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The Last SIFI: The Unwise and Illegal Deregulation of Prudential Financial

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Abstract. On October 16, federal regulators released Prudential Financial—the last remaining systemically important nonbank financial institution—from enhanced government oversight. This Essay contends that Prudential's deregulation was both unwise and illegal. In removing Prudential's "systemically important" label, regulators (1) violated their established procedural rules, (2) relied on misleading quantitative analyses, and (3) failed to consider a mandatory statutory factor. By illegally deregulating Prudential, policymakers have now opened the financial system to the same risks it experienced in the lead-up to the financial crisis. This Essay therefore urges litigation and vigilant Congressional oversight challenging the rescission of Prudential's "systemically important" status.

Introduction

On October 16, 2018, federal regulators released the largest U.S. insurance group, Prudential Financial, Inc., from enhanced government oversight.[1] Prudential had been the last remaining systemically important financial institution (SIFI)—a designation Congress created in the Dodd-Frank Act for nonbank financial companies that could threaten U.S. financial stability.[2] By rescinding Prudential's SIFI label, regulators signaled that Prudential no longer warrants the heightened capital, liquidity, and risk-management standards that accompany such a designation.

This Essay contends that the Trump Administration's decision to overturn Prudential's SIFI label was deeply misguided. While all of the other nonbank SIFIs—American International Group (AIG), General Electric Capital

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1. FIN. STABILITY OVERSIGHT COUNCIL, NOTICE AND EXPLANATION OF THE BASIS FOR THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S RESCISSION OF ITS DETERMINATION REGARDING PRUDENTIAL FINANCIAL, INC. 2 (2018) [hereinafter PRUDENTIAL DE-DESIGNATION].
2. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 113, 124 Stat. 1376, 1398 (2010) (codified at 12 U.S.C. § 5323(a) (2017)).

Corporation (GE Capital), and MetLife, Inc.—shrank or substantially simplified themselves to escape their designations, Prudential did neither. To the contrary, Prudential has only become more systemically important since its designation.

Overturning Prudential's SIFI status was not only unwise, it was also illegal. In rescinding Prudential's SIFI label, regulators (1) violated their established procedural rules, (2) relied on misleading quantitative analyses, and (3) ignored an important statutory factor that Congress required them to consider. Regulators' misguided and unlawful decision to remove Prudential—an $832 billion, multinational insurance conglomerate—from federal oversight will now expose the financial system to the same types of risks it experienced in the lead-up to the financial crisis.

I. Nonbank SIFI Designations and De-Designations

Insurance companies, investment banks, and other nonbank financial firms were primary culprits in the 2008 financial crisis.[3] Nonbank mortgage companies issued hundreds of billions of dollars in subprime loans, investment banks packaged that debt into exotic securitizations, and insurance companies guaranteed these instruments through credit derivatives and other products.[4] When the housing bubble burst, nonbanks like Bear Stearns, Lehman Brothers, and AIG were among the first firms to fail, triggering the broader panic.

After the crisis subsided, Congress addressed the problem of systemically important nonbanks in the Dodd-Frank Act. Lawmakers established the Financial Stability Oversight Council (FSOC), comprised of the heads of the major U.S. financial regulatory agencies. Congress directed FSOC to designate a nonbank financial company as a SIFI if the Council determines that the firm's material financial distress or "the nature, scope, size, scale, interconnectedness, or mix of [its] activities" could threaten U.S. financial stability.[5] Congress enumerated specific statutory factors the Council must consider, including the firm's asset size, leverage, off-balance-sheet exposures, interconnectedness, and existing regulatory scrutiny.[6]

By law, any firm that FSOC designates as a SIFI becomes subject to consolidated supervision and regulation by the Federal Reserve, including risk-based capital, leverage, liquidity, and risk-management requirements.[7] These

3. *See* Jeremy C. Kress, Patricia A. McCoy & Daniel Schwarcz, *Regulating Entities and Activities: Complementary Approaches to Nonbank Systemic Risk*, 92 S. CAL. L. REV. (forthcoming 2019) (manuscript at 10-11), https://perma.cc/WN4N-FU36; Daniel Schwarcz & David Zaring, *Regulation by Threat: Dodd-Frank and the Nonbank Problem*, 84 U. CHI. L. REV. 1813, 1824-30 (2017).
4. *See* Kress et al., *supra* note 3 (manuscript at 10-11).
5. 12 U.S.C. § 5323(a)(1).
6. *See id.* § 5323(a)(2).
7. *See id.* § 5365(b)(1).

standards are more onerous than nonbanks' baseline regulatory regimes and are designed to limit the stability risks that nonbank SIFIs pose to the financial system.

At least initially, the FSOC embraced its mission to identify nonbank SIFIs. The Council promulgated, through notice-and-comment rulemaking, formal procedures for evaluating a nonbank's systemic importance.[8] Then, in 2013, FSOC designated insurance-focused companies Prudential and AIG, as well as General Electric's captive finance subsidiary, GE Capital, as nonbank SIFIs.[9] The Council designated MetLife, another insurance-focused company, the following year.[10]

FSOC's reasoning for each of these designations was similar. FSOC concluded that material financial distress at any of the four companies could destabilize the financial system by (1) inflicting losses on counterparties with direct exposures to the firm and (2) triggering asset fire sales that might spread through the financial sector.[11] Thus, FSOC determined that enhanced Federal Reserve oversight was appropriate for each firm.

The four designees, unsurprisingly, resisted the nonbank SIFI label and accompanying Federal Reserve oversight. The firms complained of increased burdens associated with this added layer of regulation. Prudential, for example, estimated that its SIFI status resulted in $135 million in additional compliance costs per year.[12] The companies likewise insisted that their SIFI status put them on an uneven playing field relative to competitors that operated free from enhanced regulation.[13]

Accordingly, several of the nonbank SIFIs challenged their designations. Prudential requested an administrative hearing to contest its proposed designation, but FSOC affirmed its SIFI status by a 7-2 vote.[14] After losing its own administrative hearing, MetLife sued FSOC in federal district court, resulting in protracted litigation over its SIFI status.[15]

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8. 12 C.F.R. pt. 1310 app. A (2018).
9. *See Financial Stability Oversight Council: Designations*, U.S. DEP'T TREASURY, https://perma.cc/W9X6-ERQ6 (archived Dec. 7, 2018).
10. *See id.*
11. *See* FIN. STABILITY OVERSIGHT COUNCIL, BASIS OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S FINAL DETERMINATION REGARDING AMERICAN INTERNATIONAL GROUP, INC. 6-7 (2013).
12. *See* Katherine Chiglinsky & Jesse Hamilton, *Prudential Last of the Non-Banks to Shed 'Too Big to Fail' Tag*, BLOOMBERG (Oct. 17, 2018, 8:41 AM EDT), https://perma.cc/854D-4Z8M.
13. *See, e.g.*, Steven A. Kandarian, Chairman, President, and CEO, MetLife, Inc., Address at the U.S. Chamber of Commerce Capital Markets Summit: Life Insurers as SIFIs: A Case of Mistaken Identity? (Apr. 10, 2013).
14. *See* Zachary Tracer & Ian Katz, *Prudential Financial Got Systemic Risk Label in 7-2 Vote*, BLOOMBERG (Sept. 20, 2013, 3:03 PM EDT), https://perma.cc/YN4W-8M3H.
15. *See, e.g.*, Ryan Tracy, *MetLife Case Challenging SIFI Designation Nears Hearing*, WALL ST. J. (Feb. 9, 2016, 1:35 PM ET), https://perma.cc/87BF-2ZAA.

One by one, as the designated companies came to grips with their newfound SIFI status, the firms began to sell off parts and shift to less risky activities in an effort to escape the SIFI label. GE Capital, for example, shrank by more than half and substantially reduced its heavy reliance on risky short-term funding.[16] AIG likewise contracted by roughly 10 percent relative to when it was designated.[17] Even MetLife, which eventually prevailed in its district court battle with FSOC, spun off its retail insurance segment, shrinking by nearly 20 percent in the process.[18]

FSOC, in turn, de-designated these firms in recognition of their reduced systemic footprints. FSOC removed GE Capital's SIFI label in 2016, and it did the same for AIG the following year.[19] After the Trump Administration's policymakers took control of FSOC, the Council dropped its appeal of the MetLife case, effectively freeing MetLife from its SIFI status.[20] Thus, just seven years after Dodd-Frank, nearly all of the nonbank SIFIs were free from federal oversight.

All, that is, except Prudential. In contrast to its former SIFI peers, Prudential neither shrank nor simplified itself. To the contrary, Prudential actually expanded its systemic footprint after becoming a SIFI. Prudential increased its asset size and its involvement in risky activities like repurchase agreements, securities lending, and derivatives.[21] Prudential apparently calculated that it could escape its SIFI label simply by waiting until deregulatory policymakers controlled FSOC.

Prudential's gamble paid off when Donald Trump won the presidency, earning the right to appoint new members to the Council. Trump selected nominees drawn from the financial sector and conservative legal circles, which had long criticized nonbank SIFI designations as burdensome and inequitable.[22] After these appointees took office, the chair of the Council

16. *See* Ted Mann & Joann S. Lublin, *Why General Electric Is Unwinding Its Finance Arm*, WALL ST. J. (updated Oct. 13, 2015 11:44 PM ET), https://perma.cc/STN5-E4T8.
17. *See* FIN. STABILITY OVERSIGHT COUNCIL, NOTICE AND EXPLANATION OF THE BASIS FOR THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S RESCISSION OF ITS DETERMINATION REGARDING AMERICAN INTERNATIONAL GROUP, INC. 12 (2017) [hereinafter AIG DE-DESIGNATION].
18. *See* Leslie Scism, *MetLife to Shed Big Chunk of Life Unit*, WALL ST. J. (updated Jan. 12, 2016, 6:59 PM ET), https://perma.cc/XST2-YYU8; Leslie Scism, *Breaking From MetLife, Brighthouse Has a Tough Task: Selling Insurance*, WALL ST. J. (Aug. 5, 2017, 8 AM ET), https://perma.cc/R3FL-2YSP.
19. *See* AIG DE-DESIGNATION, *supra* note 17, at 2; FIN. STABILITY OVERSIGHT COUNCIL, BASIS FOR THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S RESCISSION OF ITS DETERMINATION REGARDING GE CAPITAL GLOBAL HOLDINGS, LLC 1 (2016).
20. *See* Alistair Gray, *Trump Administration Drops Appeal in MetLife 'Too Big to Fail' Case*, FIN. TIMES (Jan. 19, 2018), https://perma.cc/DZ2J-XEMU.
21. *See* Jeremy Kress, *Prudential Hasn't Earned the Right To Shed SIFI Label*, AM. BANKER (Mar. 13, 2018, 9:29 AM EDT), https://perma.cc/R8QK-RAM8.
22. For a discussion of why criticisms of nonbank SIFI designations are overblown, see Kress et al., *supra* note 3 (manuscript at 45-47).

derided nonbank SIFI designations as a "blunt instrument" for regulating systemic risk.[23] Thus, in November 2017, the U.S. Department of the Treasury announced that FSOC would effectively stop relying on nonbank SIFI designations as a regulatory tool.[24]

On October 16, 2018, FSOC formally de-designated Prudential. Although the Council pointed to no material way in which Prudential had reduced its systemic footprint, it nonetheless "rescinded its final determination that material financial distress at Prudential could pose a threat to U.S. financial stability."[25] And with that, that last remaining nonbank SIFI escaped federal oversight, and nonbank SIFI designations—a key post-crisis regulatory tool—fell into complete disuse.

II. Prudential's Arbitrary and Capricious De-Designation

The Council's decision to rescind Prudential's SIFI status was deeply flawed. Three errors are particularly problematic. In reversing Prudential's SIFI status, FSOC (1) violated its formal procedures by second-guessing the Council's original assessment of Prudential's systemic importance, (2) performed misleading quantitative analyses while dismissing more reliable indicators of Prudential's systemic importance, and (3) ignored a critical statutory factor that Congress instructed the Council to consider. These flaws substantially undermine the Council's conclusion that Prudential is no longer systemically important and render FSOC's action arbitrary and capricious.[26]

A. FSOC Violated Its Procedures by Second-Guessing Its Original Assessment of Prudential's Systemic Importance

FSOC's rescission of Prudential's SIFI label was inappropriate because the Council ignored its established procedures for reassessing a nonbank SIFI's systemic importance. In contrast to its previous de-designations—which hinged on GE Capital's and AIG's efforts to shrink and simplify themselves—FSOC does not even try to argue that Prudential had reduced its systemic footprint. Rather, FSOC's rationale for rescinding Prudential's SIFI label boils down to its belief that the Council erred in designating Prudential in the first place. FSOC,

23. U.S. DEP'T OF THE TREASURY, REPORT TO THE PRESIDENT OF THE UNITED STATES PURSUANT TO THE PRESIDENTIAL MEMORANDUM ISSUED APRIL 21, 2017, FINANCIAL STABILITY OVERSIGHT COUNCIL DESIGNATIONS 10 (2017).
24. *See id.* at 19-21.
25. *See* PRUDENTIAL DE-DESIGNATION, *supra* note 1, at 7-8.
26. An agency's decision is arbitrary and capricious if the agency did not rely on the factors Congress intended or the decision runs counter to the evidence before the agency. *See* Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 42-43 (1983). In addition, an agency may not "simply disregard rules that are still on the books." FCC v. Fox Television Stations, Inc., 556 U.S. 502, 515 (2009).

however, has foreclosed itself from engaging in this type of second-guessing in the formal procedures it adopted through notice-and-comment rulemaking.

FSOC does not deny that Prudential has done little to shrink or simplify itself since being designated as a SIFI. To the contrary, FSOC admits that Prudential's systemic footprint has grown. According to the Council's data, since 2013, Prudential's total assets have risen 17 percent, repurchase agreements have increased 45 percent, securities lending is up 13 percent, and derivatives are up 37 percent.[27] Repurchase agreements, securities lending, and derivatives were all sources of significant systemic risk during the financial crisis.

Rather than argue that Prudential has reduced its systemic footprint, FSOC instead insists that the Council erred when it originally designated Prudential. Indeed, the entire basis for FSOC's decision—to the extent one can be discerned—boils down to its belief that the Obama Administration FSOC made a mistake in 2013. In particular, the Trump Administration FSOC disagrees with the Obama Administration's assessment of the extent to which a forced asset liquidation by Prudential would disrupt markets or cause losses to other firms with similar holdings. According to the Trump Administration FSOC, the Obama Administration overestimated the extent to which Prudential customers would redeem their policies if Prudential were to experience distress. The Trump FSOC concludes that Prudential would not need to liquidate as many assets as previously assumed and therefore would be less likely to disrupt trading markets.[28]

The Council, however, is not supposed to second-guess itself in this way. To the contrary, FSOC has committed that it will rescind a SIFI designation only if the company's systemic footprint has materially decreased. In its procedures for SIFI designations and de-designations, the Council stated that its reevaluation of a nonbank SIFI's status "will focus on any material changes with respect to the nonbank financial company or the markets in which it operates since the Council's previous review."[29] FSOC's reevaluation of Prudential, however, does not focus on these factors.

FSOC's analysis does not show that Prudential has materially changed; if anything, it poses more systemic risk than ever. Nor does the Council show that changes in the markets in which Prudential operates have reduced its systemic importance. Rather, FSOC merely revises its conclusions about how many customers would redeem their policies from Prudential, and how those redemptions and Prudential's ensuing fire sale would affect other market participants.

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27. *See* PRUDENTIAL DE-DESIGNATION, *supra* note 1, at 11, 16.
28. *See id.* at 35-42.
29. *See* Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637, 21,650 (Apr. 11, 2012).

Having established formal procedures for evaluating the systemic importance of nonbank SIFIs, FSOC is not free to disregard those processes. Indeed, FSOC lost its legal battle over MetLife's SIFI designation on the ground that FSOC had not followed its established procedures during MetLife's designation process.[30] By second-guessing the Obama Administration's determination, the Council illegally violated its procedures in Prudential's case, as well.

B. FSOC Relied on Misleading Quantitative Analyses and Ignored More Reliable Indicators of Prudential's Systemic Importance

Even if FSOC had not violated its procedural rules, Prudential's de-designation would still be arbitrary and capricious because the Council based its decision on misleading evidence. FSOC's justification for relieving Prudential of its SIFI label depends on specious empirical analyses and, conversely, disregards well-respected quantitative metrics on which the Council has previously relied.

1. FSOC Cites Misleading Empirical Analyses

FSOC's assessment of Prudential's systemic importance is based on deceptive empirical evidence. FSOC uses three quantitative tests to estimate how many Prudential customers would surrender their policies—and demand cash from Prudential—if the insurer were to experience distress. First, the Council uses historical surrender rates from AIG during the financial crisis; second, it uses surrender rates from several insurance companies that failed in the early 1990s; and third, it uses a credit rating agency's proprietary model to assess Prudential's liquidity risk. As noted above, FSOC concludes based on these assessments that relatively few policyholders would redeem their claims and the magnitude of Prudential's ensuing asset fire sales would be low.

But each of FSOC's three empirical tests is seriously flawed. First, AIG's historical surrender rates dramatically underestimate how many policyholders would withdraw claims from Prudential if it were to experience distress. That is because the federal government stabilized AIG with an $85 billion bailout in September 2008, protecting AIG from the onslaught of withdrawals that Prudential would experience absent government support.[31] Second, the 1990s historical comparison is inapposite because the insurance companies that failed

30. *See* MetLife, Inc. v. Fin. Stability Oversight Council, 177 F. Supp. 3d 219, 237-39 (D.D.C. 2016).
31. *See* PRUDENTIAL DE-DESIGNATION, *supra* note 1, at 38, 41. To its credit, the Council acknowledges that the government bailout limits the utility of the AIG example, but it nonetheless cites the example as support for de-designating Prudential. *See id.* at 38.

during that period were small and broader financial markets were stable, in contrast to the likely scenario if Prudential were to experience distress today.[32]

Finally, FSOC's reliance on the credit rating agency's liquidity model is particularly troubling. The credit rating agency, A.M. Best, is not a financial stability regulator, and its model, therefore, may not be appropriate for assessing Prudential's threat to financial stability.[33] Crucially, FSOC admits that it knows little about the assumptions A.M. Best used to construct its model.[34] Regulators, therefore, have little reason to trust the model's conclusions.

In lieu of these inappropriate metrics, FSOC could have constructed its own models to estimate the effect of Prudential's potential fire sales. FSOC, however, did not even attempt to create its own empirical tests to assess Prudential's liquidity risk, instead relying on these three flawed metrics. FSOC's determination to rescind Prudential's SIFI label therefore lacks rational empirical support.

2. FSOC Arbitrarily Rejects Indicia of Prudential's Systemic Importance

FSOC not only relies on misleading empirical analyses, it also inappropriately disregards well-respected metrics of Prudential's systemic importance. For example, Prudential ranks third among all U.S. financial companies in SRISK, one of the most commonly cited measures of a firm's systemic footprint.[35] SRISK measures a firm's expected capital shortfall given a severe market decline, based on its size, leverage, and risk.[36] Prudential's SRISK is roughly comparable to Morgan Stanley's, and it ranks behind only Citigroup's and Goldman Sachs'.

FSOC, however, inappropriately dismisses Prudential's exceptionally high SRISK. FSOC insists that SRISK "does not necessarily capture [Prudential's] interconnectedness with the broader financial markets."[37] Moreover, FSOC claims that SRISK "does not fit the long-term nature of the insurance business model."[38]

But FSOC's dismissal of Prudential's elevated SRISK is disingenuous—indeed, it is arbitrary and capricious—because FSOC cited SRISK favorably last

32. *See id.* The Council likewise acknowledges these dissimilarities but still uses the 1990s example to support its conclusion. *See id.*

33. *See About A.M. Best*, A.M. BEST, https://perma.cc/5CDW-DHY8 (archived Dec. 12, 2018).

34. *See* PRUDENTIAL DE-DESIGNATION, *supra* note 1, at 40 n.125 ("A.M. Best analysts did not cite specific data or historical examples that were used to support the A.M. Best liquidity model assumptions . . . .").

35. *See Systemic Risk Analysis*, V-LAB, https://perma.cc/HQQ5-8F72 (archived Dec. 7, 2018).

36. *See* Christian Brownlees & Robert F. Engle, *SRISK: A Conditional Capital Shortfall Measure of Systemic Risk*, 30 REV. FIN. STUD. 48, 49 (2017).

37. *See* PRUDENTIAL DE-DESIGNATION, *supra* note 1, at 49.

38. *See id.* at 50.

year in its evaluation of AIG, another insurance company. In its decision de-designating AIG, FSOC heralded AIG's negligible SRISK.[39] The Council emphasized that before the crisis AIG's SRISK had been equivalent to those of systemically important banks, but AIG had shrunk and its SRISK had fallen close to zero by 2013.[40] Having cited AIG's diminished SRISK as a justification for its de-designation, the Council cannot arbitrarily disregard Prudential's exceptionally high SRISK just a year later.

In sum, FSOC's rationale for de-designating Prudential relies on questionable empirical analyses and, at the same time, inappropriately rejects more reliable evidence. These substantive deficiencies strongly suggest that the Council skewed its analysis to support its preordained conclusion in favor of removing Prudential's SIFI label.

C. FSOC Ignored Congress's Mandate To Consider Prudential's Baseline Regulatory Regime

Finally, Prudential's de-designation was improper because FSOC completely ignored one of the factors Congress required the Council to consider when assessing a nonbank's systemic importance. Dodd-Frank enumerates several statutory factors that the Council must weigh when evaluating a nonbank, including the firm's asset size, leverage, off-balance-sheet exposures, interconnectedness, and "the degree to which the company is already regulated by 1 or more primary financial regulatory agencies."[41] In this case, however, FSOC completely ignored its statutory mandate to consider Prudential's existing regulatory scrutiny.

Prudential's insurance subsidiaries, like all U.S. insurance companies, are regulated primarily by the states. Traditionally, however, U.S. insurance conglomerates like Prudential have not been regulated on a consolidated basis at the holding company level.[42] Commentators have criticized this gap in insurance regulation, suggesting, for instance, that the lack of consolidated regulation enabled AIG to amass excessive risks outside of its regulated insurance subsidiaries in the lead-up to the crisis.[43] In fact, the absence of consolidated insurance holding company regulation was a key reason the Council originally designated Prudential in 2013.[44]

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39. *See* AIG DE-DESIGNATION, *supra* note 17, at 49 n.133.
40. *See id.*
41. *See* 12 U.S.C. § 5323(a)(2) (2017).
42. *See* Daniel Schwarcz & Steven L. Schwarcz, *Regulating Systemic Risk in Insurance,* 81 U. CHI. L. REV. 1569, 1632-34 (2014); *see generally* Patricia A. McCoy, *Systemic Risk Oversight and the Shifting Balance of State and Federal Authority over Insurance,* 5 U.C. IRVINE L. REV. 1389, 1393-96 (2015) (discussing history of U.S. insurance regulation).
43. *See* Schwarcz & Schwarcz, *supra* note 42, at 1634.
44. *See* FIN. STABILITY OVERSIGHT COUNCIL, BASIS FOR THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S FINAL DETERMINATION REGARDING PRUDENTIAL FINANCIAL, INC. 11 (2013).

In its de-designation of Prudential, however, FSOC points to new legislation enacted by Prudential's home state of New Jersey in 2014. The new law authorizes the New Jersey Department of Banking and Insurance (DOBI) to supervise New Jersey-based insurance conglomerates on a consolidated, group-wide basis.[45] FSOC insists that, in contrast to 2013, the DOBI can now collect data on and monitor Prudential's worldwide operations pursuant to this authority.[46] Indeed, the Council's belief that Prudential is adequately supervised by the DOBI is central to its rationale for removing Prudential from the Federal Reserve's jurisdiction.

FSOC, however, fundamentally misconstrues its statutory mandate. FSOC focuses on the extent to which the DOBI *supervises* Prudential, but Congress instructed it to consider the degree to which other agencies *regulate* the firm. Supervision and regulation are very different. Supervision refers to the oversight of an institution's financial condition and compliance with relevant laws.[47] Regulation, by contrast, refers to the setting of rules and guidelines applicable to the firm.[48] There are good reasons why Congress wanted FSOC to consider how Prudential is regulated instead of how it is supervised. Supervision is meaningless where, as here, the relevant agency lacks authority to require the nonbank to de-risk or improve its risk management.

Despite its statutory mandate, FSOC focuses solely on the extent to which the DOBI supervises Prudential. The Council does not even attempt to address Prudential's baseline regulatory regime. Although the DOBI indisputably regulates Prudential's New Jersey insurance subsidiary, its ability to regulate the parent holding company is unclear, at best. New Jersey law provides that DOBI may "[c]ompel development and implementation of reasonable measures designed to assure that [the parent holding company] is able to timely recognize and mitigate material risks."[49] This ambiguous language does not clearly authorize the DOBI to establish group-wide capital and liquidity rules for Prudential and other New Jersey-domiciled insurance conglomerates.[50] Nor does it clearly authorize the DOBI to stop Prudential affiliates from engaging in exotic non-insurance activities like AIG did in the lead-up to the crisis.[51] Critically, in the four years since New Jersey adopted this law, the DOBI has not even attempted to impose group-wide regulations on insurance holding companies.

45. N.J. STAT. ANN. § 17:27A-5.2 (2018).
46. *See* PRUDENTIAL DE-DESIGNATION, *supra* note 1, at 57.
47. *See What Is the Fed: Supervision and Regulation*, FED. RES. BANK S.F., https://perma.cc/UY4L-7LFH (archived Dec. 7, 2018).
48. *See id.*
49. N.J. STAT. ANN. § 17:27A-5.2(e)(3).
50. *See* Kress, *supra* note 21.
51. *See id; see also* Schwarcz & Schwarcz, *supra* note 42, at 1584-86 (discussing AIG's non-insurance activities).

FSOC fails to appreciate Prudential's continued systemic importance because it ignores these shortcomings in the firm's baseline regulatory regime. While the DOBI supervises Prudential, the New Jersey agency lacks clear authority to address the company's weaknesses through regulation. The Council's de-designation of Prudential was thus arbitrary and capricious because it inappropriately conflated state-level supervision with regulation.

Conclusion

This Essay has argued that the FSOC illegitimately rescinded Prudential's SIFI label, thereby removing the company from Federal Reserve regulation and subjecting the financial sector to increased systemic risks. FSOC's decision is arbitrary and capricious because the Council (1) violated its established procedures, (2) relied on misleading quantitative analyses, and (3) failed to consider a mandatory statutory factor.

The good news is that the Council's action could be subject to judicial review. Although it may be difficult for an individual citizen to assert a claim against FSOC,[52] a financial company has standing to challenge an agency's action that eases regulations on a competitor.[53] The competitor suffers a cognizable injury in fact when it loses profits due to enhanced competition by the de-regulated institution—in this case, Prudential. Thus, a court would review Prudential's de-designation if one of its competitors—or a group of competitors—were to challenge FSOC's flawed reasoning.

Granted, the likelihood of such a case being brought may be low. Even if Prudential's competitors are injured because Prudential now operates with less regulatory burden, the costs borne by each individual competitor are probably negligible. It may be unlikely, therefore, that any competitor will have sufficient incentive to bring a costly lawsuit challenging Prudential's de-designation. There is thus an asymmetry inherent in FSOC's designation scheme: A company like MetLife has strong incentive to challenge its designation in court, but no one is likely to sue FSOC when the Council illegally de-designates a SIFI.

Vigilant congressional oversight, therefore, is the most promising pathway to hold FSOC accountable for improperly de-designating Prudential. The House Financial Services Committee and Senate Committee on Banking, Housing, and Urban Affairs should hold hearings to evaluate the legitimacy of Prudential's de-designation. Moreover, each voting member of FSOC must annually submit a signed statement to Congress certifying that the Council is

52. *See, e.g.*, Lee v. Bd. of Governors of the Fed. Reserve Sys., 118 F.3d 905, 911-13 (2d Cir. 1997) (denying citizens' standing to challenge a bank merger approved by the Federal Reserve).

53. *See, e.g.*, Nat'l Credit Union Admin. v. First Nat'l Bank & Trust Co., 522 U.S. 479, 488 (1998) (holding that banks have standing to sue National Credit Union Administration for loosening credit unions' membership requirements, thereby increasing competition for banks).

taking all reasonable steps to ensure financial stability.[54] Congress should carefully review these certifications and, if appropriate, require each FSOC voting member to testify about Prudential's systemic importance. This type of oversight should be a priority for the Democratic Party after taking control of the House of Representatives in the 2018 midterm elections.

In sum, FSOC's de-designation of Prudential was both unwise and illegal. The Council violated its established procedures, used misleading quantitative analyses, and ignored a crucial statutory factor—all in an effort to reach its preordained conclusion that Prudential should be removed from enhanced federal regulation. In doing so, the Council opened the financial system to the same risks that the country experienced in 2008. Congress and the courts should not tolerate this renewed threat to U.S. financial stability.

54. *See* 12 U.S.C. § 5322(b) (2017).