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THE “TOO BIG TO FAIL” PENALTY: A NEW ERA OF INSURANCE REGULATION IN THE WAKE OF THE FINANCIAL CRISIS

INTRODUCTION

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) into law, advancing one of the most far-reaching efforts in financial reform since the Great Depression.¹ The Dodd-Frank Act, created in response to the financial crisis of 2008, has as one of its main goals the end of excessive risk-taking in the financial services industry.² The Dodd-Frank Act created several new regulatory agencies and rules to further this goal.³ This new regulatory regime seeks to rein in “systemically important financial institutions,” or “SIFIs,” which are financial institutions so large that their downfall would cause wide-ranging damage throughout the entire American economy.⁴

The Financial Stability Oversight Council (“FSOC”), one of the agencies created by the Dodd-Frank Act, has the authority to label non-bank financial companies as SIFIs.⁵ Once FSOC labels a non-bank financial company as a SIFI, the Federal Reserve can impose strict regulations upon the company, such as the requirement to hold a greater amount of capital in order to absorb potential losses.⁶ In June 2013, FSOC designated large insurers, such as American International Group Inc. and Prudential Financial Inc., as SIFIs.⁷ In

¹ *Wall Street Reform: The Dodd-Frank Act*, WHITE HOUSE, <https://www.whitehouse.gov/economy/middle-class/dodd-frank-wall-street-reform> (last visited Feb. 3, 2016); Jesse Lee, *President Obama Signs Wall Street Reform: ‘No Easy Task,’* WHITE HOUSE (July 21, 2010, 2:22 PM), <https://www.whitehouse.gov/blog/2010/07/21/president-obama-signs-wall-street-reform-no-easy-task>; Steven J. Markovich, *The Dodd-Frank Act*, COUNCIL ON FOREIGN RELATIONS (Dec. 10, 2013), <http://www.cfr.org/united-states/dodd-frank-act/p28735>.

² *Wall Street Reform: The Dodd-Frank Act*, *supra* note 1.

³ Markovich, *supra* note 1.

⁴ Ctr. for Regulatory Strategies, *SIFI Designation and its Potential Impact on Nonbank Financial Companies 1*, DELOITTE (2013), <http://fsroundtable.org/wp-content/uploads/2014/05/SIFI-designation-and-its-potential-impact-on-nonbank-financial-companies.pdf>.

⁵ *Designations*, FIN. STABILITY OVERSIGHT COUNCIL, <https://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx> (last updated July 27, 2015, 4:38 PM).

⁶ Ctr. for Regulatory Strategies, *supra* note 4.

⁷ Jeff Sistrunk, *MetLife Continues SIFI Fight Alone 5 Years After Dodd-Frank*, LAW360 (July 22, 2015, 4:58 PM), <http://www.law360.com/articles/681664/metlife-continues-sifi-fight-alone-5-years-after-dodd-frank>.

December of that year, FSOC designated MetLife, the largest life insurance company in North America,⁸ as a SIFI.⁹ In January 2015, MetLife became the first non-bank to challenge its SIFI status when it filed suit against FSOC in D.C. federal court.¹⁰

MetLife has also pursued another tactic in its fight to ease its regulatory burden: it plans to divest itself of a major part of its U.S. life insurance unit.¹¹ By placing higher capital requirements on SIFIs, the regulatory regime created by the Dodd-Frank Act is indirectly encouraging large firms like MetLife to break up.¹² The once “too big to fail” companies are being penalized for their size, as SIFI status results in a regulatory burden that brings down profits.¹³ This Essay will examine the development of the new regulatory regime established by the Dodd-Frank Act and will argue that the indirect breaking up of SIFIs has resulted in less systemic risk in the financial services industry. Furthermore, the Dodd-Frank Act and the Federal Reserve’s intervention in the insurance industry may signal the beginning of a new era of regulation: one where federal regulators take a more active role in the state-dominated insurance regulatory system.

I. BACKGROUND ON THE DODD-FRANK ACT

In the years leading up to the Dodd-Frank Act, the world economy was marked by low, stable interest rates.¹⁴ Such an environment of low interest rates spurred on investors like commercial banks, investment banks, and hedge funds to seek novel ways of generating profits.¹⁵ Investors were drawn to

⁸ *MetLife Begins*, METLIFE, <https://www.metlife.com/about/corporate-profile/metlife-history/metlife-begins/index.html> (last visited Feb. 3, 2016).

⁹ Sistrunk, *supra* note 7.

¹⁰ Andrew Zajac, et al., *MetLife Sues Over Too-Big-to-Fail Label by Regulators*, BLOOMBERGBUSINESS (Jan. 13, 2015, 1:08 PM), <http://www.bloomberg.com/news/articles/2015-01-13/metlife-sues-over-too-big-to-fail-designation-by-u-s-regulators>; see Caroline Simson, *MetLife Takes SIFI Designation Challenge to DC Court*, LAW360 (Jan. 13, 2015, 12:15 PM), <http://www.law360.com/articles/610869/metlife-takes-sifi-designation-challenge-to-dc-court>.

¹¹ Leslie Scism, *MetLife to Shed Big Chunk of Life Unit*, WALL ST. J. (Jan. 12, 2016, 6:59 PM), <http://www.wsj.com/articles/metlife-looks-to-divest-u-s-life-insurance-unit-1452635005>.

¹² Ryan Tracy et al., *Not Too Big to Fail. Too Expensive to Exist*, WALL ST. J. (Jan. 13, 2016, 7:54 PM), <http://www.wsj.com/articles/has-the-government-made-it-too-expensive-to-be-a-big-bank-1452731317?cb=logged0.784445948433131>.

¹³ *Id.*

¹⁴ *The Origins of the Financial Crisis; Crash Course*, THE ECONOMIST (Sept. 7, 2013), <http://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article>.

¹⁵ *Id.*

certain high-yielding assets, such as collateralized debt obligations (“CDOs”).¹⁶ CDOs were a form of mortgage-backed security that were backed by pools of mortgages.¹⁷ CDOs had received high credit ratings from prominent rating agencies such as Moody’s and Standard & Poor’s, and appeared to be relatively safe assets that produced higher returns.¹⁸ The stability of the low interest rate environment made investors more attracted to leverage, or the use of borrowed money to bolster returns.¹⁹ Investors assumed that returns would be greater than the cost of borrowing, so firms took on more debt to fund their investing operations.²⁰ This left many large financial services companies highly levered.²¹

CDOs and other mortgage-backed securities were greatly affected when the American housing bubble burst.²² Although CDOs had received safe credit ratings, they became worthless and unsellable when the mortgages supporting them failed to be paid.²³ The largest commercial and investment banks in the U.S., who both issued and invested in mortgage-backed securities, were gravely hurt by their failure to accurately value these securities.²⁴ The SEC later charged many of these firms for defrauding investors and misrepresenting their true losses.²⁵ Insurance companies were also caught in the chaos. The massive insurance company, AIG, used a financial instrument called a “credit default swap” to insure the CDOs, promising to indemnify the holder of the CDO in the event of default.²⁶ When the CDOs failed, AIG needed to reimburse the buyers of the credit default swaps, but AIG did not have enough capital to pay its claims.²⁷ The heavy use of leverage in the financial services industry left many firms with too much debt to withstand the downturn in the

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *The Origins of the Financial Crisis; Crash Course, supra* note 14.

²¹ Anat R. Admati, *Address Excessive Leverage*, N.Y. TIMES (Apr. 18, 2011, 2:46 PM), <http://www.nytimes.com/roomfordebate/2011/01/30/was-the-financial-crisis-avoidable/address-excessive-leverage>.

²² *The Origins of the Financial Crisis; Crash Course, supra* note 14.

²³ *Id.*

²⁴ John Carney, *Lehman Brothers Was Dramatically Over Valuing Its CDOs*, BUSINESS INSIDER (Mar. 17, 2010, 12:47 PM), <http://www.businessinsider.com/lehman-brothers-was-dramatically-over-valuing-its-cdos-2010-3>.

²⁵ *SEC Enforcement Actions Addressing Misconduct that Led to or Arose from the Financial Crisis*, SEC AND EXCH. COMM’N, <http://www.sec.gov/spotlight/enf-actions-fc.shtml> (last updated Jan. 14, 2016).

²⁶ *What Went Wrong at AIG?*, KELLOGGINSIGHT (Aug. 3, 2015), <http://insight.kellogg.northwestern.edu/article/what-went-wrong-at-aig>.

²⁷ *Id.*

market.²⁸ As banks and other lenders lost faith in the creditworthiness of borrowers, short-term lending came to a halt.²⁹ Without the availability of credit, the American economy in general began to suffer.³⁰

The Dodd-Frank Act creates a raft of new rules designed to stop Wall Street firms from dealing in and exposing themselves to the dangerous assets characteristic of the pre-crisis years. § 619, or the “Volcker Rule,” prohibits commercial banks from engaging in proprietary trading (the trading of securities by a bank on its own account rather than on behalf of customers³¹), and from investing in hedge funds and private equity funds.³² The principle behind the rule is to stop deposit-taking banks, which are insured by taxpayer dollars through the FDIC, from engaging in the type of speculative activity characteristic of investors like hedge funds.³³ The Dodd-Frank Act also grants authority to the SEC and Commodity Futures Trading Commission to regulate the derivatives market, which had only been lightly supervised.³⁴ Credit default swaps, a form of derivative, fall under this umbrella of authority.³⁵

The Dodd-Frank Act also established a host of new federal agencies tasked with the objective of preventing another crisis like the one in 2008.³⁶ The Consumer Financial Protection Bureau was created as a new enforcer of federal consumer financial law.³⁷ It specifically deals with consumer deception and abuse by financial companies, such as the sort of predatory lending that led to the housing bubble.³⁸ But most important to this Essay’s discussion of non-bank regulation is the Dodd-Frank Act’s creation of the Financial Stability

²⁸ Ben S. Bernanke, Chairman, Board of Governors of Federal Reserve System, *Some Reflections on the Crisis and the Policy Response* (Apr. 13, 2012) (transcript available at <http://www.federalreserve.gov/newsevents/speech/bernanke20120413a.htm>).

²⁹ *The Origins of the Financial Crisis; Crash Course*, *supra* note 14.

³⁰ *Id.*

³¹ *Definition of proprietary trading*, FIN. TIMES, <http://lexicon.ft.com/Term?term=proprietary-trading> (last visited Feb. 3, 2016).

³² *Volcker Rule Resource Center: Overview*, SEC. INDUS. AND FIN. MKTS ASSO’N, <http://www.sifma.org/issues/regulatory-reform/volcker-rule/overview/> (last visited Feb. 3, 2016).

³³ Ryan Tracy & Peter Rudegeair, *Volcker Bank-Risk Rule Set to Start With Little Fanfare*, WALL ST. J. (Jul. 21, 2015, 6:17 PM), <http://www.wsj.com/articles/volcker-bank-risk-rule-set-to-start-with-little-fanfare-1437517061>.

³⁴ *Derivatives*, SEC. AND EXCH. COMM’N, <https://www.sec.gov/spotlight/dodd-frank/derivatives.shtml> (last updated May 4, 2015).

³⁵ *Id.*

³⁶ Markovich, *supra* note 1.

³⁷ *Wall Street Reform: The Dodd-Frank Act*, *supra* note 1.

³⁸ *Creating the Consumer Bureau*, CONSUMER FIN. PROT. BUREAU, <http://www.consumerfinance.gov/the-bureau/creatingthebureau/> (last visited Feb. 3, 2016).

Oversight Council. Through the Dodd-Frank Act, the Federal Reserve has the authority to impose greater capital requirements on “systemically important financial institutions,” which are financial institutions that regulators don’t want to become “too big to fail.”³⁹ The Dodd-Frank Act never actually uses the term “SIFI,” but it does refer to the concept of the institution whose collapse would destabilize the U.S. economy.⁴⁰ The Financial Stability Board, an international body, was the first to use the label “SIFI” to refer to such institutions.⁴¹ However, experts and journalists now use the term SIFI to refer to the entities that the Dodd-Frank Act seeks to rein in. § 165 of the Dodd-Frank Act authorizes the Federal Reserve to designate a commercial bank as a SIFI if its total assets are over \$50 billion. On the other hand, the newly created FSOC will determine whether a non-bank financial company is a SIFI.

FSOC has the broad mandate of “identifying risks to the financial stability of the United States; promoting market discipline; and responding to emerging risks to the stability of the United States’ financial system.”⁴² Lawmakers and regulators recognize that many of the firms whose financial distress caused widespread damage during the crisis were not traditional commercial banks, but were rather non-banks engaged in a variety of activities that were not regulated as heavily as banking.⁴³ In order to address the gap in oversight over these large, interconnected entities, and to ensure that distress at these firms would not again cause instability in the economy, Congress has used the Dodd-Frank Act to broaden the authority of the federal regulatory apparatus over non-bank financial companies.⁴⁴ Under § 113 of the Dodd-Frank Act, FSOC has the authority to designate a non-bank financial company as a SIFI if it determines that financial distress at the non-bank financial company, or the nature of the activities conducted by the company, could threaten the financial stability of the United States.⁴⁵

³⁹ Jonathan Marino, *The Government’s ‘Too Big to Fail’ List is Going to Change*, BUS. INSIDER (Jun. 9, 2015, 11:50 AM), <http://www.businessinsider.com/the-governments-too-big-to-fail-list-is-going-to-change-2015-6>.

⁴⁰ Wall Street Reform and Consumer Protection Act § 112, 12 U.S.C. § 5322 (2012).

⁴¹ *About the FSB*, FIN. STABILITY BD., <http://www.fsb.org/about/#mandate> (last visited Feb. 3, 2016); *Financial Stability Board*, NAT’L ASS’N OF INSURANCE COMM’RS, http://www.naic.org/cipr_topics/topic_financial_stability_board.htm (last updated Sept. 28, 2015).

⁴² *Financial Stability Oversight Council*, FIN. STABILITY OVERSIGHT COUNCIL, <https://www.treasury.gov/initiatives/fsoc/Pages/home.aspx> (last visited Feb. 3, 2016).

⁴³ Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637 (Apr. 11, 2012) (to be codified at 12 C.F.R. pt. 1310).

⁴⁴ *Id.*

⁴⁵ Wall Street Reform and Consumer Protection Act § 112, *supra* note 40.

As a SIFI, the non-bank financial company is subject to supervision by the Federal Reserve, and must comply with heightened standards on capital reserves, liquidity, and risk management.⁴⁶ FSOC and the Federal Reserve follow a multi-step framework for imposing SIFI status on nonbank financial companies: (i) first, FSOC determines if the nonbank is “predominately engaged in financial activities;” (ii) if FSOC so determines, then FSOC applies a three-step analysis for determining whether the nonbank financial company is “systemically important;” (iii) if FSOC deems that company as systemically important, then FSOC labels the company as a SIFI; and (iv) the Federal Reserve places heavy regulatory burdens on the SIFI.⁴⁷

II. THE SIFI DESIGNATION PROCESS

At the first step of the framework, FSOC analyzes whether the non-bank is actually a financial company. § 102 of the Act defines a “U.S. nonbank financial company” as a company other than a bank holding company, national securities exchange, or certain types of entities involved in the swap and derivatives markets, that is “(i) incorporated or organized under the laws of the United States or any State; and (ii) predominantly engaged in financial activities.”⁴⁸ The Act goes on to state that a company is “predominately engaged in financial activities” if (i) 85 percent or more of the company’s annual gross revenues are derived from activities that are defined as financial in nature in the Bank Holding Company Act; or (ii) 85 percent or more of the company’s consolidated assets are related to activities that are defined as financial in nature under the Bank Holding Company Act.⁴⁹ The Bank Holding Company Act defines a broad range of activities as “financial in nature,” including lending, insuring, underwriting securities, and providing financial advisory services.⁵⁰

Although the Dodd-Frank Act defines “nonbank financial company,” it leaves a major job open to the rulemaking function of the Federal Reserve. The Act states that the Federal Reserve “shall establish, by regulation, the

⁴⁶ *Id.* § 115.

⁴⁷ Definitions of “Predominantly Engaged in Financial Activities” and “Significant” Nonbank Financial Company and Bank Holding Company, 78 Fed. Reg. 20,756 (Apr. 13, 2015) (to be codified at 12 C.F.R. pt. 242); Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. at 21,641.

⁴⁸ Wall Street Reform and Consumer Protection Act § 102.

⁴⁹ *Id.*

⁵⁰ Bank Holding Company Act, 12 U.S.C. § 1843 (2010).

requirements for determining if a company is predominantly engaged in financial activities.⁵¹ In April 2013, the Federal Reserve approved a final rule that established the criteria that FSOC must follow in determining whether a company is “predominantly engaged in financial activities.”⁵² The rule includes a “two-year test based on consolidated financial statements,” that clarifies the “85 percent or more” language of § 102 of the Dodd-Frank Act.⁵³ The rule states that a company is predominately engaged in financial activities if in either of its two most recently completed fiscal years, 85 percent or more of its consolidated annual gross revenues were financial revenues, or if 85 percent or more of its consolidated assets were financial assets.⁵⁴

If FSOC finds that the company is predominately engaged in financial activities, then at the second step of the framework, FSOC analyzes the systemic importance of the company. In one of the only rules issued by FSOC, the agency states that § 113 of the Dodd-Frank Act sets out two standards for systemic importance: the “First Determination Standard,” where “material financial distress at the nonbank financial company could pose a threat to the financial stability of the United States;” and the “Second Determination Standard,” where “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.”⁵⁵ FSOC uses a three-stage review process to assess whether the company meets either of the two Determination Standards.⁵⁶ Although the review is based on quantitative data, FSOC does not believe that the process can be “reduced to a formula.”⁵⁷ The second and third stages are designed to be “flexible” and “company-specific,” accounting for the “unique risks” posed by each company.⁵⁸

At the first stage of the review, FSOC seeks to sift out potential SIFIs from the vast pool of non-banks in the financial services industry.⁵⁹ To do this, FSOC paints with a broad brush by applying a uniform quantitative test across the entire group of non-bank financial companies. To move on to second stage

⁵¹ Wall Street Reform and Consumer Protection Act § 112, *supra* note 40.

⁵² 78 Fed. Reg. 20, *supra* note 47.

⁵³ *Id.* at 20,757.

⁵⁴ *Id.*

⁵⁵ Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. at 21,640 (Apr. 11, 2012).

⁵⁶ *Id.* at 21,641.

⁵⁷ *Id.* at 21,642.

⁵⁸ *Id.*

⁵⁹ *Id.* at 21,643.

of the review, the company must meet a threshold of \$50 billion in total consolidated assets, and then must meet one of several different numerical thresholds, such as \$30 billion in credit default swaps, \$20 billion in outstanding debt, or a 15 to 1 leverage ratio.⁶⁰ At the second stage, FSOC considers a variety of industry- and company-specific factors, applying a quantitative and qualitative analysis generally focused on the company's (i) size, (ii) interconnectedness, (iii) substitutability, (iv) leverage, (v) liquidity risk and maturity mismatch,⁶¹ and (vi) existing regulatory scrutiny.⁶² At the third stage, FSOC considers several qualitative factors, such as the company's "resolvability, the opacity of its operations, its complexity, and the extent and nature of its existing regulatory scrutiny."⁶³

Once it determines that a company satisfies all three stages, FSOC will move onto the third step of the framework and finally label the company as a SIFI.⁶⁴ At this point, the Federal Reserve has the authority under the Dodd-Frank Act to regulate the non-bank SIFI. At the fourth and final step of the framework, the Federal Reserve will subject the SIFI to a range of regulatory actions. § 165 of the Dodd-Frank Act mandates that the Federal Reserve must require the SIFI to adhere to "enhanced prudential standards."⁶⁵ Most significantly, these standards require the SIFI acquire less capital through the use of leverage, and to hold more risk-based capital, which is the amount of capital a company must hold in order to protect creditors and consumers from the company's anticipated risks.⁶⁶

The mandated prudential standards also cover liquidity, risk-management, credit exposure reporting, and resolution planning.⁶⁷ Each SIFI must submit a "resolution plan" to the Federal Reserve, FSOC, and the FDIC.⁶⁸ The

⁶⁰ This specific leverage ratio is calculated by dividing total consolidated assets by total equity. *Id.*

⁶¹ Maturity mismatch occurs when a company has more short-term liabilities than short-term assets, but has more total assets than long-term liabilities. *Maturity Mismatch*, BUS. DICTIONARY, <http://www.businessdictionary.com/definition/maturity-mismatch.html> (last visited Feb. 3, 2016).

⁶² Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. at 21,641, 21,645 (Apr. 11, 2012).

⁶³ *Id.* at 21,646.

⁶⁴ *Id.*

⁶⁵ Wall Street Reform and Consumer Protection Act § 112, *supra* note 40.

⁶⁶ *Id.*; *Risk-Based Capital*, SOL. OF ACTUARIES, http://rmtf.soa.org/riskbased_capital.pdf (last visited Feb. 3, 2016).

⁶⁷ Wall Street Reform and Consumer Protection Act § 112, *supra* note 40.

⁶⁸ *Id.*

resolution, or “living will,”⁶⁹ must describe the SIFI’s plan for “rapid and orderly resolution in the event of material financial distress or failure.”⁷⁰ The Act also allows the Federal Reserve to impose further regulations on the SIFI in regards to contingent capital requirements,⁷¹ enhanced public disclosures, short-term debt limits, and any other requirements that the Federal Reserve deems appropriate.⁷² Finally, a SIFI must undergo an annual “stress test” by the Federal Reserve, and must conduct stress tests on itself semi-annually.⁷³ The stress test evaluates the company’s performance in a hypothetical scenario of economic distress.⁷⁴

III. THE EFFECTS OF SIFI STATUS ON NON-BANK FINANCIAL COMPANIES

SIFI designation has had a very real effect on the four non-bank financial companies labeled as SIFIs so far: AIG, MetLife, Prudential, and GE Capital Corporation.⁷⁵ Although the Federal Reserve makes SIFIs safer through the requirement that SIFIs follow conservative financial standards, safety is not the driving factor of stock price.⁷⁶ In January 2016, the stock price of MetLife fell by 13% and Prudential’s fell by 15%.⁷⁷ The requirement that SIFIs hold more capital explains the cause of this drop. Firms that are funded with more equity instead of debt can withstand more loss, but they also seem less profitable to investors because greater capital reserves reduce shareholders’ return on equity.⁷⁸ Companies that receive the SIFI label are put at a significant disadvantage.⁷⁹ Currently, shares of smaller financial companies and banks not labeled SIFIs are trading at a much higher value than those of SIFI

⁶⁹ *Resolution Plans*, FEDERAL RESERVE, <http://www.federalreserve.gov/bankinforeg/resolution-plans.htm> (last updated Jan. 15, 2016).

⁷⁰ Wall Street Reform and Consumer Protection Act § 112, *supra* note 40.

⁷¹ “Contingent Capital is debt that converts into equity when there is a crisis or when certain triggers are met.” *Definition of Contingent Capital*, FIN. TIMES, <http://lexicon.ft.com/Term?term=contingent-capital> (last visited Feb. 3, 2016).

⁷² Wall Street Reform and Consumer Protection Act, *supra* note 40.

⁷³ *Id.*

⁷⁴ Press Release, BD. OF GOVERNORS OF THE FED. RESERVE SYS. (Oct. 9, 2012) <http://www.federalreserve.gov/newsevents/press/bcreg/20121009a.htm> (on file with author).

⁷⁵ *Designations*, *supra* note 5.

⁷⁶ John Carney, *Why Big Banks Are Being Treated Like Penny Stocks*, WALL ST. J. (Jan. 15, 2016, 2:35 PM), <http://www.wsj.com/articles/why-big-banks-are-being-treated-like-penny-stocks-1452886547>.

⁷⁷ *Id.*

⁷⁸ Ryan Tracy et al., *supra* note 12.

⁷⁹ *Id.*

companies.⁸⁰ Without the burden of the SIFI regulatory requirements, these companies can demonstrate a better ROE.⁸¹

The Federal Reserve has not yet announced the regulations it will impose on MetLife.⁸² However, in January 2015, MetLife became the first non-bank SIFI to challenge its SIFI designation in court.⁸³ Filing suit against FSOC in D.C. federal court, MetLife complained that FSOC acted in an “arbitrary and capricious” manner when it concluded that MetLife’s material financial distress would pose a systemic risk to the American economy.⁸⁴ The company has argued that rather than presenting systemic risk, MetLife is “a source of financial stability.”⁸⁵ In March 2016, the court ruled in favor of MetLife, holding that the SIFI designation process was procedurally flawed.⁸⁶ The government plans to appeal the decision.⁸⁷ However, because the court overturned the SIFI designation on procedural rather than substantive grounds, FSOC may now redo the designation process and again label MetLife as a SIFI.⁸⁸

Despite the favorable ruling, MetLife had already begun a process to make itself smaller and simpler. In January 2016, MetLife announced that it would sell, spinoff, or take public one of its major lines of business: life insurance products for individuals and families in the U.S.⁸⁹ This is a major upset to MetLife’s size, as this line of business generates about 20% of MetLife’s annual earnings.⁹⁰ Before the favorable ruling, MetLife executives stated that the divestiture was due to the increased capital burden that the Federal Reserve

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² Leslie Scism, *MetLife CEO Warned Federal Regulators in 2014 of Possible Breakup, Court Filing Shows*, WALL ST. J. (Jan. 27, 2016, 5:21 PM), <http://www.wsj.com/articles/metlife-ceo-warned-federal-regulators-in-2014-of-possible-breakup-court-filing-shows-1453933316>.

⁸³ Sistrunk, *supra* note 7.

⁸⁴ Simson, *supra* note 10.

⁸⁵ Jonathan Stempel, *U.S. Says MetLife Too-Big-To-Fail Lawsuit Should be Dismissed*, REUTERS (May 11, 2015), <http://www.reuters.com/article/us-metlife-lawsuit-idUSKBN0NX01920150512>.

⁸⁶ Ryan Tracy & Erik Holm, *MetLife Wins Bid to Shed ‘Systemically Important’ Label*, WALL ST. J. (Mar. 20, 2016, 7:47 PM), <http://www.wsj.com/articles/federal-judge-rescinds-federal-government-determination-that-metlife-is-systemically-important-1459349828?cb=logged0.4904358632269181>.

⁸⁷ Peter Schroeder, *Government to appeal MetLife decision*, THE HILL (Apr. 7, 2016, 1:16 PM), <http://thehill.com/policy/finance/275492-lew-judges-metlife-decision-is-wrong>.

⁸⁸ Ryan Tracy & Leslie Scism, *Judge Rips ‘Unreasonable’ Decision on MetLife in Order—2nd Update*, NASDAQ (Apr. 7, 2016, 3:06 PM), <http://www.nasdaq.com/article/judge-rips-unreasonable-decision-on-metlife-in-order—2nd-update-20160407-00899>.

⁸⁹ Scism, *supra* note 11.

⁹⁰ *Id.*

would likely require of MetLife.⁹¹ According to the company, SIFI status places MetLife at a “competitive disadvantage,” since it faces more burdensome capital and compliance requirements than non-SIFI insurers.⁹² Although the recent court decision shed MetLife of its SIFI status, MetLife is continuing its planned divestiture.⁹³ This move may reflect MetLife’s strategy to avoid regulatory scrutiny in the future, as FSOC may ultimately again label MetLife as a SIFI. However, even with the divestiture, MetLife will remain a vast corporation.⁹⁴ If its SIFI status were reinstated, MetLife would likely retain SIFI status even after it sheds itself of its U.S. life insurance unit.⁹⁵ However, MetLife expects that such a shrinkage would result in a more tolerable capital burden.⁹⁶

MetLife’s decision to downsize has put pressure on AIG.⁹⁷ The billionaire investor Carl Icahn, a major shareholder of AIG, has proposed that AIG break up into three smaller companies, with each hopefully free of the SIFI label.⁹⁸ However, AIG Chief Executive Peter Hancock opposes the break-up.⁹⁹ AIG is betting that since it has a lower risk profile than MetLife, the company-specific regulations imposed on it by the Federal Reserve will be tolerable.¹⁰⁰ In order to persuade Icahn not to wage a proxy fight against AIG’s current management, Hancock agreed to nominate Icahn to AIG’s board.¹⁰¹ Icahn, however, still believes that “smaller and simpler” is the best strategy for AIG.¹⁰² Until the Federal Reserve proposes the regulations facing AIG, it remains to be seen whether AIG can accept the cost of SIFI status.

⁹¹ *Id.*

⁹² *Id.*

⁹³ Ryan Tracy & Erik Holm, *supra* note 86.

⁹⁴ *See* Scism, *supra* note 11.

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ Tess Stynes, *Carl Icahn Again Pushes for AIG Split in Wake of MetLife’s Breakup Plans*, WALL ST. J. (Jan. 19, 2016, 9:45 AM), <http://www.wsj.com/articles/carl-icahn-again-pushes-for-aig-split-in-wake-of-metlifes-breakup-plans-1453212908>.

⁹⁸ David Benoit & Anne Steele, *Carl Icahn to Solicit Shareholder Support for AIG Breakup*, WALL ST. J. (Nov. 23, 2015 5:25 PM), <http://www.wsj.com/articles/carl-icahn-to-solicit-shareholder-support-for-aig-breakup-1448288702>.

⁹⁹ *Id.*

¹⁰⁰ Ryan Tracy, *Unlike Rival MetLife, AIG Not Shunning SIFI Tag*, WALL ST. J.: MONEYBEAT (Jan. 26, 2016, 11:16 AM), <http://blogs.wsj.com/moneybeat/2016/01/26/unlike-rival-metlife-aig-not-shunning-sifi-tag/>.

¹⁰¹ David Benoit & Leslie Scism, *Activist Investors Make Peace With AIG*, WALL ST. J. (Feb. 11, 2016, 7:37 PM), <http://www.wsj.com/articles/aig-reaches-agreement-with-icahn-for-board-representation-145226425>.

¹⁰² *Id.*

IV. A NEW REGULATORY ENVIRONMENT

The penalties levied on the “too big to fail” institutions are changing the landscape of the financial services industry. Critics of the Dodd-Frank Act state that the regulatory regime established by the Act is an unsupervised, meddlesome bureaucracy that has done little to reduce systemic risk on Wall Street.¹⁰³ However, financial data demonstrates that large firms are shrinking in order to meet the Federal Reserve’s standards. According to AIG in its “living will,” released publically in January 2016, it has decreased “its total assets by 53%, to \$502 billion from \$1.06 trillion; decreased total debt by 83% to \$31 billion from \$176 billion, and increased shareholders’ equity 3% to \$99 billion from \$96 billion.”¹⁰⁴ Furthermore, the banking industry has reduced leverage and increased capital reserves. Since 2009, the largest banks in the U.S. have increased their common equity capital by \$641 billion.¹⁰⁵

But the attempt to reform the “too big to fail” nature of Wall Street has also resulted in a surprising and significant outcome: the federal government is slowly transforming the United States’ longstanding system of state-based insurance regulation. The Dodd-Frank Act created an advisory body within the Department of the Treasury called the Federal Insurance Office (“FIO”).¹⁰⁶ Although the FIO is not a regulatory agency, it serves to identify “issues or gaps in the regulation of insurers that could contribute to a systemic crisis in the insurance industry or the U.S. financial system.”¹⁰⁷ But more important to the transforming nature of insurance regulation is the authority that the federal government yields over insurers through FSOC and the Federal Reserve. FSOC is composed of both federal and state regulators, with members having either a voting role or non-voting, advisory role.¹⁰⁸ Voting members include

¹⁰³ Jeb Hensarling, *After Five Years, Dodd-Frank Is a Failure*, WALL ST. J. (July 19, 2015, 5:50 PM), <http://www.wsj.com/articles/after-five-years-dodd-frank-is-a-failure-1437342607>; *Shrinking MetLife*, WALL ST. J. (Jan. 14, 2016, 7:14 PM), <http://www.wsj.com/articles/shrinking-metlife-1452816861>.

¹⁰⁴ Ryan Tracy & Leslie Scism, *AIG, Prudential Make Pitch to Regulators on ‘Living Wills*, WALL ST. J. (Jan. 15, 2016, 2:59 PM), <http://www.wsj.com/articles/aig-prudential-make-pitch-to-regulators-on-living-wills-1452887953>.

¹⁰⁵ *Comprehensive Capital Analysis and Review 2015: Assessment Framework and Results*, BD. OF GOVERNORS OF THE FED. RESERVE SYS. (Mar. 2015), <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20150311a1.pdf>.

¹⁰⁶ *About FIO*, FEDERAL INSURANCE OFFICE, <https://www.treasury.gov/initiatives/fio/about-fio/Pages/default.aspx> (last updated June 12, 2013, 9:00 AM).

¹⁰⁷ *Id.*; *Federal Insurance Office*, NAT’L ASS’N OF INSURANCE COMM’RS, http://www.naic.org/cipr_topics/topic_fio.htm (last updated Jan. 11, 2016).

¹⁰⁸ *Who is on the Council?*, FED. STABILITY OVERSIGHT COUNCIL, <https://www.treasury.gov/initiatives/fsoc/about/council/Pages/default.aspx> (last updated Oct. 14, 2014, 2:11 PM).

the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the SEC, and an independent insurance expert appointed by the President and confirmed by the Senate.¹⁰⁹ Non-voting members include the director of the FIO, a state banking supervisor, a state insurance commissioner, and a state securities commissioner.¹¹⁰ The mixed membership of state and federal regulators is notable, as the entire system of insurance regulation has historically been delegated to the states.¹¹¹

Under the McCarran-Ferguson Act of 1945, Congress established the states’ primary responsibility in insurance regulation and prohibited the federal government from superseding state authority in this area.¹¹² Although the federal government is statutorily mandated to separate itself from the insurance regulatory system, the financial crisis has left it concerned with nationwide, interconnected institutions, like insurance companies, that may threaten the financial stability of the economy as a whole. Some argue that the Federal Reserve’s authority over the three insurance SIFIs reflects the Federal Reserve’s position as the de facto federal insurance regulator, as the three SIFIs represent about one-fifth of the insurance industry in terms of assets.¹¹³ Even if one finds this argument overblown, it is difficult not to agree that the inclusion of state regulators in FSOC demonstrates the federal government’s attempt to balance its statutory mandate and its post-crisis concern with the lack of federal oversight over the massive insurance industry.

However, recent events hint at a conflict between the Federal Reserve and the state-based insurance regulatory system. The National Association of Insurance Commissioners (“NAIC”), an organization composed of the insurance regulatory departments of all fifty states and the District of Columbia, submitted an amicus brief on behalf of MetLife in its suit against FSOC.¹¹⁴ In its amicus brief, the NAIC argued that FSOC’s designation of

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ The McCarran-Ferguson Act, 15 U.S.C. § 1012 (2012); *State Insurance Regulation: History, Purpose and Structure*, NAT’L ASS’N OF INS. COMM’RS, http://www.naic.org/documents/consumer_state_reg_brief.pdf (last visited Feb. 4, 2016).

¹¹² *Id.*; *State Insurance Regulation: History, Purpose and Structure*, *supra* note 111.

¹¹³ *How the Federal Reserve Became the De Facto Federal Insurance Regulator*, BIPARTISAN POLICY CTR. (July 30, 2014), <http://bipartisanpolicy.org/blog/how-federal-reserve-became-de-facto-federal-insurance-regulator/>.

¹¹⁴ Brief for Petitioner, Nat’l Ass’n of Ins. Comm’rs as Amicus Curiae Supporting Respondents, *MetLife, Inc. v. Fin. Stability Oversight Council*, No. 1:15-CV-45, 2015 WL 4615941 (D.D.C. June 26, 2015).

MetLife as a SIFI demonstrated that “FSOC largely ignored or discounted the state regulatory system,” and was a “flawed analysis of the insurance business and its regulation.”¹¹⁵ It is likely that the current state-based insurance regulatory system will continue to push back against the federal government’s steps into the field of insurance regulation. The conflict may result in redundancy and gridlock between two separate systems of regulation. But hopefully the conflict results in a compromise: a regulatory regime that retains the strengths of the current system and also decreases the possibility of systemic risk, a distinctly interstate issue.

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¹¹⁵ *Id.* at 3.

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