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Northern Trust

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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-1238

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 05-16

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW.
Washington, DC 20552
regs.comments@ots.treas.gov
Attention: No. 2005-40

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW.
Washington, DC 429
comments@FDIC.gov

RE: Comments on the Advanced Notice of Proposed Rulemaking (ANPR) for revisions to the existing risk-based capital framework

Ladies and Gentlemen:

Northern Trust Corporation appreciates the opportunity to comment on the proposed revisions to the existing risk-based capital framework ("Basel I-A"), as described in the October 20, 2005 ANPR.

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, international offices in seven countries and approximately 9,000 employees worldwide. Northern Trust had balance sheet assets totaling over $53 billion and assets under custody totaling $2.9 trillion as of December 31, 2005. 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.

Northern Trust intends to implement a Basel II Advanced IRB framework within the timelines established by the Regulatory Agencies in the jurisdictions in which we have operations. Since 2001, Northern Trust has taken an active interest in the efforts to update the current risk-based capital framework ("Basel I"). We have dedicated extensive resources to prepare for the New Basel Capital Accord ("Basel II"), submitted comments to both the Basel Committee and U.S. Regulatory Agencies on proposed changes to the framework or proposed rules, and participated in multiple quantitative impact studies.

As a general comment, Northern Trust supports efforts to make the United States' risk-based capital framework more risk sensitive for all financial institutions. We support the broad principles behind the Basel I-A framework (as stated in Section II of the ANPR). We also recognize that the framework, while similar in many respects to the Basel II Standardized Approach for Credit risk, is a simpler and less costly approach for banks and thrifts to implement.

Based on a cursory analysis of the impact of the proposed framework, Northern Trust does not expect the Basel I-A framework (as described in the ANPR) to change our capital position significantly, in terms of either total risk-weighted assets or capital ratios. This is largely due to the high quality of securities, loans and commitments on our balance sheet: the proposed framework does not allow lower risk weights beyond what the current capital framework allows for much of our portfolio.

We do have some concerns with respect to the implementation approach described in the ANPR. Our comments fall into three categories: the use of Basel I-A by Basel II banks, the Basel I-A framework in general, and comments on the details of the Basel I-A framework.

Basel I-A for Basel II Banks

Our primary concern with the proposed Basel I-A framework is the burden it would impose on banks already working to implement their Basel II frameworks. While Basel I-A is an improvement over Basel I, Basel II is a far more comprehensive approach to risk-based capital and overall risk management. Northern Trust has invested significant resources in developing a risk management framework compliant with Basel II, and we expect this effort to continue for some time. If Northern Trust is required to rebuild its existing risk-based capital framework in order to comply with the Basel I-A requirements, the Basel I-A effort would draw resources from our Basel II efforts. Additionally, it would be useful to understand how the implementation of Basel I-A might affect the interim Basel II implementation expected by host country regulators requiring Basel II adoption earlier than the U.S. (home country) regulators.

It should be noted that for banks intending to implement a Basel II compliant framework, the resources required to rebuild existing systems to comply with Basel I-A represent an additional expense providing little benefit. The new Basel I-A systems would be used only to determine the floor for Basel II capital requirements during the transition period. It is estimated that the additional expense would not be insignificant, since at many banks the Basel I framework has far-reaching impacts on the general ledger systems, loan and asset accounting systems, as well as the business unit processes associated with loan and trade entry. Updating all the systems impacted by Basel I-A would be a major undertaking.

We therefore believe that it would be inappropriate to require those banks that are implementing a Basel II framework to comply also with the Basel I-A approach. We recommend that the U.S. Regulatory Agencies allow such banks to choose between the Basel I and Basel I-A approaches. By extension of this argument, we further suggest that any banks that choose the Basel I approach over Basel I-A be allowed to use the Basel I framework to determine any capital floors required during the Basel II transition process.

General Comments on Basel I-A

In spite of our view that banks intending to implement Basel II should be allowed to opt out of Basel I-A, we also would like to comment on some of the specific aspects of the framework proposed in the ANPR. We offer these comments for two reasons: First, we might, regardless of our views, be required to implement a framework compliant with Basel I-A. Second, the framework will impact the banking industry overall, including our competitors or counterparties.

The proposed Basel I-A framework provides far greater flexibility and granularity in determining risk weights, but does not impose any requirements that banks control the quality of their credit data or processes. Though this might be implicit in other regulatory requirements, Northern Trust believes that the Basel I-A framework should explicitly require banks to maintain accurate and up-to-date information on the data elements that impact the determination of risk weights: e.g., ratings information, credit scores, loan to value ratios, and product categorizations. In general, if a bank is claiming a preferred risk weight for a category of assets, it should be required to support that preferential treatment with reliable data and systems.

The ANPR considers "allowing banking organizations to choose among alternative approaches for some of the modifications to the existing capital rules". This suggests that banks might be able to implement Basel I-A on a selective basis, utilizing certain of its elements while ignoring others. Northern Trust favors this approach for two reasons. First, banks might need time to transition to the new approaches and develop the processes and data to support them. This might be quick and simple for some categories of assets, but might require a longer term effort for others. Second, banks could use materiality as a basis for determining which elements of the Basel I-A framework make sense. For categories of assets with small balances, the costs to implement Basel I-A for those assets might not be justified by the impact of the change.

Northern Trust therefore recommends that the U.S. Regulatory Agencies allow banks a high degree of flexibility in choosing which elements of the new framework are appropriate for them, and allow adequate time to transition to the new approach. In granting this flexibility, however, it is important that the regulators set standards of materiality, and ensure that banks are not 'cherry picking' methodologies simply to obtain favorable capital treatment.

Comments on Specific Aspects of Basel I-A

The ANPR proposes many specific changes to the Basel I framework. For most of the proposed changes, the ANPR offers illustrative values for risk weights and general concepts. With the caveat that the final details might affect our view of these changes, Northern Trust offers the following comments on the specific proposals within the ANPR. We also reiterate our concerns that the modification of existing systems to support the Basel I-A framework would be time consuming and require extensive resources.

> <u>Increased Number of Risk Weight Categories</u>: Northern Trust agrees that a greater number of risk weights would dramatically improve the alignment of risk and capital.

The exact number of risk weights and their specific values are less important than offering a more granular and diverse set that covers the wide range of products and customers with which banks deal. However, we believe that the addition of a risk weight category between zero and 20% would be appropriate for very high quality assets, such as short-term AAA rated commercial exposures, or any over-collateralized lending arrangements. As noted in our earlier comments, banks should be allowed to opt out of using the additional risk weights for immaterial asset classes.

Use of External Credit Ratings: Northern Trust supports the greater use of external ratings to determine risk weights. We would go further, and suggest that maturity also be considered in combination with external ratings. While the use of external credit ratings might impose burdens on banks, it is important that any capital reductions derived from this approach be justified. Therefore, Northern Trust suggests that banks should be required to demonstrate their ability to track the external ratings in order to use this element of the framework.

Expand Recognized Financial Collateral and Guarantors: Northern Trust supports the use of an expanded list of collateral types and an expanded scope of recognized guarantors in determining risk weights. As with the other proposed changes, we believe banks must be able to justify their use of these elements. Banks that do not have adequate systems to track their collateral or guarantors should not be allowed to use them in determining risk weights.

One-To-Four Family Mortgages: First and Second Liens: Northern Trust supports the use of an expanded set of risk weights for mortgages. We further support the use of LTV, lien position, and borrower credit quality in determining the appropriate risk weights. Northern Trust recommends that banks using this element of the framework should be required to track the necessary data elements. For those banks that cannot meet this requirement, the U.S. Regulatory Agencies should generally allow the continued use of the existing framework, except for high LTV (over 80%) or low-quality assets, which should carry risk weights higher than the current framework allows.

Other Retail Exposures: Northern Trust supports the use of credit scores or other borrower quality measures to determine risk weights for other retail exposures, subject to a bank's ability to justify the risk-weight categorizations.

Short-term Commitments: Northern Trust agrees that the application of a non-zero credit conversion factor (CCF) to commitments having original maturities of less than a year is appropriate. However, a 10% CCF for all such commitments is too simplistic. Such a low factor does little to discourage the current regulatory arbitrage being practiced on off-balance sheet assets. We recommend a graduated approach, for example 10% CCF for maturities of 90 days or less, 25% for 91-180 days, 50% for 180 days to 1 year (values are illustrative only). This would reduce existing incentives for regulatory arbitrage, but still recognize the varying levels of risk associated with unfunded commitments.

Conclusion

Overall, Northern Trust agrees that Basel I-A, as described in the ANPR, represents a substantial improvement over Basel I for those U.S. Banks not intending to implement Basel II as their risk-based capital framework. Basel I-A provides for a clearer, more precise credit risk accounting than Basel I, although it does not account for operational risk.

Northern Trust Corporation appreciates the opportunity to comment on its primary concerns with the proposed revisions to the existing risk-based capital framework. We trust that these comments will be useful as the U.S. Regulatory Agencies develop an updated framework that is practical for financial institutions while achieving the industry's risk management goals. 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 complex effort.

Respectfully Submitted,

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