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Memorandum

MetLife Wins Court Ruling Removing FSOC's "Too-Big-to-Fail" Designation

Unsealed Court Opinion Finds That FSOC's Classification of MetLife as a "Systemically Important Financial Institution" Was Arbitrary and Capricious

April 11, 2016

On March 30, Judge Rosemary Collyer of the U.S. District Court for the District of Columbia invalidated the Financial Stability Oversight Council's ("FSOC") designation of MetLife as a systemically important financial institution ("SIFI").[1] Although the court found that MetLife may be deemed "predominantly engaged" in "financial" activities and therefore eligible for designation as a SIFI, the court found "fundamental violations of administrative law" and a designation process that was "fatally flawed." In particular, the court determined that FSOC did not follow its own published standards for SIFI-designation: it did not assess MetLife's likelihood of failure, but simply assumed that a failure would occur, and never attempted to quantify or estimate the actual consequences of a failure to the financial system. In addition, FSOC failed to consider the costs associated with designating MetLife as a SIFI. Accordingly, the court determined that FSOC's decision was "arbitrary and capricious," and granted MetLife's motion for summary judgment to rescind its SIFI designation.

Although the case was determined largely on procedural grounds, it highlights the continuing challenges regulators face in defining systemic risk on an empirically clear basis.

Background

Section 113 of the Dodd-Frank Act empowers FSOC to designate certain nonbank financial companies as systemically important and therefore subject to supervision by the Federal Reserve. To be eligible for designation as a nonbank SIFI, a company must be a "U.S. nonbank financial company," defined as a U.S.-incorporated company that is "predominantly engaged in financial activities." To be "predominantly

[1] *MetLife, Inc. v. Financial Stability Oversight Council*, C.A. No. 15-0045 (D.D.C. Mar. 30, 2016).

engaged" in financial activities, a company must satisfy either of two tests under Section 102 of the Dodd-Frank Act. Under the first test, at least 85% of the company's consolidated annual gross revenues must be "derived" from activities that are "financial in nature." Under the second test, at least 85% of the company's consolidated assets must be "related to activities that are financial in nature." Eligible companies may be designated by FSOC for enhanced supervision under either of two determination standards: (1) when material financial distress at the company could pose a threat to the financial stability of the United States; or (2) when the very "nature, scope, size, scale, concentration, interconnectedness, or mix" of the company's activities could pose the same threat.

In April, 2012, FSOC issued through formal rulemaking a final rule and interpretive guidance related to nonbank SIFI determinations.[2] In its final rule, FSOC explained that it would consider a "threat to the financial stability of the United States" to exist if a company's material financial distress would "inflict significant damage on the broader economy" through any of three "transmission channels": Exposure, Asset Liquidation, or Critical Function or Service.

The final rule detailed six categories that FSOC would consider when assessing whether a company's material financial distress could pose such a threat to the national economy. According to FSOC, the first three categories—interconnectedness, substitutability and size—"seek to assess the potential for spillovers from the firm's distress to the broader financial system or real economy." The other three categories—leverage, liquidity risk/maturity mismatch and existing regulatory scrutiny—"seek to assess how vulnerable a company is to financial distress."

MetLife's Designation

On July 16, 2013, FSOC notified MetLife that it was being considered for designation as a nonbank SIFI. After MetLife conducted multiple meetings with FSOC staff and submitted more than 21,000 pages of materials for evaluation, FSOC voted 9-1 to designate MetLife as a nonbank SIFI on December 18, 2014. According to its "Explanation of the Basis of Final Determination," FSOC based its designation on the first determination standard (*i.e.*, FSOC concluded that material financial distress at MetLife "could pose a threat to the financial stability of the United States"). Notably, FSOC did not expressly rely on the second determination standard, that the very nature, scope, size, scale, concentration, interconnectedness, or the mix of MetLife's activities could pose such a threat.

FSOC found that MetLife's material financial distress would inflict significant damage on the broader economy through the Exposure and Asset Liquidation transmission channels. With respect to the Exposure channel, FSOC determined that MetLife's exposure to creditors, counterparties, investors, or other market participants is significant enough to materially impair those counterparties and thereby pose a threat to U.S. financial stability in the event of material financial distress. With respect to the Asset Liquidation channel,

[2] *See* 77 Fed. Reg. 21637 (Apr. 12, 2012).

FSOC determined that MetLife holds assets that, if liquidated quickly, would cause a fall in asset prices and thereby significantly disrupt trading or funding in key markets or cause significant losses or funding problems for other firms with similar holdings. FSOC further concluded that MetLife's existing regulatory scrutiny would not be able to prevent either threat from being realized, and that MetLife's complexity would hamper its resolution.

MetLife's Challenge

On January 13, 2015, MetLife submitted a complaint challenging FSOC's decision to designate MetLife as a nonbank SIFI. Among its many arguments against its SIFI designation, MetLife claimed that it was not eligible for designation because it is not "predominantly engaged" in "financial" activities, that FSOC violated its own regulations in making its designation decision, and that FSOC failed to examine the costs of its designation decision, focusing exclusively on the presumed benefits instead.

MetLife Eligible for SIFI Designation

As an initial matter, the district court rejected MetLife's assertion that it was ineligible for designation as a nonbank SIFI because it is not "predominantly engaged" in "financial" activities, citing MetLife's previous certification to the Federal Reserve when electing to become a financial holding company that "the vast majority of [its subsidiaries] are engaged in activities that are 'financial in nature.'" The court further found no merit in MetLife's technical arguments that foreign activities cannot qualify as "financial in nature."

"Arbitrary and Capricious" Standard

Although the court found MetLife to be potentially eligible for designation as a nonbank SIFI, the Dodd-Frank Act allows companies designated as nonbank SIFIs to challenge the merits of such designation in court. When considering such challenges to SIFI designations, however, courts are expressly limited to reviewing whether the final FSOC determination was "arbitrary and capricious" (a common standard in administrative law). The standard is highly deferential to administrative agencies such as FSOC; courts applying the "arbitrary and capricious" standard generally "will not disturb the decision of an agency that has examined the relevant data and articulated a satisfactory explanation for its action."[3] Instead, courts consider only whether the decision was based on a consideration of all relevant factors and whether there has been a clear error of judgment. However, the standard prohibits an agency from departing from a prior policy without explanation or simply disregarding existing rules.

Under this standard, the district court determined that FSOC's designation of MetLife as a nonbank SIFI was arbitrary and capricious on two grounds. First, FSOC departed from its prior policy on whether MetLife's vulnerability to financial distress would be considered as a threshold to SIFI designation, and on how a

[3] *MD Pharm., Inc. v. DEA*, 133 F.3d 8, 16 (D.C. Cir. 1998).

threat to the financial stability of the United States would be measured, in each case without explanation. Second, FSOC failed to consider the costs associated with its designation of MetLife.

FSOC's Departure from Prior Policy without Explanation

The court first determined that FSOC violated its own stated policy by failing to assess MetLife's vulnerability to material financial distress before addressing the potential effect of that distress. The FSOC's own final rule specified that of the six factors it would consider when assessing whether a company's material financial distress could pose a threat to U.S. financial stability, three would "seek to assess how vulnerable a company is to financial distress." By contrast, the final determination delivered to MetLife did not include any such vulnerability assessment, claiming instead that all six categories of analysis were meant only "to assess the potential effects of a company's material financial distress." The court found these positions to be "undeniably inconsistent," and flatly rejected FSOC's insistence that it had not changed its position on whether it must assess vulnerability to financial distress in its designation decisions.

Similarly, the court found that FSOC was inconsistent in its standard for determining whether MetLife's material financial distress would inflict significant damage on the broader economy. In fact, the court critiqued FSOC for "hardly adher[ing] to any standard when it came to assessing MetLife's threat to U.S. financial stability," relying instead on sweeping assumptions and summarily deeming every possible effect of MetLife's distress grave enough to damage the U.S. economy. Even under the deferential standard of review, the court refused to affirm a finding that MetLife's distress would cause severe impairment of financial intermediation or of financial market functioning when FSOC refused to perform such an analysis itself.

In its analysis of the Exposure transmission channel, FSOC refused to account for collateral and other mitigating factors. Although FSOC argued that accounting for collateral and other mitigating factors would only worsen the Asset Liquidation impact, it failed to quantify either impact. Instead, FSOC was content to evaluate interconnectedness but stopped short of calculating what could actually happen if MetLife were to suffer material financial distress. FSOC's designation decision assumed MetLife's distress would inflict "significant damage" on the U.S. economy, but never explained how it would result, in contravention of its own regulations. Like the FSOC's reversal on the vulnerability assessment, this change in policy was neither acknowledged nor explained.

The court acknowledged that the FSOC's initial interpretation of the Dodd-Frank requirements is "not instantly carved in stone," but in the event of a changed position, the FSOC must acknowledge and show good reasons for such change. With respect to its policy reversals regarding both the vulnerability assessment impact assessment, FSOC failed to provide any "good reasons" for its change because it stated that there was no "new policy" to begin with.

Accordingly, having announced two key interpretations of Dodd-Frank requirements through formal rulemaking, FSOC was required either to maintain them or to explain its deviation from them. The court determined that FSOC's failure to do either was arbitrary and capricious, and sufficient in each case to rescind MetLife's SIFI designation.

FSOC's Disregard of Cost Considerations

FSOC conceded that it did not consider the costs of designating MetLife a nonbank SIFI, but argued that it need not undertake such an analysis absent a congressional command. Although the Dodd-Frank Act requires FSOC to consider "any other risk-related factors that [FSOC] deems appropriate," FSOC contended that cost is not necessarily an "appropriate" "risk-related factor" that it must consider.

Citing the recent Supreme Court decision of *Michigan v. Environmental Protection Agency*,[4] however, the court concluded that cost is necessarily an "appropriate" factor for FSOC's consideration, since "no regulation is 'appropriate' if it does significantly more harm than good."

Turning to the question of whether cost is "risk-related," the court rejected FSOC's argument that the only risk that should be considered is whether the company's distress could pose a threat to the financial stability of the U.S. Instead, the court determined that cost must be considered "risk-related" because of its relation to the risk of MetLife's distress in the first place. FSOC refused to address MetLife's contention that imposing billions of dollars in compliance costs could actually make MetLife more vulnerable to financial distress, and thus failed to determine whether its designation of MetLife does significantly more harm than good. This failure, in the court's view, also rendered the MetLife SIFI designation arbitrary and capricious.

Conclusion

On April 7, the Treasury Department announced that the government would appeal the court's ruling. If the ruling were to stand on appeal, FSOC will most certainly need to revisit the level of rigor with which it conducts its designation analyses going forward. Any such changes to FSOC's approach may have significant implications for its ongoing assessment of the asset management industry. In the short-term, it appears that FSOC has determined that it is more feasible, if not less controversial, for it to focus on asset management *products and services*, rather than *designations* of specific firms. The FSOC held two meetings in March alone on the potential risks to U.S. financial stability from asset management products and services. It is particularly focused on "liquidity and redemption risks and risks associated with the use of leverage by asset management vehicles," and it has announced that it "expects to provide a public update on its analysis this spring."[5]

For MetLife and other nonbank SIFIs, the ultimate implications of an upheld ruling remain unclear.

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[4] 135 S. Ct. 2699 (2015).
[5] *See* Press Release, U.S. Treasury Department (Mar. 21, 2016).

Because the court found that MetLife is eligible to be designated as a nonbank SIFI but found fault only with FSOC's determination process, it may be possible for FSOC to revisit MetLife's SIFI designation following a revamped evaluation (including a vulnerability-to-distress assessment, a quantifiable damage-impact assessment, and a cost-benefit analysis).

One day after the MetLife order was issued, GE Capital, which was designated a nonbank SIFI in July 2013, filed a formal request that its SIFI designation be removed. It remains unclear whether Prudential and AIG, the only other two designated nonbank SIFIs, will similarly challenge their designation in the wake of the MetLife ruling. A Prudential spokesman stated only that company executives "continuously review developments that impact our company, and we are evaluating what is in the best interests of the company and our stakeholders." AIG CEO Peter Hancock has said he is watching the dispute closely, and that the district court's decision may provide an opportunity for AIG to look for ways to shed its SIFI status.

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