liability of Northern Trust to the client for the amount of the deposit, and thus – unlike the client's securities held in custody – is reflected on Northern Trust's balance sheet. Whereas a custody client does not have credit exposure to Northern Trust for its securities held in custody, it does have a credit exposure to Northern Trust for the amount of its cash on deposit.[48]

A custody bank's balance sheet is driven primarily by its client cash deposits, which in turn are driven by clients' investment and transactional activity, and a custody bank such as Northern Trust has little or no direct means of control over such client activities. As a result, Northern Trust's custody-related cash balances can fluctuate even on a relatively short-term basis, and in times of market unrest or crisis can actually expand as custody clients may liquidate holdings of securities in favor of cash and leave more cash on deposit. However, because client cash deposits are generally held in connection with broader relationships with the firm, including the security accounts discussed above and ancillary record keeping and accounting service relationships, all of which are governed by custody agreements and other relationship documentation that include provisions limiting the ability of a client to terminate immediately its custody

[48] A portion of a client's cash deposit with Northern Trust may be insured by the Federal Deposit Insurance Corporation or under an equivalent non-U.S. deposit guarantee scheme.

relationship with the firm, a substantial percentage of Northern Trust's cash deposits qualify as operational deposits under the Agencies' liquidity coverage ratio rules.[49] Consistent with these provisions, Northern Trust has developed detailed statistical analysis demonstrating that a substantial proportion of custodial deposits reflect the characteristics of core, stable funding with material durations far in excess of 30 days.

The asset side of a custody bank's balance sheet generally reflects the volume of its clients' investment and transaction activities. This is one of the primary reasons Northern Trust has never favored the idea of tying enhanced prudential standards solely or even primarily to asset size: for a custody bank, asset size is effectively a derivative of its agency custody activities, which reflect client activity. Imposing requirements based solely or primarily on asset size means that a custody bank may find itself subject to an additional level of regulatory constraints and burdens solely as a result of providing agency custody activities that are necessary for investors such as U.S. pension funds, mutual funds, index funds, exchange traded funds and the like to access securities markets around the world in line with market growth.

The asset side of Northern Trust's custody business balance sheet consists primarily of securities that are HQLAs and cash on deposit with Federal Reserve Banks and other central banks. The firm's securities portfolios are generally held for investment purposes, to secure extensions of credit from financial market utilities and sub-custodians related to Northern Trust's securities settlement activities on behalf of its clients, and to enable Northern Trust to meet any outflows of liquidity resulting from a reduction in client activity and thus client cash deposits.

In the course of facilitating the settlement of clients' securities transactions or the timing of availability of cash receipts arising from redemptions, dividends or interest payments, a custody bank such as Northern Trust may also extend short-term credit (which in most cases is limited to intraday or overnight credit) to a client when the amount in the client's cash account is not sufficient to fund the client's transactions. In the case of Northern Trust, these custody-related short-term loans represent a significant percentage of the firm's total custody-related loans, which typically are supported by cash or securities held in client accounts at Northern Trust. The firm's custody business balance sheet, unlike the balance sheets of most commercial banks, does not reflect significant maturity transformation activities, i.e., the making of long-dated loans or investments funded primarily by demand deposits, and thus does not present a significant duration or liquidity mismatch. As a result, from a liquidity perspective, Northern Trust's custody business relies primarily on custody-related client cash deposits and does not rely on material amounts of short-term wholesale funding.

Northern Trust's custody business is international in scale, as it allows U.S. clients access to securities issued and traded in markets outside the United States and non-U.S. clients access to securities issued and traded in the United States. Northern Trust has

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[49] These agreements may include provisions that generally would require notice before terminating the custody relationship. In addition, moving securities portfolios from one custodian to another is a process that typically occurs over a period of months rather than days or weeks.

operations in 23 countries. However, its cross-jurisdictional claims and cross-jurisdictional liabilities are concentrated primarily in five jurisdictions outside the United States, namely, the United Kingdom, Ireland, Luxembourg, the Cayman Islands and Australia: 50% of the firm's foreign cross-jurisdictional claims and 61% of the firm's foreign cross-jurisdictional liabilities are concentrated in these five jurisdictions.

B. Northern Trust's Wealth Management Business

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 Northern Trust. All residential real estate loans are underwritten utilizing Northern Trust's credit policies, which do not support the origination of loan types generally considered to be of high risk, such as option adjustable-rate mortgage loans, subprime loans, loans with initial "teaser" rates, and loans with excessively high loan-to-value ratios. Residential real estate loans consist of traditional first lien mortgages and equity credit lines that generally require a loan-to-collateral value of no more than 65% to 80% at inception. The commercial real estate portfolio consists of commercial mortgages and construction, acquisition and development loans to high quality borrowers. Underwriting standards generally reflect conservative loan-to-value ratios and debt service coverage requirements. Recourse to owners through guarantees also is commonly required in commercial real estate loans made to wealth management clients.

C. Ancillary Custody- and Wealth Management-Related Services

In connection with its custody and wealth management businesses, Northern Trust offers various ancillary asset servicing options to its clients, including foreign exchange services and agency securities lending services. Because clients need to settle securities transactions in multiple currencies, Northern Trust offers a variety of foreign exchange (**FX**) products and services, including FX spot and forward transactions and FX derivatives to help clients manage their FX risk.

Northern Trust also offers agency securities lending services in response to client demand to enhance their yield on securities they hold in custody with Northern Trust. In agency securities lending transactions, Northern Trust generally acts as agent for the securities lender. Securities lending transactions are secured transactions in which borrowers collateralize their obligations to the lenders to return the loaned securities with cash or other securities, often government and agency securities. In its role as agent, Northern Trust effects the loan of securities against collateral, monitors the value of the collateral over the life of the transaction and verifies that, to the extent necessary, additional collateral is posted or excess collateral is released. Northern Trust may also agree to indemnify securities lenders in the event that borrowers do not return the loaned securities, with its principal credit exposure being limited to any shortfall in the value of the collateral posted by the borrower compared to the value of the loaned securities.

D. Conclusion

We intend for the detail in this Appendix to provide additional context regarding Northern Trust's business and the considered recommendations in the accompanying comment letter. In sum, our custody business by its nature does not present significant risks to Northern Trust as an entity nor to the U.S. banking system in the aggregate and, indeed, supports stable and efficient intermediation in the U.S. financial ecosystem. We would be pleased to provide any additional information if it would be helpful as the Agencies consider revisions to the Proposed Rule.