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LEGAL UPDATE

OCC and FDIC Propose Joint Rule to Define "Unsafe or Unsound Practices" and Establish Uniform Standards for MRAs

On October 7, 2025, the Office of the Comptroller of the Currency (the "OCC") and the Federal Deposit Insurance Corporation (the "FDIC" and together, the "Agencies") issued a joint notice of proposed rulemaking to establish a uniform definition for the term "unsafe or unsound practice" for purposes of the Agencies' enforcement and supervisory authority under 12 U.S.C. § 1818, and to revise the supervisory framework for issuing matters requiring attention ("MRAs"). Comments on the proposed rule are due within 60 days of publication in the Federal Register.

The Agencies stated that they proposed a regulation to "promote greater clarity and certainty" regarding their enforcement and supervision standards, and that the rule is part of a larger effort to prioritize "material financial risks" over concerns related to policies, process, documentation, and nonfinancial risks. Our key takeaways from the proposed rule appear at the end of this Legal Update.

Definition of "Unsafe or Unsound Practice"

The Agencies propose to define an "unsafe or unsound practice" to mean a practice, act, or failure to act, alone or together with one or more other practices, acts, or failures to act, that: (i) is contrary to generally accepted standards of prudent operation; and (ii)(a) if continued, is likely to (1) materially harm the financial condition of the institution, or (2) present a material risk of loss to the deposit insurance fund; or (b) materially harmed the financial condition of the institution. The Agencies asserted that the proposed definition aligns with the interpretations of the term adopted by most federal courts.

The Agencies acknowledged that, in "limited circumstances," some acts or practices may meet the standard because, if they were continued, they could "likely" cause material harm to a bank's financial condition. The proposal points to severe critical infrastructure or cybersecurity deficiencies as such examples, as those issues could result in a material disruption to an institution's core operations that prevent it from conducting business operations.

The Agencies clarified that to qualify under (ii)(a)(1) or (2), the chance for material harm to the bank or material risk of loss to the deposit insurance fund through a failure must

be "likely" and not "merely possible." The conduct at issue must also be "sufficiently proximate" to the harm caused to meet the definition. Typically, harm to a bank's financial condition will show up as a clear and predictable impact to capital, asset quality, earnings, liquidity, or sensitivity to market risk. Risk of "minor harm" to an institution's financial condition, even if "imminent," would not meet this standard.

Under (ii)(b), material financial harm that has already occurred at the institution will meet the definition. However, non-material financial losses will be insufficient to meet the proposed standard. All of these same standards would apply to acts or practices taken by institution-affiliated parties ("IAPs") of a bank.

The Agencies observed that the lack of a statutory definition of unsafe or unsound practice has led to enforcement actions and supervisory criticisms for concerns unrelated to material financial risks. The Agencies proposed to codify the "unsafe or unsound practice" definition in regulation to provide greater consistency for institutions and IAPs, and to direct the focus and resources of both the regulators and regulated institutions on the most critical financial risks to them and the financial system. The Agencies articulated a belief that the new definition will give banks' boards of directors and management additional flexibility to enact day-to-day decisions based on their business judgment and risk tolerance. The proposed regulatory definition would, in the view of the Agencies, provide a consistent nationwide standard and avoid inconsistent application of the terms in communicating supervisory findings by examination teams across the country.

Issuance of MRAs

The proposed rule would also establish joint standards to be used by the Agencies for issuing MRAs. The proposed rule would provide that the Agencies may only issue an MRA for a practice, act, or failure to act, alone or together with one or more other practices, acts, or failures to act, that:

(i) (a) is contrary to generally accepted standards of prudent operation; and
(b)(1)
if continued, could reasonably be expected to, under current or reasonably foreseeable conditions, (A) materially harm the financial condition of the bank, or (B) present a material risk of loss to the deposit insurance fund; or
(2) has already caused material harm to the financial condition of the bank; or
(ii) is an actual violation of a banking or banking-related law or regulation.

The key phrases in this standard would mirror those from the unsafe or unsound practice definition. The Agencies stated that the acts or practices captured by the MRA standard would, in the "vast majority of cases," relate to risks of violations of laws and regulations, or material harm to a bank's financial condition—i.e., be directly related to capital, asset quality, earnings, liquidity, or sensitivity to market risk. The Agencies

explained that the phrase "reasonably expected" is intended to be a lower bar than the "likely" phrase used in the unsafe or unsound practice definition. The "reasonably expected standard" would exclude *possible* future conditions, but does not necessarily mean the most likely future outcomes. The Agencies also stated that the proposal would not permit examiners to issue MRAs as a pretext to force an institution to comply with an examiner's managerial judgment instead of the judgment of the institution's own management, without that reasonable expectation of material harm.

Regarding the violations of banking-related laws and regulations, the Agencies clarified that this prong of the standard is limited to the universe of banking and consumer financial protection laws, and excludes those laws and regulations outside those narrow areas. As an example, the proposal points to tax laws as being outside the scope of such coverage. Further, the Agencies stated that they will not issue MRAs for policies, procedures, or internal control design that could *lead to* a violation of law or regulation, unless the above standard for an MRA was met.

Under the proposal, MRAs would be tailored based on a bank's capital structure, risk profile, complexity, activities, asset size, and any financial risk-related factor that the Agencies deem appropriate. This applies to tailoring related to the requirements or expectations set forth in such actions, as well as whether, and the extent to which, such actions are taken.

The proposal further suggested that complementary changes to the Agencies' MRA verification and validation procedures are warranted, to ensure MRAs are lifted "as soon as practicable after the institution completes corrective actions."

The changes to the MRA framework stem from the Agencies' view that MRAs are not intended to serve as a vehicle for examiners to recommend best practices or enhancements to already acceptable standards. The Agencies found that their own current practices allow examiners to frequently use MRAs to communicate deficiencies that are not directly relevant to a bank's financial condition. This has led, according to the proposal, to a proliferation of supervisory criticisms for "immaterial" procedural, documentation, or other deficiencies that distract management from other business, and do not clearly improve a bank's financial condition. The proposed rule is intended to focus on material financial risks and increase consistency in supervisory criticisms rendered.

For concerns that do not rise to the level of an MRA, examiners would be permitted to informally provide non-binding suggestions to enhance an institution's policies, practices, condition, or operations. Examiners would not be permitted to require submission of an action plan to incorporate those observations, and management would not be required to present those supervisory communications to their board of directors. In addition, the Agencies would not be permitted to criticize an institution for declining to remediate a concern or weakness identified by a supervisory communication or to escalate

the communication into an MRA solely because the bank did not choose to adopt the suggestion over the course of multiple examination cycles.

Finally, the proposed rule noted that the Agencies would expect that any downgrade in a composite rating to less-than-satisfactory would only occur in circumstances in which the institution receives an MRA or an enforcement action. The Agencies would not necessarily expect to issue a new MRA or take an additional enforcement action before further downgrades in an institution's composite rating, unless the additional downgrade was based on new concerns, or there has been further deterioration in the institution's condition. The Agencies expect that they would not downgrade an institution's composite rating to less-than-satisfactory based only on a violation of law, unless the violation was also likely to cause material harm to the financial condition of the institution, is likely to present a material risk of loss to the deposit insurance fund, or has caused material harm to the institution's financial condition.

Takeaways

- The proposed standard for an "unsafe or unsound practice" sharply curtails the scope of the traditional definition employed by enforcement counsel at the Agencies, who have consistently rejected attempts by defendants to enforcement actions to argue that a practice must affect an institution's financial soundness or stability to be unsafe or unsound. Therefore, the body of case law that the Agencies have amassed, at least at the administrative level, will likely not have much precedential effect going forward, except for those less frequent cases where the alleged misconduct actually threatened or impacted a bank's financial condition or viability.

- In addition to the likely elimination of a large swath of unsafe or unsound practice citations in supervisory correspondence that focus on policy, process, and documentation, as well as weaknesses in planning, controls, and oversight, the proposed definition will also operate to preclude use of the label for actions that have a more muted financial effect, if a responding institution or IAP can establish that the effect does not rise to the requisite level of materiality.

- Use of the term "unsafe or unsound practice" will likely need to be vetted by Agency supervisors and legal staff to ensure the new standards are being met. Close calls may favor not designating a practice with the label of "unsafe or unsound" out of a concern that a challenge by a responding bank could establish a negative precedent for the Agencies at an intra-agency appeal, administrative hearing, or federal hearing.

- Notably, the Agencies predicted in the proposal that "finding an unsafe or unsound practice would be a much higher bar for a community bank than for a larger

institution when considered against the overall operations of the institution," suggesting that the term may be reserved in most cases for regional or large banks.

- As with the changes to the previously-accepted "unsafe or unsound practice" definition, the newly-established standard for issuing an MRA will significantly narrow the scope of activities that spawn an MRA. This is especially true for operational and governance issues, where MRAs have often focused on process weaknesses and speculated as to potential effects.

- The proposed MRA standard also limits the scope of the Agencies' authority by restricting the permissible bases to issue them only to violations of *banking-related* laws. Prior to this proposed rulemaking, the Agencies adopted an expansive view of the types of violations of law and regulation that could support a finding and MRA, including niche, non-banking areas of federal and state law. While not explicitly addressed, it would not be unexpected if the Agencies took a similarly restricted view, either privately or publicly, that only violations of banking-related laws and regulations can support enforcement actions.

- Based on statements in the proposal, banks should expect that the Agencies will, on their own, push to lift MRAs once all of the delineated corrective actions have been completed. This initiative on the part of the Agencies should address a common industry complaint that MRAs linger for multiple examination cycles under the cover of ongoing validation, despite the overall objective of the MRA having been fulfilled. It would not be unexpected if this view of proactively lifting actions carried over to informal and formal enforcement actions, such as memoranda of understanding, formal agreements, and cease-and-desist orders.

- The Agencies' commitment to tailoring based on the capital structure, riskiness, complexity, activities, asset size, and other appropriate financial risk-related factors will lead to less one-size-fits-all provisions in MRAs and enforcement actions. In lieu of lengthy, overly-prescriptive provisions that delineate requirements that may not be necessary in a given case for a given institution—which oftentimes is justified by a need to align with past actions—banks can expect a negotiation that ultimately allows a proposed action to better reflect the remedial progress they have made, and addressing the most pressing issues the institution faces.

- As with other recent proposed rules, the Federal Reserve Board ("FRB") did not join this proposal. Therefore, it is unclear whether state member banks will be held to the previously accepted "unsafe or unsound practice" definition as well as the FRB's traditional standards for issuing matters requiring immediate attention and MRAs.

- State-chartered banks, whether or not a member bank should also be aware that their state banking regulators may use their own definitions for "unsafe or unsound practice," and that they retain independent statutory authority to use supervisory or remedial tools, which will not be directly affected by this proposed rule. In some cases, the state banking regulators may take a different view as to the consequences of a given practice and the appropriate response.

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Luse Gorman, PC regularly advises financial institutions on regulatory and compliance developments of, supervisory relationships with, enforcement actions from, and licensing applications to, the federal banking agencies. If you have any questions related to this Legal Update, please reach out to Brendan Clegg at (202) 274-2034 or bclegg@luselaw.com, or your Luse Gorman contact. To learn more about our firm and services, please visit our website.