

# Northern Trust Corporation

## Pillar 3 Regulatory Disclosures

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*For the quarterly period ended December 31, 2015*

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# Northern Trust Corporation

## PILLAR 3 REGULATORY DISCLOSURES

*For the quarterly period ended December 31, 2015*

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### **Introduction**

Northern Trust Corporation (the “Corporation”) is a financial holding company that is a leading provider of asset servicing, fund administration, asset management, fiduciary and banking solutions for corporations, institutions, families and individuals worldwide. The Corporation focuses on managing and servicing client assets through its two client-focused reporting segments: Corporate & Institutional Services and Wealth Management. Asset management and related services are provided to Corporate & Institutional Services and Wealth Management clients primarily by the Asset Management business. The Corporation conducts business through various U.S. and non-U.S. subsidiaries, including through its principal subsidiary, The Northern Trust Company (the “Bank”). At December 31, 2015, the Corporation had consolidated total assets of \$116.7 billion and stockholders’ equity of \$8.7 billion.

The Corporation is a bank holding company that has elected to be a financial holding company under the Bank Holding Company Act of 1956, as amended. Consequently, the Corporation and its business activities throughout the world are subject to the supervision, examination, and regulation of the Board of Governors of the Federal Reserve System (the “Federal Reserve”). The Federal Reserve has established risk-based and leverage capital guidelines for bank holding companies, including the Corporation. As discussed below, on July 2, 2013, the Federal Reserve issued final rules implementing a strengthened set of capital requirements, known as Basel III, in the United States.

The Basel Capital Framework, as described below, requires disclosures based on the third pillar of Basel III (“Pillar 3”). The purpose of Pillar 3 disclosures is to provide information on banking institutions’ regulatory capital and risk management practices. This report is designed to satisfy these requirements and should be read in conjunction with the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2015 (the “2015 Annual Report”).

Except where the context otherwise requires, when we use the terms “Northern Trust,” “we,” “us,” and “our,” we mean Northern Trust Corporation and its subsidiaries on a consolidated basis. The basis of consolidation used for regulatory reporting is consistent with that used under U.S. generally accepted accounting principles (“GAAP”).

- Refer to Note 1 within the Corporation’s 2015 Annual Report for further information on the basis of presentation of the Corporation’s financial statements.

Measures of exposures and other metrics disclosed in this report may not be based on GAAP, may not be directly comparable to measures reported in our 2015 Annual Report and may not be comparable to similar measures used by other companies. These disclosures are not required to be, and have not been, audited by our independent auditors. Our historical filings with the U.S. Securities and Exchange Commission (the “SEC”) and other regulatory disclosure documents are located in the Investor Relations section of our website at [www.northerntrust.com](http://www.northerntrust.com).

## ***Forward-Looking Statements***

This document may include statements which constitute “forward-looking statements” within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are identified typically by words or phrases such as “believe,” “expect,” “anticipate,” “intend,” “estimate,” “project,” “likely,” “plan,” “goal,” “target,” “strategy,” and similar expressions or future or conditional verbs such as “may,” “will,” “should,” “would,” and “could.” Forward-looking statements include statements, other than those related to historical facts, that relate to Northern Trust’s financial results and outlook, capital adequacy, dividend policy, anticipated expense levels, spending related to technology and regulatory initiatives, risk management policies, contingent liabilities, strategic initiatives, industry trends, and expectations regarding the impact of recent legislation. These statements are based on Northern Trust’s current beliefs and expectations of future events or future results, and involve risks and uncertainties that are difficult to predict and subject to change. These statements are also based on assumptions about many important factors, including the factors discussed in Northern Trust’s most recent annual report on Form 10-K and other filings with the U.S. Securities and Exchange Commission, all of which are available on Northern Trust’s website. We caution you not to place undue reliance on any forward-looking statement as actual results may differ materially from those expressed or implied by forward-looking statements. Northern Trust assumes no obligation to update its forward-looking statements.

## ***Basel Capital Framework***

On September 12, 2010, the Group of Governors and Heads of Supervision, the oversight body of the International Basel Committee on Banking Supervision, announced agreement on the calibration and phase-in arrangements for the Basel III capital requirements. On July 2, 2013, the Federal Reserve issued final rules implementing Basel III capital requirements in the United States. The U.S. implementation of Basel III, among other things: (1) increases the minimum capital thresholds for banking organizations and tightens the standards for what qualifies as capital; (2) introduces a new Common Equity Tier 1 capital measure; and (3) presents two methodologies for calculating risk-weighted assets, a standardized approach and an advanced approach. For large and internationally active banks and bank-holding companies, including the Bank and the Corporation, Basel III became effective on January 1, 2014, although certain requirements will be phased in over several years.

The Basel capital framework seeks the alignment of capital requirements with the underlying risks a bank faces and consists of the following three complementary “pillars” designed to reinforce the safety and soundness of the financial system.

### *Pillar 1 — Minimum Capital Requirements*

Pillar 1 provides a framework for calculating minimum regulatory capital requirements. Pillar 1 consists of three risk types: credit risk, operational risk and market risk.

### *Pillar 2 — Supervisory Review*

Pillar 2 addresses the need for banks to consider all material risks and determine the level of capital required to remain solvent during extreme circumstances and requires banks to have sound internal capital adequacy assessment processes. The internal capital adequacy assessment process includes setting objectives for capital that are consistent with the bank’s risk profile and the control environment in which it operates.

### *Pillar 3 — Risk Disclosure and Market Discipline*

Pillar 3 requires qualitative and quantitative descriptions of capital structure, capital adequacy, internal control processes, risk management and the nature of underlying risks. The purpose of Pillar 3 disclosures is to provide information on banking institutions’ regulatory capital and risk management practices.

On February 21, 2014, the Corporation was notified by the Federal Reserve that both the Corporation and the Bank would be permitted to exit parallel run. Accordingly, the Corporation and the Bank were required to use the advanced approaches methodologies to calculate and disclose publicly their risk-based capital ratios beginning with the second quarter of 2014. These methodologies include the Advanced Internal Ratings Based approach (“AIRB”) for credit risk, the Advanced Measurement Approach (“AMA”) for operational risk and the Market Risk Rule for market risk.

In order to complete the parallel run to the satisfaction of its supervisors, a bank is required to demonstrate that, over a period of at least four consecutive quarters, it meets the qualification requirements of the Basel III advanced rules. These qualification requirements address the following areas: the bank's governance processes and systems for maintaining adequate capital commensurate with its risk profile; its internal systems for segmenting exposures and applying risk weights; its quantification of risk parameters used, including its model-based estimates of exposures; its operational risk management processes, data management and quantification systems; the data management systems that are designed to support the timely and accurate reporting of risk-based capital requirements; and the control, oversight and validation mechanisms exercised by senior management and by the Board of Directors. Once a bank has completed the parallel run, it is required to meet these requirements on an ongoing basis, and to notify supervisors of any change to a system that would result in a material change in its risk-weighted assets for an exposure type, or when it makes any significant change to its modeling assumptions.

## Capital Structure

### Regulatory Capital

Under a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Northern Trust is subject to a capital floor that is based on the Basel standardized approach. We are therefore required to calculate our risk-based capital ratios under both the standardized and advanced approaches and are subject to the more stringent of the risk-based capital ratios as calculated under the standardized approach and the advanced approach in the assessment of our capital adequacy under the prompt corrective action framework. The Corporation's capital ratios as of December 31, 2015, are shown in the following table.

**Table 1: Northern Trust Corporation Capital Ratios**

(\$ In Millions)	As of December 31, 2015	
	Basel Standardized Transitional	Basel Advanced Transitional
<b>Regulatory Capital</b>		
Common Equity Tier 1 Capital	\$ 8,013	\$ 8,013
Tier 1 Capital	8,431	8,431
Total Capital	9,768	9,530
<b>Assets</b>		
Risk-Weighted Assets	\$ 73,962	\$ 67,335
Average Adjusted Total Assets	113,100	113,100
Supplementary Leverage Exposure	N/A	135,975
<b>Capital Ratios</b>		
Common Equity Tier 1 Capital	10.8%	11.9%
Tier 1 Capital	11.4%	12.5%
Total Capital	13.2%	14.2%
Tier 1 Leverage	7.5%	7.5%
Supplementary Leverage	N/A	6.2%

The Common Equity Tier 1 ratio is defined as Common Equity Tier 1 capital divided by risk-weighted assets; the Tier 1 ratio is defined as Tier 1 capital divided by risk-weighted assets; and the Total Capital ratio is defined as total capital divided by risk-weighted assets. The Tier 1 Leverage ratio is defined as Tier 1 capital divided by average adjusted total assets (which includes adjustments for goodwill and identifiable intangible assets). The Supplementary Leverage ratio is defined as Tier 1 capital divided by supplementary leverage exposure.

Northern Trust is required to maintain minimum ratios of capital to risk-weighted assets and adjusted quarterly average assets, the current levels of which are as shown in the following table.



**Table 2: Minimum Capital Ratios**

	As of December 31, 2015	
	Well-Capitalized Ratios (a)	Minimum Capital Ratios (a)
<b>Capital Ratios</b>		
Common Equity Tier 1 Capital	6.5%	4.5%
Tier 1 Capital	8.0%	6.0%
Total Capital	10.0%	8.0%
Tier 1 Leverage	5.0% (b)	4.0%
Supplementary Leverage (c)	N/A	N/A

(a) As defined by the regulations issued by the Federal Reserve, Office of the Comptroller of the Currency and FDIC. Beginning January 1, 2015, Basel III Transitional Common Equity Tier 1 capital, the Basel III Standardized Transitional and the Basel III Advanced Transitional Common Equity Tier 1 capital ratios became relevant capital measures under the prompt corrective action requirements defined by the regulations.

(b) Represents requirements for bank subsidiaries pursuant to regulations issued under the FDIC Improvement Act. There is no Tier 1 leverage component in the definition of a “well capitalized” bank holding company.

(c) Effective January 1, 2018, the Corporation will be subject to a minimum supplementary leverage ratio of 3 percent.

For regulatory purposes, Northern Trust’s capital is classified into Common Equity Tier 1 capital, Tier 1 capital and Tier 2 capital. Under the Basel III transitional provisions, certain items are being phased in from 2014 through 2018, including the capital treatment for accumulated other comprehensive income, floating rate capital securities and other items required for risk-based capital calculations.

The methods for the calculation of Northern Trust’s risk-based capital ratios will change as the provisions of the Basel III final rule related to the numerator (capital) and denominator (risk-weighted assets) are phased in. For example, effective with the first quarter of 2015, Standardized Approach risk-weighted assets are required to be calculated in compliance with the Basel III Standardized Approach final rules. These ongoing methodology changes will result in differences in our reported capital ratios from one reporting period to the next that are independent of applicable changes to our capital base, asset composition, off-balance-sheet exposures or risk profile.

The table below presents the components of the Corporation's regulatory capital as defined under Basel III as of December 31, 2015.

**Table 3: Components of Regulatory Capital**

(\$ In Millions)	As of December 31, 2015	
	Basel Standardized Transitional	Basel Advanced Transitional
<b>Regulatory Capital</b>		
Common Stock and Related Surplus	\$ 447	\$ 447
Retained Earnings	8,243	8,243
Accumulated Other Comprehensive Income	(373)	(373)
<b>Common Stockholders' Equity</b>	<b>\$ 8,317</b>	<b>\$ 8,317</b>
Adjustments for:		
Accumulated Other Comprehensive Income	213	213
Goodwill and Other Intangible Assets (Net of deferred tax liability)	(494)	(494)
Other	(23)	(23)
<b>Common Equity Tier 1 Capital</b>	<b>\$ 8,013</b>	<b>\$ 8,013</b>
Preferred Stock	389	389
Floating Rate Capital Securities	67	67
Other	(38)	(38)
<b>Tier 1 Capital</b>	<b>\$ 8,431</b>	<b>\$ 8,431</b>
Long-Term Debt (a)	909	909
Floating Rate Capital Securities	202	202
Allowance for Credit Losses	233	—
Other	(7)	(12)
<b>Total Capital</b>	<b>\$ 9,768</b>	<b>\$ 9,530</b>

(a) Long-term debt that qualifies for risk-based capital amortizes for the purpose of inclusion in Tier 2 capital during the five years before maturity.

- Refer to Note 12, Note 13 and Note 14 to the consolidated financial statements included within the Corporation's 2015 Annual Report for the terms and conditions of the main features of all regulatory capital instruments.

### Risk-Weighted Assets

The Corporation's risk-weighted assets, as calculated under Basel III methodologies as of December 31, 2015, are presented in the following table. For credit risk, the Basel III Standardized Transitional risk-weighted assets reflect prescribed regulatory risk-weights, while the Basel III Advanced risk-weighted assets reflect the results of the AIRB approach, which is described in the Credit Risk section. Market risk-weighted assets are calculated based on the final Market Risk Rule approved by the Federal Reserve in June 2012, and are identical for both the standardized

and advanced approaches. Market risk is further discussed in the Market Risk section. Risk-weighted assets as calculated under the advanced approaches may show variability over time due to changes in data, methodology, models, regulatory guidance or other items.

**Table 4: Risk-Weighted Assets**

(\$ In Millions)	As of December 31, 2015			
	Basel Standardized Transitional		Basel Advanced Transitional	
Wholesale Exposures	\$	66,327	\$	44,109
Securitization Exposures		1,068		1,133
Equity Exposures		900		954
Other Assets		5,465		3,565
Credit Valuation Adjustment (a)		N/A		793
<b>Total Credit Risk-Weighted Assets</b>	<b>\$</b>	<b>73,760</b>	<b>\$</b>	<b>50,554</b>
<b>Operational Risk-Weighted Assets (b)</b>		<b>N/A</b>	<b>\$</b>	<b>16,579</b>
<b>Market Risk-Weighted Assets</b>	<b>\$</b>	<b>202</b>	<b>\$</b>	<b>202</b>
<b>Total Risk-Weighted Assets</b>	<b>\$</b>	<b>73,962</b>	<b>\$</b>	<b>67,335</b>

(a) The credit valuation adjustment is included only in the Basel III Advanced calculations.

(b) Operational risk-weighted assets are included only in the Basel III Advanced calculations and are the result of the AMA approach, which is described in the Operational Risk section.

### Supplementary Leverage Ratio

Beginning with the first quarter of 2015, advanced approaches banking organizations must calculate and report their supplementary leverage ratio. Effective January 1, 2018, the Corporation will be subject to a minimum supplementary leverage ratio of 3 percent.

The table below presents the components of the Corporation's supplementary leverage ratio as of December 31, 2015. Line items reflecting components of the supplementary leverage ratio that are not relevant to the Corporation have been omitted.

**Table 5: Summary Comparison of Accounting Assets and Total Leverage Exposure**

(\$ In Millions)		As of December 31, 2015
Line No.		
1	Total Consolidated Average Assets	113,673
4	Adjustment for Derivatives Exposures	1,954
5	Adjustment for Repo-Style Transactions	66
6	Adjustment for Off-Balance-Sheet Exposures	20,855
7	Other Adjustments	(573)
8	<b>Total Supplementary Leverage Exposures</b>	<b>135,975</b>

**Table 6: Supplementary Leverage Ratio**

(\$ In Millions)		As of December 31, 2015
Line No.		
<b>On-Balance-Sheet Exposures</b>		
1	On-Balance-Sheet Assets (excluding on-balance-sheet assets for repo-style transactions and derivative exposures, but including cash collateral received in derivative transactions)	110,862
2	LESS: Amounts Deducted from Tier 1 Capital	(573)
3	Total On-Balance-Sheet Exposures (excluding on-balance-sheet assets for repo-style transactions and derivative exposures, but including cash collateral received in derivative transactions)	110,289
<b>Derivative Exposures</b>		
4	Replacement Cost for Derivative Exposures (that is, net of cash variation margin)	1,331
5	Add-On Amounts for Potential Future Exposure (PFE) for Derivative Exposures	1,954
11	Total Derivative Exposures	3,285
<b>Repo-Style Transactions</b>		
12	On-Balance-Sheet Assets for Repo-Style Transactions	1,480
14	Counterparty Credit Risk for All Repo-Style Transactions	66
16	Total Exposures for Repo-Style Transactions	1,546
<b>Other Off-Balance-Sheet Exposures</b>		
17	Off-Balance-Sheet Exposures at Gross Notional Amounts	41,144
18	LESS: Adjustments for Conversion to Credit Equivalent Amounts	(20,289)
19	Off-Balance-Sheet Exposures	20,855
<b>Capital and Total Leverage Exposure</b>		
20	Tier 1 Capital	8,431
21	Total Leverage Exposure	135,975
<b>Supplementary Leverage Ratio</b>		
22	Supplementary Leverage Ratio	6.2%

## The Northern Trust Company and Our Other Subsidiaries

The Bank is an Illinois banking corporation headquartered in Chicago, Illinois, and, as discussed above, is our principal subsidiary. Founded in 1889, the Bank conducts its business through its U.S. operations and its various U.S. and non-U.S. branches and subsidiaries. At December 31, 2015, the Bank had consolidated assets of \$116.4 billion and equity capital of \$7.9 billion.

It is expected that the Bank will continue to be the major source of the Corporation's consolidated assets, revenues and net income in the foreseeable future.

The Bank's capital ratios at December 31, 2015, are shown in the following table.

**Table 7: The Northern Trust Company Capital Ratios**

The Northern Trust Company As of December 31, 2015		
	Basel Standardized Transitional	Basel Advanced Transitional
<b>Capital Ratios</b>		
Common Equity Tier 1	10.4%	11.6%
Tier 1	10.4%	11.6%
Total Capital	12.0%	13.1%
Tier 1 Leverage	6.7%	6.7%
Supplementary Leverage	N/A	5.6%

The Corporation's subsidiary banks located outside the U.S. are also subject to regulatory capital requirements in the jurisdictions in which they operate. As of December 31, 2015, each of Northern Trust's subsidiaries, including the Bank, had capital ratios above their specified minimum requirements.

- Refer to Note 30 to the consolidated financial statements included within the Corporation's 2015 Annual Report and page 9 of the Corporation's 2015 Annual Report for a description of restrictions on transactions between the Corporation and its subsidiaries.

## ***Capital Adequacy***

One of Northern Trust's primary objectives is to maintain a strong capital position to merit the confidence of clients, counterparties, creditors, regulators and stockholders. A strong capital position helps Northern Trust execute its strategies and withstand unforeseen adverse developments.

In addition to the risk management organization and activities described below in the Risk Management Overview section, Northern Trust manages its capital on both a consolidated and legal entity basis. The Capital Committee is responsible for measuring and managing the Corporation's and Bank's capital ratios against levels set forth within the Capital Policy approved by the Board of Directors.

Senior management, with oversight from the Capital Governance Committee of the Board of Directors and the full Board of Directors, is responsible for capital management and planning. Northern Trust's capital adequacy assessment process, overseen by the Capital Committee, provides the framework for evaluating the adequacy of capital levels against capital requirements for both the current and projected periods given its risk profile and business growth objectives. The capital adequacy assessment process contains three main components:

- assessing required capital needs for risks that can be reliably quantified;
- understanding the sensitivity of Northern Trust's earnings, balance sheet, risk-weighted assets and capital ratios to current or potential changes in Northern Trust's risk profile and/or economic conditions; and
- evaluating the potential impact of all material risks on Northern Trust's capital position, and its resulting ability to meet its capital management objectives under a wide range of scenarios, including severely stressful conditions.

The stress scenarios included in Northern Trust's capital adequacy assessments are developed with consideration given to Northern Trust's risk profile, key vulnerabilities, business activities and strategic plans, and can include both stressful macroeconomic conditions and idiosyncratic loss events. Northern Trust's capital adequacy assessments are approved by the Capital Governance Committee of the Board of Directors quarterly, support the annual Capital Plan and are closely coordinated with the liquidity risk management processes.

## Risk Management Overview

Northern Trust employs an integrated enterprise risk management framework to support its strategies. The framework provides a methodology to identify, assess, monitor, measure, manage and report both internal and external risks to Northern Trust, and promotes a culture of risk awareness across the organization. Northern Trust's risk culture encompasses the general awareness, attitude and behavior of employees to risk and the management of risk across all lines of defense within the organization. The key risk categories that are inherent in Northern Trust's business activities include: credit, operational, fiduciary, compliance, market, liquidity, and strategic risk. Northern Trust reinforces a culture of effective risk management through training and developing employees and evaluating and rewarding employee performance.

- Refer to page 62 and 68 of the Corporation's 2015 Annual Report for more information on Northern Trust's Liquidity Risk Management and Risk Management processes.

## Risk Governance and Oversight

Risk governance is an integral aspect of corporate governance at Northern Trust, and includes clearly defined accountabilities, expectations, internal controls and processes for risk-based decision-making and escalation of issues. The diagram below provides a high-level overview of Northern Trust's risk governance structure, highlighting the oversight of the Board of Directors and key risk-related committees.

**Table 8: Risk Governance Structure**

Northern Trust Corporation Board of Directors					
Audit Committee	Business Risk Committee	Capital Governance Committee	Compensation and Benefit Committee		
Global Enterprise Risk Committee (GERC)					
Global Enterprise Risk Management Committee (GERM)					
Credit Risk Committee	Operational Risk Committee	Fiduciary Risk Committee	Compliance & Ethics Oversight Committee	Asset & Liability Management Committee	Model Risk Oversight Committee

The Board of Directors provides oversight of risk management directly and through certain of its committees: the Audit Committee, the Business Risk Committee, the Capital Governance Committee and the Compensation and Benefits Committee. The Board annually approves Northern Trust's enterprise risk management framework, risk universe and Corporate Risk Appetite Statement. The Business Risk Committee assumes primary responsibility and oversight with respect to credit risk, operational risk, fiduciary risk, compliance risk, market risk, liquidity risk, and strategic risk. The Audit Committee provides oversight with respect to financial reporting and legal risk, while the Compensation and Benefits Committee oversees the development and operation of Northern Trust's incentive compensation program. The Compensation and Benefits Committee annually reviews management's assessment of the effectiveness of the design and performance of Northern Trust's incentive compensation arrangements and practices in providing incentives

that are consistent with Northern Trust's safety and soundness. This assessment includes an evaluation of whether Northern Trust's incentive compensation arrangements and practices discourage inappropriate risk taking behavior by participants. The Capital Governance Committee of the Board was established in November 2015 to assist the Board in discharging its oversight duties with respect to capital management and planning activities. Among other responsibilities, the Capital Governance Committee oversees Northern Trust's capital adequacy assessments, forecasting, and stress testing processes and activities, including the annual CCAR exercise. Accordingly, the Capital Governance Committee provides oversight with respect to Northern Trust's risk identification for the capital adequacy assessment process.

The Chief Risk Officer ("CRO") oversees Northern Trust's management of risk, promotes risk awareness and fosters a proactive risk management environment wherein risks inherent in business strategy are understood and appropriately monitored and mitigated. The CRO reports directly to the Business Risk Committee of the Board of Directors and the Corporation's Chief Executive Officer. The CRO regularly advises the Business Risk Committee and reports to the Committee at least quarterly on risk exposures, risk management deficiencies and emerging risks. In accordance with the Enterprise Risk Management framework, the executive management team of Northern Trust, together with the General Auditor, meets as the Global Enterprise Risk Committee ("GERC") to provide executive management oversight and guidance with respect to the management of the categories of risk overseen by the Business Risk Committee. Among other risk management responsibilities, GERC receives reports or recommendations from senior risk committees that are responsible for the management of risk, and from time to time may delegate responsibility to such committees for risk issues. Senior risk committees include:

- The Global Enterprise Risk Management Committee ("GERM") provides senior management oversight and guidance to the management of all categories of risk within Northern Trust. GERM is chaired by the CRO, and members include risk practice leads, business unit and regional chief risk officers, and various functional risk leaders.
- The Credit Risk Committee establishes and monitors credit-related policies and practices throughout Northern Trust and promotes their uniform application. The Credit Risk Committee is chaired by the Chief Credit Officer, and members include the CRO, the Treasurer, the Chief Operational Risk Officer, the Controller, and various functional risk and business management leaders.
- The Operational Risk Committee ("ORC") provides independent oversight and is responsible for setting the Corporate Operational Risk Management Policy and developing the operational risk management framework and programs that support the coordination of operational risk activities to identify, monitor, measure, manage and report on operational risk. At ORC, senior management reviews and discusses operational risks including existing and emerging issues. The ORC also is responsible for coordinating operational risk issues related to compliance and fiduciary risks.
- The Fiduciary Risk Committee ("FRC") is responsible for establishing and reviewing the fiduciary risk policies and establishing the fiduciary risk framework, governance and programs that support the coordination of fiduciary risk activities to identify, monitor, manage



and report on fiduciary risk. At FRC, senior management reviews and discusses fiduciary risks including existing and emerging issues.

- The Compliance & Ethics Oversight Committee provides oversight and direction with respect to compliance policies, implementation of the compliance and ethics program, and the coordination of regulatory compliance initiatives across the Corporation. This committee also may resolve significant interpretive issues regarding compliance in situations where specific compliance policies do not provide for or allow resolution of the issue by another individual or committee.
- The Asset & Liability Management Committee (“ALCO”) establishes and monitors Northern Trust’s market and liquidity risk frameworks and policies as well as actively manages Northern Trust’s market and liquidity risks through oversight of the implementation of approved asset and liability management strategies. At ALCO, senior management reviews and discusses Northern Trust’s market risk profile as well as various scenario analyses. ALCO establishes and monitors guidelines based on measures such as sensitivity of earnings (“SOE”), sensitivity of economic value of equity (“SEVE”), value-at-risk (“VaR”) and notional position sizes.
- The Model Risk Oversight Committee (“MROC”) is responsible for providing management attention, direction, and oversight of the model risk management framework and model risk within Northern Trust. MROC reviews and, where applicable, provides guidance and approval as to the direction of the Northern Trust Model Risk Program and Policy. MROC tracks and provides oversight, advice, approval and direction on risk mitigation activities and the acceptance of significant risks, where appropriate.

In addition to the aforementioned committees, Northern Trust deploys business and regional risk committees that also report into GERC. For more detail on risk practices at Northern Trust, see the relevant discussions on pages 18, 30 and 34.

### **Risk Identification and Risk Management Process**

Northern Trust utilizes a risk classification system called the “risk universe” to identify and classify the risks that it inherently faces. The risk universe forms the basis of common risk language and provides a consistent framework for the definition and categorization of risk and the organization of risk management activities. The risk universe supports risk management at all levels and enables risks to be clearly and consistently identified, categorized, assessed, managed and reported to line management, corporate risk and committees.

As part of the integrated enterprise risk framework, Northern Trust has established four key processes as described below.

- Risk Appetite – Northern Trust defines the organization’s risk appetite as the amount and types of risk that it is willing to assume in its exposures and business activities to achieve its strategic and financial objectives. Risk appetite is a methodology to measure Northern Trust’s willingness to take risk and reflects Northern Trust’s tolerance of certain levels of risk exposures as measured at the enterprise and business level, as applicable. Northern

Trust's Corporate Risk Appetite Statement reflects Northern Trust's expectation that risk is consciously considered as part of day-to-day activities and strategic decisions. Northern Trust manages its business activities consistent with the risk appetite statement, in which specific guidelines are detailed for credit, operational, fiduciary, compliance, market, liquidity, and strategic risk. GERC reviews the measurement and assessment of risk within the Corporation and against Northern Trust's Corporate Risk Appetite Statement. When appropriate, GERC addresses emerging risk issues and directs risk mitigation actions.

- **Assessment of Risks** – Northern Trust's risk assessment process consists of a series of programs that identify, manage and measure risks. Risk assessments are performed on a regular basis by business risk management and facilitated by the Risk Management function. The risk assessment process draws on the input of management, staff and risk personnel across the business, focusing on the inherent drivers of risk, the effectiveness of controls and the resulting residual risks.
- **Risk Management Embedding** – Risk management processes extend beyond risk assessment and measurement, and are embedded in strategic and business planning and decision-making. Although the Risk Management function sets the direction for Northern Trust's risk management activities, Northern Trust's businesses are the first line of defense for protecting it against the risks inherent in its businesses and are supported by dedicated business risk management teams.
- **Risk Reporting, Review and Communication** – The risk reporting, review and communication process produces risk reports that provide updates on the risk profile, performance against risk guidelines and thresholds, and analysis and trend information, all of which highlight top and emerging risks for management and the Board of Directors. Risk reporting includes a robust escalation process to alert senior management of significant issues.

### **Systems**

Risk data and technology form the infrastructure that enables the successful execution of risk management processes. Data quality principles (such as accuracy, consistency and integrity) are an integral element of Northern Trust's risk measurement and management process, ensuring quality, control and protection of the risk data and systems at both corporate and business levels.

## Independent Review and Verification

### *Risk Control*

Risk Control is an internal, independent review function within the Risk Management function. Risk Control is managed by the Chief Risk Control Officer and is comprised of the following groups, each with its own risk focus and oversight. The Business Risk Committee oversees Risk Control and each of the groups below.

#### *Model Risk Management*

Financial and risk modeling are used by Northern Trust to inform numerous decisions regarding risk management, as well as capital estimation, financial reporting and disclosure, valuation and pricing and portfolio management. Model risk may result from decisions based on models that produce incorrect results or models that are improperly used. Model Risk Management is responsible for the implementation and management of the enterprise-wide model risk framework and independently validating new models and reviewing and re-validating existing models. Validations are documented and include an assessment of the conceptual soundness of the modeling approach, outcomes analysis, applicability of use, model assumptions and limitations, development documentation, ongoing monitoring and model controls. Oversight of Model Risk Management is provided by the MROC.

#### *Credit Review*

Credit Review provides an independent, ongoing assessment of credit exposure and related credit risk management processes across Northern Trust. The scope of Credit Review activities includes all client-related transactions that give rise to credit exposure and processes that are designed to manage or monitor such exposure. Credit exposure includes credit risk inherent in the entire portfolio, as well as individual credits or transactions in the form of direct outstandings, potential exposure and contingent liabilities that are on- or off-balance sheet.

#### *Global Compliance Testing and Independent Verification*

Global Compliance Testing evaluates the effectiveness of procedures and controls designed to comply with relevant laws and regulations, as well as corresponding Northern Trust policies governing regulatory compliance activities. Global Compliance Testing identifies weaknesses that could result in regulatory compliance violations or risks to Northern Trust's businesses, and monitors action plans designed to mitigate those weaknesses. Oversight of Global Compliance Testing activities is provided by the Compliance & Ethics Oversight Committee.

Also included is an Independent Verification program that promotes rigor and accuracy in Northern Trust's ongoing compliance with Basel III requirements and adherence to Enhanced Prudential Standards, including Liquidity Stress Testing. The program independently verifies Northern Trust's advanced systems in order to comply with the qualification requirements related to the AIRB and AMA approaches. In addition,

Independent Verification performs conceptual soundness evaluations of proposed changes to the Bank's advanced systems prior to notification to regulatory authorities as required in Basel Coordination Committee Bulletin 14-2. The Independent Verification program assesses the effectiveness of the Credit Risk, Operational Risk, and Market Risk frameworks. The Independent Verification team presents an annual assessment report of its findings to the Business Risk Committee, which is required to review and approve the effectiveness of Northern Trust's advanced systems on an annual basis.

### *Audit Services*

Audit Services is an independent control function that assesses and validates controls within Northern Trust's enterprise risk management framework. Audit Services is managed by the General Auditor with oversight from the Audit Committee. Audit Services tests the overall adequacy and effectiveness of the system of internal controls associated with the advanced systems on an ongoing basis and reports the results of these audits directly to the Audit Committee of the Board of Directors. Audit Services includes professionals with a broad range of audit and industry experience, including risk management expertise. The General Auditor reports directly to the Audit Committee and the Corporation's Chief Executive Officer.

### ***Credit Risk***

Credit risk is the risk to interest income or principal from the failure of a borrower or counterparty to perform on an obligation. Credit risk is inherent in many of Northern Trust's activities. A significant component of credit risk relates to loans, leases, securities, and counterparty-related exposures.

#### **Credit Risk Disclosures – General Qualitative**

##### *Credit Risk Framework and Governance*

The Credit Risk Management function is the focal point of the credit risk framework and, while independent of the businesses, it works closely with them to achieve the goal of assuring proactive management of credit risk. To monitor and control credit risk, the Credit Risk Management function maintains a framework that consists of policies, standards, and practices designed to promote a conservative credit culture. This function also monitors adherence to corporate policies, standards, and external regulations.

The Credit Risk Management function provides a system of checks and balances for Northern Trust's diverse credit-related activities by monitoring these activities and practices and promoting their uniform application throughout Northern Trust. These activities are designed to diversify credit exposure on an industry and client basis and reduce overall credit risk.

The credit risk framework provides authorities for approval of the extension of credit. Individual credit authority for commercial and personal loans is limited to specified amounts and maturities. Credit requests exceeding individual authority because of amount, rating, term or other conditions, are referred to the relevant Group Credit Approval Committee. Credit decisions involving exposure in excess of these limits require the approval of the Senior Credit Committee.

The Counterparty Risk Management Committee has sole credit authority for the approval, modification, or renewal of credit exposure to all wholesale market counterparties.

The Chief Credit Officer reports directly to the CRO. Independent oversight and review of the credit risk framework is provided by Risk Control.

##### *Loans and Leases and Allowance for Credit Losses*

- Refer to Note 6 and Note 7 to the consolidated financial statements, and pages 53, 56 and 72 of the MD&A, within the Corporation's 2015 Annual Report for loans and leases and allowance for credit losses qualitative information.

## Credit Risk Disclosures – General Quantitative

Northern Trust's credit risk generally takes the form of loans, leases, securities and counterparty-related exposures. Northern Trust's entire credit risk portfolio is included within the following Basel III credit categories: wholesale exposures, securitization exposures and equity holdings. All Basel III credit exposures that could otherwise qualify for retail treatment, such as personal loans and mortgages, are treated as wholesale exposures. We have determined that applying wholesale treatment, i.e. individually risk-rating each exposure rather than scoring a homogenous pool, is consistent with Northern Trust's underwriting approach, whereby each exposure is individually evaluated.

### Loans and Leases and Allowance for Credit Losses

- Refer to Note 6 and Note 7 to the consolidated financial statements included within the Corporation's 2015 Annual Report for loans and leases, allowance for credit losses and net charge-off quantitative information.

## Credit Exposures by Geography and Industry

The following tables provide Northern Trust's total credit exposures by regulatory reporting category and geographic distribution as of, and on an average basis for the three months ended, December 31, 2015. Distribution is based on geographic location of the contracting Northern Trust entity.

**Table 9: Credit Exposures by Geography**

(\$ In Millions)		As of December 31, 2015			
Credit Exposures	Americas	Europe, Middle East and Africa	Asia-Pacific	Total	
Loans, net of Unearned Income and Allowance	\$ 32,371	\$ 613	\$ 3	\$ 32,987	
Loan Commitments	40,747	805	—	41,552	
Balances Due from Depository Institutions	17,384	17,788	2,329	37,501	
Securities	32,552	3,857	466	36,875	
Trading Assets	203	811	40	1,054	
<b>Total</b>	<b>\$ 123,257</b>	<b>\$ 23,874</b>	<b>\$ 2,838</b>	<b>\$ 149,969</b>	

(\$ In Millions)		Averages for the three months ended December 31, 2015			
Credit Exposures	Americas	Europe, Middle East and Africa	Asia-Pacific	Total	
Loans, net of Unearned Income and Allowance	\$ 32,521	\$ 1,019	\$ 102	\$ 33,642	
Loan Commitments	40,437	1,130	—	41,567	
Balances Due from Depository Institutions	18,500	14,195	2,923	35,618	
Securities	31,988	3,730	466	36,184	
Trading Assets	274	817	73	1,164	
<b>Total</b>	<b>\$ 123,720</b>	<b>\$ 20,891</b>	<b>\$ 3,564</b>	<b>\$ 148,175</b>	

The following table provides Northern Trust's credit exposures by industry and exposure type with the associated contractual maturity as of December 31, 2015.

**Table 10: Credit Exposures by Industry, Exposure Type and Contractual Maturity**

(\$ In Millions)	As of December 31, 2015			
	Up to 1 Year	1 to 5 Years	Over 5 Years	Total
Commercial Exposures				
Commercial and Institutional				
Finance and Insurance	\$ 3,443	\$ 2,604	\$ 18	\$ 6,065
Holding Companies	98	18	1	\$ 117
Manufacturing	2,931	7,326	18	\$ 10,275
Mining	361	482	25	\$ 868
Public Administration	97	297	7	\$ 401
Retail Trade	508	1,076	17	\$ 1,601
Services	4,907	6,320	1,035	\$ 12,262
Transportation and Warehousing	160	435	70	\$ 665
Utilities	82	1,388	—	\$ 1,470
Wholesale Trade	636	740	25	\$ 1,401
Other Commercial	\$ 970	\$ 1,709	\$ 61	\$ 2,740
<b>Total Commercial and Institutional</b>	<b>\$ 14,193</b>	<b>\$ 22,395</b>	<b>\$ 1,277</b>	<b>\$ 37,865</b>
Commercial Real Estate	657	2,623	1,261	4,541
Lease Financing, net	64	177	303	544
Non-U.S.	2,217	831	14	3,062
Other	307	34	25	366
<b>Total Commercial</b>	<b>\$ 17,438</b>	<b>\$ 26,060</b>	<b>\$ 2,880</b>	<b>\$ 46,378</b>
Personal Exposures				—
Residential Real Estate	590	1,742	7,793	10,125
Private Client	9,656	7,610	703	17,969
Other	31	4	32	67
<b>Total Personal</b>	<b>\$ 10,277</b>	<b>\$ 9,356</b>	<b>\$ 8,528</b>	<b>\$ 28,161</b>
<b>Total Commercial and Personal</b>	<b>27,715</b>	<b>35,416</b>	<b>11,408</b>	<b>74,539</b>
Balances Due from Depository Institutions	37,500	1	—	37,501
Securities	6,444	30,431	—	36,875
Trading Assets	1,054	—	—	1,054
<b>Total Exposures</b>	<b>\$ 72,713</b>	<b>\$ 65,848</b>	<b>\$ 11,408</b>	<b>\$ 149,969</b>

- Refer to page 61 of the Corporation's 2015 Annual Report for information on undrawn commitments by industry sectors.

### Advanced Internal Ratings Based Approach for Credit Risk

#### *Internal Rating System Overview*

An integral component of credit risk measurement is Northern Trust's internal risk rating system. Northern Trust's internal risk rating system enables identification, measurement, approval and monitoring of credit risk. Northern Trust uses the AIRB approach to calculate regulatory capital using regulatory formulas and exposure level risk information from Northern Trust's internal rating system. Calculations include entity-specific information about the obligor's or counterparty's probability of default ("PD") and exposure-specific information about loss given default ("LGD"), exposure at default ("EAD") and maturity. Northern Trust's internal risk rating system is intended to rank its credit risk without any modeled linkage to external credit ratings.

Obligors are assigned PDs after consideration of both quantitative and qualitative factors. Although the criteria vary, the objective is for assigned PDs to be consistent in the measurement and ranking of risk. LGD and EAD are assigned based on obligor, product, collateral and instrument characteristics.

Risk ratings are assigned at the time an obligation is approved, renewed or amended. Risk ratings are reviewed annually or when new information relevant to the rating is received. Risk ratings are utilized for credit underwriting, management reporting and the calculation of regulatory capital.

The Credit Risk Management function is responsible for the ongoing oversight of each model that supports the internal risk rating system. This oversight includes the development, monitoring and maintenance of the models, as well as providing information to the Credit Risk Committee to support model approval and monitoring of ongoing model performance. Independent model governance and oversight is further supported by the activities of Risk Control as described further in Independent Review and Verification within the Risk Management Overview section.

#### *PD, EAD and LGD Estimation*

Northern Trust has developed internal estimates of PD, EAD and LGD, each as defined below:

Probability of default – defined as the empirically-based best estimate of the long-run average one-year default rate for the rating grade assigned to an obligor, capturing the average default experience for obligors in the rating grade over a mix of economic conditions sufficient to provide a reasonable estimate.

Exposure at default – defined across various exposures types as:

- On-balance-sheet (other than over-the-counter ("OTC") derivative, repo-style transactions or eligible margin loans) – the carrying value, less any allocated transfer risk reserve (and for available for sale securities, less unrealized gains, plus unrealized losses).
- Off-balance-sheet (other than OTC derivative, repo-style transactions or eligible margin loans) – the best estimate of net additions to outstanding amounts owed that are likely to occur over a one-year horizon, assuming the exposure were to go into default. For



anything other than a loan commitment, line of credit, trade-related letter of credit or transaction-related contingency, EAD is the notional amount.

- OTC derivative, repo-style transaction or eligible margin loan – as defined by section 32 of the final rule adopted to implement Basel III in the United States.

Loss given default – defined as the greater of:

- an empirically-based best estimate of long-run default-weighted average economic loss, per dollar of EAD, that would be incurred if an obligor were to default within a one-year horizon over a mix of economic conditions; or
- an empirically-based best estimate of the economic loss, per dollar of EAD that would be incurred if an obligor were to default within a one-year horizon during a period of economic downturn.

PD, EAD and LGD parameter values are estimated using quantitative analysis of internal and external data, informed by a qualitative assessment based on business subject matter expertise. The parameter estimation (quantification) process is conducted in four phases: (1) research and exploratory data analysis; (2) detailed data analytics and modeling; (3) qualitative assessment of results and recommendations; and (4) formal review and approval.

Data used for estimation and validation of PD, EAD and LGD parameters comes from three sources:

- internal credit defaults and recoveries experienced by Northern Trust;
- external credit default and recovery data for comparative benchmark data (not directly combined with internal default history); and
- industry studies and academic works related to credit risk and defaults.

### *Control Mechanisms*

Independent oversight and review of the internal risk rating system is provided by Audit Services and Risk Control as described in Independent Review and Verification within the Risk Management Overview section.

The following table provides a distribution of EAD, Risk-Weighted Assets, Weighted Average PD, Weighted Average LGD, Weighted Average Risk-Weights and Unfunded Commitments by PD ranges as of December 31, 2015.

**Table 11: Probability of Default Ranges**

(\$ In Millions)		As of December 31, 2015					
	PD Range	EAD Amount	Risk Weighted Assets Amount (a)	Weighted Average PD	Weighted Average LGD	Weighted Average Risk-Weight	Unfunded Commitments
Wholesale	0% to <0.15%	\$ 82,703	\$ 6,458	0.04%	26.33%	7.81%	\$16,745 (b)
	0.15% to <0.50%	39,408	14,165	0.24%	41.03%	35.95%	19,354
	0.50% to <1.35%	13,150	10,175	0.80%	40.25%	77.38%	3,211
	1.35% to <10.00%	9,242	10,113	3.24%	35.79%	109.42%	2,155
	10.00% to <100%	228	452	25.15%	36.93%	197.84%	80
	<100%	247	247	100.00%	25.32%	100.00%	7
<b>Total</b>	<b>0.0% to &lt;100.0%</b>	<b>\$ 144,978</b>	<b>\$ 41,610</b>	<b>0.58%</b>	<b>32.21%</b>	<b>28.70%</b>	<b>\$41,552</b>

(a) Represents unscaled risk-weighted assets.

(b) Includes unfunded commitments without a specific PD range

### Counterparty Credit Risk of OTC Derivative Contracts, Repo-Style Transactions and Eligible Margin Loans

Counterparty credit risk for Northern Trust primarily arises from OTC currency and interest rate derivatives and from indemnified securities lending transactions, which in turn are derived from a variety of funding, treasury, trading and custody-related activities. Credit exposure to counterparties is managed by use of a framework for setting limits by product type and exposure tenor.

#### Reporting and Measurement

To calculate exposure, Northern Trust treats repurchase agreements, reverse repurchase agreements and indemnified securities lending transactions as repo-style transactions. Foreign exchange exposures and interest rate derivatives are treated as OTC derivatives. The EAD measurement methodology for each eligible type of counterparty credit exposure, including the use of netting and collateral as risk mitigants, is determined based on operational requirements, the characteristics of the contract type and the portfolio size and complexity. To calculate counterparty economic capital, Northern Trust considers each exposure's size, PD, LGD and maturity, as well as the correlation between exposures.

#### Repo-style Transactions

The Current Exposure Method with the Collateral Haircut Approach is used to estimate EAD for repurchase agreements and reverse repurchase agreements, whereby exposure amounts are summed with potential future exposure (price volatility) and then adjusted to account for collateral held as estimated using standard supervisory collateral haircuts. Repo-style transactions are not netted; EAD is estimated at the transaction level.

The Collateral Haircut Approach with standard supervisory haircuts is used to determine EAD for indemnified securities lending and indemnified repurchase transactions. For certain U.S.-based counterparties, indemnified securities lending exposures are netted across principal lenders when aggregating exposures for the counterparty. As netting is not applicable for non-U.S.-based counterparties, those exposures are estimated for individual principal client lenders with activity to the given counterparty. Indemnified repo transactions are estimated at the principal client lender level and totaled for the counterparty as well.

### *OTC Derivatives*

The Current Exposure Method is used to estimate EAD for OTC derivatives, whereby exposure amounts are summed (recognizing the benefit of eligible single product exposure netting arrangements for certain foreign exchange counterparties) with potential future exposure to derive the total counterparty exposure. Although collateral in the form of a lien on a client's financial assets custodied at Northern Trust often serves as collateral for OTC derivative transactions, the benefit of collateral is not taken into account in the EAD estimate for OTC derivative transactions.

### *Credit Limits*

Credit exposure to counterparties is managed by use of a framework for setting limits by product type and exposure tenor.

### *Collateral Arrangements*

To calculate a counterparty's net credit risk position, repo-style transactions and associated collateral are revalued on a daily basis. OTC interest rate and currency derivatives and associated collateral positions are also revalued on a daily basis, though no benefit for collateral is taken in the capital estimation for these products. Credit derivatives that are not subject to collateral requirements are revalued on a monthly basis.

Eligible collateral types are documented by a Credit Support Annex ("CSA") to an International Swaps and Derivatives Association Master Agreement and are controlled under policies aimed at ensuring the collateral agreed to be taken exhibits characteristics such as price transparency, price stability, liquidity, enforceability, independence and eligibility for regulatory purposes. Currently 100% of the collateral held by Northern Trust under CSAs is in the form of cash.

### *Collateral for Repo-Style Transactions*

Northern Trust accepts the following as collateral for the repo-style transactions below:

#### Repurchase Agreements and Reverse Repurchase Agreements

- cash;
- U.S. government securities;
- U.S. agency and government-sponsored entity securities;
- investment grade commercial paper and corporate bonds; and
- equities included in major indices, subject to stipulated diversification parameters.

### Securities Lending Transactions

- cash;
- sovereign debt (includes debt issued by governments of highly-rated Organization for Economic Co-operation and Development (“OECD”) countries and corporate debt guaranteed by select highly-rated OECD governments that meet additional pre-agreed guidelines); and
- equities included in major indices, subject to stipulated diversification thresholds.

Based on its nominal loss experience to date, Northern Trust does not currently employ a credit risk valuation adjustment to incorporate creditworthiness within its estimate of the fair value of OTC derivative transactions. Any realized credit loss associated with OTC derivatives or repo-style transactions would be accounted for as a reduction of current earnings.

### *Wrong-way Risk*

Wrong-way risk occurs when the exposure to a particular counterparty is positively correlated with the PD of the counterparty itself or where there is an adverse correlation between a counterparty’s PD and the mark-to-market value of the underlying transaction.

Northern Trust uses a range of tools to identify, control and monitor wrong-way risk. These include: the requirement to obtain prior approval before undertaking wrong-way risk transactions outside pre-agreed guidelines; exception reporting; collateral exclusion requirements; sovereign and issuer credit quality requirements for collateral accepted in repo-style transactions; approval of loan/collateral combinations based on historical quantitative correlation analysis; multi-factor stress testing scenarios to identify vulnerabilities and manage exposures against stressed exposure tolerances; and exposure reporting. Country limits and diversification parameters applicable to foreign exchange and credit default swap transactions, respectively, also limit wrong-way risk.

### *Potential Collateral Requirements*

Certain ISDA agreements require a counterparty to post additional collateral in the event of a downgrade of such counterparty’s credit rating. Accordingly, Northern Trust regularly monitors its position with regard to counterparty credit rating downgrades.

The following table describes Northern Trust's counterparty exposures by exposure type as of December 31, 2015.

**Table 12: Counterparty Exposures**

- Refer to Note 3 and Note 25 within the Corporation's 2015 Annual Report for derivative contract exposure information.

(\$ In Millions)	As of December 31, 2015	
<b>Derivative Contracts</b>		
EAD	\$	3,262
<b>Repo-Style Transactions</b>		
Gross notional exposure	\$	96,661
Cash and securities collateral		100,032
<b>Net exposure</b>	<b>\$</b>	<b>(3,371)</b>
EAD	\$	6,601

In the quarter ended December 31, 2015, Northern Trust did not purchase or sell any credit derivatives.

### Credit Risk Mitigation

Northern Trust considers cash flow to be the primary source of repayment for client-related credit exposures. However, Northern Trust employs several different types of credit risk mitigants to manage its overall credit risk in the event cash flow is not sufficient to repay a credit exposure. Northern Trust has policies in place to ensure that credit risk mitigation is appropriately recognized, recorded and monitored. Recognition of credit risk mitigants in capital estimations is dependent upon the form of mitigation. Northern Trust broadly groups its risk mitigation techniques into the following three primary categories:

#### *Physical and Financial Collateral*

Northern Trust's primary risk mitigation approaches include the requirement of collateral and/or documented guarantees. Liquidation of collateral that is securing credit risk exposures is considered in Northern Trust's LGD estimation. Residential and commercial real estate exposures are typically secured by properly margined mortgages on the property. In cases where loans to commercial or certain Wealth Management clients are secured by marketable securities, the daily values of the securities are monitored closely to ensure adherence to collateral coverage policies. The frequency of collateral valuation increases commensurate with the volatility of the collateral's value.

### Netting

On-balance-sheet netting is employed on a limited basis. Netting is primarily related to foreign exchange transactions with major banks and institutional clients subject to eligible master netting agreements. A sub-set of these arrangements are conducted under an ISDA CSA. Northern Trust has elected to take the credit risk mitigation capital benefit of netting within its regulatory capital calculation at this time.

### Guarantees

Personal and corporate guarantees are often taken to facilitate potential collection efforts and to protect Northern Trust's claims relative to other creditors. Northern Trust may also recognize "implied support," where the commitment provided is less than that of a legally enforceable guarantee, in its assignment of borrower PD as permitted under U.S. supervisory guidance. Northern Trust has elected not to take the credit risk mitigation capital benefit of guarantors within its regulatory capital calculation at this time.

Another important risk management practice is the avoidance of undue concentrations of exposure, such as in any single (or small number of related) obligor/counterparty, loan type, industry, geography, country or risk mitigant. Processes are in place to establish limits on certain concentrations and the monitoring of adherence to the limits.

### Securitization

Northern Trust does not act as originator or sponsor for securitizations. In its investment portfolio, Northern Trust has purchased securities that meet the regulatory definition of a securitization. Additionally, Northern Trust has a limited number of commercial loan transactions that have been deemed to be securitizations for regulatory capital purposes. Northern Trust uses the Simplified Supervisory Formula Approach ("SSFA") to calculate risk-weighted assets for securitizations. If the SSFA cannot be applied due to data limitations, a 1,250% risk-weight is applied to the exposure as required by current Basel III guidelines.

The following table describes Northern Trust's securitization exposures as of December 31, 2015.

**Table 13: Securitization Exposures**

(\$ In Millions)	As of December 31, 2015	
	On-Balance Sheet	Off-Balance Sheet
Asset Backed Securities	\$ 2,511	\$ —
Mortgage Backed Securities	374	—
Loan Exposures	—	138
<b>Total</b>	<b>\$ 2,885</b>	<b>\$ 138</b>

The following table describes Northern Trust's securitization exposures by risk-weight bands as of December 31, 2015.

**Table 14: Securitization Exposures by Risk-Weight Bands**

(\$ In Millions)		As of December 31, 2015				
	Risk-Weight Bands	Approach	Asset Backed Securities	Mortgage Backed Securities	Loan Exposures	
Securitizations	0% to <12%	SSFA	\$ —	\$ —	\$ —	
	12% to <20%	SSFA	—	—	—	
	20% to <50%	SSFA	2,004	374	108	
	50% to <75%	SSFA	192	—	—	
	75% to <100%	SSFA	170	—	30	
	100% to <425%	SSFA	138	—	—	
	425% to <1,250%	SSFA	—	—	—	
	1,250%	1,250%	7	—	—	
<b>Total</b>			<b>\$ 2,511</b>	<b>\$ 374</b>	<b>\$ 138</b>	

### Independent Review and Verification

Independent oversight and review of the Credit Risk Framework is provided by Risk Control. Refer to Independent Review and Verification within the Risk Management Overview section for more information.

### ***Equities Not Subject to the Market Risk Rule***

Northern Trust's equity investments that are not subject to the Market Risk Rule are entered into to meet strategic business needs and for regulatory compliance purposes, rather than for generating capital gains.

- Refer to Note 3 within the Corporation's 2015 Annual Report for discussion of valuation and accounting for equity holdings.

The following table presents the carrying and fair values and their associated risk-weight as of December 31, 2015, of Northern Trust's equity investments that are not subject to the Market Risk Rule.

**Table 15: Equities Not Subject to the Market Risk Rule**

<i>(\$ In Millions)</i>		As of December 31, 2015	
		Carrying Value	Fair Value
Non-publicly Traded	\$	658	\$ 658
Publicly Traded		3	3
<b>Total</b>	<b>\$</b>	<b>661</b>	<b>\$ 661</b>

<i>(\$ In Millions)</i>		As of December 31, 2015		
Risk-Weights		Carrying Value	Risk-Weighted Asset Amount	Capital Requirement
0%	\$	53	\$ —	\$ —
20%		200	40	3
100%		368	368	29
400%		—	—	—
1,250%		40	492	39
<b>Total</b>	<b>\$</b>	<b>661</b>	<b>\$ 900</b>	<b>\$ 71</b>

During the three months ended December 31, 2015, there were no realized gains or losses from sales or liquidations, no unrealized gains or losses recognized on the balance sheet but not through earnings, and no latent revaluation gains or losses.



## **Operational Risk**

Operational risk is the risk of loss from inadequate or failed internal processes, human factors and systems, or from external events. Operational risk is inherent in each of Northern Trust's businesses and corporate functions and reflects the potential for inadequate information systems, operating problems, product design and delivery difficulties, potential legal actions, or catastrophes to result in losses. Operational risk includes:

- execution, delivery and process management risk;
- risk resulting from business disruption and system failures;
- risk of damage to physical assets;
- risk resulting from clients, products and business practices;
- employment practice and workplace safety risk;
- internal fraud risk;
- external fraud risk;
- compliance risk;
- fiduciary risk; and
- legal risk.

Operational risk includes compliance, fiduciary and legal risks, which under the Corporation's risk structure are governed and managed explicitly.

To monitor and control operational risk, Northern Trust maintains a framework that consists of risk management policies, programs and practices designed to promote a sound operational environment.

Northern Trust's operational risk management strategy is to:

- align the operational risk framework with evolving business and industry practice and with regulatory requirements;
- identify, assess and mitigate risks inherent in business strategies;
- promote risk awareness and foster a proactive risk management environment within each business; and
- report key topics and developments to senior governance bodies.

The goal of these activities is to keep the operational risk profile and losses within the Board-approved Corporate Risk Appetite Statement and guidelines.

The Operational Risk Management function is responsible for defining the operational risk framework and providing independent oversight of the framework across Northern Trust. It is the responsibility of each business to implement the corporate-wide operational risk framework as well as business specific risk management programs to identify, monitor, measure and manage operational risk and mitigate Northern Trust's exposure to loss. Risk Control provides independent oversight and review of the operational risk framework.

### *Operational Risk Framework and Governance*

The ORC is responsible for overseeing the activities of Northern Trust related to the management of operational risk. This committee has the expanded role of coordinating operational risk issues related to compliance and fiduciary risks. The purpose of this committee is to provide executive management's insight and guidance to the management of existing and emerging operational risks.

The ORC is responsible for setting the Corporate Operational Risk Management Policy and approving the operational risk framework and programs that support the coordination of operational risk activities to identify, monitor, measure, manage and report on operational risk. In addition, the ORC serves as an escalation point for significant issues raised by its programs.

Operational risk is identified, monitored, measured, managed and reported through the operational risk framework. The framework is deployed consistently and globally across all businesses and its objective is to identify and measure the factors that impact risk and drive action to reduce future loss events. Several key programs support the operational risk framework, including:

- Loss Event Data Program - a program that collects loss data for use in monitoring operational risk exposure, various business analyses and a Basel AMA capital quantification. Both internal and external loss data are used in the operational risk capital quantification. Thresholds drive analysis, action and escalation through Northern Trust's businesses and the Operational Risk Management function.
- Risk and Control Self-Assessment - a structured risk management process used by Northern Trust's businesses to analyze the risks that are present in their respective business environments, processes and activities and to assess the adequacy of associated internal controls.
- Operational Risk Scenario Analysis - a systematic process of obtaining expert opinions from business managers and risk management experts to derive reasoned assessments of the likelihood of occurrence and the potential loss impact of plausible high-severity operational losses. This process facilitates management's consideration of operational risk to which the business is exposed and the potential impact and response to such events.
- Product and Process Risk Management Program - a program used for evaluating and managing risks associated with the introduction of new and modified noncredit products and services, significant changes to operating processes, and proposed business process outsourcing arrangements.
- Outsourcing Risk Management Program - a program that provides processes for appropriate risk assessment, measurement, monitoring and management of outsourced technology and business process outsourcing.
- Business Process Transition Risk Management Program - a program designed to manage effectively the risk associated with transitioning and migrating business processes to different geographic or jurisdictional locations within the organization.

- Information Security and Technology Risk Management - a program that communicates and implements compliance and risk management processes and controls to address information security and technology risks to the organization.
- Significant New Business Opportunity - a program that assesses the resource requirements, impact on systems and controls, and other risk factors prior to taking on significant new business.
- Scalability & Capacity Assessment Review - a program that provides a mechanism for identifying scalability and/or capacity constraints within Northern Trust's business areas; and their ability to take on change, whether driven by new business, strategic projects, market volatility or regulatory change.
- Operational Concentration Risk Management - a program that provides an assessment of process concentrations within the Corporation.
- Fraud Prevention Program - a program that provides tools, advice, and guidance to Northern Trust's businesses to help mitigate fraud risk.
- Business Continuity Management Program - a program designed to minimize business impact and support the resumption of mission critical functions for clients following an incident.
- Physical Security - a program that provides for the safety of Northern Trust partners, clients, and visitors worldwide by setting and enforcing standards, providing training, establishing partnerships, and encouraging continual improvement in workplace security.
- Insurance Management Program - a program designed to reduce the monetary impact of certain operational loss events.

As discussed in Risk Control, Model Risk Management also is part of the operational risk framework.

### *Operational Risk Measurement*

Northern Trust utilizes the AMA capital quantification process to estimate required capital for the Corporation and applicable U.S. banking subsidiaries. Northern Trust's AMA capital quantification process incorporates outputs from the Loss Event Data, Risk and Control Self-Assessment and Operational Risk Scenario Analysis programs to derive required capital. While internal loss data is the foundation for the capital quantification, external loss data is also utilized to inform the creation of scenario analysis data employed in the capital quantification process. Business environment and internal control factor information is used to estimate loss frequency and as an adjustment to capital estimates. The AMA capital quantification process uses a Loss Distribution Approach methodology to combine frequency and severity distributions to arrive at an estimate of the potential aggregate loss at the 99.9th percentile over a one-year time horizon.

The result of the AMA quantification process is the measure of operational risk-weighted assets as disclosed in Table 4.

### **Independent Review and Verification**

Independent oversight and review of the Operational Risk Framework is provided by Risk Control. Refer to Independent Review and Verification within the Risk Management Overview section for more information.

### **Market Risk**

There are two types of market risk. Interest rate risk is the potential for movements in interest rates to cause changes in earnings and the economic value of equity. Trading risk is the potential for movements in market variables such as foreign exchange and interest rates to cause changes in the value of trading positions.

#### *Market Risk Framework and Governance*

Northern Trust maintains a market risk framework consisting of risk management policies, programs and practices to keep the market risk profile within the Board-approved Corporate Risk Appetite Statement. All market risk activities are overseen by the Corporate Market Risk function, which is independent of the businesses undertaking the activities. Independent oversight and review of the market risk framework is provided by Risk Control.

Exposure limits for market risk are set by the Board of Directors, and committee structures have been established to implement and monitor adherence to corporate policies, external regulations and established procedures. ALCO and its subcommittee, the Market and Liquidity Risk Committee (MLRC), provide independent oversight and are responsible for developing the market risk management framework and programs that support the coordination of market risk activities to identify, monitor, manage and report on market risk. At ALCO and MLRC meetings, senior management reviews and discusses Northern Trust's market risk profile as well as various scenario analyses. ALCO and MLRC establish and monitor guidelines based on measures such as SOE, SEVE, VaR and notional position sizes.

### **Interest Rate Risk**

#### *Interest Rate Risk Overview*

Interest rate risk is the risk to earnings, associated with the balance sheet, or value of equity due to changes in interest rates. Changes in interest rates can have a positive or negative impact on earnings depending on the positioning of assets, liabilities and off-balance-sheet instruments. The impact to earnings will primarily come through net interest income, but it can also impact certain types of fees related to the balance sheet. Changes in interest rates also can impact the values of assets, liabilities and off-balance-sheet positions, which indirectly impact the value of equity. To mitigate interest rate risk, the structure of the balance sheet is managed so that movements of interest rates on assets and liabilities (adjusted for hedges) are highly correlated, which allows Northern Trust's interest-bearing assets and liabilities to contribute to earnings even in periods of volatile interest rates.

There are four commonly recognized types of interest rate risk:

- repricing, which arises from differences in the maturity and repricing terms of assets and liabilities;
- yield curve, which arises from changes in the shape of the yield curve;
- basis, which arises from the changing relationships between rates earned and paid on different financial instruments with otherwise similar repricing characteristics; and
- embedded optionality, which arises from client or counterparty behavior in response to interest rate changes.

*Interest Rate Risk Measurement, Reporting and Analysis*

Northern Trust uses two primary measurement techniques to manage interest rate risk: SOE and SEVE. SOE provides management with a short-term view of the impact of interest rate changes on future earnings. SEVE provides management with a long-term view of interest rate changes on the economic value of equity as of the period-end balance sheet. Both simulation models use the same initial market interest rates and product balances. These two techniques, which are performed monthly, are complementary and are used in concert to provide a comprehensive interest rate risk management capability.

*Sensitivity of Earnings (SOE)*

Sensitivity of earnings measures the change in earnings under various interest rate scenarios.

- Refer to page 78 within the Corporation’s 2015 Annual Report for further information on Northern Trust’s SOE and stress testing of interest rates.

The following table shows the estimated impact on Northern Trust’s pre-tax earnings, excluding fee waivers, for the next twelve months, as of December 31, 2015, of 100 and 200 basis point upward movements in interest rates relative to forward rates. Given the low level of interest rates, the simulation of earnings for rates 100 and 200 basis points lower would not provide meaningful results.

**Table 16: Sensitivity of Earnings to Changes in Interest Rates**

(\$ In Millions)	As of December 31, 2015	
	Increase (Decrease)	
Increase in Interest Rates above Market Implied Forward Rates	Estimated Impact on Next Twelve Months of Pre-Tax Earnings	
100 basis points	\$	(2)
200 basis points	\$	(31)

*Sensitivity of Economic Value of Equity (SEVE)*

A second technique used to measure interest rate risk is sensitivity of economic value of equity, which measures the change in the economic value of equity under various interest rate scenarios.

- Refer to page 79 within the Corporation’s 2015 Annual Report for further information on Northern Trust’s SEVE and stress testing of interest rates.

The following table shows the estimated impact on economic value of equity of 100 and 200 basis point shocks up from current interest rates as of December 31, 2015. Given the low level of interest rates and assumed interest rate floors as rates approach zero, the simulation of the economic value of equity for rates 100 or 200 basis points lower would not provide meaningful results.

**Table 17: Sensitivity of Economic Value of Equity to Changes in Interest Rates**

(\$ In Millions)	As of December 31, 2015	
	Increase (Decrease)	
Increase in Interest Rates above Market Interest Rates	Estimated Impact on Economic Value of Equity	
100 basis points	\$	(133)
200 basis points	\$	(427)

*Interest Rate Risk Monitoring*

Northern Trust limits aggregate interest rate risk (as measured by the SOE and SEVE) to an acceptable level within the context of risk/return trade-offs. A variety of actions may be used to implement risk management strategies to modify interest rate risk including:

- purchase of securities;
- sale of securities that are classified as available for sale;
- issuance of senior notes and subordinated notes;
- collateralized borrowings from the Federal Home Loan Bank;
- placing and taking Eurodollar time deposits; and
- hedges with various types of derivative financial instruments.

Northern Trust strives to use the most effective instruments for implementing its interest rate risk management strategies, considering the costs, liquidity, collateral and capital requirements of the various alternatives and the risk-return trade-offs.

**Foreign Currency Risk**

*Foreign Currency Non-Trading Risk Overview*

Northern Trust’s balance sheet is exposed to non-trading foreign currency risk as a result of its holdings of non-U.S.-dollar-denominated assets and liabilities, investment in non-U.S. subsidiaries, and future non-U.S.-dollar-denominated revenue and expense. To manage currency exposures on the balance sheet, Northern Trust attempts to match its assets and liabilities by

currency. If those currency offsets do not exist on the balance sheet, Northern Trust will use foreign exchange derivative contracts to mitigate its currency exposure. Foreign exchange contracts are also used to reduce Northern Trust's currency exposure to future non-U.S.-dollar-denominated revenue and expense.

### **Trading Risk**

Trading risk arises from providing foreign exchange, securities brokerage and interest rate derivatives services to clients. Securities and derivatives activities are limited and their trading risks are *de minimis*.

#### *Foreign Currency Trading Risk Overview*

Northern Trust provides foreign exchange services to clients. Most of these services are provided in connection with Northern Trust's growing global custody business. In the normal course of business Northern Trust also engages in trading of non-U.S. currencies for its own account. Both activities are considered trading activities. The primary market risk associated with global foreign exchange trading activities is foreign exchange risk.

Foreign currency trading positions exist when aggregate obligations to purchase and sell a currency other than the U.S. dollar do not offset each other in amount, or offset each other over different time periods.

#### *Foreign Currency Trading Risk Measurement*

Northern Trust measures daily the risk of loss associated with all non-U.S. currency trading positions using a VaR model and applying the historical simulation methodology. This statistical model provides estimates, based on a variety of high confidence levels, of the potential loss in value that might be incurred if an adverse shift in non-U.S. currency exchange rates were to occur over a small number of days. The model incorporates foreign currency and interest rate volatilities and correlations in price movements among the currencies. VaR is computed for each trading desk and for the global portfolio.

VaR measures are computed in a vended software application which reads foreign exchange positions from Northern Trust's trading systems each day. Data vendors provide foreign exchange rates and interest rates for all currencies. Corporate Market Risk monitors on a daily basis VaR model inputs and outputs for reasonableness.

#### *Foreign Currency Trading Risk Monitoring, Reporting and Analysis*

Northern Trust monitors several variations of the foreign exchange VaR measures to meet specific regulatory and internal management needs. Variations include different methodologies (historical, variance-covariance and Monte Carlo), equally-weighted and exponentially-weighted volatilities, horizons of one day and ten days, confidence levels ranging from 95% to 99.95% and look-back periods of one year and four years. Those alternative measures provide management a rich array of corroborating metrics and alternative perspectives on Northern Trust's market risks.



Automated daily reports are produced and distributed to business managers and risk managers. The Corporate Market Risk unit also reviews and reports several variations of the VaR measures in historical time series format to provide management with a historical perspective on risk.

The table below presents the levels of total regulatory VaR and its subcomponents for global foreign currency as of December 31, 2015, and September 30, 2015, based on the historical simulation methodology, a 99% confidence level, a one-day horizon and equally-weighted volatility. The total VaR for foreign currency is typically less than the sum of its two components due to diversification benefits derived from the two subcomponents.

**Table 18: Foreign Currency Value-at-Risk**

(\$ In Millions)						
	Total VaR (Spot and Forward)		Foreign Exchange Spot VaR		Foreign Exchange Forward VaR	
	December 31, 2015	September 30, 2015	December 31, 2015	September 30, 2015	December 31, 2015	September 30, 2015
High	\$ 0.6	\$ 0.8	\$ 0.5	\$ 0.8	\$ 0.5	\$ 0.3
Low	0.1	0.1	—	—	0.1	0.1
Average	0.3	0.3	0.2	0.2	0.3	0.2
Quarter End	0.3	0.6	0.1	0.6	0.3	0.1

Stressed VaR Reporting

The table below presents levels of Stressed Value-at-Risk (“SVar”) for foreign currency based on the same assumptions and inputs as above but replaying the severe one-year financial crisis period of August 2008 to August 2009.

**Table 19: Foreign Currency Stressed Value-at-Risk**

(\$ In Millions)			
	Stressed VaR 99% 1-day		
	December 31, 2015	September 30, 2015	
High	\$ 2.1	\$ 3.5	
Low	0.4	0.5	
Average	1.1	1.4	
Quarter End	1.0	1.4	

During the most recent period presented, Northern Trust did not incur an actual trading loss in excess of the daily VaR estimate.

### Valuation Practices

Northern Trust updates interest rates and foreign exchange rates daily through automated data feeds from independent internal source systems and established data vendors. Rates and prices are fed into pricing models which use standard methodologies to determine initial and theoretical mark-to-market valuations of positions. Those valuations serve as base market levels from which the VaR and stress test models calculate potential changes in values. Theoretical mark-to-market valuations prepared for risk management purposes may differ from valuations prepared in accordance with GAAP.

Foreign exchange positions do not include any options that require valuation.

Risk management and operations staff provides independent assessment of valuation inputs, processes and outputs for accuracy within approved thresholds and determines any valuation adjustments that may be required.

### Other Nonmaterial Trading Activities

- Refer to page 80 within the Corporation's 2015 Annual Report for discussion regarding market risk associated with other trading activities.

### Economic Capital Methodology for Market Risk (Trading Book)

Assessments of economic capital requirements for risks associated with foreign exchange trading are calculated based on daily VaR measures. For the quarter ended December 31, 2015, global foreign exchange comprised approximately 89% of the trading book economic capital and the brokerage inventory held by Northern Trust's broker-dealer, Northern Trust Securities, Inc., comprised approximately 11%. The drivers of risk for global foreign exchange are interest rates and foreign exchange rates; the driver of risk for the brokerage inventory is interest rates.

### Stress Tests

Northern Trust monitors stress test results on an ongoing basis to assess the potential for exceeding the base economic capital value described above. Northern Trust runs a number of stress tests on the foreign exchange portfolio, including quadrupling volatility, measuring at an extreme number of standard deviations, stressing correlations to extremes, taking tail averages (conditional VaR or expected shortfall), zero diversification benefit and zero correlation between spot and forward risks. Northern Trust runs daily a SVaR, which replays a severe one-year financial crisis period of August 2008 to August 2009. In assessing capital adequacy, Northern Trust considers in particular the results of stress tests run weekly that reenact eight of the most severe historical events over a simulated ten-day period.

### **Independent Review and Verification**

Independent oversight and review of the Market Risk Framework is provided by Risk Control. Refer to Independent Review and Verification within the Risk Management Overview section for more information.

## References to the Corporation's SEC Filings

The Corporation's SEC filings contain important information relative to this report. Specific references are listed below.

### DISCLOSURE MAP

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