The Judicial Rescission of MetLife's SIFI Designation and the Possible Implications of the SIFI Process for Reinsurers

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The Dodd-Frank Act provides that companies determined to "pose a threat to the financial stability of the United States" if they suffered "material financial distress" be designated as systemically important financial institutions ("SIFI") and subjected to enhanced prudential regulation by the Federal Reserve.[1] The Dodd-Frank Act created the Financial Stability Oversight Council ("FSOC"), and delegated to FSOC the responsibility for making the determination of which banks and nonbank financial institutions should be given the SIFI designation.[2]

FSOC designated MetLife as a nonbank SIFI,[3] and MetLife filed an action in the United States District Court in the District of Columbia challenging the designation, and seeking that the designation be rescinded.[4] MetLife and FSOC both filed potentially dispositive motions. On March 30, 2016, the Court entered an Order granting in part and denying in part MetLife's motion for summary judgment and denying FSOC's motion to dismiss or for summary judgment ("the March 30 Order"). The effect of the

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[1] 12 U.S.C. § 5323(a)(1).

[2] *See* 12 U.S.C. § 5232(a) (designation of U.S. nonbank financial companies by FSOC).

[3] FSOC published an explanation of its designation of MetLife. *See Basis For The Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc.* which may be found at https://www.treasury.gov/initiatives/fsoc/designations/Documents/MetLife%20Public%20Basis.pdf.

[4] *MetLife, Inc. v. Financial Stability Oversight Council*, Civil Action No. 15-0045 (RMC).

March 30 Order is to rescind MetLife's SIFI designation. The March 30 Order was sealed when it was entered, but was unsealed on April 7, 2016.

The court ruled in favor of MetLife for two principal reasons: (1) FSOC failed to follow its own rule, or guidance, when it designated MetLife as a nonbank SIFI; and (2) FSOC failed to take into account in making its designation determination the costs of designating MetLife as a SIFI. The court explicitly did not rule on MetLife's other alternative grounds for rescinding the SIFI designation.

This article will provide a brief analysis of the March 30 Order and discuss the implications of the SIFI process for reinsurance companies.

I. The SIFI Designation Process

While a detailed analysis of the SIFI designation process is beyond the scope of this article, a basic understanding of the designation process is needed to understand the March 30 Order. Congress identified ten factors that FSOC must consider when assessing whether material financial distress at a company could pose a threat to the national economy:

1. the extent of the leverage of the company;
2. the extent and nature of the off-balance-sheet exposures of the company;
3. the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;
4. the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system;
5. the importance of the company as a source of credit for low income, minority, or underserved communities, and the impact that the failure of

such company would have on the availability of credit in such communities;

6. the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse;

7. the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;

8. the degree to which the company is already regulated by one or more primary financial regulatory agencies;

9. the amount and nature of the financial assets of the company; and

10. the amount and types of the liabilities of the company, including the degree of reliance on short-term funding.

12 U.S.C. § 5323(a)(2). In addition, FSOC "shall consider . . . any other risk-related factors that [it] deems appropriate." 12 U.S.C. § 5323(a)(2)(K).

FSOC promulgated through formal rulemaking a Final Rule and "Guidance for Nonbank Financial Company Determinations" ("Guidance")[5] The March 30 Opinion states that in its rulemaking FSOC organized the ten statutory factors into six "categories:" (1) Interconnectedness; (2) Substitutability; (3) Size; (4) Leverage; (5) Liquidity Risk and Maturity Mismatch; and (6) Existing Regulatory Scrutiny. FSOC placed the six categories into two groups. The purpose of one of the groups was to "seek to assess the potential for spillovers from the firm's distress to the broader financial system or real economy," and the purpose of the other group was to "seek to assess how vulnerable a company is to financial distress."

[5] The Guidance was an appendix to the Final Rule, and the public was permitted to provide comments on the Guidance during the rulemaking process. The Final Rule may be found at 77 Fed. Reg. 21,637.

FSOC rejected this interpretation of its own Guidance, stating that all six categories of factors were intended "to assess the potential effects of a company's financial distress." FSOC stating in its briefing of the motions filed in the District Court that it read the Guidance to require an evaluation of "whether, and how, the company's vulnerabilities, in a distress situation, could impact the broader financial system – not to assess whether distress could occur." FSOC also took the position that "the very risks that can make a company vulnerable to distress are the ones that can cause its distress to pose a threat to the broader economy."

The Court held that in order to overturn the MetLife designation it had to find that FSOC had acted arbitrarily and capriciously, a very high standard. Acting in contravention of the Final Rule or the Guidance would be an example of conduct which violated the arbitrary and capricious standard.

II. <u>The Designation of MetLife as a SIFI</u>

The designation of a nonbank financial institution as a SIFI can be based upon either of two determination standards, namely that a determination that the financial stability of the United States could be threatened by either: (1) financial distress at the company; or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company.[6] The Court found that FSOC relied solely on the financial distress standard when it designated MetLife as a SIFI, and that it did not rely upon the character of the activities of the company.[7]

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[6] 12 U.S.C. § 5323(a)(1).

[7] In its Complaint and motion for summary judgment MetLife contended that it was not eligible for designation as a SIFI because a material portion of its revenues and assets were derived from non-U.S.

The Court found that MetLife's designation was improper because FSOC failed to follow its own Guidance in making the MetLife determination. The Court rejected FSOC's position and found FSOC's determination analysis to be "undeniably inconsistent" with the published Guidance, and that FSOC had failed to follow the process and Guidance it had adopted through rulemaking. The Court termed the Guidance "straightforward," requiring the evaluation of both the potential effect on the national economy of financial distress at MetLife and MetLife's vulnerability to material financial distress.

The Court cited law supporting the proposition that FSOC could appropriately vary from the promulgated Guidance if it provided an appropriate explanation for doing so. Such authorities were made inapplicable, however, because FSOC steadfastly maintained, through oral argument on the motions, that it had not changed its position and that it had followed an appropriate interpretation of the Guidance. Finding the process used by FSOC in making the MetLife determination inconsistent with FSOC's own Guidance, the Court found that the MetLife determination was arbitrary and capricious and must be rescinded.

The Court further held that FSOC also had failed to follow the Guidance by failing to conduct an analysis of whether MetLife's distress would cause severe impairment of financial intermediation or of financial market functioning, instead merely assuming that there would be losses sufficient to significantly damage the broader economy. FSOC conducted no analysis of the amount of likely losses and who might be affected by

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operations, which meant that it was not "predominantly engaged in financial activities" as required by the Dodd-Frank Act. The March 30 opinion rejects this contention, finding that MetLife was eligible for designation as a nonbank SIFI under the Dodd-Frank Act.

financial distress at MetLife. The Court held that FSOC might not have been required to conduct such an analysis if it had relied upon the character and mix of MetLife's activities in making the SIFI determination, but that it was inappropriate and contrary to the Guidance to fail to conduct such an analysis when FSOC had made its determination based solely on the impact of financial distress at MetLife on the national economy. FSOC therefore used an analysis that was not consistent with the determination standard it used, which amounted to either contravention of the Guidance or an unexplained deviation from the Guidance. The Court found that this approach violated the arbitrary and capricious standard.

In the alternative, the Court held that the Supreme Court's opinion in *Michigan v. Environmental Protection Agency*, 135 S.Ct. 2699 (2015) required that in making the MetLife determination FSOC consider the costs to MetLife of a SIFI designation. FSOC vigorously contested that such consideration was necessary based upon a textual analysis of the Dodd-Frank Act and other arguments. The Court stated that there was "no doubt" that FSOC deliberately refused to consider the likely costs to MetLife in making the determination. The Court concluded that FSOC's failure to consider the costs to MetLife violated the arbitrary and capricious standard given the dictates of *Michigan v. Environmental Protection Agency*.

III. SIFI Designations and the Reinsurance Sector

There have been a number of opinions published as to whether reinsurance companies should be found to be systemically important. Most notably, the IAIS issued a report dated July 19, 2012 titled *Reinsurance and Financial Stability*. Among the

conclusions stated in that paper was that

> we find that traditional reinsurance – including the reinsurance of peak risks – is unlikely to contribute, or amplify, systemic risk. While reinsurance establishes intra-sector connectivity, the hierarchical structure of the insurance market dampens the propagation of shocks through the insurance market. Although reinsurers can fail, in the past, primary insurers have typically absorbed the loss of reinsurance recoverables without a significant detrimental financial impact.[8]

The IAIS report also concluded that there might be systemic risk potential arising from non-reinsurance activities conduct by reinsurance companies. On balance, the IAIS report, although somewhat perfunctory in its SIFI analysis, provides a basis for optimism that reinsurance companies which concentrate on reinsurance activities generally should not be systemically important.

The Federal Insurance Office issued the report on the reinsurance sector required by the Dodd-Frank Act on December 13, 2014 titled *The Breadth and Scope of the Global Reinsurance Market and the Critical Role Such Market Plays in Supporting Insurance in the United States*. The FIO's report, however, expressly does not "analyze the extent to which reinsurance or any particular reinsurer could be systemically important."[9] The FIO has not otherwise expressed an opinion as to whether reinsurers should be designated as SIFIs.

Among others to express a view on this issue, Standard & Poor's has expressed the view that reinsurance companies do not have the risk profiles appropriate for SIFI

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[8] International Association of Insurance Supervisors, *Reinsurance and Financial Stability*, at 34 (July 19, 2012). This document may be found at http://www.captive.com/docs/default-source/press-release-pdfs/iais_reinsurance_and_financial_stability-19jul12.pdf?sfvrsn=2.

[9] For a short post on this report and a like to the report, see our Reinsurance Blog post dated January 26, 2015 (at http://reinsurancefocus.com/archives/9846).

designation.[10] The Geneva Association, which describes itself as an international think tank of the insurance industry, published an article in late 2014 discussing consideration being given by the Financial Stability Board of naming several large reinsurers as globally significant SIFIs. Although it has been suggested that perhaps Swiss Re, Munich Re and Gen Re might be named as globally significant institutions, the Financial Stability Board, which makes such global designation determinations, has yet to designate any reinsurance company as a global SIFI. The next update to this list is due in November 2016.[11]

Factors to consider in evaluating whether reinsurance companies present systemic risk generally should include consideration of the following:

- many reinsurers purchase substantial retrocessional coverage and do not retain all of the risk they reinsure, spreading their risk across the reinsurance market;

- some large reinsurers have transferred large amounts of risk they have assumed through issuing reinsurance to the capital markets through catastrophe bonds;[12]

- a significant portion of reinsurance outstanding is fully collateralized by high quality assets, reducing the credit risk of loss or stress if the reinsured events occur;[13]

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[10] *See Reinsurers Won't Be On Systemically Important (G-SII) List: Kessler & S & P* (March 17, 2016), which can be found at http://www.artemis.bm/blog/2016/03/17/reinsurers-wont-be-on-systemically-important-g-sii-list-kessler-sp/, and *Collateralized Retrocession Reduces Reinsurers Systemic Risk: S & P* (September 11, 2014), which can be found at http://www.artemis.bm/blog/2014/09/11/collateralized-retrocession-reduces-reinsurers-systemic-risk-sp/.

[11] *See* http://www.fsb.org/2015/11/fsb-publishes-the-2015-update-of-the-g-sii-list/.

[12] For example, Swiss Re has transferred $625 million of risk to the capital markets through the cat bonds which are outstanding. *See* http://www.artemis.bm/deal_directory/cat_bonds_ils_by_sponsor.html.

[13] One point of potential concern is the position taken by FSOC in the MetLife case that even collateralized reinsurance may pose systemic risk due to the potential shock on markets when large collateral positions must be liquidated. It is not clear whether in making this statement FSOC considered the quality and types of collateral typically held in reinsurance trusts and the depth of the markets for such products.

- historically, when an unusual amount of catastrophe losses occur which forces less well capitalized reinsurers into liquidation the reinsurance market has responded by creating side cars or other reinsurance vehicles to replace the reinsurance capacity lost as a result of the insolvencies, i.e., the reinsurance market can be resilient in difficult times;

- over the past several years, tens of billions of dollars of new capital has entered the reinsurance market, with considerable innovation occurring in putting that capital to work in covering risks; and

- the excess capital in the reinsurance market may be sufficient without new entrants into the market to absorb the failure of a large reinsurer, should such a failure occur.

The determination that any reinsurance company should be designated as a SIFI would require a fact specific analysis for any reinsurance company under consideration for such a designation. There is doubt that the factors for such a designation determination by FSOC indicate that a traditional reinsurance company should be so designated.

CONCLUSION

The MetLife opinion focuses on two principal deficiencies in the FSOC's process of determining that MetLife should receive the SIFI designation: FSOC's failure follow its own promulgated Guidance; and FSOC's refusal to consider the cost to MetLife of a SIFI designation. These "deficiencies" may be unique to the MetLife designation or they may also have occurred in the determinations by FSOC for the other nonbank financial institutions which have received a SIFI designation. Although the government has stated its intention to appeal this decision, it will be interesting to see whether FSOC changes how it administers its SIFI determination process in light of this opinion. FSOC

had already been criticized in Congress and elsewhere due to the lack of transparency of the SIFI designation process, and the Treasury Department has stated its intention to make the process more open.

It is unclear how reinsurance companies and their activities might fare in the various types of analyses described in the March 30 Opinion. However, statements by third parties which regularly perform risk assessments, such as Standard & Poor's, and the 2012 IAIS report on the reinsurance sector, perhaps provide some basis for a conclusion that reinsurance companies might fare well in a SIFI designation analysis.

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