

Chapter 3 – Unsafe or Unsound Practices and Conditions / Distinguishing Between Laws, Regulations, and Guidance

Unsafe or Unsound Practices	3-1
Practices Deemed Unsafe or Unsound	3-1
Unsafe or Unsound Conditions	3-2
Distinguishing Between Laws, Regulations, and Guidance	3-2

Unsafe or Unsound Practices

An unsafe or unsound practice is any action or lack of action that is contrary to generally accepted standards of prudent financial institution operation that, if continued, would result in abnormal risk of loss or damage to an IDI, its shareholders, or the DIF.

Because unsafe or unsound practices may involve any area of an IDI's operations, it is impossible to provide an all-inclusive list of such practices. In addition, an activity may be considered an unsafe or unsound practice at one IDI and not at another after all relevant facts and circumstances are considered for each specific institution.

Although the FDI Act does not define unsafe or unsound practices, examples have been established through Section 8 administrative proceedings. Examples of common unsafe or unsound practices are listed on the following pages.

Practices Deemed Unsafe or Unsound

Both an IAP and an IDI may engage or participate in unsafe or unsound practices in connection with any IDI. Actions deemed to be unsafe or unsound practices include, but are not limited to, the following:

- Operating with an inadequate level of capital for the kind and quality of assets held.
- Engaging in hazardous lending and lax collection practices that include, but are not limited to, extending credit without first obtaining complete and current financial information, extending credit that is inadequately secured, extending credit in the form of overdrafts without adequate controls, and extending credit with inadequate diversification of risk.
- Operating without adequate liquidity, in light of the asset and liability mix.
- Operating without adequate internal controls and an adequate audit program.
- Engaging in speculative or hazardous investment practices.
- Paying excessive dividends in relation to capital and earnings.
- Engaging in nominee lending.
- Making misrepresentations to or concealing material information from an IDI's board of directors.

Lack of action deemed to be an unsafe or unsound practice may include the following:

- Failure to provide adequate supervision and direction over the officers of an IDI.
- Failure to provide an adequate allowance for loan and lease losses or credit losses.
- Failure to implement adequate internal controls.

- Failure to effectively manage the IDI's loan portfolio.
- Failure to keep accurate books and records.
- Failure to enforce programs for repayment of loans.
- Failure to implement an adequate CMS.

Unsafe or Unsound Conditions

As with unsafe or unsound practices, it is impossible to define precisely what constitutes an unsafe or unsound condition because an IDI's condition depends on virtually every aspect of its operations. At a minimum, an IDI's capital level, asset quality, management, earnings prospects, liquidity, and sensitivity to market risk must be carefully evaluated to determine whether unsafe or unsound conditions exist. An IDI's financial performance need not deteriorate to a level near insolvency for a condition to be considered unsafe or unsound.

The FDIC BOD has determined the following to be unsafe/unsound conditions:

- Maintenance of unduly low net interest margins.
- Excessive overhead expenses.
- Excessive volume of loans subject to adverse classification.
- Excessive net loan losses.
- Excessive volume of non-earning assets.

Distinguishing Between Laws, Regulations, and Guidance

A framework of federal and state laws and regulations and supervisory guidance (each described below) form the foundation for IDIs' safe and sound operations and the FDIC's safety and soundness supervisory processes. Statutes and regulations have the force of law while supervisory guidance does not.

Statutes and laws. At the federal level, "statutes" and "laws" are interchangeable terms that refer to legislation after it has been passed by Congress and signed into law by the President. States also have legislative bodies and processes to pass state statutes and laws.

Rules and regulations. The FDIC, like other federal agencies, issues rules, after public notice and comment, when appropriate and permitted by statute. As used in this manual, "regulation" and "rule" are generally synonymous terms. Under the Administrative Procedure Act, which governs how federal agencies may propose and establish rules, "rule" means the whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency..."(5 U.S.C. § 551(4)) Because regulations implement laws, they are binding, which means that they have the force and effect of law.

Supervisory Guidance. The FDIC and other agencies also issue various types of supervisory guidance through different channels, which may include statements of policy, strategies, questions and answers, frequently asked questions, guidelines, statements, and advisories. Often, supervisory guidance documents are issued in response to industry requests and concerns. Statements of policy are often interagency and are typically published for comment and adopted by the FDIC’s BOD. Supervisory guidance may be issued by the FDIC alone or on an interagency basis and is often but not always published for public comment prior to adoption, depending on the subject matter and scope of the guidance. Unlike a statute or regulation, supervisory guidance does not have the force and effect of law, and the agencies do not take enforcement actions based on supervisory guidance. Rather, supervisory guidance outlines the agencies’ supervisory expectations or priorities and articulates the agencies’ general views regarding appropriate practices for a given subject area. (See FIL-40-2018 “Interagency Statement Clarifying the Role of Supervisory Guidance,” September 11, 2018, at <https://www.fdic.gov/news/news/press/2018/pr18059a.pdf>.)

Supervisory guidance, as articulated by the FDIC’s BOD, sets forth “the FDIC’s expectations for FDIC-supervised institutions to operate in a safe and sound manner and comply with applicable laws and regulations, including those designed to protect consumers.” According to the FDIC’s BOD, “[t]he overarching goal of supervisory guidance is to ensure that risk management and consumer protection standards and supervisory expectations are well understood by financial institution management and stakeholders.” (See “Statement of the FDIC Board of Directors on the Development and Review of Supervisory Guidance,” July 2016, at <https://www.fdic.gov/regulations/examinations/supervisory/guidance/recommendations.html>.)

Supervisory guidance also describes various general principles and practices that have proven useful to enable IDIs to operate in a safe and sound manner and to comply with applicable laws, rules, and regulations to promote consistency in supervision. It also provides information intended to assist IDIs in identifying and mitigating risks, and reducing the risk of consumer harm, including establishing and maintaining an effective CMS. Finally, supervisory guidance helps IDIs direct resources to areas representing the highest potential risks.

Supervisory guidance is intended to be flexible, in the sense that the extent to which any particular principle or practice described in supervisory guidance might be appropriate for an IDI to operate soundly and meet its consumer compliance responsibilities is a fact-specific determination. The relevance of the safety and soundness and consumer protection-related principles and practices described in guidance documents will vary according to a particular IDI’s circumstances, including its size, complexity, business model, and risk profile.