



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

AIG Trading Book Subgroup

Restricted

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Reference: Your letter dated October 6, 2005

Dear Emmanuelle, Katherine, and David,

We first want to thank you for your letter. We agree with your understanding of the July 2005 paper on "The Application of Basel II to Trading Activities and the Treatment of Double Default Effects", especially as regards to the concept of "soundness standard comparable to that of the internal-ratings based approach for credit risk" and to the possibility of capturing default risk in the 99% 10-day VaR where a highly liquid market exists.

With respect to the third point of your letter (i.e. "incremental default risk charge for less liquid positions"), we think that, although the main focus of the incremental default risk charge is on liquidity, it should not be limited to this issue and should capture more generally all aspects associated with default risk. Furthermore, we believe that the overall charge for trading book positions (i.e. VaR plus incremental default risk charge, if any) should always meet the soundness standards set out in paragraph 307 of the July 2005 paper. Thus, the onus is on the firms to demonstrate that incremental default risk charges can decrease along a continuum reflecting the impact of liquidity, concentration, hedging, and optionality characteristics.

As you may know, a subgroup of the Basel Committee's Accord Implementation Group (AIG) has been recently set up to explore possible ways to operationalise the principles set out in the July 2005 paper for improving the trading book regime (the so-called Strand 3). As co-chairs of this working group, we are looking forward to cooperating further with you on these issues.

Yours faithfully,

Norah Barger

Thomas McGowan