HM Treasury, 1 Horse Guards Road, London, SW1A 2HQ

23 January 2012

Ben Bernanke
Chairman of the Federal Reserve
Board of Governors of the Federal Reserve System
20th and C Streets NW
Washington DC 20551
USA

Dear Ben,

I very much welcome the continued partnership of you and your agency colleagues in driving forward global banking reform at the G20 and Financial Stability Board.

As you progress with the implementation of the Dodd-Frank legislation, and recognising the importance of maintaining a level playing field between UK and US financial markets, I am writing to propose the launch of a more active dialogue on the Volcker rule and the implications for global financial markets.

Two specific areas of concern that I would like to raise for further discussion are:

- the impact of proprietary trading restrictions on the liquidity of global funding markets and particularly non-US sovereign debt markets; and
- the planned breadth of exemptions to proprietary trading restrictions for firms carrying out activities which have little economic consequence for US markets.

On the first, I am concerned that the regulations could have a significant adverse impact on sovereign debt markets, including here in the UK. In particular, although we understand that the primary legislation makes an exemption for market-making activities, in practice the regulations would appear to make it more difficult and costlier to provide market-making services in non-US sovereign markets. Any consequent withdrawal of market-making services by banks would reduce liquidity in sovereign markets, which in turn would engender greater volatility and make it more difficult, riskier and costlier for countries such as the UK to issue and distribute their debt.

On the second, there may be a risk that the proprietary trading restrictions continue to have implications for firms foreign to the US which use US exchanges or other market infrastructure to carry out their business. Unless exemptions are sufficiently broad the risk is that the legislation could dis-incentivise transactions with US counterparties. This could result in a reduction in market liquidity, leading to investors experiencing higher costs, delays, and potentially greater price volatility. Over the medium term, this may encourage a migration of market making to outside the regulated banking sector.

Before Christmas, the Prime Minister and I formally accepted the Independent Commission on Banking's (ICB) recommendations to ring-fence retail banks from investment banks. The US and the UK are, together, leading structural reforms to create a safe and sustainable global banking system. The ICB proposals reflect the importance that the stability of the financial services industry within the UK economy, whilst recognising the international character of the financial sector and the desire to avoid measures that would have extra-territorial effect.

In light of our reform work, it would also be useful to use this dialogue to understand the underlying financial stability objectives of the extra-territorial aspects of the Volcker rule and to ensure that we learn from each other in taking forward these important reforms. I hope that a dialogue about these measures would be mutually beneficial and help to support greater policy consistency between the US and UK.

At this time of financial market stress, I want ensure this regulatory dialogue supports cooperation aimed at minimising any unintended consequences of regulatory reforms on either side of the Atlantic.

Best wishes.

GEORGE OSBORNE