Fact Sheet on the MetLife v. FSOC Decision: Overruling FSOC'S Designation of MetLife Was Flawed and Will Undermine Financial Stability

April 15, 2016

OVERVIEW

- THE BACKGROUND. The Financial Stability Oversight Council (FSOC) has fifteen members, comprising the heads of all of the nation's financial regulators. It is the only governmental body responsible for identifying, investigating, and designating possible systemic threats from nonbank financial companies, more commonly referred to as the "shadow banking system."[1] On December 18, 2014, after almost two years of careful analysis, FSOC exercised its authority under Section 113 of the Dodd-Frank Act to designate the massive global insurance company MetLife as a systemically important nonbank financial company, which would subject it to enhanced supervision by the Federal Reserve. The purpose of the designation was to mitigate the risk that MetLife could cause or contribute to another devastating financial crisis like the one that engulfed the nation in 2008.

- THE COURT'S DECISION. MetLife challenged FSOC's designation in the D.C. federal district court, and on March 30, 2016, Judge Rosemary Collyer rescinded it, concluding that FSOC's designation was arbitrary and capricious on three grounds. However, the Court's analysis on all three of those grounds was flawed: The Court misread the plain language of the statute; overlooked entirely or misapplied U.S. Supreme Court and D.C. Circuit precedent; and imposed on FSOC a legal requirement to conduct cost-benefit analysis where none exists. Ultimately, the Court went far beyond the limited, deferential review that the law requires and improperly substituted its own judgments for those of FSOC and Congress.

- THE THREATENED HARMS. The decision represents a pivotal moment for post-crisis financial regulation. FSOC is not only the country's front line protection against systemic risk in the shadow banking system, but also the **only** governmental body with the authority and responsibility to investigate and designate systemically significant nonbanks. If this flawed decision is not reversed on appeal, then FSOC's ability to safeguard our financial markets and protect our economy from future crises will be impaired. As a result, future taxpayer bailouts and catastrophic financial crashes will be much more likely.

THE BACKGROUND

- THE ROLE OF FSOC. The only way Congress could effectively address the threat of another financial crisis was to establish an oversight body with the broad perspective, exceptional expertise, and

[1] For more information on FSOC, *see* this Fact Sheet: https://www.bettermarkets.com/sites/default/files/Fact Sheet - The Financial Stability Oversight Council -- 11-2-2015.pdf.

flexible powers that are necessary to address potential future systemic risks—not simply risks that are already known, probable, or quantifiable. Accordingly, Congress structured FSOC to include representatives from **every** major federal agency in the area of financial regulation, along with representatives from their state counterparts, to ensure broad vision and depth of expertise. And it conferred broad, flexible powers on FSOC, including the Section 113 designation authority.

- THE THOROUGH PROCESS. FSOC has proceeded cautiously and deliberatively since its creation in 2010, exercising its designation authority just four times in five years. As to MetLife, FSOC acted only after amassing and analyzing tens of thousands of pages of information; giving MetLife a hearing and additional opportunities over 17 months to present its views; and concluding almost unanimously that "material financial distress at MetLife could pose a threat to U.S. financial stability." FSOC provided MetLife with a detailed analysis of its reasoning in a final determination spanning over 300 pages.

THE COURT'S DECISION

- ELIGIBILITY AND OTHER CLAIMS: The Court first correctly rejected as "meritless" MetLife's contention that it was not even eligible for designation by virtue of its foreign activities. The Court also declined to address MetLife's many other wide-ranging attacks on the designation, including allegations that FSOC acted prematurely in the absence of the Federal Reserve's anticipated prudential standards; failed to consider alternatives to designation; failed to apply the statutory factors correctly; and violated the separation of powers and due process provisions in the Constitution. However, the Court went on to make three incorrect rulings on three issues with far-reaching consequences.

- VULNERABILITY ASSESSMENT: First, the Court incorrectly ruled that FSOC failed to make a necessary threshold assessment of MetLife's vulnerability to material financial distress.

    - Nowhere in the Dodd-Frank Act is there any requirement that FSOC evaluate an institution's vulnerability to financial distress. Rather, the statute provides that FSOC's task is to determine whether, **assuming** a company is experiencing "material financial distress," that distress "**could** pose a threat to the financial stability of the United States."

    - Contrary to the Court's ruling, neither FSOC's own rules nor its guidance require such a threshold assessment. Under well-established Supreme Court precedent, an agency's interpretation of its own regulations is entitled to strong judicial deference, yet the Court failed to address this principle of administrative law.

- QUANTIFYING THE IMPACT OF DISTRESS: Second, the Court incorrectly ruled that FSOC failed to quantify "the actual loss" that would arise if MetLife were to experience material financial distress, and therefore failed adequately to assess whether such future distress could pose a threat to U.S. financial stability.

    - Here again, neither the Dodd-Frank Act nor the applicable rules and guidance, as interpreted by FSOC, require any quantification of losses under any scenario. In fact, Congress

deliberately refrained from imposing that obligation, as evidenced in the plain wording of Section 113. It only requires FSOC to "consider" a list of factors when making its determination. Under Supreme Court precedent, the duty to "consider" factors confers a high degree of discretion on an agency when it chooses its methodology. The legislative requirement to consider—but not quantify—a set of factors is particularly appropriate given the enormous challenges facing FSOC in the designation process. FSOC must make highly complex judgments regarding possible future catastrophic events, under unprecedented and extremely fluid stress scenarios, in the face of the gravest possible consequences: a collapse of the financial system, a devastated economy, and potentially, a second Great Depression.

  - Indeed, the Court acknowledged that under one of the two approaches set forth in Section 113, FSOC could have made the designation without any quantification or assessment of damage whatsoever. Yet the two statutory approaches are fundamentally the same insofar as neither one makes any explicit or implicit reference to the need to make quantified predictions about impacts on the financial system.

- COST-BENEFIT ANALYSIS: Finally, the Court incorrectly ruled that FSOC failed to conduct a required cost-benefit analysis to support its designation decision. The Court followed a particularly tortuous path to this result, asserting that the statutory reference to "other risk-related factors" in Section 113 somehow imported cost calculations into the determination process. To arrive at this finding, the Court had to misread the statute, ignore Supreme Court and D.C. Circuit precedent, and rely on a false premise.

  - In fact, under applicable case law, agencies are not required to conduct cost-benefit analysis unless Congress expressly imposes that requirement.[2] Moreover, as courts have also held, cost-benefit analysis cannot be forced upon an agency on the basis of the Administrative Procedure Act or an agency's general obligation to consider all relevant factors. In the Dodd-Frank Act, Congress chose not to require FSOC to perform cost-benefit analysis when making designation decisions.

  - Finally, the Court's attempt to splice cost-benefit analysis into Section 113 fails for two, more specific reasons. First, Section 113 leaves the consideration of "other risk-related" factors entirely to the discretion of FSOC, unlike the mandatory statutory provisions at issue in the case law on which the Court relied. Second, the Court conceded that the costs of designation could be a relevant risk-related factor **only** in the context of a vulnerability analysis. But, as explained above, Section 113 nowhere requires FSOC to measure the vulnerability of any institution to financial distress.

[2] For a more detailed discussion of why quantitative cost-benefit analysis is particularly inappropriate for financial and banking regulatory agencies, *see* BETTER MARKETS, SETTING THE RECORD STRAIGHT ON COST-BENEFIT ANALYSIS AND FINANCIAL REFORM AT THE SEC (2012), *available at* https://www.bettermarkets.com/sites/default/files/documents/Setting The Record Straight.pdf.

THE THREATENED HARMS

- THE IMMEDIATE DAMAGE. By overruling FSOC's designation of MetLife for enhanced regulation, the Court removed an important layer of protection that FSOC deemed necessary to protect our financial system from the destabilizing effects of financial distress at MetLife.

- GUTTING THE DESIGNATION AUTHORITY. On a broader level, the decision threatens to severely hamper the ability of FSOC to exercise its designation authority regarding nonbank systemically significant financial companies in the shadow banking system. As a consequence of the ruling, in effect **no** government body will have the power or authority to perform that critical oversight and protective function. A significantly unregulated shadow banking system will incubate the same kinds of unforeseen risks that triggered the financial crash in 2008, and we will face the increased likelihood of future financial crises, taxpayer bailouts, and economic misery.[3]

  This regulatory vacuum will follow from the Court's ruling because FSOC will be saddled with the duty to perform a number of essentially impossible analytical tasks as a predicate to designation, including (1) an assessment of a company's vulnerability to material financial distress; (2) a quantitative evaluation of the impact of such distress on financial stability; and (3) a cost-benefit analysis. Overcoming these obstacles will mire FSOC in long, resource-intensive, and ultimately fruitless processes that will result in litigation over virtually all of FSOC's designation actions and grind the designation mechanism to a halt.[4]

- UNDERMINING REFORM AT ALL AGENCIES. Finally, by ignoring Congressional language and intent and thus expanding the circumstances under which an agency must conduct cost-benefit analysis, the decision will fuel the on-going campaign by industry opponents of reform to kill, slow, or weaken the regulatory process at all agencies—regulation that is necessary to protect Americans' homes, jobs, and savings and to preserve the long-term health of our financial markets and our economy.

- THE DESIRED OUTCOME. FSOC has already filed its appeal of the decision. The D.C. Circuit should reverse the District Court's three adverse rulings.

For more information, please contact Stephen Hall, Legal Director & Securities Specialist, at (202) 618-6464.

[3] The staggering cost of the 2008 financial crisis is detailed in BETTER MARKETS, THE COST OF THE CRISIS: $20 TRILLION AND COUNTING, *available at* https://www.bettermarkets.com/sites/default/files/Better Markets - Cost of the Crisis.pdf.

[4] The Report cited in footnote 2 above elaborates on some of these likely outcomes.