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Risk is in the Eye of the Beholder: Court Reconsiders "Too Big to Fail" Designation of MetLife, Inc.

Client Advisories

Hughes Hubbard & Reed LLP • A New York Limited Liability Partnership
One Battery Park Plaza • New York, New York 10004-1482 • +1 (212) 837-6000

May 16, 2016 - The determination by the Financial Stability Oversight Council ("FSOC") that MetLife, Inc. ("MetLife") could "pose a threat to the financial stability of the United States" was recently rescinded by the District Court for the District of Columbia.[1] Administrative law provided the grounds for the court's conclusion that, in designating MetLife as "too big to fail," FSOC failed to follow: (1) recent Supreme Court precedent requiring consideration of the costs and benefits of an administrative action; and (2) the agency's own guidance. The court's decision provides a framework for other designated companies who have received a similar designation and seek to challenge that status.[2] The decision also poses a hurdle for further designations by FSOC, which, in addition to following its own guidance, must consider whether the costs of designation to the company outweigh the benefits of heightened regulation.

Background

Dodd-Frank[3] established FSOC to, among other things, identify risks to financial stability in the United States that could "arise from the material financial distress or failure" of nonbank financial companies.[4] A nonbank financial company designated by FSOC as too big to fail becomes subject to Federal Reserve supervision and heightened regulatory standards, such as higher capital requirements. In 2012, FSOC issued the Guidance for Nonbank Financial Company Determinations (the "Guidance"), which organized ten statutory factors into six categories, further subdivided into two groups.[5] FSOC intended the first group "to assess the potential impact of the nonbank financial company's financial distress on the broader economy," and the second group "to assess the vulnerability of a nonbank financial company to financial distress."

In 2014, after more than a year of meetings between FSOC and MetLife, the evaluation of more than 21,000 pages of materials, and a hearing, FSOC designated MetLife as a "nonbank financial company." FSOC anchored its conclusion on four findings: (1) exposed counterparties would potentially suffer substantial losses if MetLife underwent material financial distress; (2) this financial distress would potentially cause MetLife to liquidate assets rapidly, upsetting capital markets; (3) the existing regulatory framework would not stop either (1) or (2) from occurring; and (4) "MetLife's complexity would hamper its resolution and thus 'prolong uncertainty, requiring complex coordination among numerous regulators, receivers, or courts that would have to disentangle a vast web of intercompany agreements.'" With this designation, MetLife joined the ranks of American International Group, Prudential Financial Inc., and General Electric, the only other entities to have been designated nonbank financial companies.

MetLife filed a complaint against FSOC challenging the designation. On March 30, 2016, the District Court found that FSOC's determination was "arbitrary and capricious" and rescinded MetLife's designation.

Standard of Review

Under Dodd-Frank, district courts may rescind FSOC's designation only upon a conclusion that it was "arbitrary and capricious." This narrow and highly deferential standard of review requires only that the court find a rational basis for FSOC's decision. To rescind, the court must find that FSOC departed from its prior policy or rules without providing sufficient justification.

With respect to MetLife, the District Court concluded that FSOC's designation process was "fatally flawed." FSOC "critical[ly] depart[ed]" from standards previously adopted in its guidance, and FSOC's intentional disregard of the "downside cost" considerations to designating MetLife ignored recent Supreme Court standards.

Cost-Benefit Analysis Necessary For Dodd-Frank Administrative Decisions

FSOC's intentional exclusion of cost considerations rendered its determination arbitrary and capricious under recent Supreme Court precedent. The Supreme Court's decision in *Michigan v. Environmental Protection Agency* provided that cost-benefit analyses may be imputed: a statute's use of the word "appropriate" "naturally and traditionally includes consideration of all relevant factors." [6] The Supreme Court found cost to be an "important aspect of the problem" and noted that "any disadvantage could be termed a cost." In its analysis, however, FSOC ignored cost considerations, arguing that Dodd-Frank does not require FSOC to perform a cost-benefit analysis.

MetLife argued that the heightened regulatory standards associated with its designation would "impos[e] billions of dollars in cost [that] could actually make MetLife more vulnerable to distress." FSOC's designation actually did "foist[] 'billions of dollars' of regulatory costs" upon MetLife. The District Court explained that, because the "cost-benefit analysis is a central part of the administrative process," "cost must be balanced against benefit because '[n]o regulation is 'appropriate' if it does significantly more harm than good."[7] The District Court found it "impossible" to determine whether FSOC's designation of MetLife as systemically important "does significantly more harm than good." Significantly, the District Court anticipated that the line of cases on which FSOC anchored its disregard of cost is unlikely to survive Michigan.

FSOC's Process "Critically" Departed From Its Guidance

The District Court determined that FSOC's analysis deviated materially from the analytical, dual-group process established in the Guidance. FSOC ignored the grouping entirely and applied all six categories as if they "were meant only 'to assess the potential effects of a company's material financial distress.'" The court found this to be "undeniably inconsistent" and "inarguably different" from the framework established by the Guidance. According to the District Court, "[t]he distinction [in the Guidance] was clear: FSOC intended the second group of analytical categories to assess a company before it became distressed and the first group to assess the impact of such distress on national financial stability."

The District Court also found that, when analyzing MetLife's potential threat to the financial system, FSOC failed to apply the standards delineated in the Guidance. The Guidance interpreted the statutory phrase "could pose a threat to the financial stability of the United States"[8] to mean that a nonbank financial company could only be deemed a threat "if there would be an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy."[9] The Guidance explains that "significant damage on the broader economy" could occur through one of three "transmission channels:" (1) exposure,[10] (2) asset liquidation,[11] or (3) critical function or service.[12] The District Court concluded that FSOC not only failed to "abide by that standard," it "hardly adhered to any standard when it came to assessing MetLife's threat to U.S. financial stability." For example, in its analysis of the exposure channel, FSOC "merely summed gross potential market exposures" while failing to consider mitigating factors, like collateral. FSOC also applied the phrase "could sustain losses" throughout its analysis, but it neglected to quantify the losses in any way. Such generalized assumptions were found to "pervade the analysis" so that "every possible effect of MetLife's imminent insolvency was summarily deemed grave enough to damage the economy." The District Court concluded that, although the mode of thinking reflected by FSOC's analysis was "entirely consistent" with Dodd-Frank, it "was not the standard invoked by FSOC." And thus, FSOC's assumption of damage, without explaining how it would result, was "in contravention of the Guidance."

Final Considerations

The Court's rescission of FSOC's determination provides two potential paths for institutions seeking to avoid or appeal a designation of systemic importance. If an entity can show that the costs of heightened regulation exceed the potential benefit of that regulation, FSOC's determination can potentially be avoided or rescinded. The necessity of a cost-benefit analysis may be the linchpin entities need to argue against designation under Dodd-Frank. Furthermore, because the MetLife decision presents the Guidance as FSOC's roadmap for designation, companies should look closely at the Guidance to assure that their operations do not lend themselves to designation or that a designation has not been inappropriately made.

Footnotes

[1]. *MetLife, Inc. v. Financial Stability Oversight Council*, Civil Action No. 15-0045 (RMC) (D.D.C. March 30, 2016).

[2]. Shortly after the MetLife decision, General Electric—one of four nonbank entities to ever earn the designation—filed a request with FSOC for the rescission of its designation as too big to fail.

[3]. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376-2223, codified at 12 U.S.C. §§ 5301 et seq. (2010)

[4]. FSOC consists of the heads of certain federal financial regulatory bodies, including the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission, and the Chairperson of the Federal Deposit Insurance Corporation.

[5]. 77 Fed. Reg. 21,637 (FR); codified at 12 C.F.R. § 1310. The six categories are: interconnectedness, substitutability, size, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. 76 Fed. Red. 4,555 (Jan 26, 2011). 12 C.F.R. § 1310 App. A.II.d.

[6]. *Michigan v. Environmental Protection Agency*, 135 S. Ct. 2699 (2015).

[7]. The Federal Reserve recently proposed a new rule that would affect financial contracts like those that destabilized financial markets after Lehman Brothers Holdings, Inc.'s 2008 collapse. The proposed rule preemptively applies the cost-benefit analysis required by Michigan and is intended to reduce the risk when large financial institutions fail. It explicitly considers the relatively small cost of the rule against the benefits to financial stability. See Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 12 CFR Parts 217, 249, and 252.

[8]. 12 U.S.C. § 5323(a)(1).

[9]. 12 C.F.R. §1310 App. A.II.a.

[10]. The Guidance defines the "exposure channel" to mean: "A nonbank financial company's creditors, counterparties, investors, or other market participants have exposure to the nonbank financial company that is significant enough to materially impair those creditors, counterparties, investors, or other market participants and thereby pose a threat to U.S. financial stability." 12 C.F.R. §1310 App. A.II.a.

[11]. The Guidance describes how financial distress could destabilize the U.S. through the "asset liquidation channel": "A nonbank financial company 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. This channel would likely be most relevant for a nonbank financial company whose funding and liquid asset profile makes it likely that it would be forced to liquidate assets quickly when it comes under financial pressure." 12 C.F.R. §1310 App. A.II.a.

[12]. Op. at 9; 12 C.F.R. §1310 App. A.II.a.

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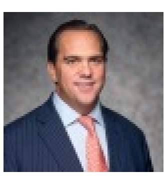

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