October 6, 2005

Institute of International Finance, Inc.

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Dear Ms Barger and Mr McGowan:

Interpretation of the new trading book default risk capital requirement

We are writing to seek confirmation of the industry's understanding of what constitutes an acceptable approach to calculating a trading book default risk charge.

At the large industry feedback meeting on 29 June 2005, members of the BCBS-IOSCO Working Group provided informal guidance on the intentions of those who drafted the Strand 3 text. Industry members appreciated this clarification greatly and concluded that the rather general final language would work as further interpreted by the regulators in work to be conducted going forward, using the June 29 guidance as a starting point.

Given the reliance placed by firms on the information provided at the 29 June 2005 meeting, we believe that it makes sense to record the common understanding of what was communicated. We are aware that regulators plan to conduct further work in consultation with industry with regard to the trading book default risk charge, and we are not seeking to pre-empt this review. However, we believe that confirmation of the underlying principles on the basis of the 29 June meeting will assist regulators, industry associations, and firms to work on the basis of a consistent and clear understanding across firms and in accordance with the Working Group's intentions.

Therefore, we would be grateful if you could confirm that the industry's understanding of the following key aspects is correct:

– The concept of "*a soundness standard comparable to that of the internal-ratings based approach for credit risk … under the assumption of a constant level of risk and adjusted where appropriate to reflect the impact of liquidity, concentrations, hedging, and optionality*" indicates that firms are not limited to using the standard, unadjusted IRB banking book calculations when modelling the default risk of all of their trading book positions;

– Positions that have default risk, and where there is a highly liquid market so that the default risk of the positions could be sold or hedged in all material respects at a quoted market price within the 10 day trading book horizon, will not generally be subject to an incremental default risk charge provided that the default risk is adequately captured by firms' 99^{th}-percentile internal specific-risk VaR model; and

- The incremental default risk charges for less liquid positions may be calculated along a continuum with charges increasing as exposures grow less liquid (i.e., as the minimum time required to hedge completely or sell the default risk of the positions increases beyond 10 days).

Yours sincerely

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