Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Financial Regulators On Watch As Brexit Fallout Builds

By **Evan Weinberger**

Law360, New York (June 24, 2016, 6:41 PM ET) -- U.S. financial regulators and their global counterparts are on high alert for signs of financial stress both in the short and long term, after voters in the U.K. on Thursday chose to leave the European Union, with a particular focus being placed on stresses in banks' trading books.

Although the vote by British citizens to leave the EU caught many observers by surprise, bank executives and policymakers at the U.S. Federal Reserve and other financial regulatory agencies have been preparing at least somewhat for a victory for the "leave" campaign.

But that preparation can only go so far, and the unpredictability that has now been put into the financial system — everything from the falling value of the British pound to the potential for changes to global financial regulations — has put officials on guard to ensure they stamp out any signs of contagion before it takes hold.

"It's not like the firms or the Fed were unaware of the risks here, so there's always been discussions around preparations and contingency plans for the potential risks. Of course, we're still in that uncertain period," said David Wright, a managing director at Deloitte & Touche LLP's banking and securities regulatory practice and a former Fed official.

The results of Thursday's referendum resulted in the pound getting pounded and stocks around the world, in particular bank stocks, getting hammered. JPMorgan Chase & Co. reported a record amount of currency trading, and caused regulators around the world to say they were monitoring the situation.

The Dow Jones Industrial Average in the U.S. fell by more than 600 points, or nearly 3.4 percent. The S&P 500 cratered by around 76 points, or approximately 3.6 percent. And the Nasdaq was down 4 percent for the day. Stocks in the eight biggest U.S. banks were all broadly lower, with Morgan Stanley stock losing more 10.15 percent and Citigroup Inc., one of the most internationally exposed U.S. banks, falling around 9.4 percent.

Wells Fargo & Co., which does not have the same level of trading exposure as the big investment banks, saw its stock drop around 4.6 percent on the day, the best performer of the eight global systemically important banks.

Along with those losses, oil prices fell as the U.S. dollar strengthened amid investors' flight to safer investments and the dampened prospects of near-term interest rate hikes in the U.S., putting a further squeeze on bank earnings.

European and especially U.K. banks did even worse.

And because of that, the Bank of England and the Fed took action. Mark Carney, the governor of the Bank of England, vowed to provide some £250 billion ($341.5 billion) to support financial markets.

The Fed said it would keep swap lines with other central banks open to maintain market liquidity. Doing so would allow those central banks to borrow U.S. dollars from the Fed while posting their own currencies as collateral.

"The Federal Reserve is prepared to provide dollar liquidity through its existing swap lines with central banks, as necessary, to address pressures in global funding markets, which could have adverse implications for the U.S. economy," the Fed said in a statement, adding that it was "carefully monitoring" global financial market developments.

U.S. Department of the Treasury Secretary Jacob J. Lew, the U.S. Securities and Exchange Commission and other regulators around the world put out similar statements. The Financial Stability Oversight Council, a panel of U.S. financial regulators, was set to meet Friday afternoon via telephone to discuss the post-Brexit market route.

It was no surprise that the Fed took the most direct action among U.S. financial regulators.

"This is really a central bank issue and to a lesser extent market regulators," said Donald Lamson, of counsel at Squire Patton Boggs LLP.

The ability of the Fed and other central banks to boost liquidity in the currency markets is vital when currencies are getting routed. And given the concerted efforts that are underway to calm markets, Lamson said, central bankers feel they have the tools necessary to do so.

"The numbers involved may be huge, but they think they can control that," he said.

Wright said that aside from boosting liquidity, banking supervisors, particularly those that are housed inside of big banks, will be working with institutions to ensure their own liquidity levels are able to handle volatility in the short term.

"One of the first things they’ll be looking at is how well the markets are functioning and any short-term dislocations in the market," he said.

In the long-term, regulators and the banks they oversee are going to have to monitor any changes to U.K. financial regulation and trade agreements that may come about as a result of the country's negotiations with the EU over the terms of the U.K.'s exit.

"The issue of duplicative regulation will arise as these things move forward," said Joseph T. Lynyak, a partner at Dorsey & Whitney LLP.

It’s unlikely that many of the prudential rules that banks operate under — the raised capital, leverage and liquidity requirements called for under the Basel III international banking accords and agreements by G-20 member states — will change much in negotiations between the U.K. and the EU.

For one, the EU has restrictions on doing business with countries whose regulations are not as strong as EU rules. So if the U.K. wants to retain its role as a financial center, it will have to keep those standards in place, said Mark Compton, a London-based partner with Mayer Brown LLP.

In addition, the U.K. has been at the forefront of toughening up financial standards, in many ways leading the EU to adopt tougher standards than other member states wanted, Compton said.

"It's not like we're going to all of a sudden say this is a bad idea, because it was our idea in the first place," he said.

If anything, there may be some minor tinkering on prudential bank regulation in the U.K., which should make it easier for banks to navigate the new landscape as it develops, Compton said.

There are still questions about market rules that could pose bigger issues, and banks have already discussed moving staff to cities in EU member states, like Dublin, Ireland, and Frankfurt, Germany.

And that could raise operational issues at banks that regulators will keep their eyes on, said Mayra Rodriguez Valladares, the principal at consulting firm MRV Associates.

"This is going to be a long, drawn-out battle," she said.

--Editing by Katherine Rautenberg and Edrienne Su.

All Content © 2003-2016, Portfolio Media, Inc.