Research

FSOC: For Sure Overly Capricious? MetLife Thinks So

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EXECUTIVE SUMMARY

After being designated a systemically important non-bank financial institution (SIFI), MetLife sued the Financial Stability Oversight Council (FSOC) on the grounds that the process leading to its designation was "arbitrary and capricious." Both the FSOC and MetLife have filed arguments in the court case. A review of these documents indicates that MetLife has solid arguments in favor of its case, merits its day in court, and may well prevail.

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On December 18, 2014, the Financial Stability Oversight Council (FSOC) voted to designate MetLife as a systemically important non-bank financial company. Unfortunately, being "systemically important" in the government's eyes is no honor. When FSOC decides to designate an entity like MetLife as systemically important, that entity is immediately subject to myriad regulations that impose high costs of compliance, costs which are, more often than not, passed on to the consumer.

Those regulations are often summed up as "enhanced prudential standards" and are the result of regulatory rulemakings by the Federal Reserve. Such standards include increased supervision by the Federal Reserve Board, heightened capital requirements, the requirement that the company produce a "living will" each year, increased reporting, stress testing, credit exposure limits, debt-to-equity ratio requirements, and early remediation requirements. In its primer on FSOC's designation process, AAF estimated that these requirements will force designated entities to hire additional staff, increase data and technology infrastructure and set aside capital. AAF goes even further to argue that subjecting only *certain* non-bank financial companies to such regulation could have impacts on the structure of the market and economy. Perhaps even more troublesome is the level of uncertainty surrounding FSOC's firm-specific designation process and the lack of attention by regulators to the costs inflicted as a result of a systemically important designation. Of utmost uncertainty regarding is the process is the fact that none of the enhanced prudential standards have been written for non-banks; so how can FSOC make a determination that enhanced supervision for an entity is necessary when they don't know what enhanced supervision will actually mean?

This uncertainty is evident in FSOC's designation of MetLife. For example, according to its "Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc.," ("the Basis") FSOC voted to designate MetLife as systemically important solely based on its conclusion that "MetLife's material financial distress could lead to an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy." Its decision failed to take into account the Second Determination Standard as required by Section 113 of Dodd-Frank which includes a study of whether the "nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company could pose a threat to the financial stability of the United States" regardless of

whether the company were experiencing material financial distress. Roy Woodall, FSOC's own Independent Member with insurance expertise said, "By not considering the Second Determination Standard, the Council has continued its practice of not informing a company of those aspects of its business that were the primary factors associated with a designation."

Mr. Woodall went on to advocate for an activities-based approach to designation – one that considers the overall mix of services, offerings, and dealings of MetLife as the precursor that could affect the potential for material financial distress – as opposed to the arbitrary size-based approach, which considers little more than the financial size of a company in concluding "that the origin of the company's systemic risk would stem from a sudden and unforeseen insolvency of unprecedented scale, of unexplained causation, and without effective regulatory responses or safeguards." Coincidentally, FSOC is, in fact, considering this activities-based approach for asset managers, but has never done so for insurers or any other non-banks.

Further complicating matters, in an effort to expose the lack of reason and understanding among the Council, Adam Hamm, FSOC's State Insurance Commissioner Representative said that "[his] staff sought to correct basic factual errors regarding the operation of the state regulatory system just days before the vote on the final designation of the company. Even though some errors were corrected, it is unclear whether the Council fully considered the nature and scope of the state insurance regulatory system." In addition to pointing out factual errors on the Council's Basis, Mr. Hamm argues that "the Council should have sought to match the areas of concern to the authorities of existing regulators to address those concerns. The Basis fails to do this. As a result, the Basis fails to acknowledge that most, if not all, of the concerns it identifies (several of which have questionable merit) are addressed by the existing regulatory structure. This omission makes the Council's rationale for its decision fundamentally flawed." Indeed, the Basis submits no proposal for additional regulatory tools beyond those already in place as it fails to consider the fact that the risks the Council identifies are already overseen by state insurance regulators that were specifically designed to address those concerns. In closing, Mr. Hamm points out that through this Basis, FSOC has created an impossible burden of proof for companies being considered for a designation as a company would have to prove that there are absolutely no circumstances under which the material financial distress of the company could possibly pose a threat to the financial stability of the country. Mr. Hamm states that "it remains to be seen whether this approach is legally tenable," and that is just what MetLife is seeking to clarify in its lawsuit.

MetLife isn't the first insurance company to end up with this tenuous designation. In fact, of the four total non-bank financial company designations that FSOC has made in its four and a half year existence, three have been insurance companies. In addition to MetLife's designation, on July 8, 2013, FSOC voted to designate AIG, and on December 18, 2014, it voted to designate Prudential as systemically important. This supposed concentration of systemic risk in the insurance industry has led many to question whether FSOC is treating other non-bank financial companies differently both in its analysis and process. Under Dodd-Frank, within 30 days of a designation, companies may file an action in a U.S. Federal court asking that the determination be overturned. Prudential appealed its designation to FSOC and lost, whereas AIG accepted the designation without challenge. It is also interesting to note that these three companies, AIG, Prudential, and MetLife, are already designated as Global Systemically Important Insurers ("G-SIIs") by the international regulatory body, the Financial Stability Board (FSB), recently in the news for its proposed designation of certain asset managers. Many experts argue that a company cannot be designated by FSB and avoid being designated by FSOC, although the two groups do have different standards and processes for determining systemic importance.

After FSOC rejected MetLife's initial challenge of its designation, MetLife filed suit in federal court challenging FSOC's designation, calling it "arbitrary and capricious" – the standard that a plaintiff must meet in order to overturn an agency action. This standard is based on, among other things, a showing of sheer

speculation instead of logic and evidence in a decision-making process. The complaint details the bureaucratic hassle MetLife went through in attempts to convince FSOC that it should not be designated as systemically important. It also underlines the importance of the arguments made in Mr. Woodall's and Mr. Hamm's dissenting and minority opinions discussed above and sets the grounds that the designation process violates both Dodd-Frank and the Administrative Procedure Act.

MetLife makes ten claims against FSOC, each of which is merited on its own, but together form a cohesive and convincing case against the Council. The first claim argues that the designation is arbitrary and capricious because MetLife is technically not a non-bank financial company under Dodd-Frank standards because less than 85% of its revenues and assets relate to "financial activities" and therefore it is not "predominately engaged in financial activities." Second, MetLife argues that the designation is fatally premature because FSOC has not yet promulgated a handful of standards and processes that were required under Dodd-Frank. Third, MetLife argues that FSOC failed to consider alternatives to the designation and provide a reasoned explanation for rejecting those alternatives. To that end, MetLife cites to numerous Supreme Court decisions on the matter as well as letters and statements from Members of Congress – including those involved in the writing of Dodd-Frank. Next, MetLife argues that FSOC failed to assess the company's vulnerability to material financial distress and goes on to explain that the designation was inconsistent with the statutory criteria set forth in section 113 of Dodd-Frank. Finally, the last four claims argue that the designation was based on "unsubstantiated, indefinite assumptions and speculation that failed to satisfy the statutory standards for designation and FSOC's own interpretive guidance;" failed to consider the economic effects of designation; violated MetLife's due process; and violated the separation of powers by assigning legislative, prosecutorial, and adjudicative powers to the same individuals.

FSOC responded, as expected, with a motion to dismiss that would terminate the lawsuit before even going to trial. The motion, which was initially filed under seal and later released to the public as a redacted version, counters each of MetLife's arguments in turn and defends its process and ultimate designation. One might question the strength of arguments that have the tone of "We're right; you're wrong." Perhaps the most interesting aspect of the back-and-forth between MetLife and FSOC is the due process issue. MetLife, in its complaint, argues that its due process was violated by the Council never identifying the thresholds that result in designation or how the various statutory and regulatory factors are balanced against one another; by being denied access to the full record on which the designation was based even after sending ten Freedom of Information Act (FOIA) requests to FSOC; and by FSOC's reliance on new evidence and analysis in the Final Designation that was not included in the Notice of Proposed Determination. In response, the government summarily says that it believes MetLife "received ample opportunity to be heard" as it cites to the hundreds of pages of material that it sent to the company.

On June 16, 2015, MetLife filed a cross-motion for summary judgment asking the court to enter summary judgment for MetLife on all claim stating that "FSOC's errors are many, and grave. And because FSOC made clear that '[n]o single consideration [was] dispositive' in its decision to designate MetLife…each one of those errors requires rescission of the Final Determination in its entirety." As is usually the case in these types of filings, MetLife restated many of their arguments contained in the original complaint and beefed up other arguments. In particular, MetLife focused on its concept that it technically is not a U.S. non-bank financial company eligible for designation based on the premise that its non-U.S. insurance activities are not financial activities according to the Bank Holding Company Act ("BHCA"). MetLife further argued that FSOC's attempts to circumvent the requirements of BHCA were "unavailing." In support of its argument that the final designation was in fact arbitrary and capricious, MetLife submitted evidence that FSOC disregarded accepted risk analysis methodologies and failed to define criteria to guide its analysis; predicated its assumptions on illusory risks; assumed the "utter ineffectiveness" of state regulators; and, among other things, based its

"predictive judgments" on "pure speculation, rather than on evidence and reasoned analysis." Convincing arguments, to say the least.

So what happens next? If the District Court grants FSOC's motion to dismiss, this case is over, although MetLife has the right to an appeal, and the precedent essentially is set that companies have almost no opportunity for relief after a designation of systemic importance. In that situation, a dismissed case in favor of FSOC means that the court believes that, even if MetLife's claims are true, there is no law that provides a legal remedy, essentially saying that MetLife has no merit. That is simply not the case. Dodd-Frank and the FSOC's own rules provide companies the ability to challenge a designation. A ruling in favor of FSOC would give the Council nearly free-reign to make designations as it pleases, even when the numbers don't add up and the process is opaque.

On the other hand, if the court decides in favor of MetLife's latest cross-motion for summary judgment, MetLife's systemically important designation will be rescinded, and FSOC will have a higher burden of proof along with a ruling that favors more transparency throughout the designation process. At the very least, the evidence indicates that MetLife should be able to have their day in court, and, based on the arguments in the filings thus far, has good grounds to prevail.